

# Invest Smarter. Live Better.

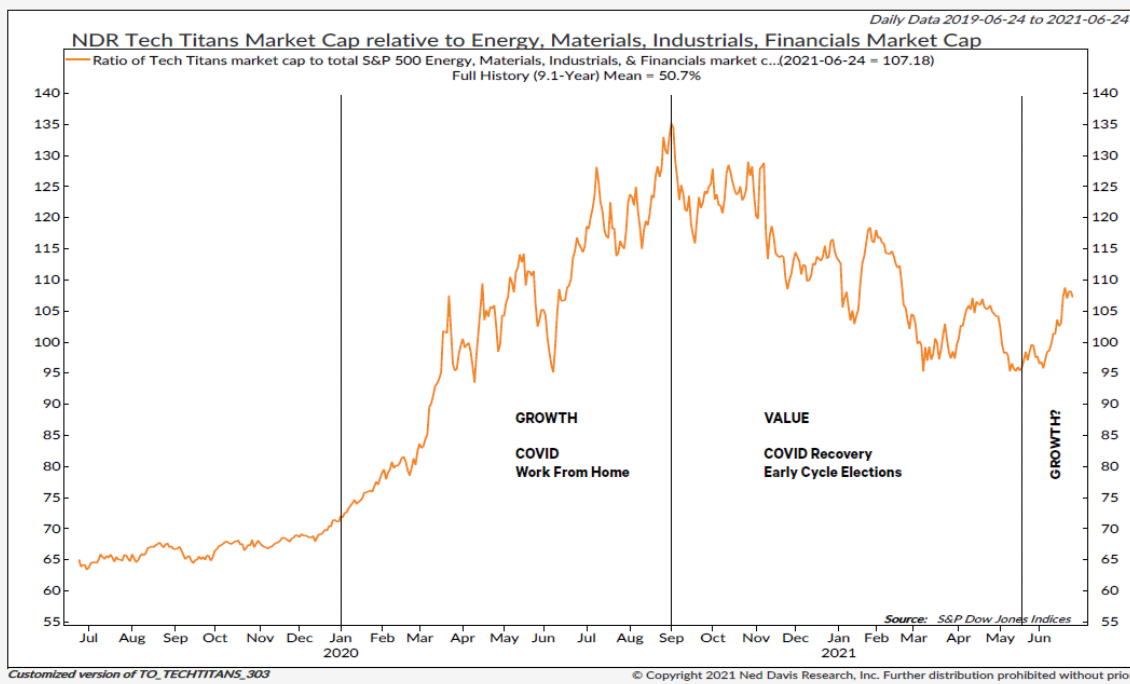
## It All Depends (on COVID, the Fed and Inflation)

For the quarterly period ended 6/30/2021 (Q2 2021), Avalon client portfolios were positive as gains from holdings in US and International equities, Real Estate, Natural Resources and other risk assets led portfolios higher. As we wrote in our year end 2020 letter, the question for 2021 was not about which equities were attractive, it was which equities were the most attractive. Through the first half of the year, major US equity indices have returned over double digits, handily outpacing foreign equity markets. And while positive US equity returns continue a long-dated trend, we want to highlight the performance of asset classes such

as Real Estate and Natural Resources which, with strong performance this year, have seemingly broken a multi-year trend of uninspiring returns. Our allocation to both Real Estate and Natural Resources were near recent highs which greatly benefited this quarter's returns.

For the first half of 2021, the markets saw optimism about growth and fear of inflation rise together, and then slip back again together. So much of what comes next in the second half of 2021 depends on COVID, the Fed and inflation and the path for these variables as they have been the strongest drivers of performance





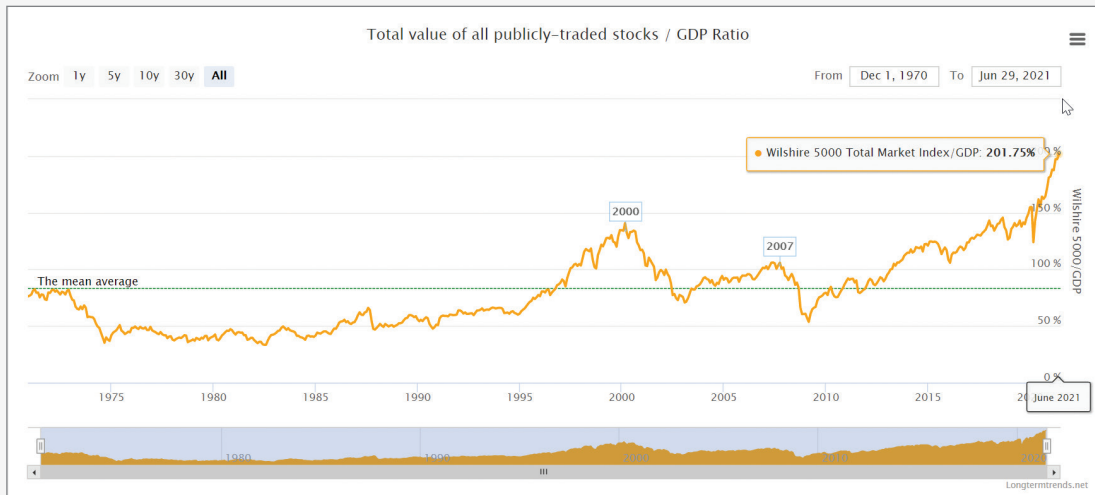
since the start of the pandemic. We would like to take the opportunity in this letter to discuss some of these trends driving the markets and how we are positioning client portfolios.

## Growth vs Value:

While the final tally for this quarter's US equity returns were across-the-board strong, the competing narratives dominating US equity price movements this quarter paint a less than clear picture as to future equity market trends. As the chart below illustrates, value and cyclically oriented stocks outperformed growth stocks from Q4 2020 until May of this year, wherein technology and growth-oriented stocks resumed the leadership they've enjoyed for most of the last decade. While valuation differences between growth and value stocks continue to be near historic highs, persistently low interest rates and a flattening yield curve (indicating lower economic growth) support the continued outperformance of technology stocks.

## Late Cycle Risks (and Rewards)

We would be remiss in not providing a broader perspective on the US equity markets as we are now over a decade into the cycle of a bull market that began in 2009. While the length of this bull market is near a midpoint by historical standards, the sharpness of the upward move relative to the actual economy's recovery means that equity risk has increased. One metric for this is taking the ratio of the value of all publicly traded stocks (as measured by the Wilshire 5000) by GDP. As the chart below shows, we are in uncharted territory and well beyond levels seen in 2000 and 2007. Stretched valuations do not necessarily mean a reversal is imminent, especially as momentum and monetary conditions continue to drive markets to new highs. Those valuations are merely an indication of the burgeoning risks that make stocks vulnerable if the fundamentals supporting the rise start to reverse.



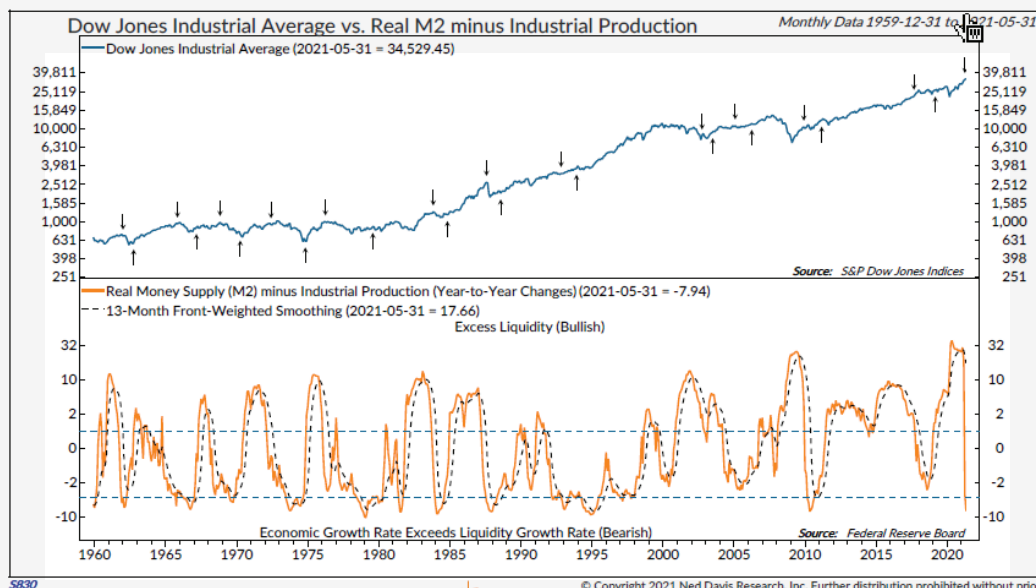
Given how important monetary conditions are in supporting risk assets, we want to highlight some of the monetary conditions we are watching. While most monetary conditions are at or near historic levels, some of these conditions such as economic growth vs money supply are becoming less accommodative. As the chart below illustrates, a growing economy is currently diverting liquidity away from the markets. And while economic growth is necessary long-term for the markets and would help bring stock valuations more in line with

historic levels, the short-term impact is likely to be more market volatility as the markets react to liquidity changes.

## Inflation:

Coinciding with the resumption of the growth over value trade, inflation and growth expectations fell this quarter as the yield curve flattened and real interest rates dropped to near historic lows, reversing the strong uptick in the first quarter and returning toward levels

## Economic growth currently exceeding real money supply





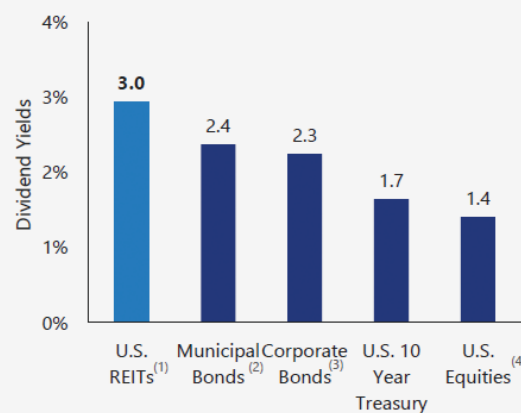
reached in the depths of the recession. While not indicating an economic contraction, the data did point to a deceleration in the rebound out of the COVID-related recession. For price levels, the data pointed to inflation being more transitory than persistent. So while supply chain readjustments should be causing a temporary rise in inflation, markets are watching US macroeconomic data, the impact of the Delta variant and China's economic conditions to gauge inflation's persistence within the economy.

## Real Estate:

One asset class that stands to benefit in an environment where inflation is rising and becoming embedded in consumer psychology is Real Estate. In general, the hard asset nature of Real Estate has historically been a hedge against price levels. From a current market standpoint, the COVID-induced shock to Real Estate negatively impacted many sectors of the asset class where the long-term impact is

neutral to positive. So while commercial office space and retail stores are likely to continue to experience headwinds, residential (homes and apartments) and technology-related real estate seem poised to benefit from long-term economic fundamentals. And yet real estate offers a compelling relative valuation featuring higher yields vs US Treasury bonds while offering more attractive capital appreciation opportunities than most equities.

**Asset class yields (%)**



At April 30 2021. Source: Cohen & Steers, ICE BofA, and Bloomberg.

# Hard Assets:

We would like to discuss Gold, which is an asset class we find attractive and hold in client portfolios. In an environment where financial assets offer negative real yields, hard assets offering no yield become more attractive as the opportunity cost to own these assets is 0. From the chart, gold has historically moved inversely to the real rate on 10-year US Treasury bonds. And with real yields on the 10-year at historically low levels, Gold is now trading at a discount to where it would normally be at this level of negative rates. We also find gold attractive from a risk perspective as, in environments where inflation expectations negatively impact the economy, gold has historically acted as a hedge against falling equity prices.

We also hold Natural Resources in client portfolios as we continue to believe they play an important role in client portfolios. As

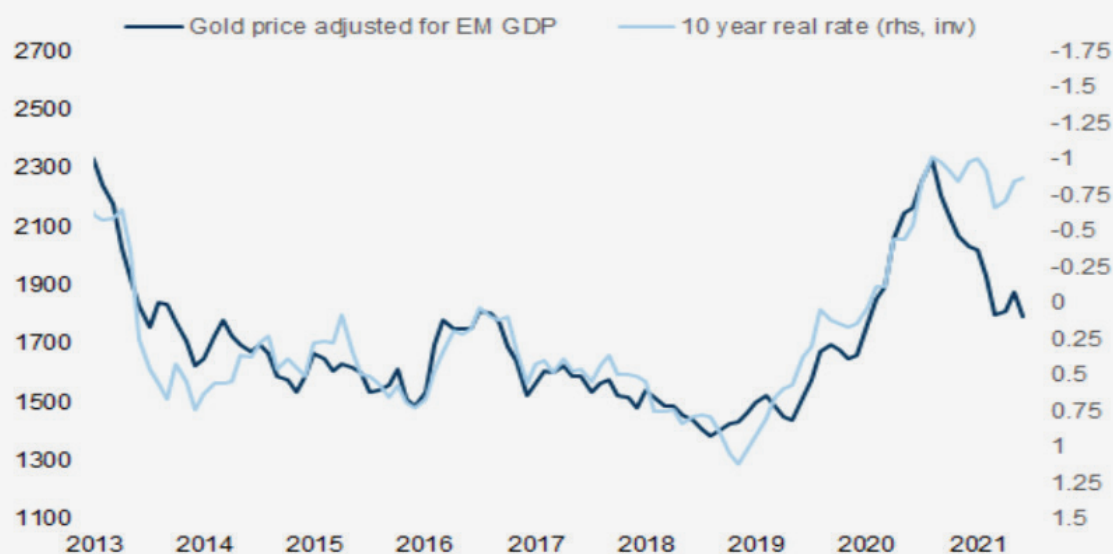
economically sensitive assets, commodities could benefit alongside more traditional stocks and corporate bonds. Commodities might also serve as a buffer against falling stocks and bonds in an environment where inflation proves persistent. Looking at fundamentals, commodities are supported by a favorable supply/demand balance, with commodity demand broadening as economies have reopened and inventories have dwindled. Of note is that the demand this period is strongest within the Developed Market economies (where nations have best managed COVID) as opposed to Emerging Market economies which drove commodities higher prior to 2008.

## Conclusion:

We have enjoyed seeing many of you in person this year and look forward to more in-person visits later in the year. As always, please reach out if you would like to discuss. We hope you are having a great summer.

### Exhibit 3: Gold is trading at a discount to 10-year real rates

\$/toz, % rhs



Source: Bloomberg, Haver Analytics, Goldman Sachs  
Global Investment Research

[View in context](#)



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# Seeing All of You

While we are not completely Zoomed out, we do prefer seeing all of you in person! We have enjoyed our socially distanced meetings with many of our clients and look forward to seeing more of you under clear blue skies.

Our business remains healthy. We brought on five new clients this quarter all of whom our existing clients referred. We are thankful to work with each and every one of you and take pride in our client's recommending their friends to us. Thank you.



Clara Basile



David Rahn



Bill Oberman



Ross Revenaugh

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