Inflection Point

For the quarterly period ended 9/30/2021 (Q3 2021), Avalon client portfolios were mixed as gains from holdings in US growth equities and Real Estate were offset by losses in non-dollar assets such as international equities and commodities. This marked a pause in a string of winning quarters since the post-COVID lows of March 2020. It was mostly a red quarter for major global asset classes as highlighted in the table below. The quarter started out strong as July and August saw further gains made by first-half leaders. Markets changed for the worse in September, as it lived up to its reputation as the cruelest month.

In our Q2 letter, we discussed three key worries: the Delta variant, the Fed and inflation. The Delta surge changed the character of the entire rally as the reopening trade retreated, bond yields fell and quality growth stocks recovered. There were also increasing worries out of China that dominated the performance of Emerging Market stocks.

ADABENCH (My Portfolios - F | Analyze List | Settings | Member Ranked Returns

View: Members / Groups | Period QTD 06/30/21 - 09/30/21 | Total Return | Currency LCL

Movers | All

Members (12)	Return
ADABENCH (My Portfolios - PRT...	-2.60%
All Members	
1) INVESCO QQQ TRUST SERIES 1	1.11%
2) ISHARES US REAL ESTATE ETF	0.72%
3) SPDR S&P 500 ETF TRUST	0.58%
4) ISHARES 20+ YEAR TREASURY BO	0.36%
5) ISHARES CORE U.S. AGGREGATE	-0.01%
6) SPDR GOLD SHARES	-0.85%
7) ISHARES MSCI EAFE ETF	-1.10%
8) ISHARES NORTH AMERICAN NATUR	-2.58%
9) SPDR S&P DIVIDEND ETF	-3.18%
10) ISHARES RUSSELL 2000 ETF	-4.34%
11) ISHARES MSCI EMERGING MARKET	-8.65%
12) VANECK GOLD MINERS ETF	-13.27%

> **“As Chinese authorities work to create political stability by reining in market excess and concerns about economic inequality, the damage to the property markets, and thus the hit to GDP, is sizable.”**

China

The deceleration in the growth of the Chinese economy coupled with the increasing tension between the US and China are at the forefront of investor concerns and were a major reason for the sell-off in emerging market equities in September. On the political side, tensions between Beijing and Washington played out on the regulatory stage as the SEC raised disclosure requirements around Chinese listings in the US. These requirements resulted in a crash in many of the leading US and Hong Kong listed Chinese equities and ground to a halt the listing of Chinese IPOs on US exchanges.

China's slowing economy was concurrently stirring investor unease. At one point in early September, the impending default of major Chinese property developer Evergrande appeared to have systemic financial risk potential. And while Chinese authorities have been quick to manage the potential financial contagion, Evergrande continues to be the poster child for the dependence of Chinese economic growth on the property market. As Chinese authorities work to create political stability by reining in market excess and concerns about economic inequality, the damage to the property markets, and thus the hit to GDP, is sizable. This bears close watching. While the Chinese government is expected to use many tools at its disposal to manage this crisis, the magnitude of the property market and the centrally-directed shift away from the Chinese economy's dependence on that market are a massive undertaking that will be a first if successful.

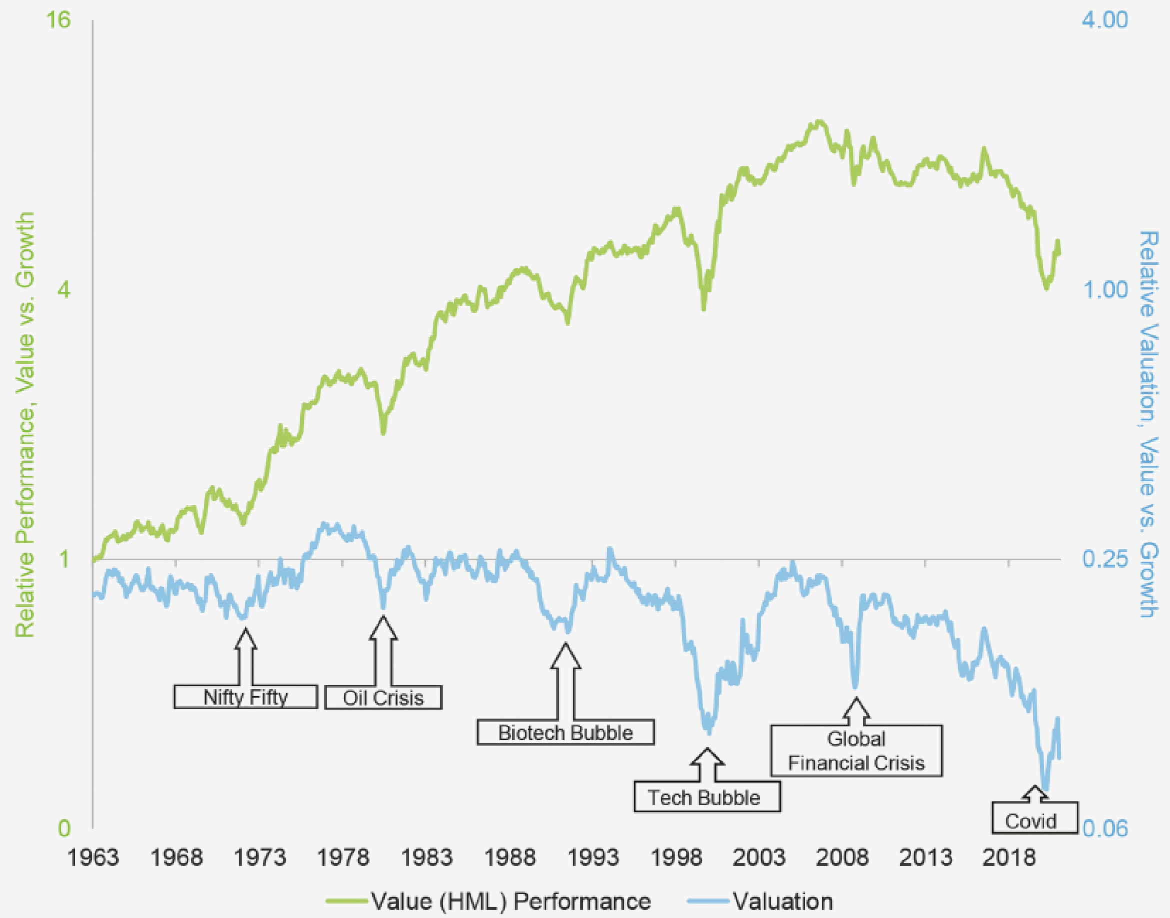
Markets

Since the COVID bottom in 2020, our analysis has favored equities as a more attractive asset class than bonds. While bond yields fell in the quarter, the steep equity decline is creating an inflection point in terms of which types of equities take a leadership role going forward. Although growth equities appear attractive on a longer-term basis, the short-term risks to growth stocks (mainly the threat of higher interest rates in an environment where valuations are already stretched) are cause for concern. While we continue to hold growth stocks like quality large-cap tech for their earnings power, we are finding US value stocks more attractive. Portfolios are favoring a return to cyclical value stocks as well as stocks that benefit from an economic reopening. Investors seem to be interpreting hawkish messaging from the Federal Reserve and other major central banks as an indication of greater optimism about the economic outlook. And with COVID-19 infection rates cresting in the US, a further improvement on the pandemic front should support a normalization in economic activity. Supported by these economic tailwinds as well as attractive valuations, value stocks appear poised to resume the brief rally they experienced starting in September of 2020.

As we noted earlier, value stocks offer two advantages over growth stocks that are especially critical in today's environment. The first is that they are less sensitive than are growth stocks to higher interest rates. Second, value stocks offer more attractive valuations than growth stocks. While this relative valuation statement is generally true (investors will almost always pay more to own stock in faster growing companies) the relative valuation differences are at historical levels. We think this setup offers an interesting entry point for value stocks and have taken positions in client portfolios.

As the chart shows, for more than fifty years, there is a major shift in favor of value stocks after major financial shocks. That pattern is likely to repeat as the COVID shock subsides.

Performance of Value and Value vs. Growth Relative Valuations, United States, Jul 1963–Jun 2021



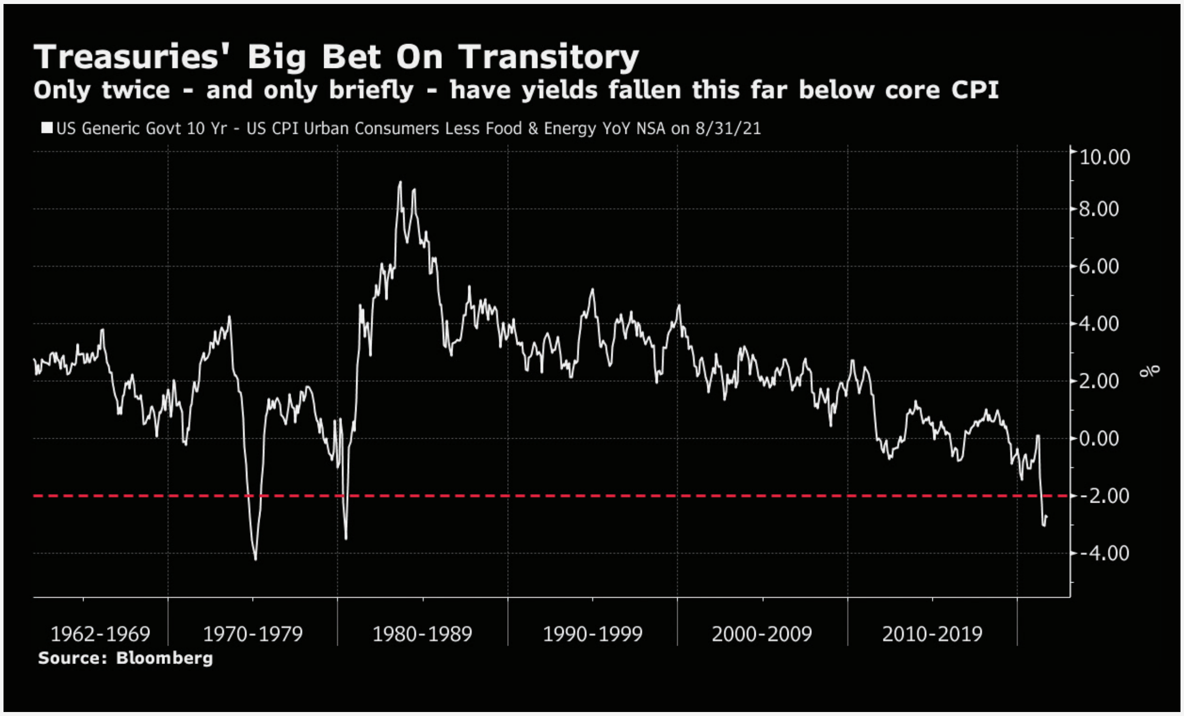
Note: Value is defined using the classic Fama–French price-to-book value-based definition. The relative valuation of value stocks versus growth stocks is also based on the long and short portfolios' price-to-book value ratios.
Source: Research Affiliates, LLC, based on data from Compustat and CRSP.

Inflation

The market continues to be conflicted as to the likelihood of inflation's staying power. The "inflation is persistent" camp cites currently rising inflation statistics, a supply chain that will likely take years to normalize and an economy on the brink of fully re-opening as its rationale. The "inflation is transitory" camp meanwhile cites what are likely temporary supply chain issues, the narrow range of items with real inflation (semiconductor chips most noticeably), as well as the low base of comparison off the 2020 lockdown induced numbers to support their view.

> "It has been over 30 years since the US 10 Year Treasury was 2% (200 bps) below a core CPI reading, a sign the bond market is looking through current inflation levels."

We note that the bond market is firmly in the transitory camp. It has been over 30 years since the US 10 Year Treasury was 2% (200 bps) below a core CPI reading, a sign the bond market is looking through current inflation levels. Were inflation to persist, the bond market would need to adjust. This would pressure not just bond yields but also valuations of assets like growth equities which are dependent on low rates. By contrast, we would expect cyclical value stocks (financials, natural resource and industrials) to perform quite well.



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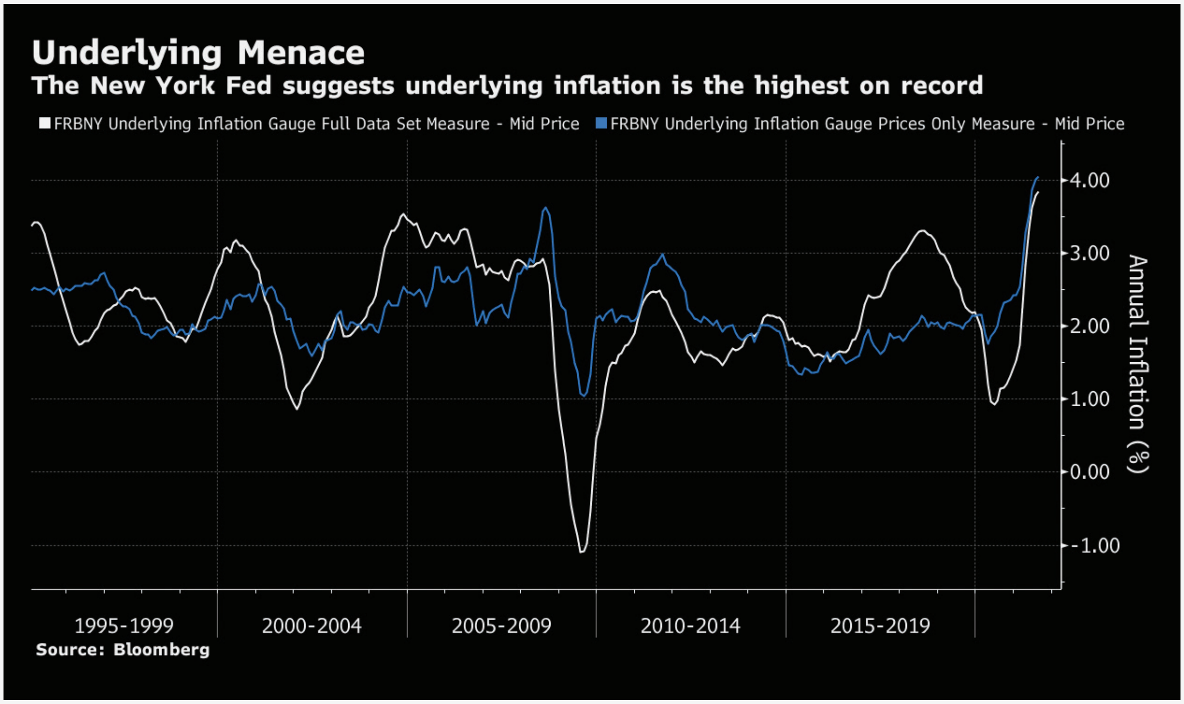
Asset Allocation Implications for Inflation

Given our view that inflation is here for at least the next few quarters, we continue to be overweight inflation-sensitive assets like commodities and natural resources. This asset class has offered historical inflation sensitivity and should outperform were inflation to persist. As the chart below indicates, commodities tend to outperform in inflationary environments. And while different commodity sectors have outperformed each other depending on the economic growth environment, these commodity sectors have outperformed all traditional asset classes in both positive and negative growth environments.

With economic growth gaining traction and with the risk that inflation could persist, we continue to view commodities favorably and hold them in client portfolios.

We also favor this asset class for ongoing demand as climate change continues to dominate the list of global concerns. While it might seem counter intuitive, fossil fuels no longer dominate the natural resource sectors. The push toward alternative energy via electric vehicles and solar will produce a steady demand for metals, mining and minerals, even if inflation proves to be transitory.



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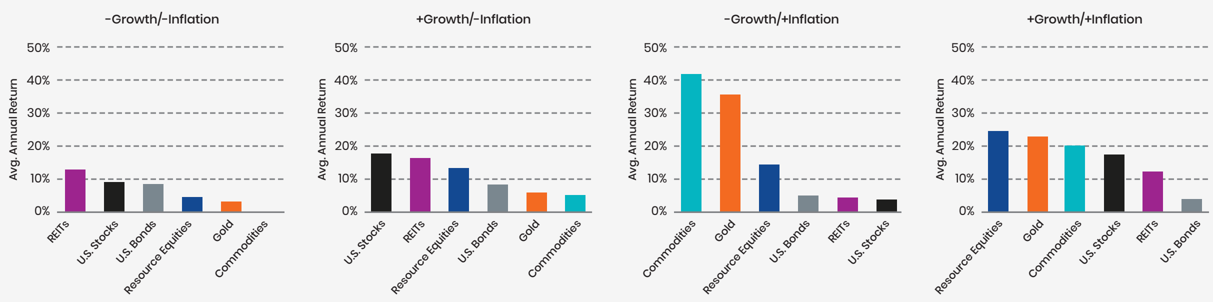
Average Annual Return in Growth/Surprise Inflation Environments (1970 - 2020)



Source: VanEck, CRSP, FactSet, Bloomberg. Data as of December 2020. Past performance is not a guarantee of future results. Please see definitions and index descriptions at the end of this presentation.

Connecting with All of You

As you have heard and will see in the next set of pages, we have created new client quarterly reports. While our goal in doing this is to make your reports more easily digestible, we recognize that there is a learning curve with items like this. We look forward to discussing our outlook and the new reporting format with you. And look forward to hearing how you are all doing.

Clara Basile David Rahn Bill Oberman Ross Revenaugh

The opinions expressed are those of Avalon Capital Management as of October 12, 2021 and are subject to change. There is no guarantee that the forecasts made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. Investment involves risk of loss, especially in volatile markets. Past performance is no guarantee of future results. Investing in foreign markets involves currency and political risks. Data contained here is obtained from what are considered reliable resources; however, its accuracy, completeness or reliability cannot be guaranteed. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Investment strategies such as diversification do not assure a profit and do not protect against losses in a declining market. Other than the research noted by footnotes, the research underlying this piece represents Avalon Capital Management's proprietary research activities. Most indices we mention are well known and full descriptions can be found at Wikipedia.

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