Invest Smarter.
Live Better.

That Was Then, This Is Now

Welcome to 2022!

2021 built on the impressive gains from the COVD 19 crash that bottomed in March of 2020. Gains from holdings in Real Estate, US and International equities, Natural Resources and other risk assets contributed to strong performance. Q4 continued 2021's banner year for the performance of certain risk assets, while more defensive assets lagged.

On the equity side, a handful of US large cap growth stocks extended their multi-year rally, propelling the S&P 500 28.7% higher for the year. This performance handily outpaced International developed equities, which rose 11.4%, while Emerging Market stocks declined by 3.6%. Outside of equities, Real Estate and Natural Resources also contributed to last year's returns. Natural Resources led all

2021 Total Return for Twelve Major Asset Classes

major asset classes higher, returning 39.4% due to strength in oil, while US Real Estate (REITS) returned 38.7%. As we discussed in our Q2 letter, leadership from the hard asset components of the portfolio appear to have signaled a reversal in the low and falling inflation-rate environment of the last decade. These are meaningful changes as we think about generating future portfolio returns in a market where the risks to conventional allocations in domestic equities and fixed income are rising.

2022 Outlook

As we begin 2022, we would like to discuss key dynamics surrounding the risk/return probabilities for equities, fixed income and hard assets like real estate and natural resources and what this means for the portfolio asset allocation. The strong upside correlations for risk assets began reversing by mid-year 2021 when the hyper growth concept stocks with little or no earnings began to diverge from the more stable quality growth stocks. As the cycle has matured, even quality stocks have started to come under pressure, signaling a meaningful correction is underway.

It is still a secular bull market. The trend that originated in 2009 after the Great Financial Crisis, is unlikely to reverse in 2022, but the cyclical rally that began in 2020, is likely over and a 10-20% decline remains a likely outcome before the next leg of the bull market resumes.

The key dynamics we discussed last year are still relevant in 2022. Namely, the Federal Reserve and interest rate policy, the duration of the Coronavirus and its effect on the economic recovery and intensifying inflation pressures. The difference is that risks to financial assets are heightened relative to 2021 as concerns about rising inflation may force policy decisions from the Federal Reserve that could depress growth at just the point when COVD is creating another economic slowdown. The expected fiscal support from Build Back Better is also unlikely as only a watered-down version is likely to pass the divided Senate, if at all. This could pressure richly valued US equities should the economy and corporate profits begin to contract. Early indications came in mid-2021 as the strong upside correlations for both growth and value equities began reversing and the hyper growth concept stocks with little or no earnings began to diverge from the more stable quality growth stocks. As Ned Davis Research recently discussed, over 36% of Nasdaq stocks are down at least 50% while the index is off less than 7%, an extremely rare combination. These divergences usually resolve in a negative direction. And as the cycle matures, even quality stocks start to come under pressure.

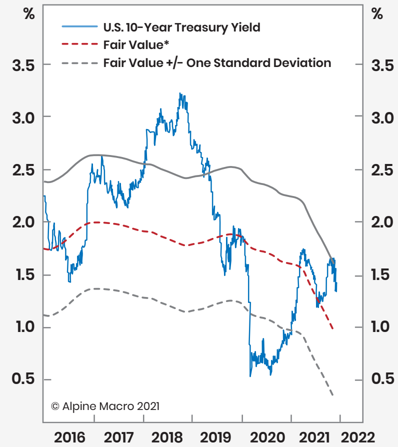
Outside of the United States, valuations remain more attractive than in the US though questions remain about China's attempt to restart its economy after negative factors caused Chinese growth to decline in 2021. This will be a key them to watch given China's influence on global growth and demand trends. Our models are turning more positive on international equities for both the better valuations and the currency exposure. The strong 2021 for the US Dollar is also showing topping signs in early 2022.

These factors have led us to be more neutral on US equities after being overweight in 2021. Within US equities, we have also shifted away from growth towards more defensive equities such as value and dividend-oriented stocks. We also continue to overweight real assets given their historical performance in inflationary environments. On the fixed income side, we are moving back to neutral after being very underweight in 2021. We also continue to utilize fixed income proxies to generate yield in this low interest rate environment. While secular trends support rising rates and higher inflation, near-term risks to the global economy are growing. This is not a time for speculation or high risk.

The Bond Market (and what it is Saying)

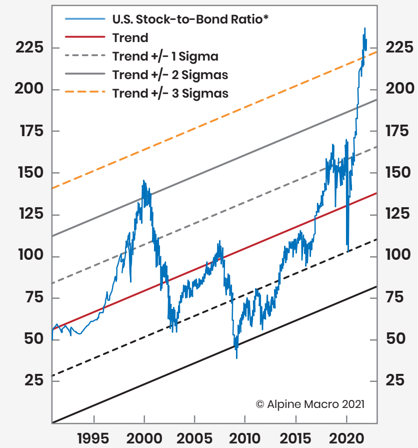
The Federal Reserve moved towards a more hawkish monetary policy late last year offering for this year an expansion and likely acceleration of the trend as inflation is proving to be stickier than they had originally expected. In response, The Fed has been decreasing its bond purchases by $15-30Bn per month and is likely to raise short term interest rates three times before the year ends. While most market participants would agree that this policy seems appropriate, the Fed's success is constrained by the low level of long-term bond yields. Were the Fed to push short-term yields above long-term yields and, in effect, invert the yield curve, they risk disrupting the economy and the financial markets. Historically inverted yield curves can be a precursor to recession. For now, the yield curve remains steep, but it is something to watch as residual inflation pressures that are rising translate into higher short-term rates while economic slowing caused by Omicron could cause long rates to drop.

Bond Model And Fair Value



*Based on inflation rate, short term interest rate and non-accelerating inflation rates of unemployment (NAIRU)

Equity-Bond Ratio at 3-Sigma Overshoot



*S&P 500 total return divided by 10-year Treasury total return index

Source: Alpine Macro

We note that bond yields continue to trade well above fair value relative to the Alpine Macro model shown above. And relative to bonds, stocks are at their most overvalued level since the peak in 2000. Low bond yields have justified the TINA (There Is No Alternative) trade into stocks. The risk now is that the factors driving US bond and stock prices are effectively the same. A Fed or inflation induced move higher for interest rates should likely lead to corresponding pain in the equity markets and a flight to safety into bonds. After holding almost zero bond exposure since 2020, we recently added back some treasury bonds and could increase further as a hedge against stock market weakness.

Inflation and Real Assets

A key difference in the Avalon asset allocation approach is the inclusion of real assets like REITs and commodity-related securities in our investment universe. In 2021, these were the best performing asset classes dues to the inflation shock.

The initial inflation shock was driven by the transitory impacts of the pandemic and only affected a few sectors of the economy. As it has steadily broadened to affect the entire economy, it raised the issue of whether the Federal Reserve had left it too late to take action. We note that wage hikes and rent (which now represents the top component impacting CPI growth) are historically stickier than other inflation components.

The argument for inflation's moderation lies in some part on the resilience of the supply chain. The inability of dislocated supply chains / low inventory levels to meet what was essentially normalized demand drove inflation higher last year. If things are different this year (meaning supply chain issues resolve and inventories normalize), the pressure on items like import prices, which grew at 11.7% last year, should dissipate. While inflation pressures could abate in 2022 and, with it, pressure on interest rates, we continue to believe a secular shift to higher inflation began in 2021, even if the path will not be straight up.

Data updated through November 2021 report

Top 5 Sub-Component Contributors to U.S. CPI YoY% NSA and Core CPI

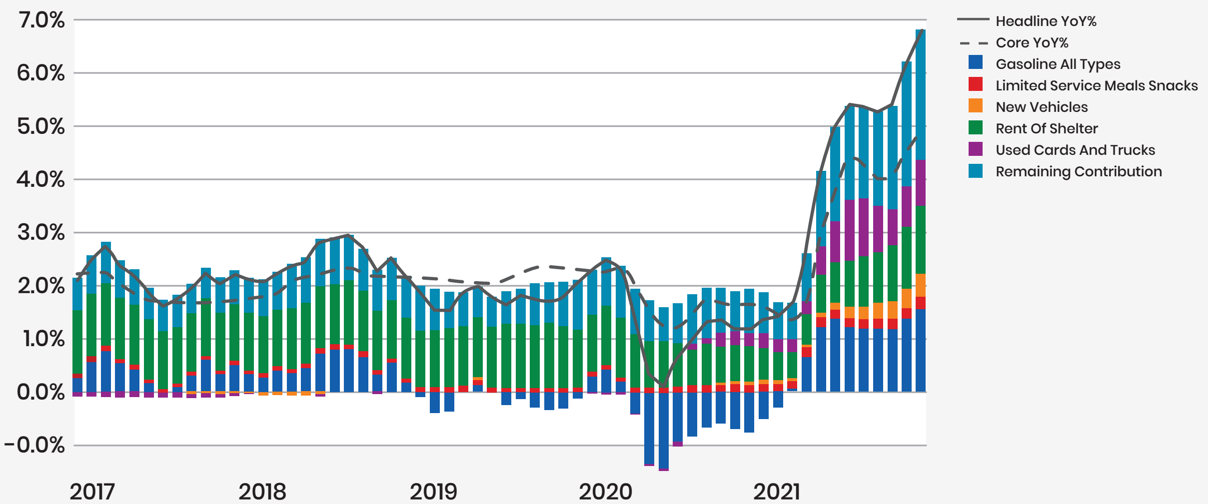
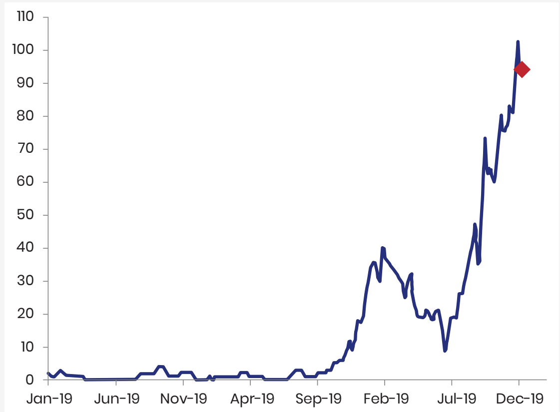


Chart Powered by Bloomberg BQNT using Bureau of Labor Statistics date {ECAN<GO>}
The top five contributors to headline CPI at level 5 or level 4 (no children) in the most recent month

94 ships are currently anchored off the coast of California

Container ships anchored at Ports of LA and Long Beach

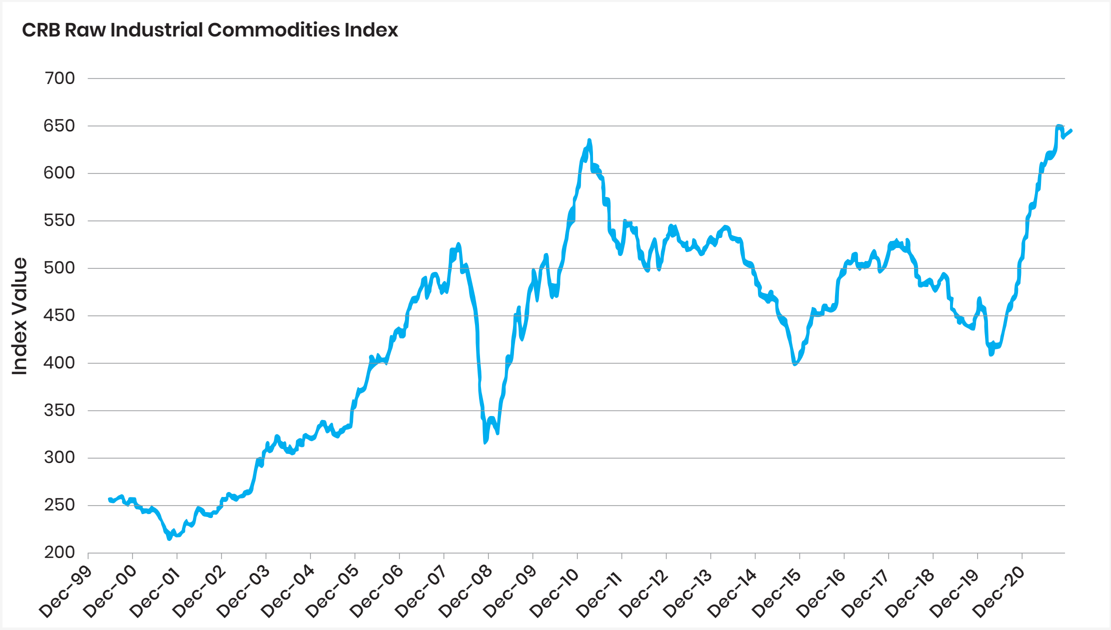


Source: Marine Exchange of Southern California, Goldman Sach GIR.

Raw Materials Prices Leading to Inflationary Pressures

Many investors attributed the 2021 price performance of natural resources towards a temporary inflationary environment. And while the path of inflation should play a role in natural resources assets going forward, we see other reasons to be optimistic. Our analysis indicates that equity valuations, improved fundamentals and supply-demand imbalances could drive natural resource assets higher in this coming cycle. Furthermore, with the markets almost maniacal focus on inflation, inflation hedged assets like natural resources have moved into a hedging role (for both stocks and bonds). Our models remain overweight Natural Resource stocks. They continue to offer significant mean reversion potential after having returned close to zero over the last decade. We are particularly favorable to gold and gold stocks. They were laggards in 2021 due to a strong US Dollar and fears of rising rates. With slowing growth in the early months of 2022, we believe the dollar could weaken which would allow pressure on rates to subside. This scenario might benefit the precious metals.

Competition For Raw Materials Has Not Slowed



Source: VanEck, Bloomberg. Data as of December 2021. CRB Raw Industrials Sport Price Index (CRB RIND) is a price index constructed from a basket of various industrial commodities

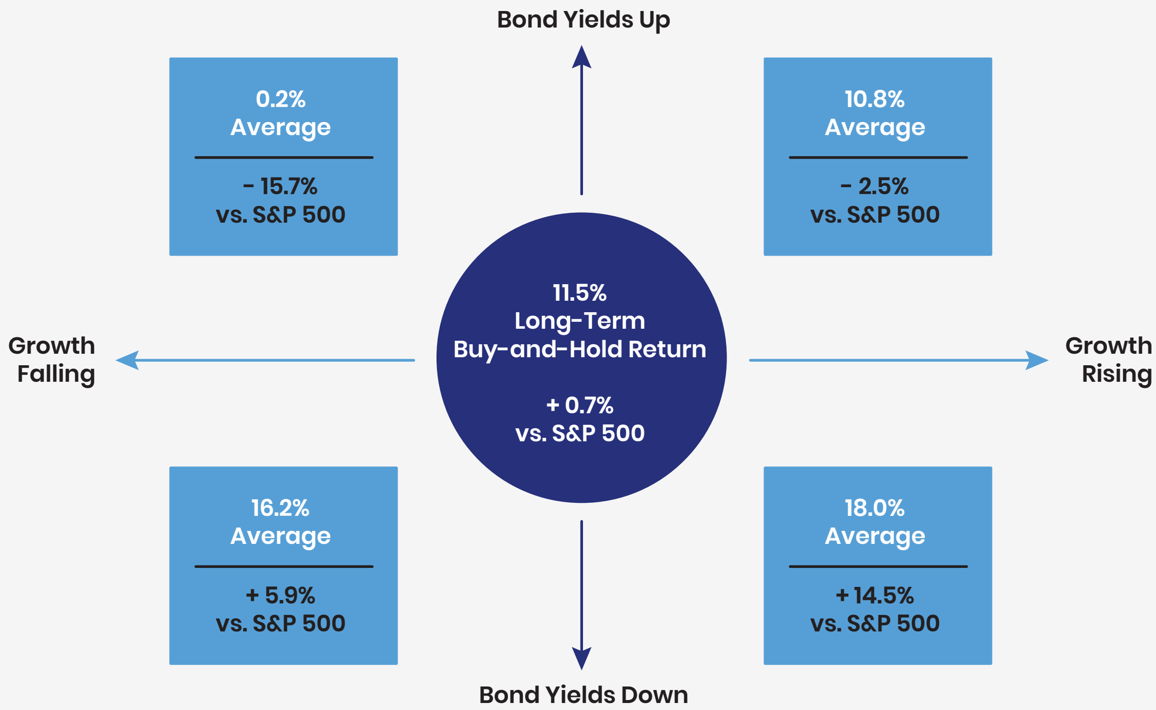
Real Estate

Real Estate contributed to 2021's positive portfolio performance as it continued its rebound from the COVD shock of March 2020. Given the economic disruption, the Real Estate investing environment is far from a one-size-fits-all market. Technology focused real estate investments (data centers, distribution hubs, towers) continue to show steadily positive returns at the expense of shopping centers and hotels while the outlook for office space continues to depend on human resource decisions around corporate COVD protocols.

Real Estate as an asset class has historically benefited from low and falling cost of capital environments as well as from rising growth environments. This makes sense given the capital (mainly debt) intensity of these assets. However, the asset class also historically performs well when inflation is tied to improving growth and upward earnings revisions. The income component also makes it a good alternative to fixed income. Given these factors as well as the compelling fundamentals within the asset class, we remain overweight Real Estate in client portfolios.

Historical Average Annualized REIT Returns in Different Growth/Bond Yield Environments

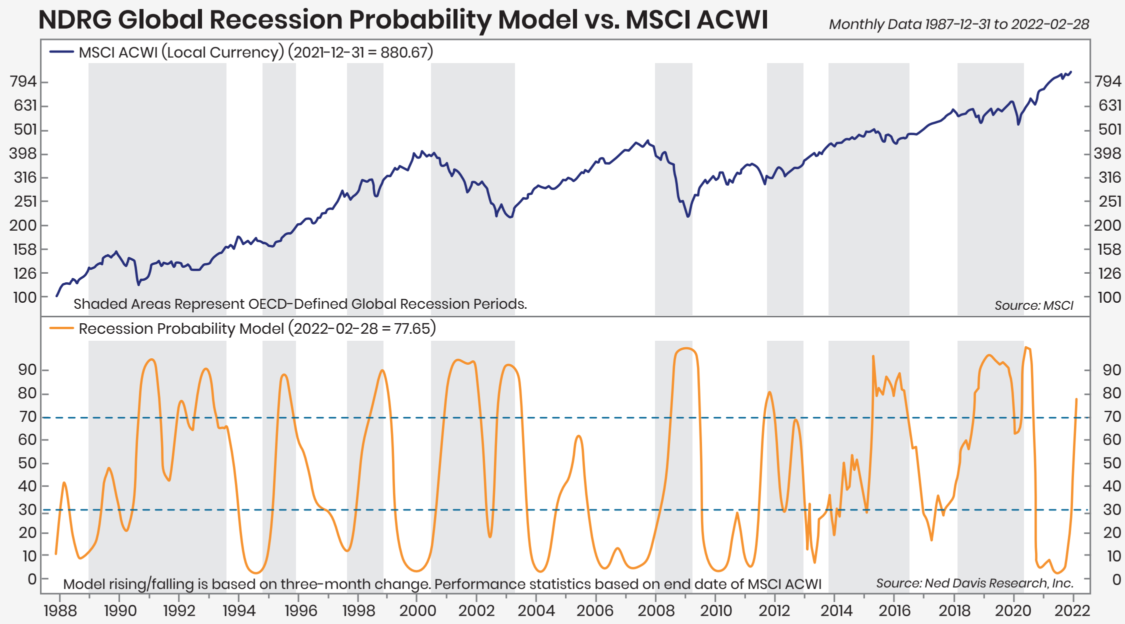
(1989-2020)



Source: Thomson Reuters, Cohen & Steers

Global Equities

Risks are rising for US equities. We are maintaining a neutral weighting given the strong secular uptrends, but within the portfolio we are hedging small cap stocks, reducing our exposure to growth stocks and overweighting value and dividend stocks. We are also holding more international securities given their relative attractiveness and the prospects for a weakening US dollar, which could be positive for international returns. According to Ned Davis Research, global recession risks are also rising, so the leadership shift into international and value stocks may be somewhat muted until the current correction runs its course. History would indicate that when the recession probability rises above 70%, equities are at risk of a decline until the indicator starts falling again. In addition, there are numerous indications for US equities in terms of breadth, valuations, interest rate trends and excessive earnings optimism, that suggest caution is warranted as the year begins.

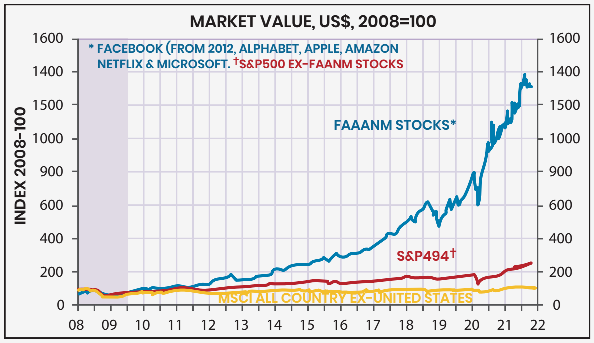


US Equity Market – Bad Breadth

The S&P 500 returned 28.7% in 2021. Once again, the stocks formerly known as FAANG (now FAAANM) represented the bulk of the outperformance. While we don't question that any of these six companies are great businesses, we note that markets are at their healthiest when there is broad participation. And when the participation rate (breadth, in market parlance) turns down, markets tend to be susceptible to corrections. Already into the new year, the NASDAQ experienced its worst weekly decline (4.5%) since February 2021. The early January move is consistent as breadth indicators such as Advance-Decline Ratio as well as New 52 Week Highs have been slowly deteriorating late last year.

US equity has outperformed RoW by a country mile (or league)...

...but outperformance has been driven mainly by 6 'tech' stocks



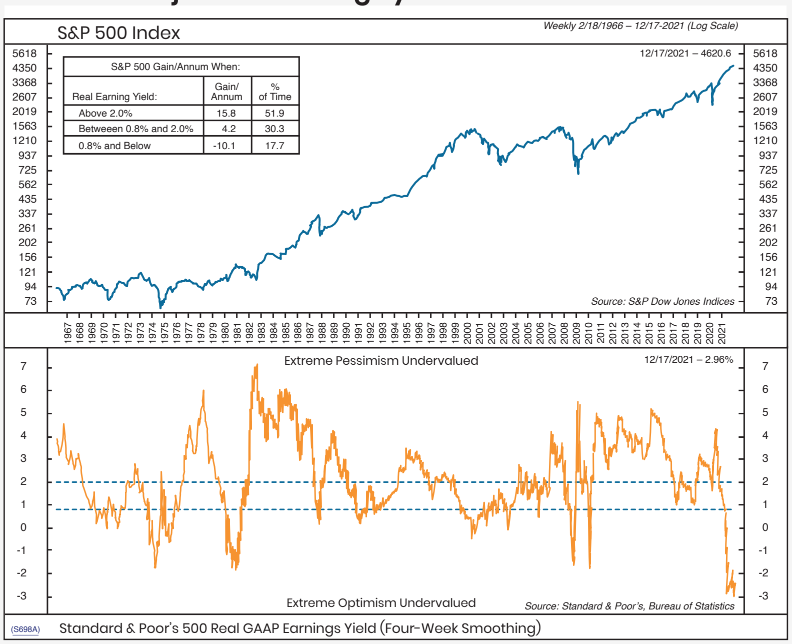
Source: Minack Advisors Pty, Ltd.

We note that it is not just the other large capitalization stocks that underperformed their peer group last year. Small capitalization stocks, as measured by the Russell 2000, were effectively flat for the last 11 months of 2021. The Russell 2000, which gained 14.8% for the year, has historically outperformed large capitalization stocks when confidence is low and rising. It is in that environment when investors want more risk in their portfolios. That was not the case last year nor does it appear to be on the horizon for 2022.

US Equity Market – Valuation

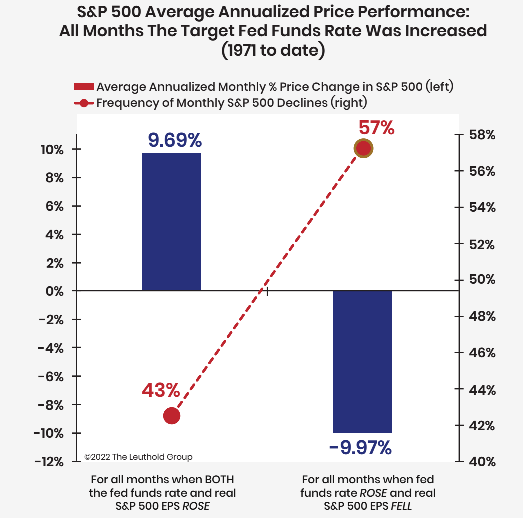
Compounding the lack of breadth within US equities are stock valuations that appear overvalued. Whether using cyclically adjusted price to earnings models (CAPE) or an inflation adjusted earnings yield like we show above, the S&P 500 is at a record high valuation. These are higher valuations relative to 2000, 2007 or 1973. And while valuations can always go beyond what anyone deems reasonable (or even unreasonable), history says that these high valuations won't last forever.

Inflation adjusted earnings yield is the lowest since 1996



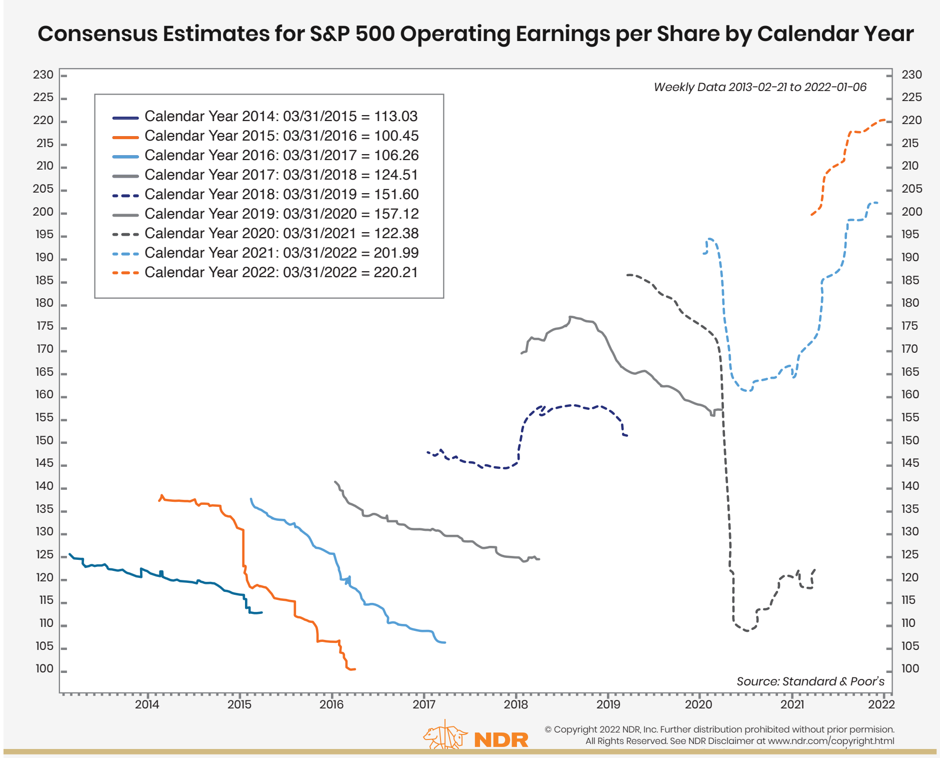
US Equity Market – Potentially Dual Headwinds of Earnings and Interest Rates

At its most basic, a stock (and a stock market) is worth its earnings power discounted over time. So, in addition to studying the bond market which will determine the discount rate, we are monitoring earnings and earnings expectations.



While poor corporate fundamentals create a stock market that is susceptible to Fed tightening, a rising earnings environment has historically looked past Fed rate hikes. As the chart below shows, the negative effect on the stock market caused by Fed tightening was, on average, only concerning if real earnings declined. When the fed funds rate rose while trailing 12-month S&P 500 real EPS rose, the S&P 500 averaged an annualized gain of 10%.

What is disconcerting about the Fed's expected tightening is that the earnings environment gives us pause. The earnings and earnings expectations ramp closely mirrored last year's stock market rally so an earnings disappointment could drive investor sentiment negative. While we could experience the same earnings ramps this year, a historical read of earnings expectations suggests 2021 was an aberration compared to most years which tend to see earnings expectations decrease over time. Adding to the earnings headwind is that, in 2021, the comparisons to 2020 were quite easy due to the COVD collapse. That will not be the case in 2022. This does not mean we think a bear market is in the offing, but a shift in earnings expectations would likely cap the upside for any rally.



info@avaloncapital.com | +1 650.306.1500 | 495 Seaport Court, Ste 106, Redwood City, CA 94063

Stay the Course

This is a more sober outlook piece after several quarters of positive comments.

That does not mean we should hide undera rock. Shifts in market dynamics are essential to allow excesses to purge and new leadership to emerge.

We can't promise positive returns in that environment, but the model overweight and underweight positions are designed to return toward the better end of possible outcomes. To that end, we will use the current volatility to position toward new leadership as it emerges.

Happy New Year

We trust that you have already received your Q4 2021 account statements. We are beginning the process of reaching out to all of you and look forward to seeing you soon.

Best wishes for a Happy New Year!

Clara Basile   David Rahn   Bill Oberman   Ross Revenaugh

The opinions expressed are those of Avalon Capital Management as of December 31, 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.

VISIT OUR NEW WEBSITE

info@avaloncapital.com | +1 650.306.1500 | 495 Seaport Court, Ste 106, Redwood City, CA 94063