Regime Change

Introduction

Avalon client portfolios finished modestly lower despite a challenging quarter as gains from Natural Resources, US value stocks and equity hedges were not quite enough to offset losses in most stock and bond allocations.

The first quarter marked one of the most difficult quarters on recent record for traditional investors as both stocks and bonds posted negative returns. The Morningstar Global Allocation benchmark lost 5.8%. Within equities, the S&P 500 finished 4.6% lower, the NASDAQ lost 8.9%, while Developed International equities finished off 6.5%,

The combination of a more hawkish Federal Reserve and Russia's invasion of Ukraine increased the odds of an economic slowdown which forced equities and bond prices lower. While the equity market rallied towards the end of the quarter, the case for future earnings growth continues to be negatively impacted by higher interest rates, geopolitical uncertainty and spiking commodity prices. Perhaps more painful than the stock market decline was the bond market's performance. After a decade of accommodative monetary policy, last quarter saw pain across the entire bond market as the Federal Reserve signaled a readiness to

Q1 2022 Total Return for Major Asset Classes

Negative Total Return | Positive Total Return

1)	ISHARES NORTH AMERICAN NATURAL RESOURCES ETF	29.20%
2)	SCHWAB SHORT-TERM US TREAS	-2.51%
3)	SPDR S&P 500 ETF TRUST	-4.62%
4)	ISHARES CORE U.S. AGGREGATE	-5.85%
5)	ISHARES US REAL ESTATE ETF	-6.43%
6)	ISHARES MSCI EAFE ETF	-6.46%

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fight inflation by raising rates and Quantitative Tightening (reversing their decade long bond buying program known as Quantitative Easing). For the quarter, the US Aggregate Bond Index finished down 5.8% while the 10-year US Treasury suffered one of its worst declines in history, finishing down 6.6%.

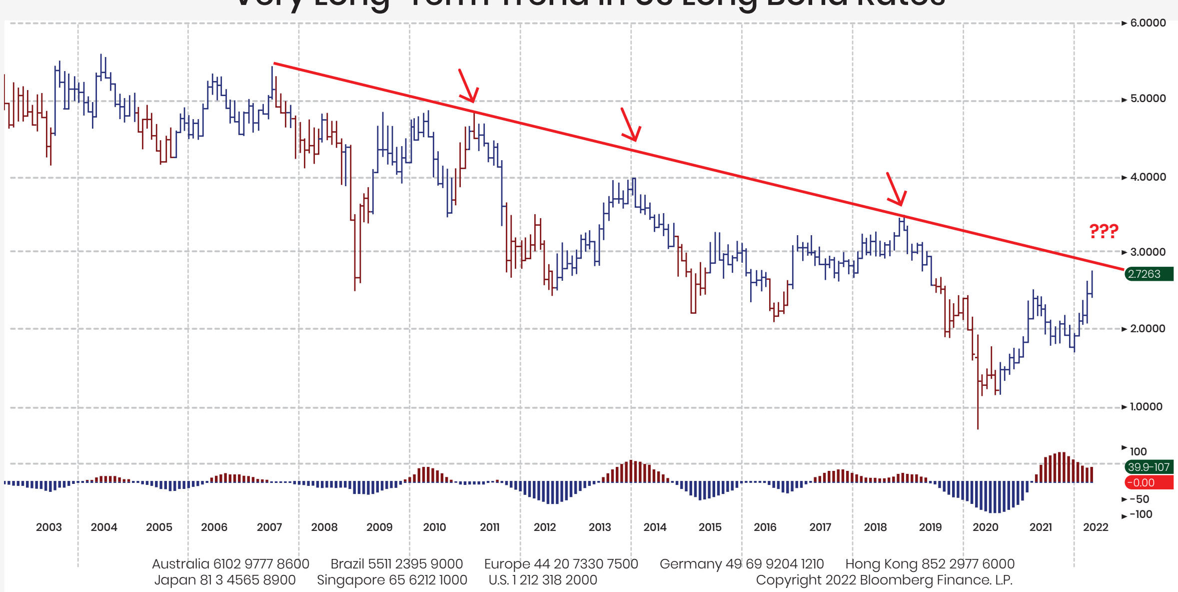
As we noted in our Q4 2021 client letter, **That Was Then, This is Now**, our analysis indicated that the risks to both stock and bond markets had increased late in 2021. This forced us to move defensively towards a higher cash position, fewer equities and higher quality equities within client equity allocations. We also noted in our last letter the potential for the yield curve to invert which happened late in Q1. Yield curve inversions are one of the more reliable warnings of an impending recession. And while much has been written about why this yield curve inversion is different (or at least different from the inversions of 1998 and 2006), the risk to the economy in terms of the flow of credit as well as the risk to stock valuations as it relates to rising discount rates does seem similar to historical episodes.

We entered this quarter cautious. We remain cautious. And while we anticipate the prospect of great opportunities as we look out to 2023 and 2024, the nearer-term focus continues to be one of capital preservation.

Regime Change and the Markets

While President Biden has discussed the necessity of regime change as it relates to Russia, the title of our letter is based on the reversal (or impending reversal) of some long-term trends in the stock, fixed income and commodity markets. The most notable and important shift appears to be within the bond market. Bonds both serve as a ballast for traditional equity investors while bond rates factor into valuations for risk assets such as the stock and real estate markets.
As the chart below shows, the bond market is showing signs of a reversal of a multi decade trend of decreasing bond yields (and rising bond prices). In this letter, we review last quarter and then discuss the implications for this bond market shift. We also explore the positive developments within the Natural Resource sector and how that asset class might impact client portfolios going forward.

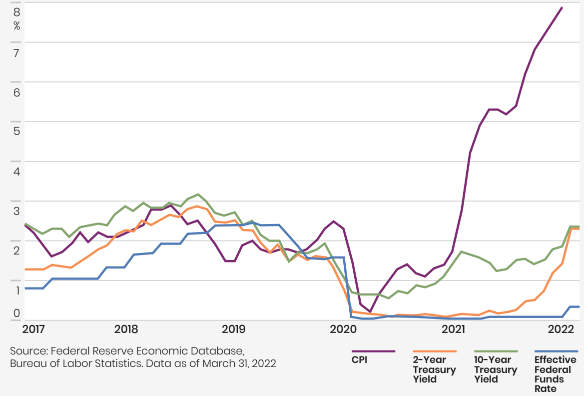
Very Long-Term Trend in US Long Bond Rates



Nowhere to Hide

One must look back to the early 1980s to find a quarter where traditional asset classes of stocks and bonds performed so poorly. As the chart Nowhere To Hide suggests, it is rare to see both the stock and bond market down for any quarter. This is because, in most environments, bonds serve as a ballast to falling stock prices. This environment has not been one of them. And given the Federal Reserve has barely begun to tighten monetary policy while inflation is running the hottest in decades, the trend could continue.

Inflation, Treasury Yields, and Federal-Funds Rate



Source: Federal Reserve Economic Database, Bureau of Labor Statistics. Data as of March 31, 2022

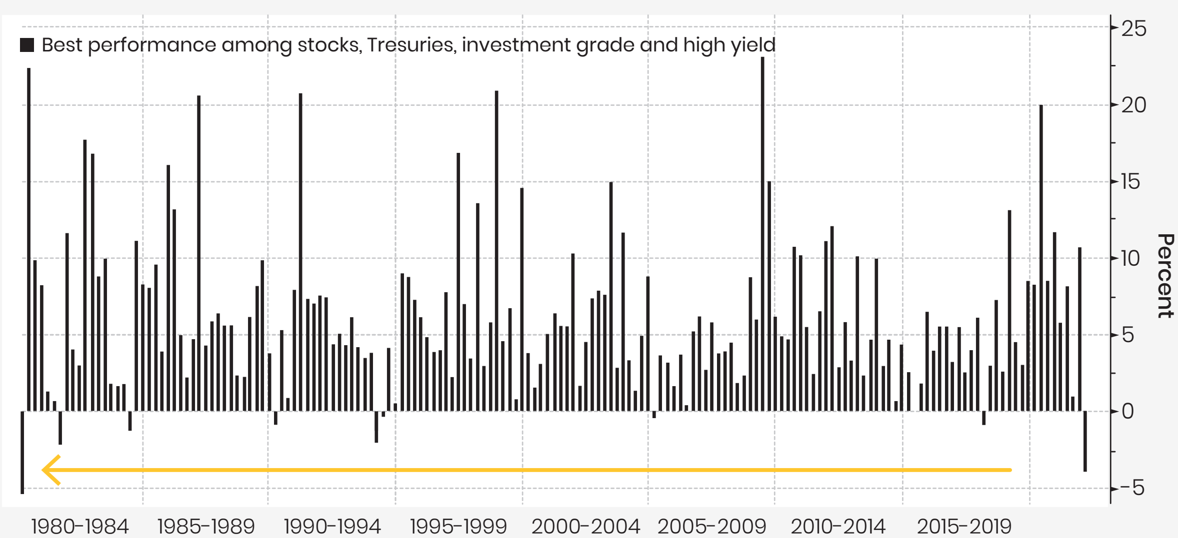
The Bond Market

The bond market experienced its worst quarter in more than two decades as yields across all durations moved markedly higher. While rising yields can be a sign of positive economic growth, inflation was the main driver of this yield spike. March's Consumer Price Index of 7.9% was the largest 12 month change since January 1982. And while food and energy dominated the inflationary discussion, we note that March's CPI ex food and energy reading was up 6.4% annualized, a sign of more structural inflationary factors such as supply chain constraints and low unemployment rates.

While we have been and remain underweight long-term bonds, near-term technical factors indicate bonds are in an extremely oversold condition. While this technical set-up would be a buying opportunity were bonds in a bull market, the potential shift longer-term towards rising yields gives us caution around a higher allocation to bonds.

Nowhere to Hide

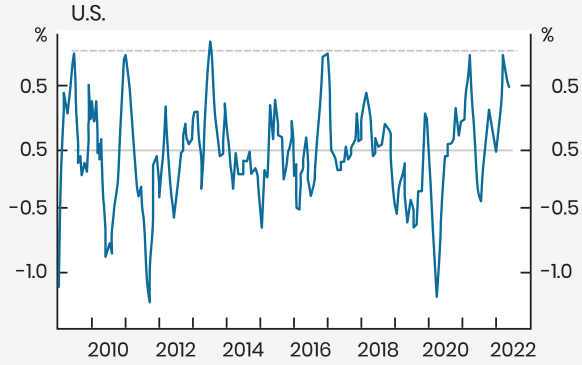
Stock and bond investors just had their toughest quarter in decades



Source: Bloomberg

Peak Bearish Momentum in Bonds

Quarterly Change in US 10-Year Bond Yields



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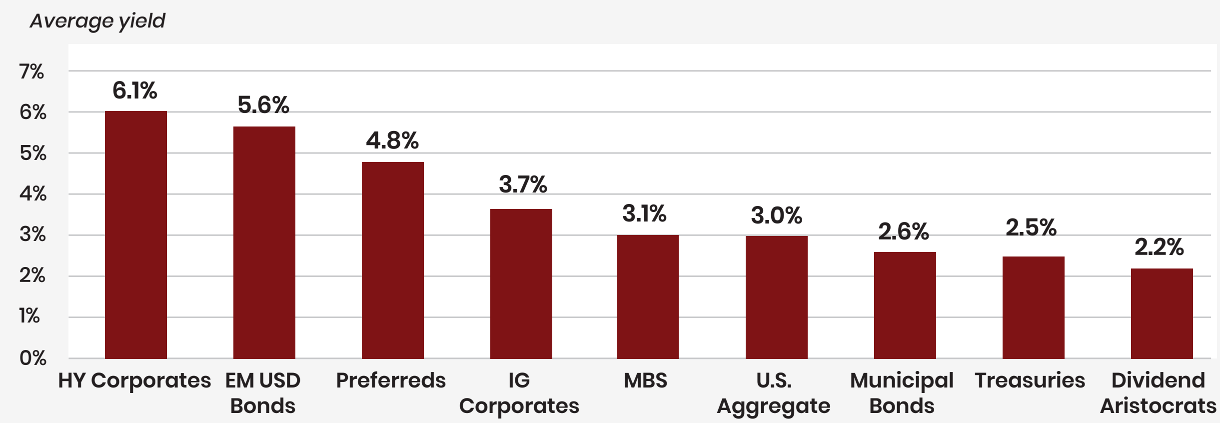
We note that current bond yields as well as future Federal Reserve policy decisions could help bonds rally from current levels. After being behind the inflation fighting curve for the better part of a year, the Fed has indicated that it is focused on handling inflation at the expense of both the stock market and economic growth. While there is risk that the Fed does not do enough to adequately bring inflation under control, the scenario where the Fed manages inflation while negatively impacting economic growth offers bond investors a reasonable opportunity.

Natural Resources: Regime Change Beneficiary

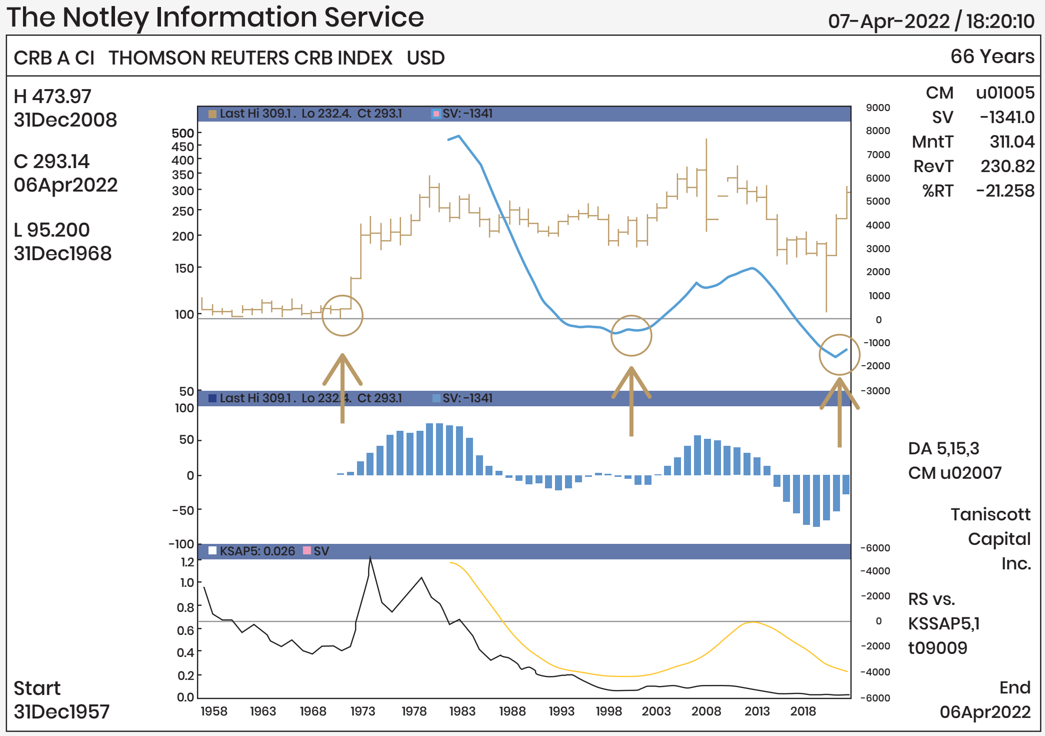
What has been a boon for Avalon client portfolios the last several quarters have been our exposure to Natural Resources. While inflation and geopolitical tensions have hurt stocks and bonds, the environment has caused Natural Resources such as oil and other hard assets to surge. WTI crude closed the quarter at $100 per barrel, up 33% for the quarter despite a 20% drop from its March 8 high of $123 per barrel. Oil pricing is historically volatile (the 33% gain was only the 3rd largest quarterly gain in the last decade) and appears likely to remain so. Nevertheless, long-term commodity prices seem to be supported by geopolitical, fundamental and monetary factors. Among these are the persistence of geopolitical tensions (and the focus of Western countries as they seek energy independence), potentially limited supply (driven by a decade long reduction in capital expenditures in the energy industry) and a constraint among monetary policymakers regarding their need to address rising prices without further stymying growth.

Yields aren't as low as many investors likely assume



Source: Bloomberg, as of 3/25/2022.

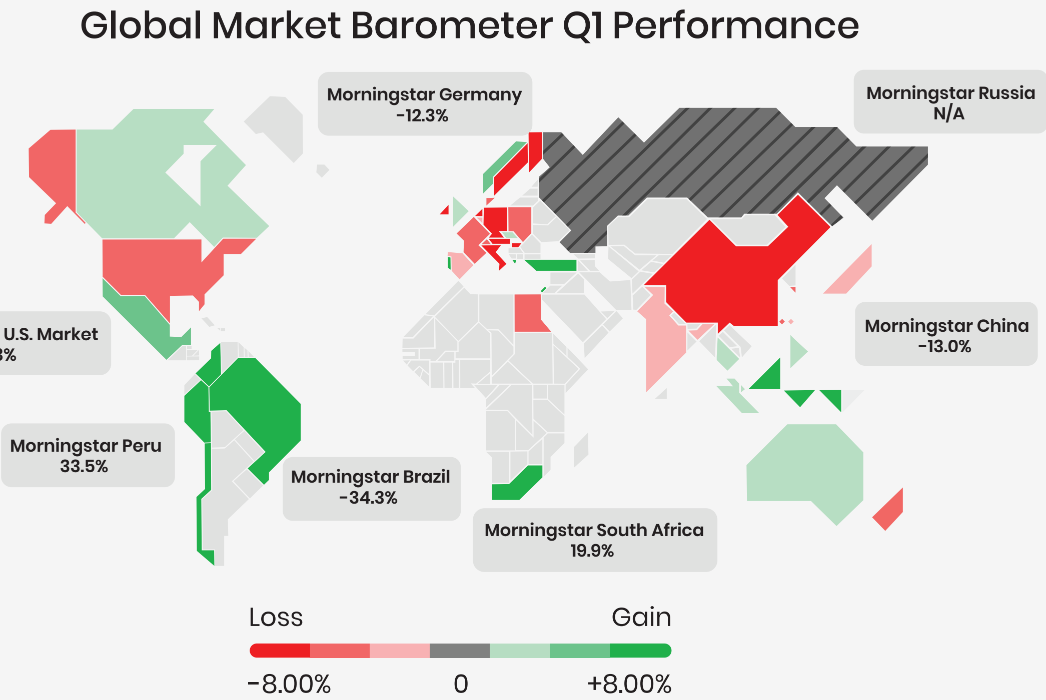
Commodities Early in Secular Uptrend



(Patiently) Waiting on Stocks

We laid out the case for patience on stocks above. Patience last quarter was warranted. The situation in Ukraine hit European stocks hardest given their relatively heavy dependence on Russia resources. Within the US, value stocks outperformed their growth stock counterparts. The S&P 500 Value index finished flat for the quarter, while the S&P 500 was down 4.6%. Within the technology world, the NASDAQ finished down almost 10% while the Bessemer Cloud Computing Index lost 21%. We note that while the S&P 500 is only 5% off its all-time high, many market leading companies generating stable and fast growing revenue have seen valuations drop over the last year and are now trading well off their all-time highs. This includes Adobe (down 33% from its peak) and Twilio (down 63% from its peak). These types of companies could represent investment opportunities once investor sentiment returns in their favor. We do expect positive sentiment to return soon as our analysis indicates we are still in a long-term uptrend in stocks.

One note regarding last quarter's stock market performance - the stock markets that performed best were primarily in Natural Resource dominant Emerging Market economies such as Brazil and Peru. Other Emerging Markets such as China performed poorly as geopolitical tension and rising interest rates strengthened the US Dollar which served as a headwind for non-resource intensive Emerging Markets. We note that many Emerging Markets offer attractive stock valuations. To the extent that the US Dollar strength does not impede capital flows within these economies, we could see Emerging Market outperformance once investor sentiment changes in their favor.



Source: Morningstar Direct. Data as of March 31, 2022

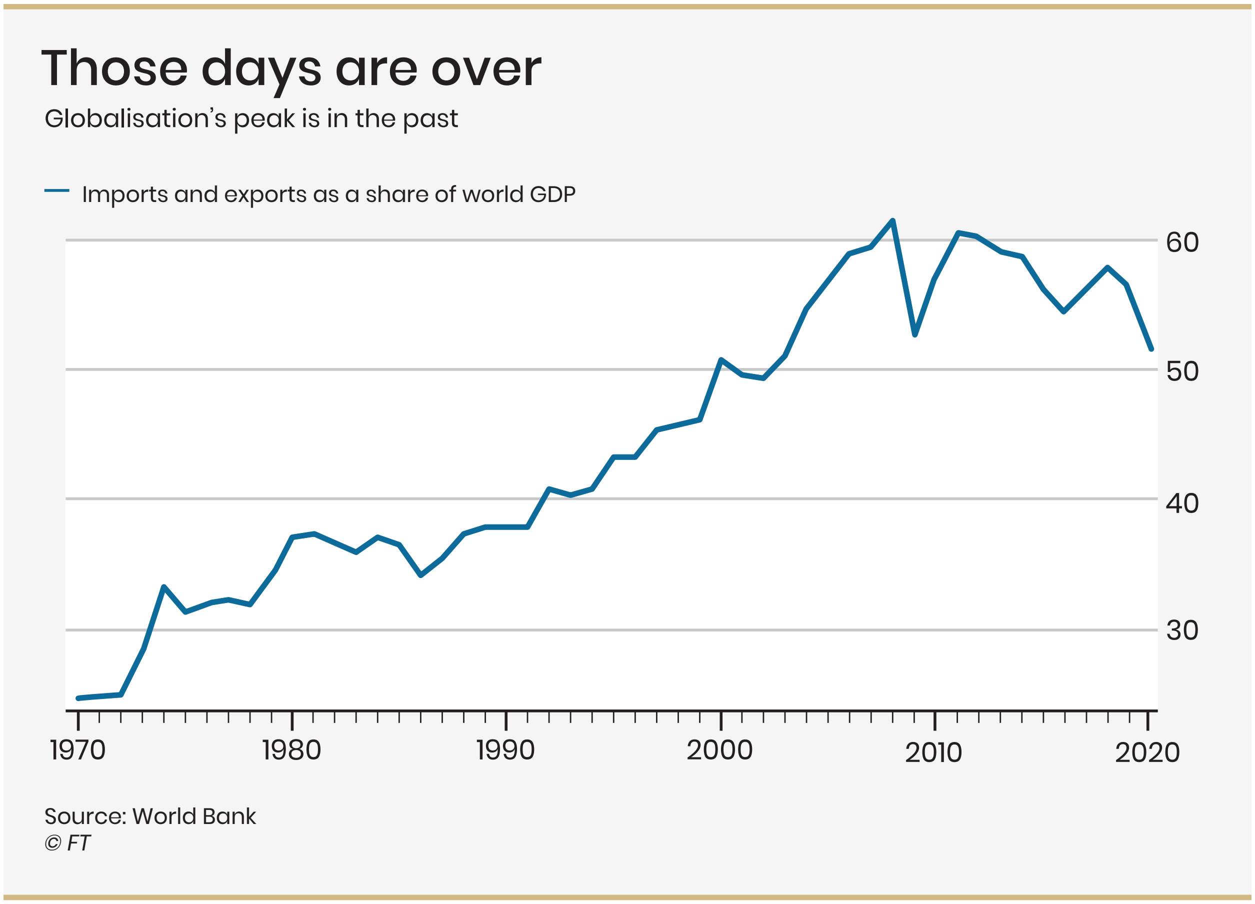
What De-Globalization Means For the Markets

The case for globalization was two-fold: trade dependency reduced the risk of war between trading partners while, concurrently, global GDP could benefit without much inflationary pressure. This was a boon for both stocks and bonds. What we are seeing in Ukraine is Vladimir Putin both taking advantage of trade dependency (eg: Europe's Russian energy dependence) and also testing the limits of these geopolitical trade benefits. Looking out on a longer horizon, what both Putin and COVD have accelerated is the trend towards de-globalization. As the chart outlining trade as a % of global GDP shows, we seem to be in the early stages of a shift away from globalization (and therefore a shift away from economic growth with disinflationary benefits). That environment puts pressure on both stock and bond returns.

Regime Shift as it Relates to Portfolios

As we discussed, our analysis indicates the bond market is reversing a multi-decade period of outperformance. The importance of the bond market cannot be overstated. Bonds both serve as a ballast for traditional equity investors while bond rates factor into risk assets such as the stock and real estate markets. With bonds seemingly ending their bull market, we are hesitant to think of them as a positively yielding ballast to stocks. Though based on the Federal Reserve's history of over and under shooting monetary policy, we will look to be opportunistic if our analysis indicates bonds offer an attractive risk/return profile.

The outlook for stocks is mixed. While rising bond yields could negatively impact stock prices, the stock market continues in a long-

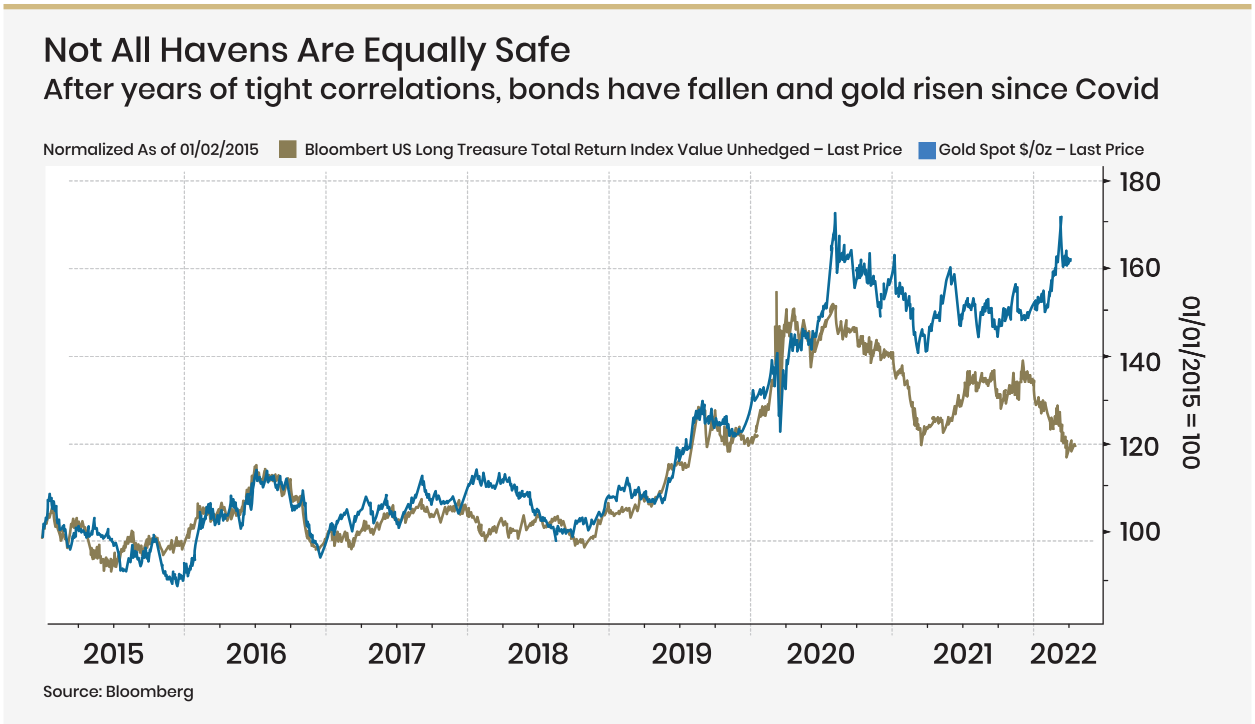


term uptrend. Though the volatility of the last six months has kept us defensive with regard to our stock allocation, we do expect to have opportunities to add equities to our portfolio allocation over the next few years.

We are optimistic as it relates to commodities. We appear to be at the start of a long-term uptrend in Natural Resources with tailwinds such as inflation serving as headwinds for stocks and bonds. This changes how we think about portfolio returns as well as how we think about managing our commodity exposure. For the last 15 years, the proper strategy for trading commodities has been to sell into any strength. The breakout in commodities has changed our framing.

We would look to take advantage of any short-term weakness in commodities to add to our portfolio allocation.

The chart above, Not All Havens Are Equally Safe, highlights an aspect of this regime change as it relates to bonds and gold. Historically, these assets have been positively correlated as investors viewed both as safe haven assets. And while US Treasuries are likely to always be a safe haven asset, the impact of inflation has forced investors away from US Treasuries as THE safe haven asset and into inflation sensitive assets such as gold.



With both the fixed income market and the gold market sending the message that deflation is no longer the main threat for portfolios, we are likely to rely on a different type of return stream than most investors have depended on over their investing lifetimes. This could mean that investors are forced to deal with more portfolio volatility as commodities are inherently more volatile than are bonds. We have confidence that our large investment universe combined with our tactical decision-making will help navigate client portfolios towards their goals.

Seeing All of You

We expect that you have already received your Q1 2022 account statements. We are beginning the process of reaching out to all of you and look forward to seeing you soon.

We continue to value your trust in us.

Clara Basile   David Rahn   Bill Oberman   Ross Revenaugh

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