Boxed In

Introduction

The second quarter marked one of the most difficult quarters on record for investors as inflation fears caused both stocks and bonds to accelerate their slide after an already difficult first quarter. With the Federal Reserve boxed in by a mandate to normalize interest rates and contain high inflation, the draining of liquidity from the system and the rising fear of recession resulted in one of the worst quarters on record for the broader markets. Avalon client portfolios were not immune. Gains from equity hedges and a tepid response from normal buffers were not enough to offset losses across all major asset classes.

Q2 2022 Total Return for Major Asset Classes

Negative Total Return | Positive Total Return

1)	ISHARES CORE U.S. AGGREGATE BOND ETF	-4.58%
2)	SPDR S&P DIVIDEND ETF	-6.73%
3)	SPDR GOLD SHARES	-6.75%
4)	ISHARES MSCI EMERGING MARKETS ETF	-10.41%
5)	ISHARES NA NATURAL RESOURCES ETF	-10.59%
6)	ISHARES 20+ YEAR TREASURY BOND ETF	-12.59%
7)	ISHARES MSCI EAFE ETF	-13.18%
8)	ISHARES US REAL ESTATE ETF	-14.70%
9)	SPDR S&P 500 ETF TRUST	-16.11%
10)	ISHARES RUSSELL 2000 ETF	-17.27%
11)	INVESCO QQQ TRUST SERIES 1	-22.54%
12)	VANECK GOLD MINERS ETF	-28.60%

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

For the second quarter, the S&P 500 finished down 16% while the 30-Year US Treasury Bond fell 12%. Both the S&P 500 and 30-Year US Treasuries are now down over 20% YTD. To put this in historical perspective, the first half of 2022 was the worst first half in over 50 years for the S&P 500 and the worst ever for the 30-Year US Treasury bond. For balanced (60/40) portfolios, the first half of the year is the second worst on record, after 1932.

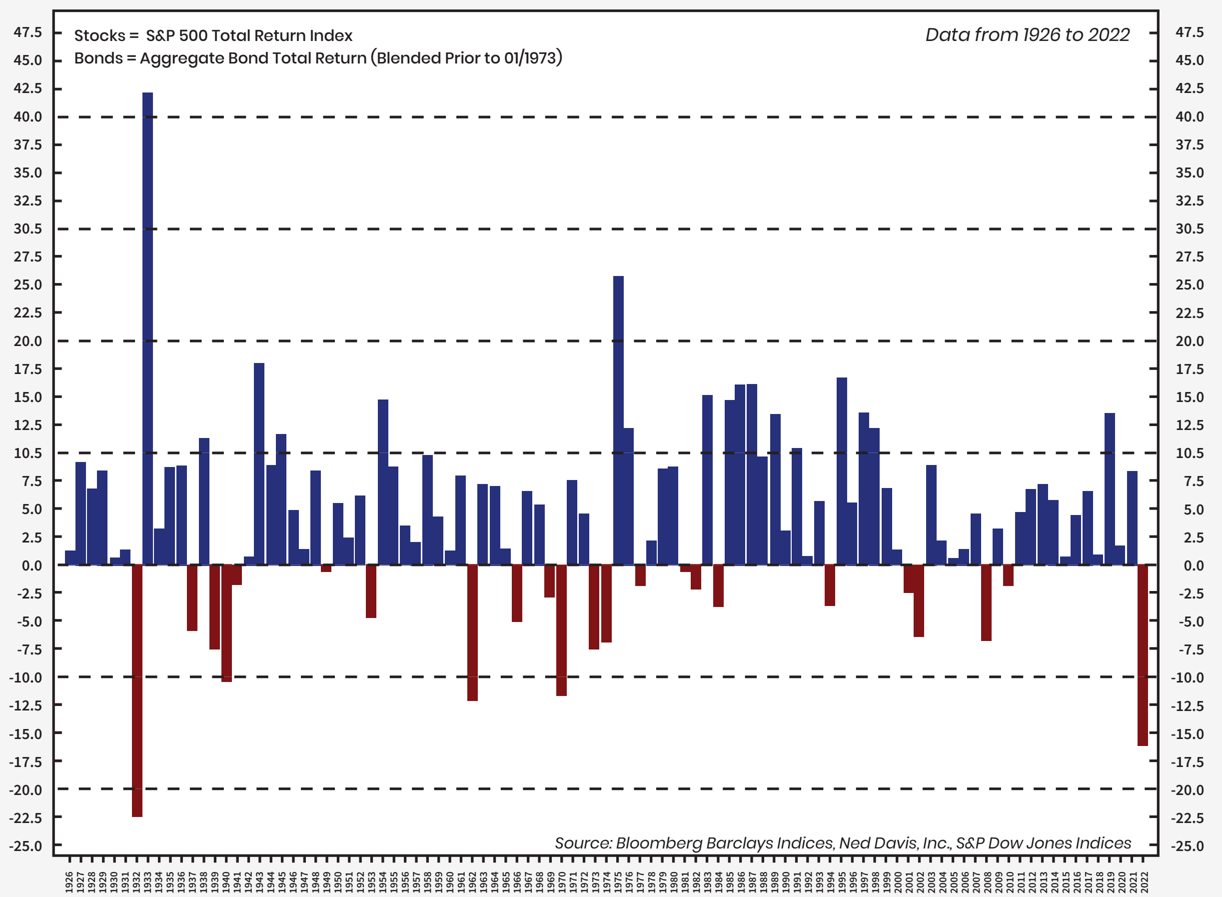
Other popular asset classes have fared even worse. The NASDAQ lost 23% this quarter and is off 30% YTD. The carnage is even greater for growth stocks where over half of the stocks in the Russell 2000 growth index have dropped by more than 50%. Even high profile FAANG names have not been spared with META (Facebook) and Netflix down 53% and 70%, respectively.

Portfolio Positioning

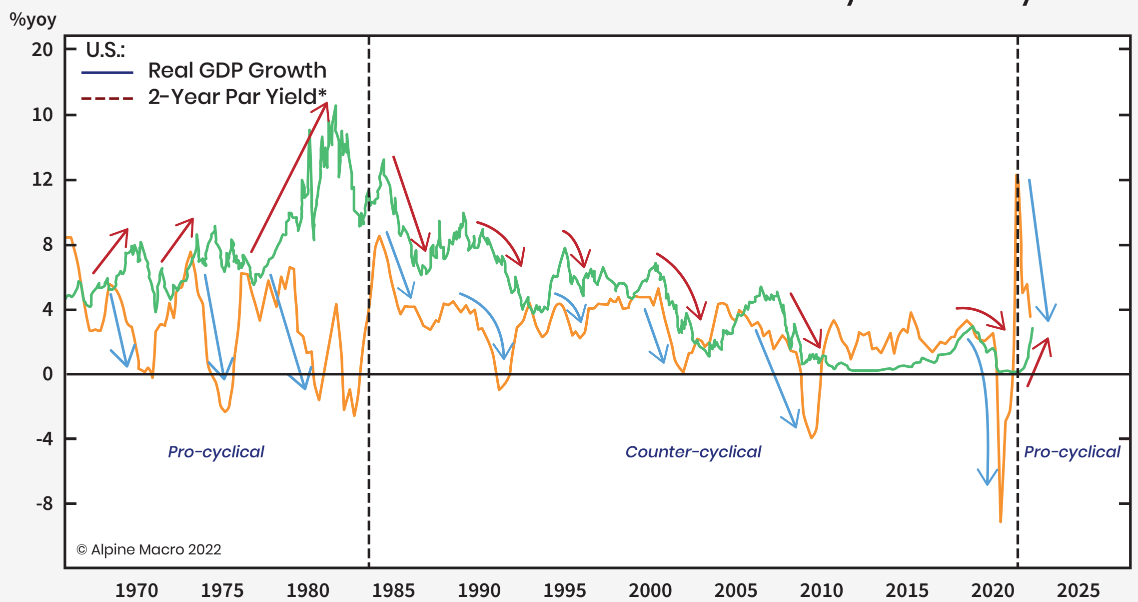
We would like to take the opportunity to briefly describe the factors driving the market environment as well as outline the steps we have taken to manage client portfolios and what might change our outlook going forward.

As we have discussed in our last few client letters, inflationary supply shocks combined with rising shelter, food and energy prices have moved the global economy into a high inflation regime last seen over 40 years ago. While the stickiness of this price environment remains a question, the delayed reaction from policymakers as well as the consumer and business response has served to both tighten financial conditions and to lower confidence.

Balanced Portfolio (60% Stocks, 40% Bonds) H1 Performance



Inflation Forces The Fed to Abandon Counter-Cyclical Policy



*Source: Federal Reserve

Risks have also been raised in response to the amount of debt created due to artificially stimulative financial conditions born out of the Great Financial and COVD Crisis.

Complicating the situation further is that the normal Federal Reserve "put" has vanished. Instead of using monetary policy tools to stabilize teetering markets as investors have come to expect over the last 24 years, the Fed's actions to combat inflation have created market and economic headwinds. The Fed's actions to remove liquidity are thus serving to exacerbate an environment where recession risks are rising, profit expectations are starting to decline and markets are well off their recent highs. The question is whether an imminent slowdown in the economy will lessen the urgency for the Fed to tighten.

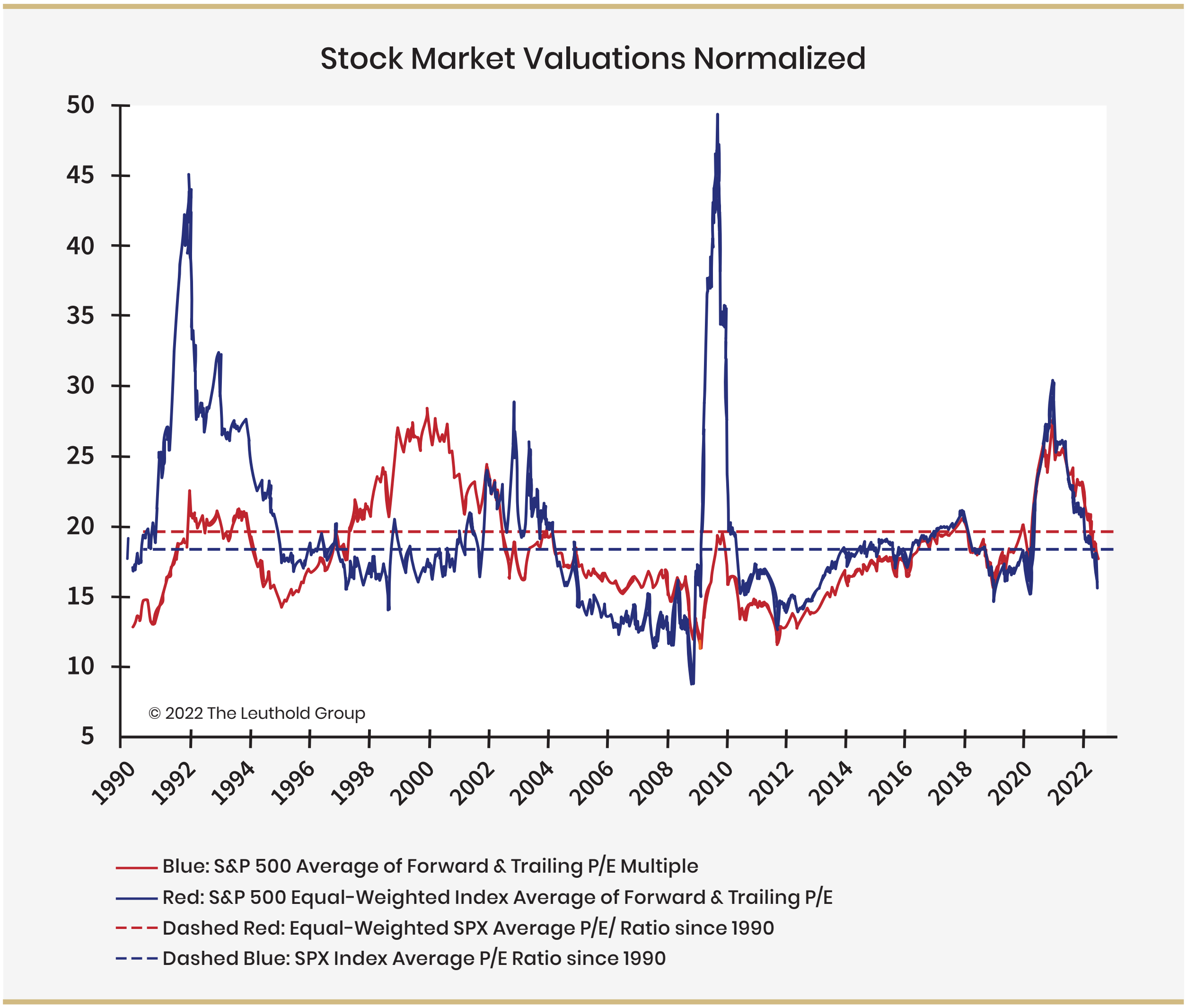
At the portfolio level, we identified many risks to the markets late last year: overvaluation, overconfidence, rising inflation, distorted negative nominal yields, COVD, and more recently the war in Ukraine. As a result, client equity exposures have been consistently low this year while cash levels have been at some of the highest levels on record. While holding cash long term is a sure-fire way to lose purchasing power, cash can be a safe-haven asset in the short term. As an example, cash (specifically the US Dollar) was the best performing major asset class this quarter.

The Silver Lining

We would look to be more aggressive and hold less cash were our analysis to identify that more asset classes had completed this painful period of adjustment. We are not there yet though we are much closer than it might feel. Our current view is that the bear market in equities is advanced, yet incomplete. In the short term, neither fundamentals, valuations, nor financial conditions are bullish. At the fundamental level, corporate profits are priced to grow though are more likely to contract, as the impact of a strong US Dollar, rising rates, and high oil prices raise the odds of an earnings shortfall , offsetting recent improvement from falling prices. On the valuation side, stocks are not cheap relative to bonds as bond yields have risen more than the equity earnings yield (inverse of the P/E). At the financial conditions level, the liquidity backdrop is negative for stocks as the Federal Reserve's quantitative tightening and rate-hike campaign has just started.

On the bullish side, both bonds and commodities are pricing in a drop in inflation which would be positive for equities. Similarly, a slowing economy and falling inflation would restore the near-term outlook for bonds. This would also alleviate pressure on REITs where prices are already discounting a recession. The ability for other central banks to raise rates and / or an end to the war in Ukraine would likely take some pressure off the overvalued US Dollar. A weaker US Dollar would help emerging market stocks, gold and other non-US Dollar assets.

As it relates to investor sentiment and the narrative in the market, there is a dearth of good news. The most recent Michigan Consumer Sentiment Index hit an all-time low. As investing is a rate of change game, even a hint of good news (or even less bad news) can be bullish. Also, while we might see



earnings compress over the next quarter, stocks have sold off to the point where absolute valuations are moving in the right direction. While this might take a quarter or two to materialize, we are watching for these signs that would cause us to add risk to client portfolios.

Historical Perspective

We would add that this market downturn has been preceded by one of the great bull markets in history and that these types of markets, however frustrating for all of us, are part of the cost of being a long-term investor. As counselors, we would note that the last ten years have allowed our clients to be ahead of plan with regards to financial planning goals. We would encourage you to revisit these goals as appropriate and to revisit them with us, especially in times of market volatility.

We hope you're enjoying your summer 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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info@avaloncapital.com | +1 650.306.1500 | 495 Seaport Court, Ste 106, Redwood City, CA 94063