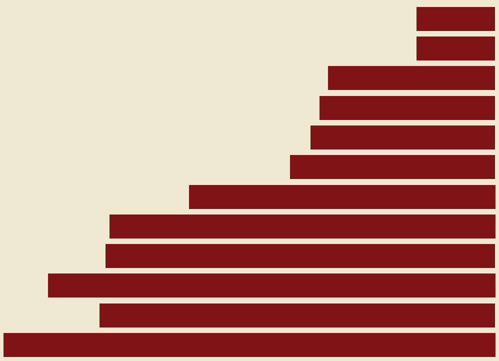
Waiting for the All Clear

Introduction

The third quarter started with a glimmer of hope as equity markets rallied into August based on data suggesting that inflation in the US might be easing. Those hopes were dashed as reports showing inflation's persistence coupled with the Federal Reserve's increased willingness to subdue it drove global bonds and equities lower. Although during this quarter we increased our defensiveness with regards to our equity allocation and our cash positions, Avalon client portfolios were not immune. Gains from equity hedges were not enough to offset losses across all major asset classes. Despite the difficult year, our continued defensiveness has allowed Avalon portfolios at all risk levels to perform at the better performing end of our investment universe and the Global Balanced Benchmark.

Q3 2022 Total Return for Major Asset Classes



1)	ISHARES RUSSELL 2000 ETF	-2.1%
2)	ISHARES NA NATURAL RESOURCES ETF	-2.2%
3)	INVESCO QQQ TRUST SERIES 1	-4.5%
4)	ISHARES CORE U.S. AGGREGATE BOND ETF	-4.7%
5)	SPDR S&P 500 ETF TRUST	-4.9%
6)	SPDR S&P DIVIDEND ETF	-5.4%
7)	SPDR GOLD SHARES	-8.2%
8)	ISHARES 20+ YEAR TREASURY BOND ETF	-10.3%
9)	ISHARES MSCI EAFE ETF	-10.4%
10)	ISHARES US REAL ESTATE ETF	-10.5%
11)	VANECK GOLD MINERS ETF	-11.9%
12)	ISHARES MSCI EMERGING MARKETS ETF	-13.0%

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For the third quarter, the S&P 500 finished down 4.9% while the 20-Year US Treasury Bond fell 10.3%. For the year, the S&P 500 is down 23.9% while both 20-Year US Treasuries (down 29.9%) and the Nasdaq Composite (down 32.5%) are faring worse. 2022 continues to set records for downside performance especially for the bond market. As the chart below shows, we are in the midst of one of the greatest sovereign bond sell-offs in history.

The bond market's performance has created a situation investors rarely see which is that conservative risk portfolios are experiencing as much downside as moderate and aggressive risk portfolios. Historically, bonds have been less volatile relative to stocks, which meant muted returns (both up and down) for bond-oriented portfolios. That relationship has not held this year and it continued throughout the quarter. The third quarter saw the Global Balanced benchmark decline 6.5% - for both this quarter and the year, the Global Balanced benchmark has only slightly outpaced the comparable conservative benchmark.

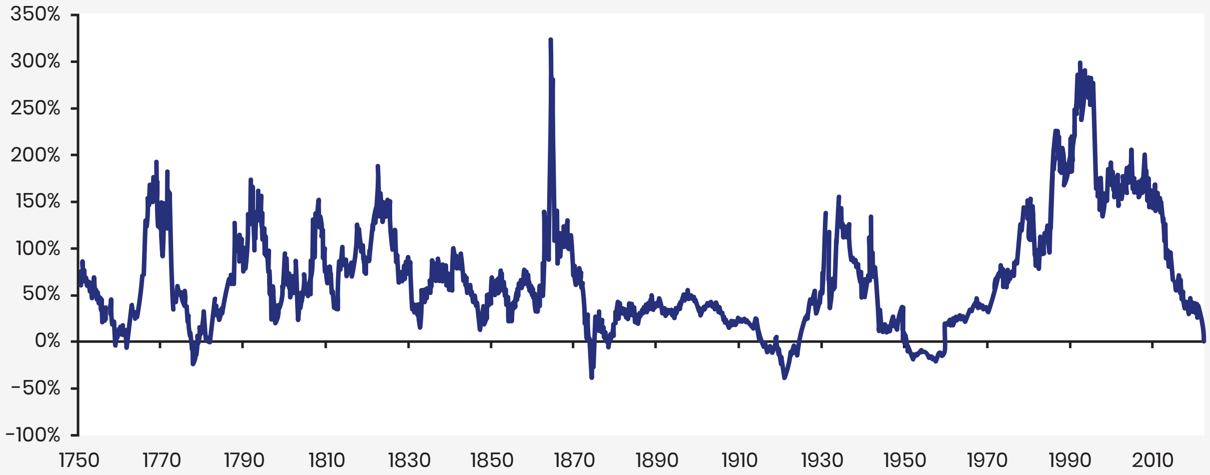
While bonds serving as a ballast will likely return once markets normalize, we are cognizant of the continued risks to bonds in an environment where inflation persists.

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.

At the beginning of the year, we had a defensive portfolio positioning, with an overweight in commodities and underweights across global equities. Throughout the year, as investor sentiment has deteriorated, we reduced what was modest equity exposure and ramped up our cash position. At the end of this quarter, cash is our largest holding across client accounts. Yields of 4% or more for one-year US Treasury Notes are attractive compared to .07% just one year ago.

10-Year Rolling Nominal Returns for Global Government Bonds (GDP-weighted ($)) - The worst return period since the 1950's



Note: Data to 31 Aug 2022

Source : GFD, Deutsche Bank

While long-term cash holdings are a sure way to lose purchasing power, the short-term cash position has offered client portfolios some stability in a market where major asset classes are tumbling.

US Dollar Wrecking Ball

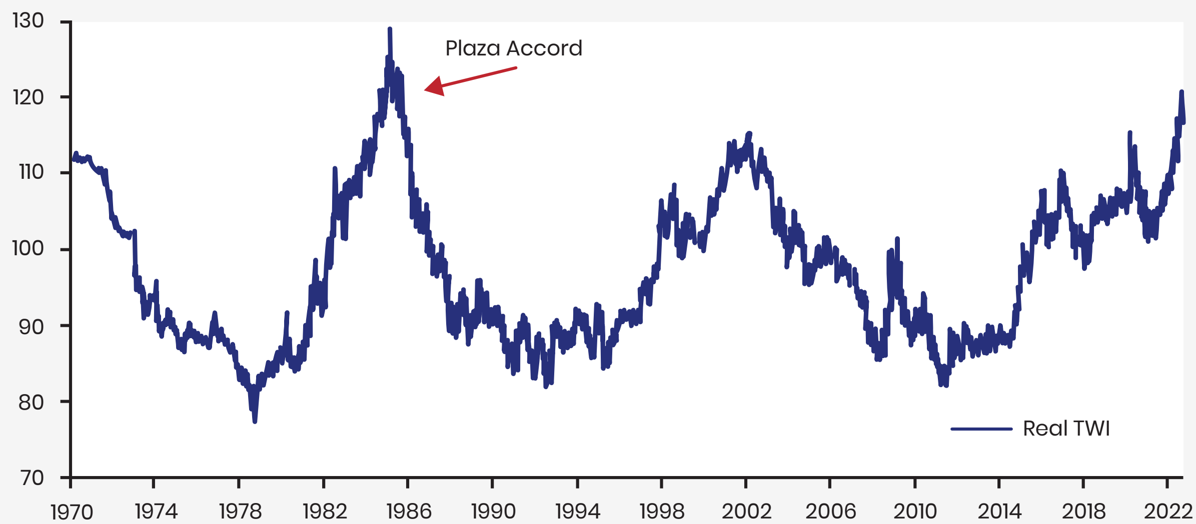
In 1971, Treasury Secretary John Connelly famously said to his foreign counterparts, “The dollar is our currency, but your problem.” That has rung true this year as the rapid rise in the dollar has caused massive pain in most international assets. The reason for the pain is in large part due to the relative strength of the US economy vs the rest of the world. While energy costs are higher in the US than they were a year ago, they are not 10x the cost vs a year ago as they can be found in Europe. Nor is the US economy suffering the twin burdens of a massively over-leveraged real estate market while operating in economically restrictive COVD policy as is China.

This relative economic strength in the US has meant that the Federal Reserve has raised interest rates faster than central banks across the rest of the world. Higher relative real interest rates here in the US has led yield-focused investors into a rising dollar which has impaired foreign currencies. Year to date, the Japanese Yen is down 23%, the Euro is down 15%, while a basket of Emerging Market currencies is down 9% vs the dollar. These currency shifts are part of the reason why, on a YTD dollar basis, the Nikkei is down 26%, the EAFE is down 27% while a basket of Emerging Market equities is down 28%.

In the intermediate term, this trend is self-fulfilling and could mean the dollar continues to strengthen. And while Japan, England and China have all started to intervene in currency markets to weaken the dollar, the trend is only likely to change fundamentally when other economies start to strengthen relative to the US and/or when the Federal Reserve pivots and starts to ease monetary policy.

USD real trade weighted index is near historic highs, where it was when the Plaza Accords were signed.

Real GS USD Trade Weighted Index



Source: Goldman Sachs Global Investment Research

A silver lining (and we all seem to looking for some these days) is that gas is cheaper here than it is overseas. And that there is a major sale on that European or Japanese vacation you might be eyeing. If we have learned one thing these last two years it is that we, as humans, need connection in the same way we need food, water and shelter.

So connect! With your friends. With your family. With a part of the world you love. And please send us more pictures of you with the people you love and the places you visit because we love seeing our clients living their best lives.

Pictured: Emily (a Netflix character) in Paris

The Phoenix After the Wrecking Ball

History is filled with spectacular bull markets that proceeded financial crises. The post Great Financial Crisis rally in US stocks from 2009-2021 is a recent example while the Asian currency crisis of 1997 set the stage for a rally in Emerging Markets into 2008. Our analysis indicates that this dollar crisis is setting the stage for a massive opportunity in foreign equities. The last time the dollar traded above 120, the US and other major countries intervened to depreciate the dollar. At that time, the primary goal of the US Treasury was to aid US exporters who were uncompetitive due to the strong dollar. This catalyzed two of the greatest bull markets ever (the 1981-2000 US equity market and the 1980s Japanese equity and real estate market).

As we are experiencing this year, and as we experienced in 2008 with the deleveraging enhanced by a dollar spike, there are major risks to markets and the global economy when the dollar appreciates this far this fast. And, with Russia threatening nuclear war, the new UK government doing their best Keystone Cops impression, and the Federal Reserve still tightening monetary policy, we are likely far from out of the woods.

Though with an investment horizon of only a few years, the opportunity for many international equity markets (were the dollar to even stabilize) is growing quite large. A weak currency has improved the competitiveness of international companies in places such as Japan, South Korea and in many Emerging Market countries such that, even if their currencies do not measurably appreciate vs the dollar (which would enhance foreign equity returns in doing so), the expected earnings growth of these companies due to currency competitiveness should be materially better than average.

Not all investors have the patience nor the fortitude to take advantage of these opportunities though these are exactly the types of opportunities for which Avalon's strategy is designed.

Gold

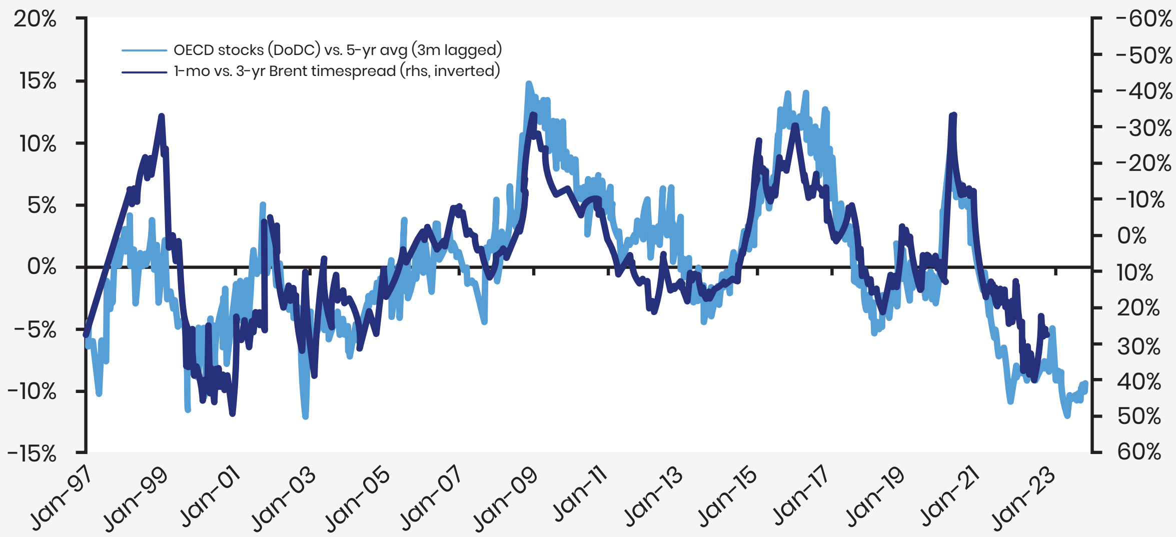
One of the perplexing asset classes over the last year has been gold. With inflation taking center stage and real interest rates negative, the fundamentals for gold were as positive as any major asset class. And yet gold has not been able to build on its 2019-2020 rally, finishing down 4% in 2021 and down 10% year to date. As history does sometimes rhyme, we can look at the early stages of the last inflation environment in the US and wonder if better days might be ahead for gold. For the two-year period from 1969 to 1970, with inflation moving higher in the US and CPI firmly above 5%, gold experienced a modest decline. For patient investors, gold paid off in the following years, even as inflation (which decelerated in both 1971 and 1972) appeared to be coming under control. After closing at just over $37 per oz in 1970, the price of gold rose to $195 per oz in late 1974, a 5x increase in less than four years.

The Energy Transition

Throughout the quarter, oil prices succumbed to rising growth concerns and gave back most of their gains for the year. While the demand side of oil could continue to face headwinds due to the strong dollar and falling demand, we continue to be optimistic about the supply set-up for oil. With regards to supply, oil inventories are near record lows, suggesting tight supply. That tightness will likely increase in October, when the US ends its release of 1mm barrels per day out of the Strategic Petroleum Reserve. With geopolitical risks growing and the inability and/or unwillingness for oil producers to quickly pivot after a decade long lack of investment in the sector, even reasonable demand dynamics could require much higher oil prices.

Despite all the fundamental headwinds this year, inventories remain at record lows in OECD...

OECD commercial stocks in days of OECD demand coverage vs. 5-yr avg (lhs) vs. 1-mo to 3-yr Brent timespreads (%, rhs, inverted). Balances shown pre- and post- price changes required to normalise stocks by end-23.



Source: IEA, ICE, Goldman Sachs Global Investment Research

Patience

We stated in our last quarterly client letter, *"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."* A quarter later, we have the same view. Things have changed, however. With price movements this quarter, return expectations for many asset classes have gotten appreciably better than they were a quarter ago. Our long-term regression work is approaching levels of attractiveness that we have not seen since the Great Financial Crisis. Still, the risk that we move into a full-blown panic before investor sentiment improves remains elevated and so we wait patiently for the all clear.

We hope you enjoyed your summer.
We 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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