Recalibration

Introduction

2022 marked the beginning of a generational shift in global financial markets and a recalibration of global interest rates.
After 40 years of falling inflation and falling interest rates, the wealth effect created from easy monetary and fiscal policy reversed course. This, combined with pandemic bottle necks, worker attrition and the war in Ukraine, caused an inflation spike that created havoc across global asset markets. The combined wealth destruction within global stocks and bonds (not accounting for the drop in real estate) was $45 Trillion. Our analysis indicates that this recalibration, while ultimately a necessary normalization, could portend a change in market leadership that is only just beginning to develop.

Within Avalon client portfolios, gains from commodity exposure, equity hedges, and sizeable cash positions (with yields at rates not seen in over a decade) were not enough to offset losses across most major asset classes. Despite the difficult year, our continued prudence allowed Avalon portfolios at all risk levels to perform toward the better end of the global investment benchmarks.

Global Asset Class Benchmarks: 2022 Full Year Returns

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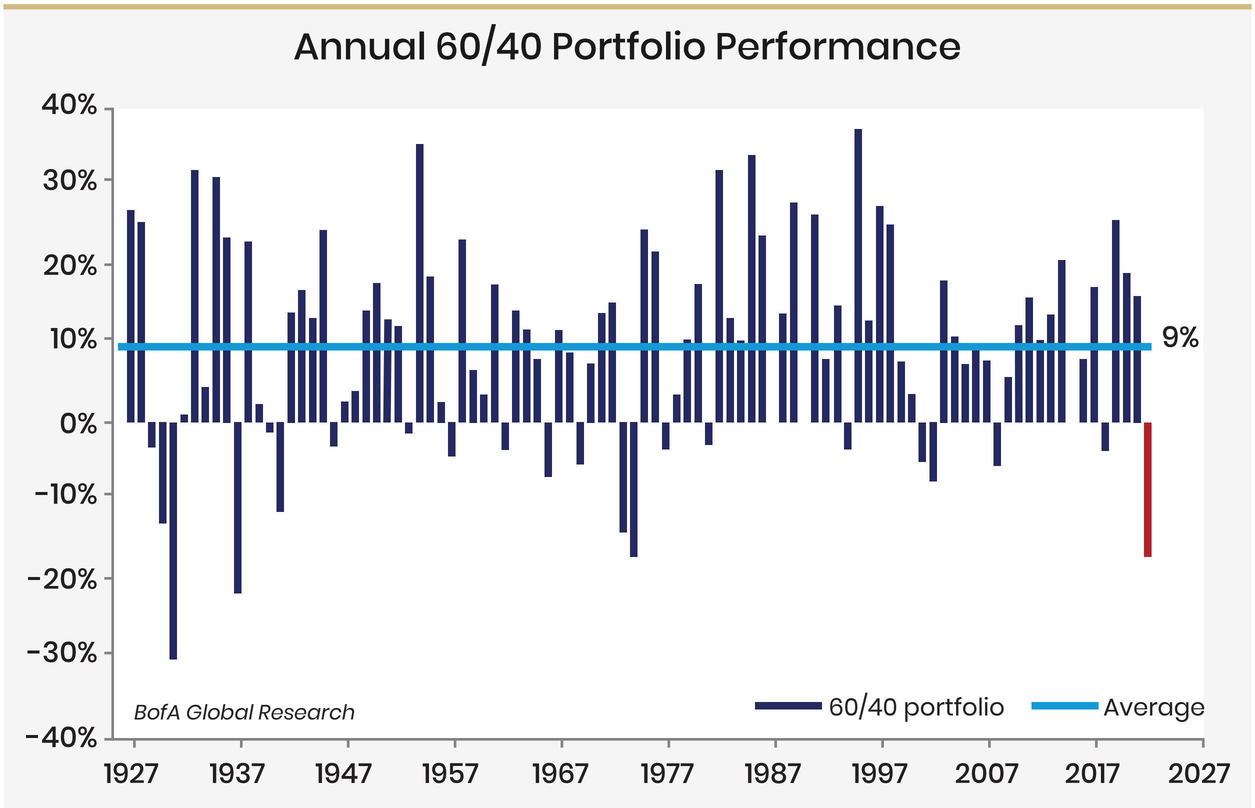
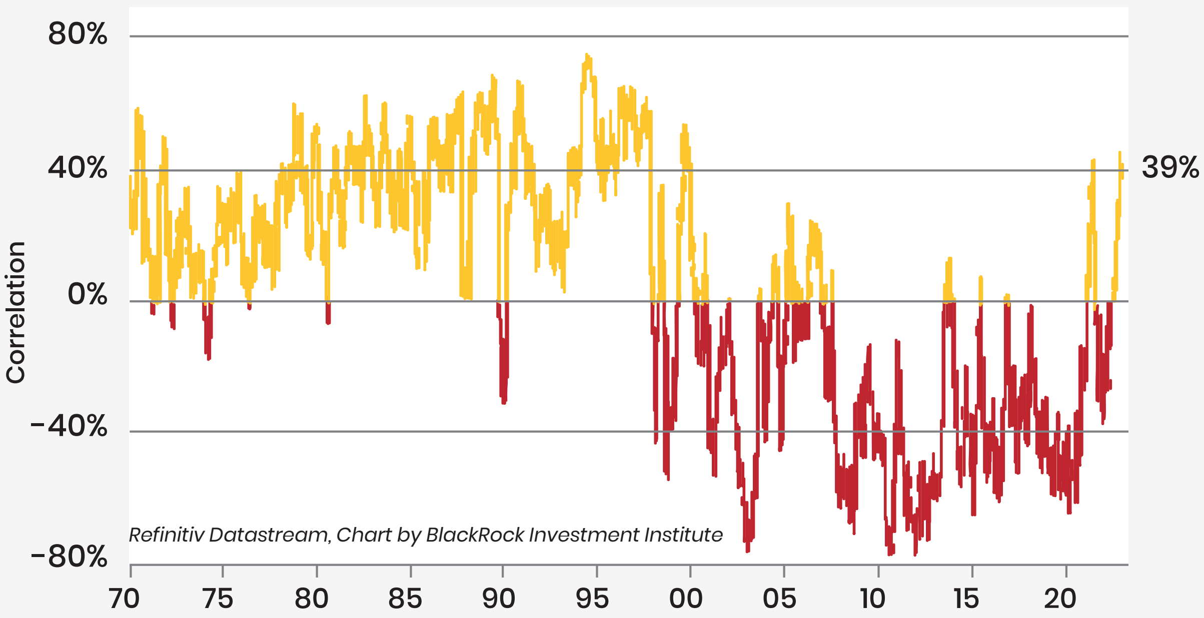
For the year, inflation punished the long-duration assets that had outperformed their shorter-duration counterparts over the last decade. This phenomenon applied to equities where the Nasdaq Composite (lead by the high growth FAANG stocks) finished down 32.6% while the S&P 500 lost 18.2%. It also applied to the fixed income market where the 20-Year US Treasury Bond fell 31.2% while the Barclays US Aggregate Bond Index (with a duration of 6.5 years) fell by 13.0%. Taking this duration concept to an extreme, last year saw a popular index of cloud software companies (fast growing and some even profitable) lose 50% while a 100-year (not a typo) Austrian bond dropped over 90% in value.

Inflation's negative impact on both stocks and bonds created a rare occurrence for the traditional 60/40 portfolio in that last year was only the sixth time since 1926 that both the S&P 500 and Bloomberg U.S. Aggregate declined. Even rarer was the magnitude of losses. Last year marked the only time in history where each fell by more than 10% with the S&P 500 suffering its worst year since 2008 (and sixth worst in history) while the Barclays US Aggregate Bond Index suffered its worst year on record.

2022 saw the multi-decade relationship of negatively correlated stocks and bonds come to a halt. Until last year, investors were able to rely on their bond investments for protection when equities sold off, but the threat of more persistent inflation changed that relationship, exhibiting behaviors not seen in recent decades. As the chart below shows, this form of stock/bond correlation hasn't always been the case. Research suggests that what drove the negative correlation over the last 20 years was that the market was almost purely focused on growth (stoked by a disinflation tailwind). Though we know from last year and from investing prior to 2000 that inflation and/or inflation



Correlation of Bond and Equity Returns



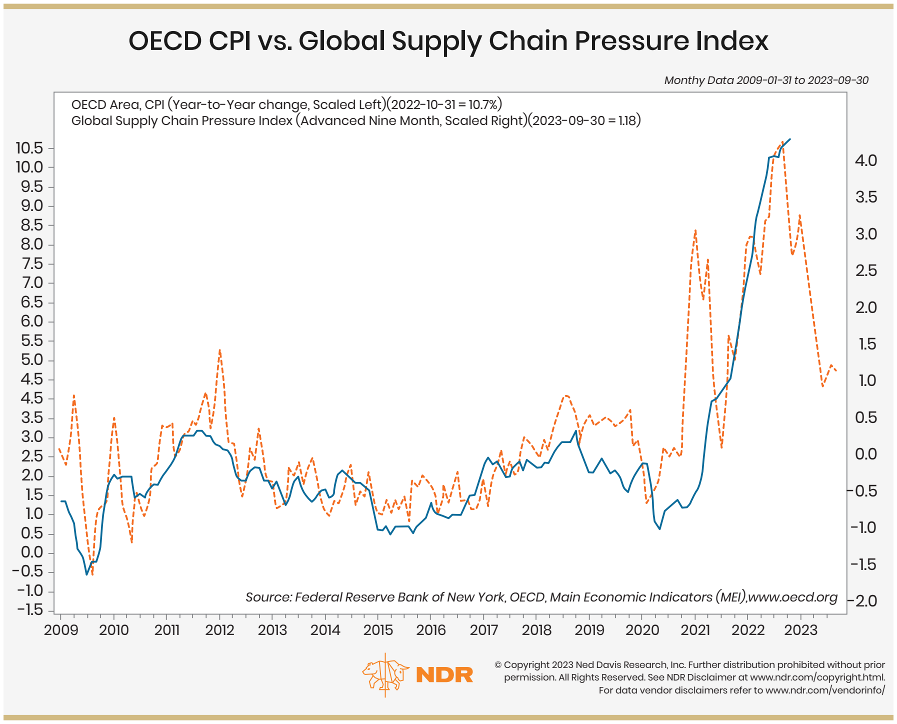
uncertainty (experienced in the '70s, '80s and '90s) can take priority over the market's growth focus and force the Federal Reserve to adopt policies that combat inflation and result in a positive stock/bond correlation.

As we noted in our Q1 client letter REGIME CHANGE, some of the multi-decade macroeconomic forces that contributed to disinflation (and allowed investors to focus almost purely on growth) are reversing. While factors such as technology, productivity and demographic trends might continue to weigh on costs, the effect of de-globalization and the emphasis on security vs efficiency as it relates to global supply chains seem set to deliver an indirect tax on asset prices.

This environmental change could have major impacts on future risk-return profiles. Avalon client portfolios reflect this new environment as we made several mid-year investments in vehicles designed to generate bond-like returns while maintaining low to negative correlation to stocks. The recalibration also allowed us to take advantage of higher yielding short-term fixed income options such as investing in Money Market funds with rates near 4%.

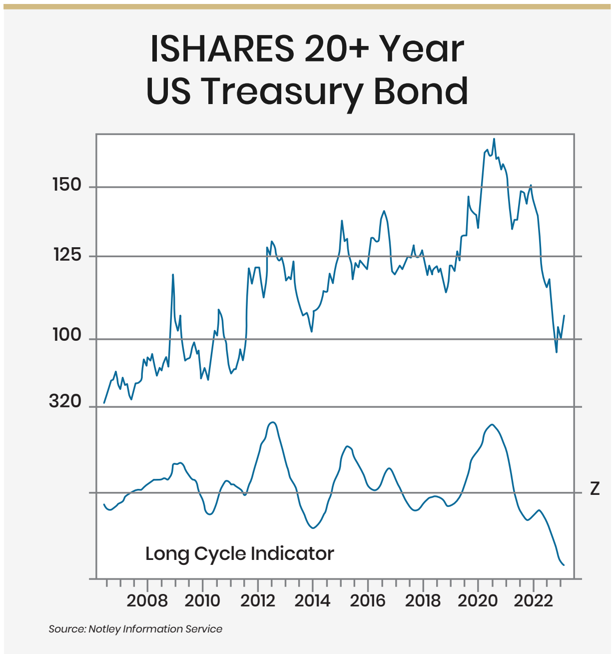
The Market is Focused on the Fed (Who is Focused on Inflation)

Inflation continues to be the dominant factor driving the investing environment. With inflation hitting 40-year highs in the US and many other economies, central banks including the Federal Reserve have moved swiftly (after having been caught flat-footed earlier in the year) to tighten monetary policy and subdue inflation. The Fed raised interest rates seven times in 2022, moving the Federal Funds Rate from 0.25-0.5% in March to 4.25-4.5% to close the year. Their hope is that this sharp spike in rates contains inflation and, under a newly normalized interest rate environment, the economy can resume steady real growth. Early indications are that inflation has peaked for now though, with the Fed continuing to raise rates, it seems probable that the Fed's hawkishness drives economic growth lower.



Long Duration US Treasury Bonds – Revisiting the Old Playbook

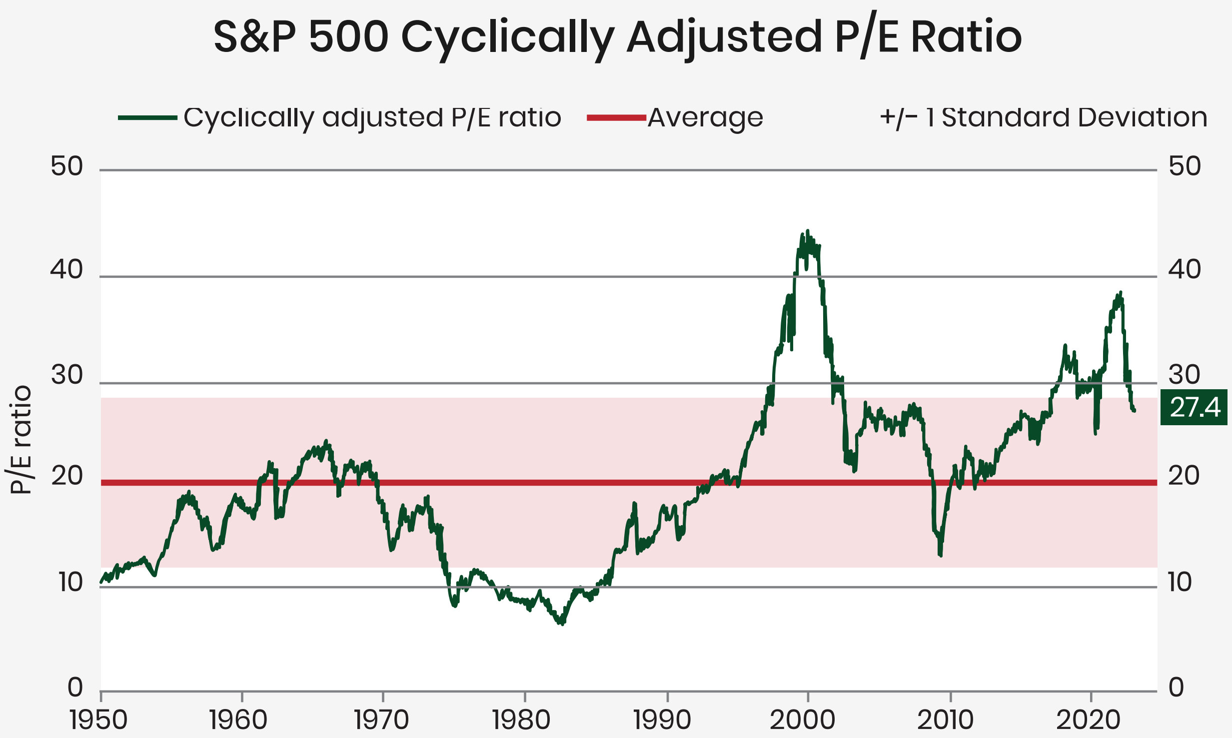
While our analysis indicates that many of the long-term forces that drove interest rates lower are starting to unwind, our models also show that the market's reaction to this trend is overdone. Nowhere is that more the case than with long-duration fixed income. Our regression analysis shows that the 20-Year US Treasury Bond is more than two standard deviations undervalued (based on more than 20 years of history) and our bond timing model is giving its first long-term signal in more than four years. Bonds would not even need to return to previous highs in order to create a double-digit return. This coupled with the Fed's aggressiveness around containing inflation are the main factors driving our allocation to long bonds.



While we are aware of the shifting forces at play longer-term, we know that markets do not follow a straight path in either direction. We also are aware that the Fed is not perfect. Just as they were too slow to contain inflation last year (causing long duration assets to sell-off), they appear to have moved too fast later in the year towards containing it (increasing the probability of a recession which could lead to a move lower in long-term interest rates and a rise in bond prices).

US Large Cap Growth Stocks – Is the Game Finished for Now?

Whether the US experiences a recession this year or not, there are many asset classes we view as attractive on a risk-reward basis in 2023. Looking out a year, US Large Cap Growth stocks are not high on that list, even if a counter-trend bounce may develop. Despite having dropped 18.1% last year, the technology dominated S&P 500 is still expensive by historical standards. As the chart below shows, the S&P 500 is trading in line with the peak seen in 2007-2008. This does not mean that the S&P 500 or even the Nasdaq might not have a great year this year. It just means that the risks to owning US Large Cap Growth stocks are elevated. Far more elevated than are the risks to owning US Value stocks, US Small Cap stocks and even International stocks.



Source: Refinitiv Datastream and Robert Shiller, chart by BlackRock Investment Institute. Dec. 30, 2022
Note: The green line shows the cyclically-adjusted P/E ratrio which is the price divided by the 10-year moving average of earning.

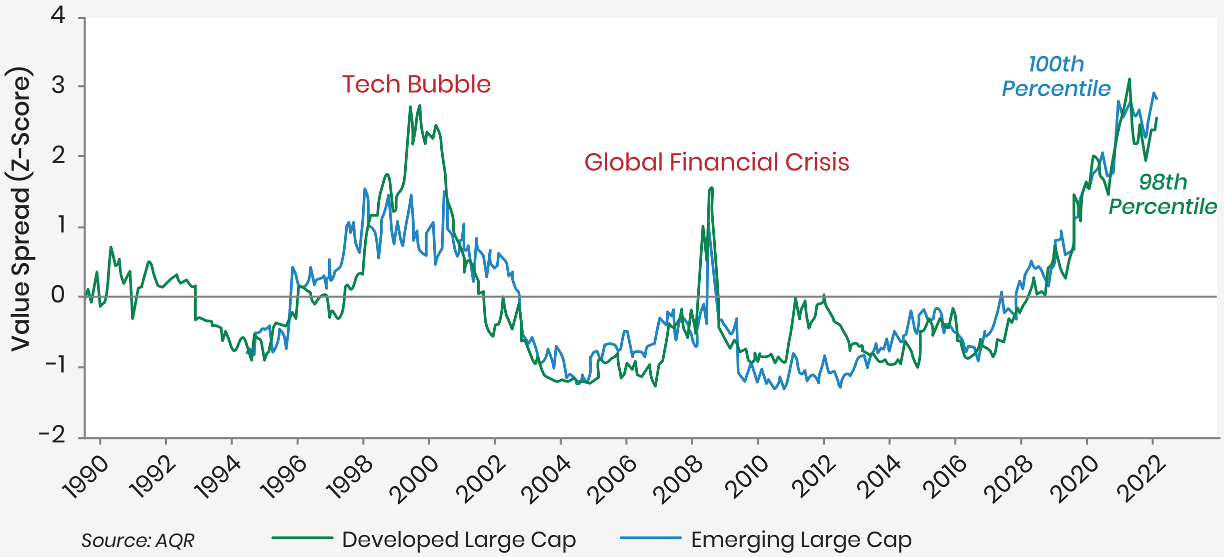
Value Stocks – Rising from the Dead

As we mentioned earlier, 2022 saw the reversal of growth stocks outperforming value stocks. Our analysis indicates this trend could continue. Even with 2022's reversal in favor of value, spreads for value stocks remain historically cheap relative to growth stocks in both the US and International markets. As the chart below indicates, value stocks relative to growth stocks are near 2000 and 2007 levels which preceded massive outperformance in value stocks.

History indicates that macroeconomic factors might also favor value stocks over growth stocks. While most growth stocks surged (and then cratered) based on interest rate levels, value stocks historically tend to be uncorrelated with changes in interest rates and also tend to outperform growth in recessionary environments.

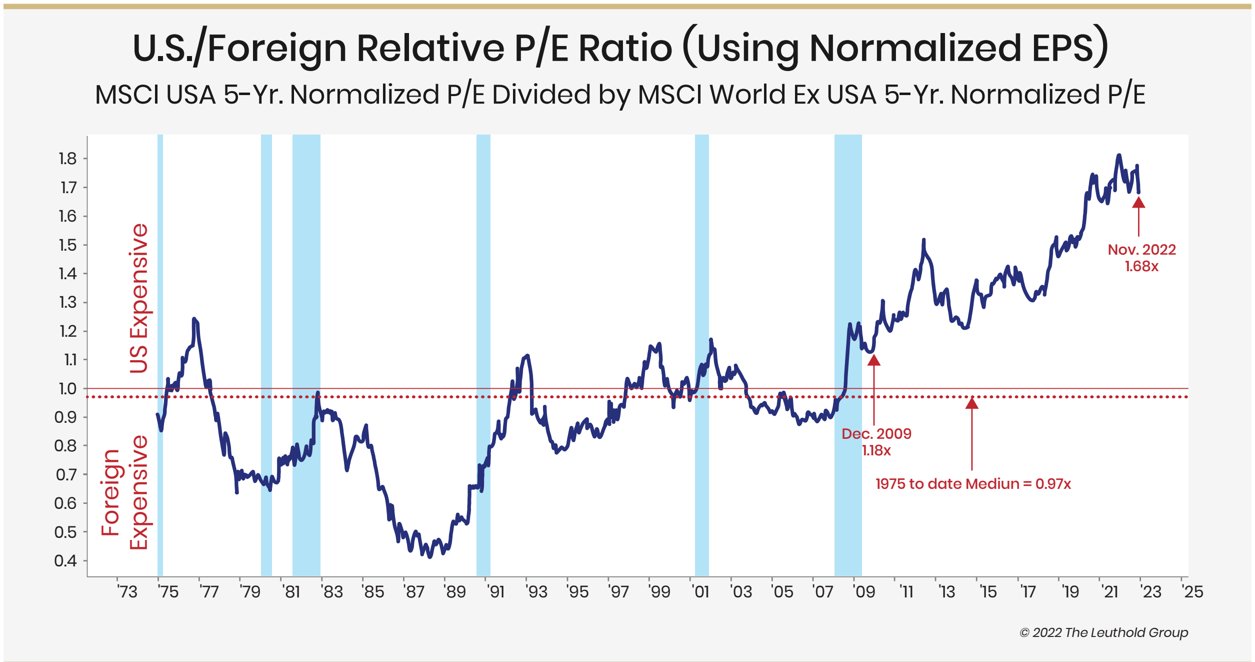
Value Spreads for Hypothetical Industry-and-Dollar-Neutral Value Portolios

January 1, 1990 - September 30, 2022



International Stocks

Largely based on US Dollar weakness and nearly two decades of undervaluation, our largest equity overweight is in International stocks. As long rates retreat in 2023, the lower yields put more downward pressure on the US Dollar. As is the case with US value to growth stocks, International stocks are historically cheap relative to US markets. In our Q3 client letter WAITING FOR THE ALL CLEAR, we outlined the case for Emerging Market stocks based on corporate fundamentals and currency trends. While it's difficult to extrapolate that framework across all International markets, Europe's ability to weather the war in Ukraine, China's economic re-opening and the newly weakening Dollar augur a potential shift in the performance of International equities vs their US counterparts.



Gold's Time to Shine

We wrote about gold's underwhelming YTD performance as a hedge in our Q3 letter and noted that history offered the lesson that while gold might react slowly to an inflation shock, the asset could be a favorable asset class were inflation to persist. While it is early, the performance of gold and gold mining stocks over the last few months appears to show an asset class breaking higher with favorable long-term support and fundamentals.

A large source of support for gold (and all non-US Dollar denominated assets) is the price of the Dollar which is showing weakness after a massive spike in 2022 (chart below). The geopolitical environment could also be a factor in terms of Dollar headwinds. While China has demonstrated a long-term focus on developing a competing currency, the Biden Administration's weaponization of the Dollar in response to Russia's invasion of Ukraine heightened that urgency. As we move towards a multi-polar geopolitical power structure, we are seeing the likes of China, Russia and petro-states attempt to shift away from this Dollar dependency.

Aftrer a Strong 2022, Could the Dollar's Reversal Have Legs?

A New Year

We stated in our last two quarterly client letters, *"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."* Entering 2023, our view is different. The combination of a falling Dollar, the normalization of interest rates and historically attractive valuation spreads for many types of asset classes has us more optimistic than we have been in recent past. The 2022 recalibration created more diverse opportunities across global markets. And given the types of asset classes that are most attractive, we believe 2022 also triggered a multi-year shift in market leadership.

We enter the new year overweight long duration US Treasuries and would look to add to that position. Similarly, we are overweight International (especially Emerging Market) stocks and are likely to add to those allocations. We remain underweight US equities, with the exception of US stocks featuring quality and value characteristics. And we remain overweight gold and gold stocks. We have outlined in our last few client letters why this decade favors an overweight to hard assets and our intermediate-term analysis favors gold and gold stocks over their natural resource counterparts.

We are looking forward to a better 2023! And are looking forward to seeing you soon.

Clara Basile David Rahn Bill Oberman Ross Revenaugh

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