Avalon
CAPITAL MANAGEMENT

# Invest Smarter. Live Better.

## Mid Year Update

Avalon client portfolios had positive returns in the second quarter, driven by gains in both US and international stocks as well as real estate. Tailwinds from an AI frenzy, tempering inflation, a respite in the banking crisis and a resolution to the debt ceiling threat drove strong gains across US growth stocks. These gains were most heavily represented in the FAANGM stocks which represented a large percentage of the gains in the NASDAQ and the S&P 500 indices.

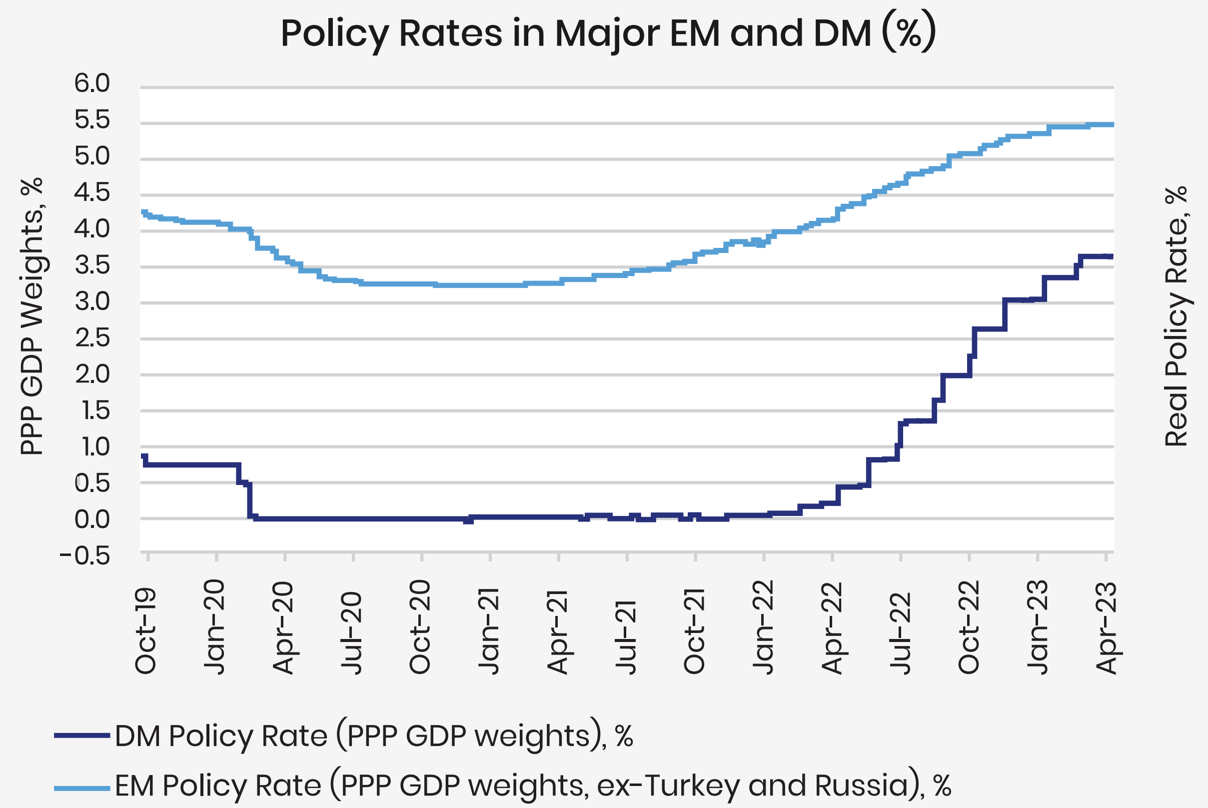
Most other stocks, including stocks in value indices like the Dow Jones Industrials, lagged. Even with the Federal Funds rate now above 5%, portions of the equity markets have looked through statements from the Federal Reserve indicating that they will resume raising interest rates later this year. Current market levels suggest a strengthening economy and firm employment has delayed or softened the likelihood an economic recession.

## A Mixed Quarter for Major Asset Classes

While we are less defensive with client portfolio positioning as it relates to certain equities, our analysis indicates many large cap growth stocks have elevated risk. During the quarter, we maintained or added to positions in quality and dividend yielding US and International stocks as well as US small cap stocks. Our caution is partly based on elevated valuations and operating margins within the growth universe. And partly based on historical precedent. While the Federal Reserve has done a commendable job to date of tightening to bring inflation under control without major economic damage, the history of Federal Reserve interventions is one of overstimulation and overtightening. Goldilocks was not a central banker.

We would note that technical indicators point to an equity rally broadening out from the tech focused AI beneficiaries. We would expect this increased breadth to positively benefit companies operating in industries with long-term economic tailwinds. Specifically, our analysis identified stocks of water, solar and other clean energy companies as attractive. We subsequently added to these themes since the last quarter.

Within fixed income, in light of persistent economic strength, we reduced long duration US Treasury Bonds and currently maintain modest overweight positions in short duration US Treasuries, mortgage securities and municipal bonds. With prospects of an economic downturn delayed and the Fed's stated commitment to raise rates after their June pause, our analysis indicates that short-dated US




Source: VanEck Research; Bloomberg LP. Data as of May 2023 (left chart) and as of March 2023 (right chart).

Treasuries are much more attractive within our fixed income allocation. Still, from a longer-term perspective, long bonds are now a more attractive value than stocks. Should economic growth start to buckle under the weight of further rate rises, we will once again increase duration.

We did add a position in Emerging Market (EM) debt within client portfolios this quarter. Our analysis indicates EM bonds are attractive given their high yields and healthy balance sheets relative to developed markets (DM). What makes EM bonds particularly attractive now is that EM central banks were much more aggressive than their DM counterparts early in the interest rate hiking cycle. As a result, real interest rates are higher in EM than they are in DM economies. This could allow EM currencies to benefit and allows EM central banks more freedom to lower rates, potentially raising EM bond prices.

Markets tend to meander in the summer. Coming into 2023 many expected a weak first half and a strong second half. With investors now showing some signs of complacency, the Federal Reserve still raising rates and earnings expectations still elevated, it would not be surprising to see a partial retest of the uptrend that started last October. For now, our models are holding the conservative positioning of the last 15 months. Were a shakeout to occur, we have plenty of cash to take advantage of it. For now, we are sitting tight.

We hope you are enjoying your summer. And we are looking forward to seeing you soon.

Clara Basile Bill Oberman Ross Revenaugh

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