Avalon
CAPITAL MANAGEMENT

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Rate Shock

Avalon client portfolios had modestly negative returns in the third quarter, as returns from the natural resource sector, hedges and US Treasury bills were not enough to offset losses across most major asset classes. After a strong start to 2023, US stock markets pared back this year's gains in the second half of the quarter. Competing factors were at play. Until late August, a resilient economy, fiscal expansion and somewhat improving corporate profits outweighed investor concerns around higher bond yields, a stronger dollar, rising energy costs, a hawkish Federal Reserve and a dysfunctional Congress.

While large capitalization indices such as the NASDAQ and S&P 500 fell around 3% for the quarter, value and small capitalization indices lost closer to 5%. The asset class hit hardest was long US Treasury bonds which fell a staggering 13%. With stocks and bonds falling, the benchmark Morningstar Conservative and Moderate portfolios fell 3.06% and 3.29%, respectively.

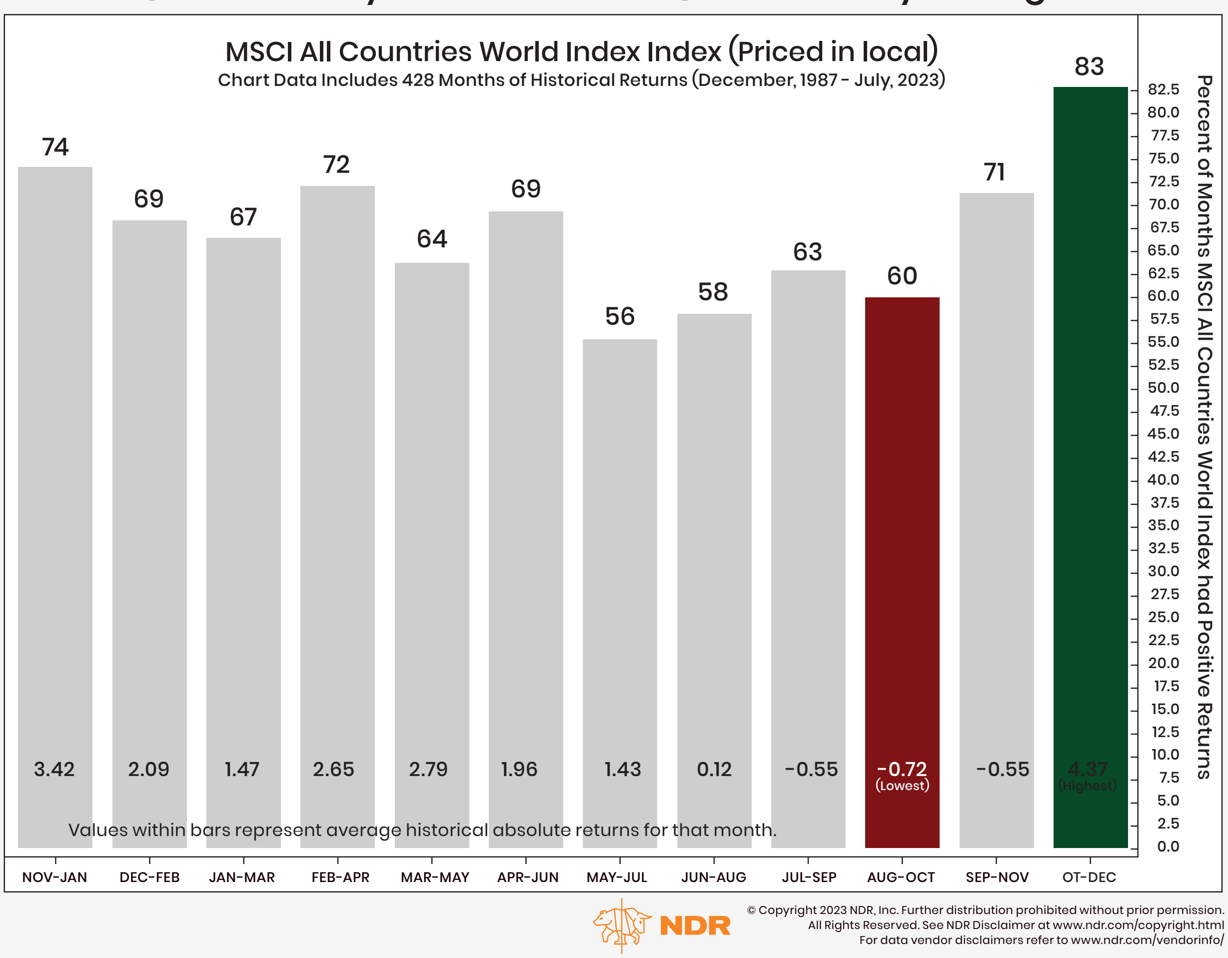
A Rough Quarter for Major Asset Classes

Tis the Season

No, we are not referring to the normal merriment associated with the holidays. We are referring to the market's tendency to sell off from late summer through October each year. As the below table shows, 2023 has followed this tendency. We alluded to this in our July client letter. Three months later, investors are worn out, thinking the bottom is about to drop out of the stock market.

Expectations for a soft landing that dominated the rally since the banking crisis in the first quarter have morphed into fears that unbridled fiscal spending will necessitate a need for structurally higher long-term interest rates. The resulting drop in long bonds since late July along with a sharp rise in oil has precipitated a steep drop in all asset classes and delivered a shock to the whole financial system. We continue to remain cautious for now in our equity allocation though we note that a secular long-term bull market for US stocks remains intact. Once rates peak, another rally in stocks is likely to follow. While we understand investor fears, we also recognize that the seasonally strongest period of the year for returns begins in October.

Q3 seasonally weakest while Q4 seasonally strongest



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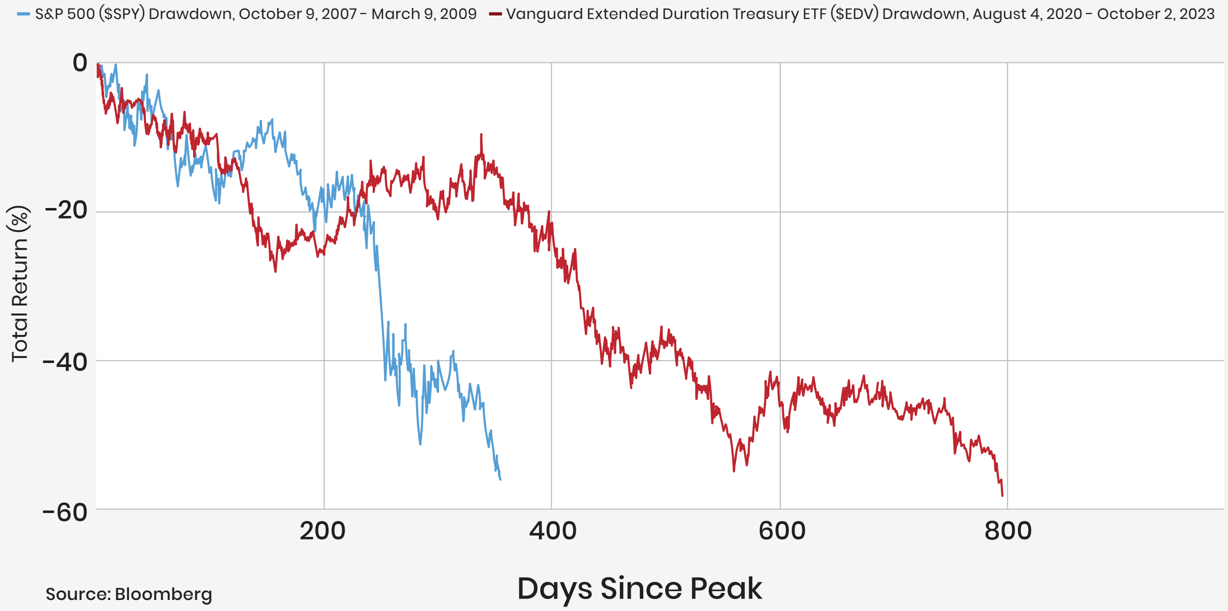
Blood in the Streets in Long Duration Bonds

While equities remain in a very long-term uptrend from 2009, bonds peaked during the Covid panic when rates were close to zero. Secular trends normally materialize over a decade or more, so rates will present a headwind for years to come. We remain cautious on fixed income structurally, though we recognize a meaningful rally is likely over the next 12 months once recession fears resurface. Recently, while both the long and short end of the US Treasury yield curve moved higher, long dated bonds were hurt most with US Treasury bonds experiencing a drop of over 13% this quarter. Just as last year's decline was historic, the significance of this quarter's drop cannot be overstated. This was the fourth worst quarter for US Treasury bond performance since 1926. To put the last several years in context, the drawdown in US Treasury bonds of 53% has now surpassed the decline US equities experienced in the 2008 Great Financial Crisis.

Earlier in the year, we had reduced client exposure to long duration US Treasury bonds while maintaining positions in short duration US Treasuries, mortgage securities and municipal bonds. We continue to hold a large allocation to short duration US Treasuries through money market instruments now yielding over 5%. And while there is reinvestment risk to maintaining such a large position in money market funds, our analysis continues to favor short-term Treasuries over Treasury bonds even as we are watching for signs that the worst is over for now. Continued improvement in the inflation numbers, an uptick in the unemployment rate and reductions in the budget deficit are key factors that will influence a peak in rates.

Total Drawdown In Ultra Long-Duration U.S. Treasury Bonds Now Exceeds Stock Market Peak-To-Trough Stock Market Crash During Great Financial Crisis

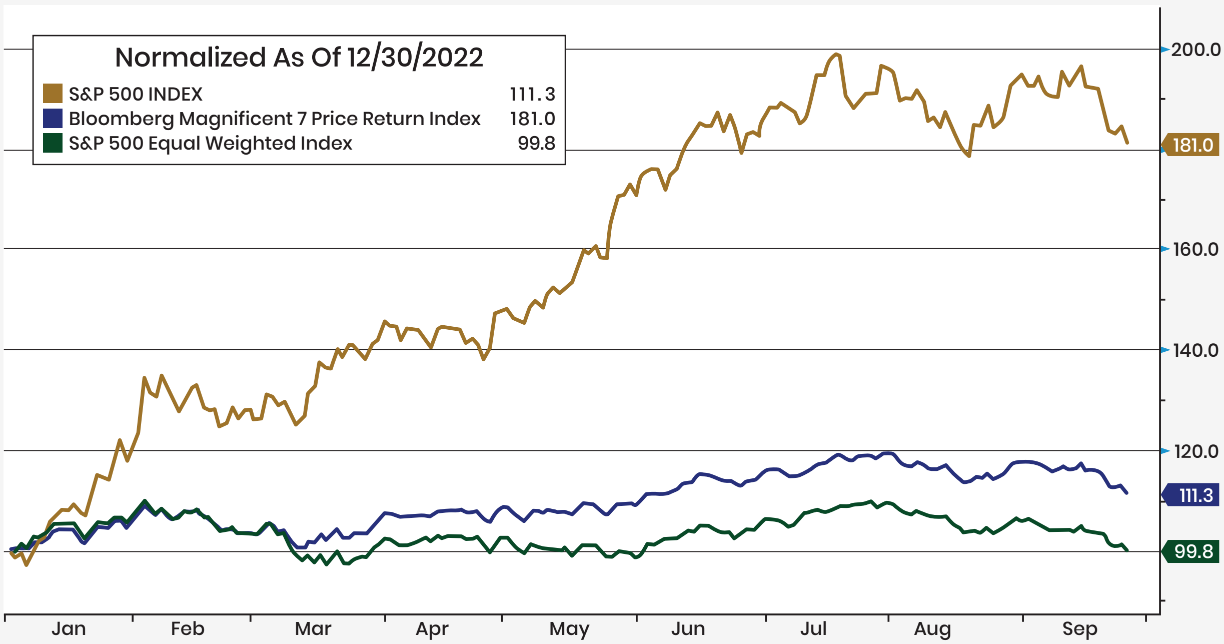


Source: Bloomberg

Breadth Remains Thin for US Equities

The AI frenzy has driven outsized gains for stocks of companies most positioned to capitalize on the new technology. Year to date, the Magnificent 7 technology stocks (AAPL, AMZN, MSFT, GOOGL, META, NVDA, TSLA) have returned over 80%. This phenomenon drove the S&P 500 higher though it has masked what has been a disappointing year for most S&P 500 constituents. While the S&P 500 remains up 12% YTD, the equal- weighted version of the S&P 500 is flat through the third quarter.

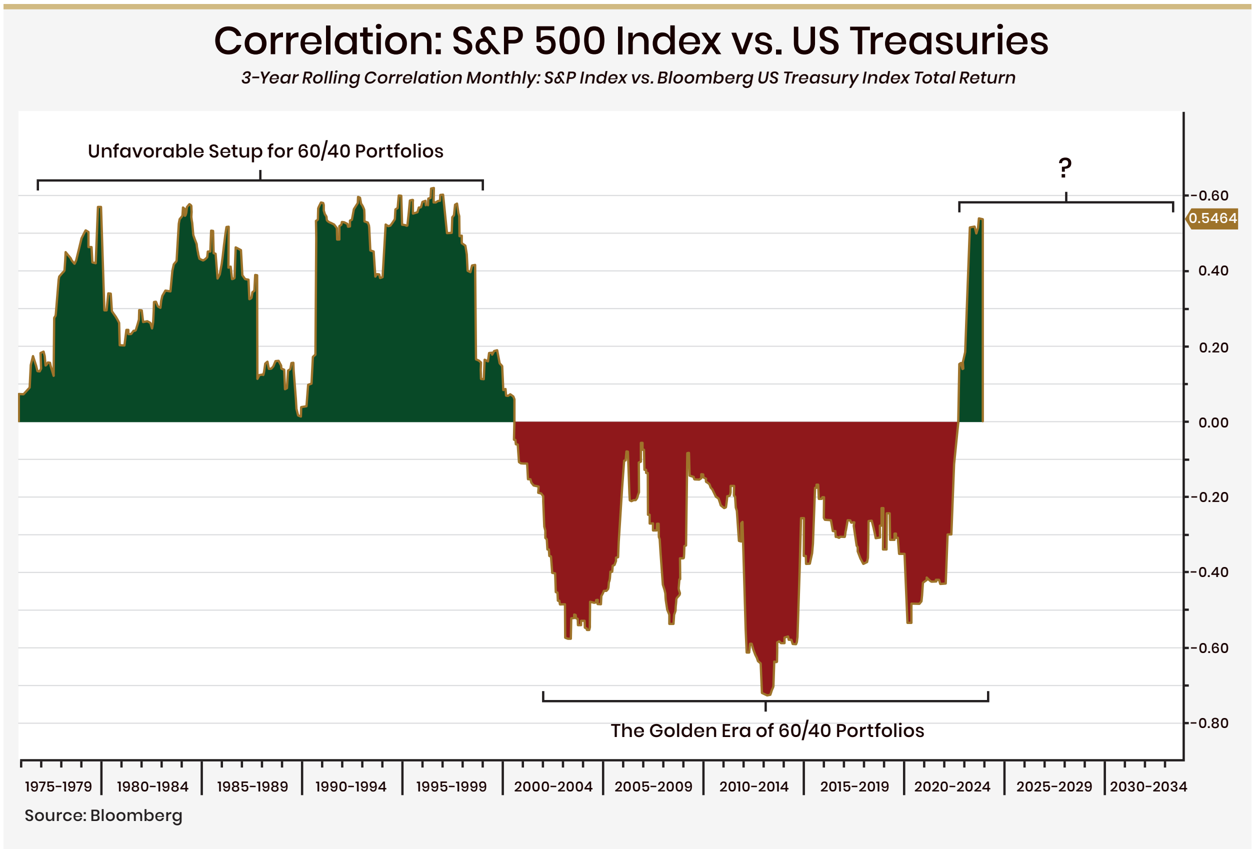
Historically, a lack of breadth indicates a less than healthy market. As breadth narrows, market concentration peaks. And, historically, market concentration has tended to foreshadow equity drawdowns. We are not suggesting an imminent market correction though we would feel much better about equities were breadth to broaden.



SPX Index (S&P 500 INDEX) SPX vs. Mag 7 vs. SPW Daily 30DEC2022-26SEP2023 Copyright© 2023 Bloomberg Finance L.P. 27-Sep-2023 08:40:19
Source: Bloomberg

Regime Shift as it Relates to Portfolios – The Continuation of a Multi Year Trend

In our Q1 2022 client letter, we wrote the italicized paragraphs below: *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 regards 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 last 18 months have solidified our view from early last year. Investors can no longer rely on bonds to serve as a ballast for stocks. In fact, traditional 60/40 investors who have relied on this now outdated framework have experienced deep pain these last 18 months. We continue to believe that the need for broad diversification, especially into asset classes that move inversely to stocks and bonds, has never been greater. And we remain committed to weathering this storm with increased exposure to natural resources, short duration US Treasuries and managed futures funds. As we have noted in earlier letters, managed future funds have historically generated balanced portfolio returns while exhibiting low correlation with the broader stock and bond markets.

Seeing All of You

The last few years have been very tumultuous for all asset classes. Since the Covid crash, the subsequent path of interest rates and inflation has trended higher, reversing decades of decline. The impact on the most conservative of portfolios has been uncharacteristically punitive.

We maintain our cautious positioning of the last 18 months. Were signals to start to improve, we have plenty of cash to take advantage of it. For now, we are sitting tight.

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

Clara Basile   Bill Oberman   Ross Revenaugh

The opinions expressed are those of Avalon Capital Management as of October 16, 2023 and are subject to change. There is no guarantee that the forecasts made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. Investment involves risk of loss, especially in volatile markets. Past performance is no guarantee of future results. Investing in foreign markets involves currency and political risks. Data contained here is obtained from what are considered reliable resources; however, its accuracy, completeness or reliability cannot be guaranteed. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Investment strategies such as diversification do not assure a profit and do not protect against losses in a declining market. Other than the research noted by footnotes, the research underlying this piece represents Avalon Capital Management's proprietary research activities. Most indices we mention are well known and full descriptions can be found at Wikipedia.

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