Avalon
CAPITAL MANAGEMENT

Invest Smarter.
Live Better.

Off Balance

Avalon portfolio returns were positive in the second quarter as gains in US and international growth stocks, gold, and stocks of gold mining companies more than offset losses in real estate, US value stocks, small cap stocks, and long duration US Treasuries. These results outpaced the nearly flat performance of diversified benchmarks as the Morningstar Balanced portfolios from conservative to aggressive returned between 0.3% and 0.4%.

In a tale of market "haves and have-nots," conventional approaches to diversification and balance have been challenged by a narrowing concentration into the asset classes that are performing well. The pockets of the investment world that are benefiting from AI advanced strongly in the face of geopolitical adversity, inflation concerns, and a potentially slowing economy. While these AI beneficiaries include the largest technology companies such as Nvidia, Microsoft and Alphabet, they also include many parts of the energy and utilities complex which stand to gain from AI's increased energy demands.

Asset Class Returns for Q2 2024

	Negative Total Return		Positive Total Return
	Average Return All Members	1.45%	
1)	INVESCO QQQ TRUST SERIES 1	8.08%	
2)	VANECK GOLD MINERS ETF	7.31%	
3)	SPDR GOLD SHARES	4.52%	
4)	ISHARES MSCI EMERGING MARKETS ETF	4.39%	
5)	SPDR S&P 500 ETF TRUST	4.38%	
6)	ISHARES CORE U.S. AGGREGATE	0.03%	
7)	ISHARES MSCI EAFE ETF	-0.18%	
8)	ISHARES NORTH AMERICAN NATURAL RES ETF	-1.59%	
9)	ISHARES US REAL ESTATE ETF	-1.78%	
10)	ISHARES 20+ YEAR TREASURY BOND ETF	-2.01%	
11)	SPDR S&P DIVIDEND ETF	-2.45%	
12)	ISHARES RUSSELL 2000 ETF	-3.25%	

Source: Bloomberg

Avalon portfolios have been well positioned to benefit from these trends this year. We have maintained our bias to stocks over bonds, US over international stocks, growth over value, and large cap over small cap. We have also maintained an overweight allocation to hard assets and, until very recently, kept the duration of our fixed income exposure to a minimum.
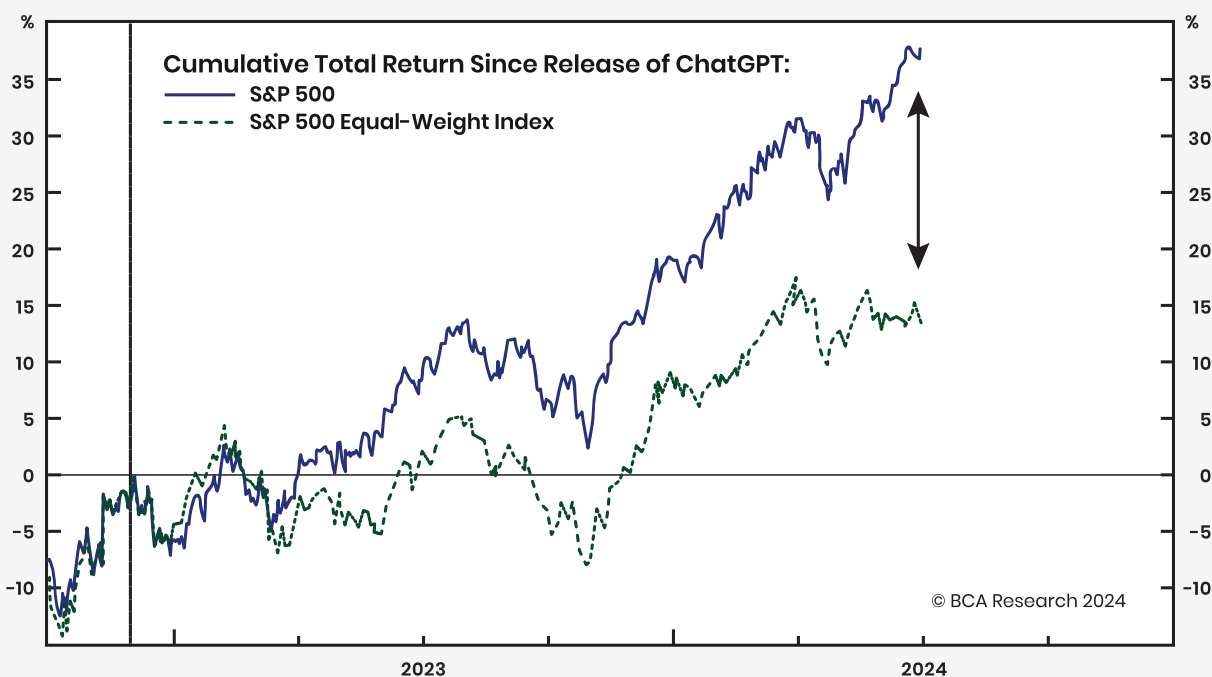
The Magnificent 7 (or Bust)

With the S&P 500 making record highs and up over 14% this year, it is easy to lose sight of the imbalances in the overall market. As a comparison, the Dow Jones Industrial Average, while also rising, is up 3.7% YTD, reflecting the performance of the average stock. Even more striking is that the equal weighted S&P 500 finished **down** over 2.3% for the quarter vs a 4.3% gain when weighted by market capitalization.

The US equity market has rarely been more concentrated and is reminiscent of the tech bubble of the late 1990s. The "Magnificent Seven," which now make up about 30% of the S&P and 40% of the Nasdaq, have driven most of the gains in both indices. The lack of breadth is concerning, as this type of narrow market has historically corresponded with market tops. And while mean reversion is still a reasonable investing law, there are some fundamental reasons to believe that AI has allowed the largest and most dominant technology companies to increase their competitive positions.

The "Generative AI Effect" has Accounted For Over Half of US Equity Market Returns Over The Past 18 Months

Cumulative Total Return Since Release of ChatGPT:
— S&P 500
- - - S&P 500 Equal-Weight Index

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Note: Vertical line denotes November 30, 2022, the release date of ChatGPT by OpenAI.

The Commodity Bull Case

Since 2022, the natural resource category (hard assets) has been discussed as a timely alternative to a traditional mix of stocks and bonds. We continue to see secular tailwinds for hard assets and have maintained an overweight allocation to the asset class. Commodities have historically served as a hedge against inflation and geopolitical risk. The heightened risks of both have supported some of the gains in commodities year to date. Additionally, there are some economic mega trends that are driving the attractiveness of commodities such as copper and uranium. Outside of AI's energy intensity, the rise of Electronic Vehicles (EVs) and a reshoring trend are causing significant surges in demand for electricity. And, due to a variety of factors, the supply of many of these commodities has not kept pace with expected demand.

Similarly, our analysis finds utility companies, especially those exposed to nuclear energy, as attractive given these same economic trends. We note that the defensive nature of utility equities and the income they provide offers some diversification from the growth oriented large cap technology stocks.

Bonds

Our analysis indicates that US Treasury bonds are becoming increasingly attractive as a tactical investment. Even though US Treasury bonds are in a secular bear market, there are several factors indicating that interest rates may be peaking, making bonds attractive and indicating the early stages of a rally. Valuation-wise, our regression analysis estimates that US Treasury bonds have the highest reward-to-risk ratio of any asset class in our investment universe. From a macroeconomics perspective, weakening economic data, slowing consumption, and cooling inflation appear to be setting the stage for at least a cyclical bond rally.
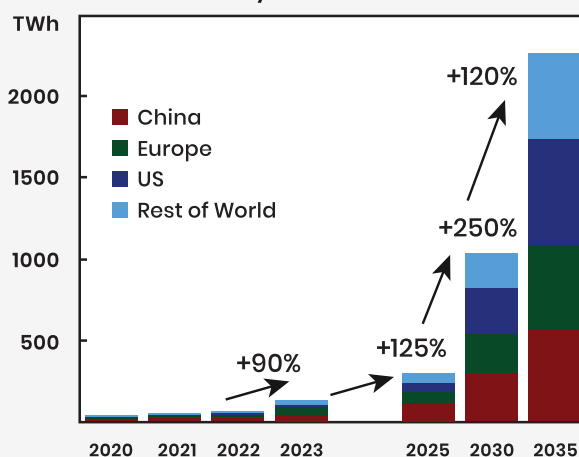
Historical data suggests fixed income typically outperforms cash after Federal Reserve hiking cycles peak. Estimates of a peak have been pushed out for most of 2024, but with unemployment now troughing and inflation receding, the Fed could begin cutting rates as soon as September. The odds now favor lower vs higher rates over at least the next 12 months. This would support higher total returns for bonds.

Large Trends are Driving Energy Demand

Watts Up?

Global Datacenter Share of Global Electricity Consumption*
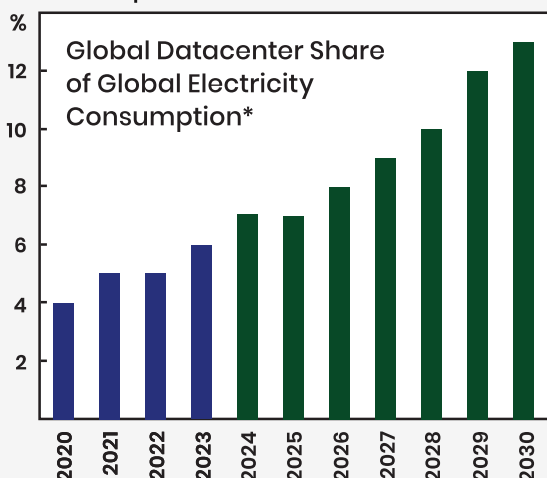
Total Electricity Demand from EVs**

Legend: China, Europe, US, Rest of World

+120%
+250%
+125%
+90%

* Source: Huawei Technologies, on Global Electricity Usage of Communication Technology: Trends to 2023.
** Includes Passenger Cars, Buses, Light Commercial Vehicles, and Heavy-Duty Trucks. Source: Global EV Data Explorer, IEA.

The Presidential Election

The only thing greater than the combined age of the likely Democrat and Republican Presidential candidates are the number of twists and turns leading up to November 6. We would note that the economic impact of a Democratic victory is likely to benefit climate-related themes, clean energy providers, US industrial manufacturing, and the health care ecosystem. A Republican victory is likely to benefit more traditional energy providers. And while the federal debt burden (an issue where both parties bear responsibility) is inherently inflationary, it is likely that a Republican administration would lead to higher inflation based on some combination of trade policy (tariffs) and less than historical central bank independence. Gold could benefit from either outcome.

Conclusion

Significant imbalances have skewed portfolio results over the last several quarters.

Overweighting global growth stocks, natural resource stocks and cash have been accretive to returns compared to a traditional stock/bond framework. We are moving to neutral stocks over bonds and overweighting bonds over cash to mitigate equity risk and benefit from a likely economic slowdown. We expect the impact of the AI renaissance on capital expenditure spending and economic productivity to continue to be an opportunity for growth for the US economy even if volatility could be high.

A strong first half of the year in the stock market historically boded well for the rest of the year. Whether that will be the case in 2024 is up for debate. The global economy has shown signs of resilience despite earlier concerns about potential recession, but recent trends are softening, and the consumer seems tapped out. There is uncertainty around the US presidential election and the future path of interest rate cuts. We continue to be cautiously optimistic but also have prepared for a potential softening in the market by allocating the portfolios toward fixed income and defensively positioned equities such as healthcare, utilities, hedges and hard assets.

Finally, with the recent rise in interest rates and increased allocations to fixed income, client portfolios may be generating more taxable income than was typical in the past. If you are seeing higher tax bills and have any questions, or want to see income projections during the year, please do not hesitate to contact us.

Thank you for your ongoing support. Enjoy the summer!

Clara Basile   Ross Revenaugh

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