Eye of the Storm

Geopolitical tensions and U.S. government policy decisions had a larger than normal impact on markets in the second quarter of 2025. Volatility was evident in both directions, as markets responded to the ever-changing news cycle with sell-offs, dip buying, rotation to international assets, safe-haven flows into gold and short duration bonds and eventually, back to long-term growth. The lack of a clear strategic direction from the administration and their constant change of direction rattled confidence in the near-term business outlook.

And yet, in the face of two major wars and unprecedented trade tensions, corporate earnings have continued to pull markets higher in response to AI spending, the implied increased fiscal spending in the new tax bill and the prospect for lower interest rates. Despite unrelenting pressure from Trump to lower rates "now", the Fed has thus far opted to keep interest rates unchanged as the Middle East crisis and tariff uncertainties cloud the American fiscal horizon. Policymakers have indicated the likelihood of future rate cuts as they assess signs of a cooling economy, the risk of higher inflation from U.S. import tariffs and a falling dollar.

Avalon client portfolios were strong in the second quarter. We continue to navigate this challenging environment with a barbell approach: maintaining exposure to fast growing areas of the equity markets (AI winners such as semiconductors, software and mega-cap hyperscalers) while complementing that exposure with assets designed to protect for left side (negative) tail risks such as international currencies, gold, bitcoin and short duration bonds.

info@avaloncapital.com | +1 650.306.1500 | 495 Seaport Court, Ste 106, Redwood City, CA 94063

Asset Class Returns for Q2 2025

U.S. Stocks

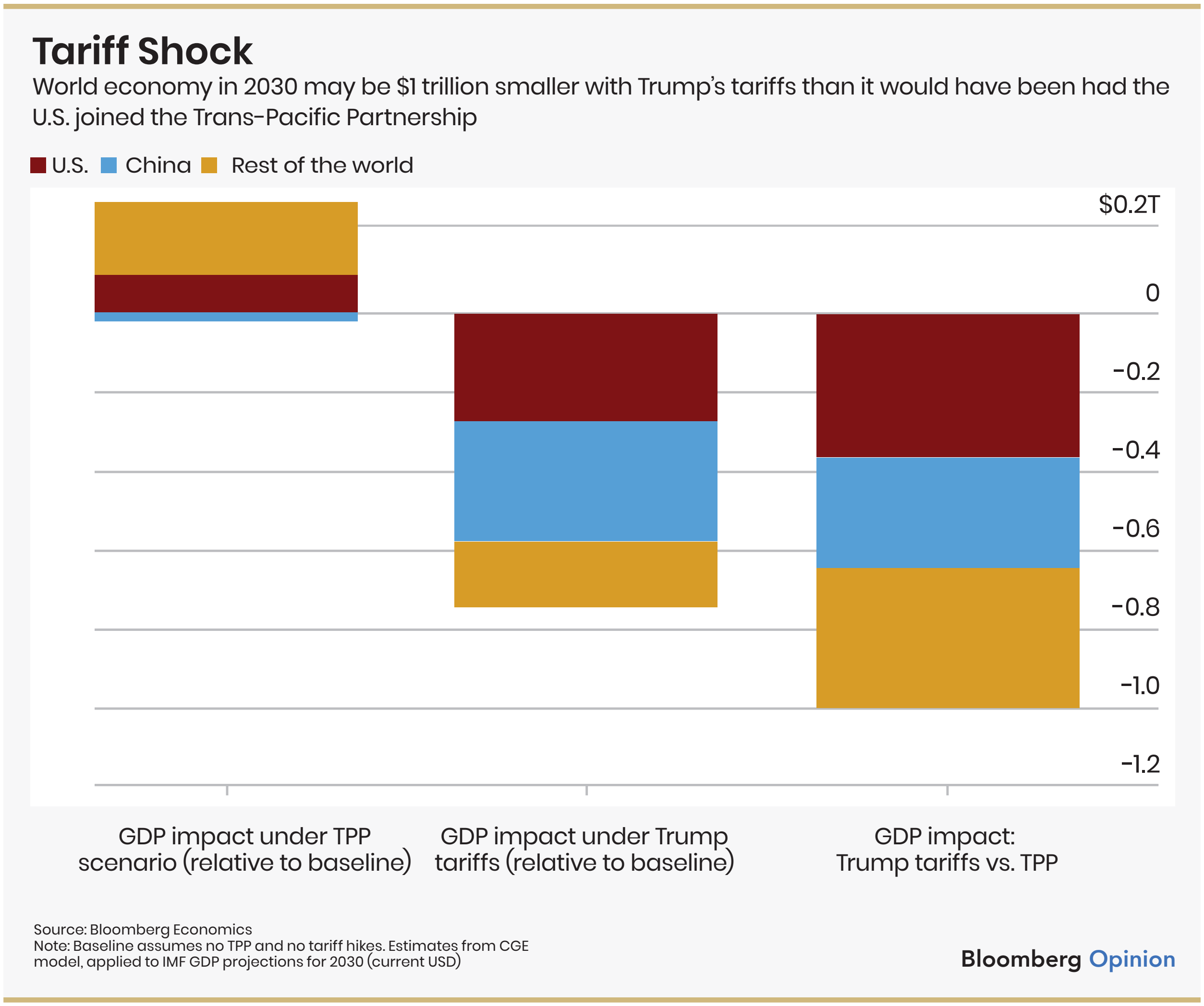
The second quarter was a roller coaster of volatility. Trump's retaliatory "Liberation Day" tariffs on April 2 triggered a sharp global equity sell-off. At one point in early April, the NASDAQ and the Russell 2000 (small cap stocks) were down over 20% for the year. With markets melting down and other countries announcing their own retaliatory tariffs, the Trump administration announced a week later that it would temporarily pause the tariff increases. This back and forth gave rise to the term "TACO" trade, based on the assumption that "Trump Always Chickens Out." Between "TACO" and the continued juggernaut that is AI, the U.S. equity markets rebounded into the quarter end, reversing a year-to-date loss to post a 6% gain. The S&P rallied 11% in June alone and currently sits at an all-time high. The rally was driven largely by technology, industrials, financials, growth and high beta stocks. We note that three AI-focused mega cap stocks (Nvidia, Microsoft and Meta) drove 50% of the S&P's gain this quarter, while the average stock in the index rallied closer to 5%. High-quality, low volatility names were barely changed, having held up well during the tariff-induced crash.

Stock Market Performance In 2025

Index	At April low	At June 30 close
Nasdaq composite	-23%	5.5%
S&P 500	-18%	5.5%
Dow Jones	-14%	3.6%
Russell 2000	-22%	-2.5%

Source: Bloomberg

Second quarter earnings reports and a newly extended August 1 deadline on the tariff pause will be an early second-half test for the sustainability of this rally. As we go to press, tariff levels are anticipated to average around 15%, with even higher levels contemplated for some industry sectors and specific countries. While this is far below the initial shocking levels in April, it is still among the highest levels since the 20% levels introduced by Smoot-Hawley in the 1930s. It will likely result in slowing growth globally. A new estimate by Bloomberg Economics says that if the new tariffs remain, the global economy will be $1 trillion smaller by 2030 than would have been the case had the U.S. joined the Trans-Pacific Partnership.

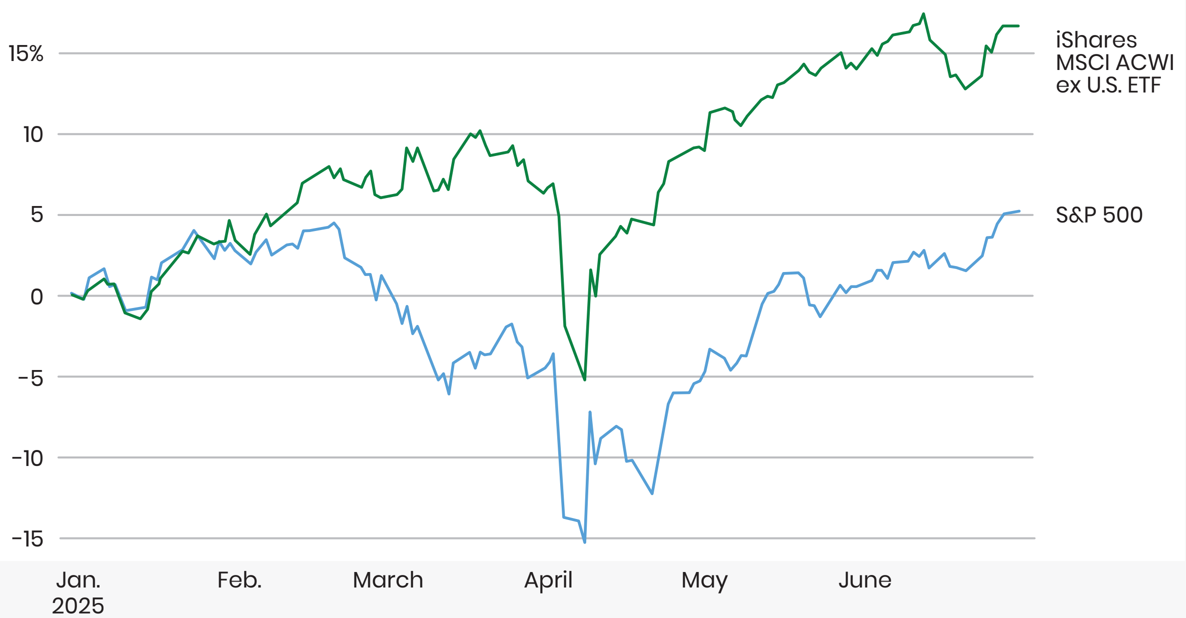


Commodities

As we discussed in our first quarter piece, *Systemic Shock*, we continue to support investments in gold and gold mining companies. Diversifying out of the U.S. dollar played an important role among central bank buyers who continue to accumulate gold for their own country's reserves. Gold mining stocks outperformed gold bullion again this quarter with the broad-based gold mining index finishing up double digits versus bullion, which gained almost 6%. Another important fundamental development for gold is that the Basel III banking regulations will now classify gold as a Tier 1 High-Quality Liquid Asset (HQLA) starting July 1, 2025. This means that U.S. banks can count physical gold at 100% of its market value toward their core capital reserves along with bonds and cash, instead of the 50% discount they previously received as a Tier 3 asset. This change is a significant shift in how regulators view gold, and some say it's a long-overdue recognition that gold is money. It may also explain the safe-haven role gold has played over more traditional assets like bonds and cash.

U.S. Equities Trailing International in 2025

An ETF tracking noon U.S. stocks is outperforming the S&P 500 so far this year



S&P 500 versus ACWX ETF in 2025

Source: Reuters

International Markets

International stocks continued to outperform U.S. equities this quarter, aided by both multiple expansion and currency appreciation. This outperformance is aligned with the larger rotation out of American investments into anything international. We note that more than $100 billion has flowed into European equity funds in 2025, triple the amount from the same period in 2024. In June, NATO leaders agreed to a new defense spending target of 5% of gross domestic product (GDP) by 2035. This target is a significant increase from the 2% minimum that NATO leaders agreed to in 2023 and, while it is expected to require a large mobilization of financial resources, this could spur innovation in Europe as well as job creation in the industrial sector.

U.S. Dollar

The U.S. dollar was a clear loser in the markets, dropping 7% this quarter as measured by the US Dollar Index (DXY). The index, which measures the currency's strength against a basket of six other currencies to include the pound, euro and yen, has slumped more than 10% this year, marking its worst first-half performance since the early 1970s. The dollar's decades-long rally has been driven mainly by strong economic fundamentals. Those fundamentals seem to be deteriorating, largely due to a haphazard American tariff policy, concern about the budget deficit and rising expectations that the Fed will cut rates aggressively to support the U.S. economy. With the administration seemingly trying to engineer a weaker dollar (which would be a tailwind for American exporters) by adding to the budget deficit, this trade seems likely to extend.

As the dollar fizzled, non-dollar alternatives rallied. The Euro rallied 5% versus the dollar this quarter, and having gained 14% for the year, is on course for its best annual performance against the dollar since 2017. We note that the Euro's appreciation has also benefited the dollar return of Euro-denominated stocks. And while international currencies outperformed, alternative currencies did even better. As we highlighted earlier, gold bullion rose almost 6% for the quarter, while Bitcoin finished the quarter up 30% as inflows into Bitcoin ETFs surged. Bitcoin has, from its beginning, represented a store of value with a fixed circulation. The investment case for this digital gold is growing given the administration's weak dollar and pro cryptocurrency bias.

Our shift earlier this year into overweighting these asset classes and moving away from U.S. dollar exposure has benefited client portfolios, which are now at all-time highs.

Fixed Income

Long duration U.S. Treasuries continued their anemic performance, with TLT (the 20 Year U.S. Treasury Bond ETF) finishing down 2% for the quarter. Performance seemed less related to economic events (though the U.S. did avoid a self-inflicted recession this quarter) and more a function of investors diversifying away from all dollar-based investments. The importance of U.S. long bonds cannot be overstated given their preeminence across so many parts of the financial world. Most mortgages, many credit instruments and even, indirectly, stocks are priced based on U.S. Treasury rates. A continued increase in rates would generally not be good for these leveraged assets. It would also not be good for our growing deficit. What are generally seen as high current rates have forced both this and the last administration to borrow more at the shorter end of the U.S. Treasury curve. Whether this administration has the opportunity to borrow at scale at the long end of the Treasury curve (and relieve some pressure on our growing fiscal issue) bears watching.

International bonds continue to present more opportunities versus U.S. bonds, mainly due to currency factors. We continue to maintain short-term U.S. Treasury exposure and also international fixed income exposure.

Sentiment

As we discussed in the first quarter, 2025 has been marked by widespread uncertainty and economic pessimism as reflected in most measures of Consumer Sentiment. Despite a slight rebound in June, U.S. consumer sentiment remains near record lows, driven by price pressures, economic unease and income worries. The Consumer Confidence Index continued to decline, citing tariffs and inflation as top concerns. As these "soft indicators" remain low, hard economic data like jobs and inflation are mostly holding up, and the stock market has rallied back from April's selloffs. Given the typically predictive nature of these sentiment drops, questions remain as to whether the negative soft data points will flow through to hard data via declines in retail sales, employment and growth over the coming months.

Conclusion

Between Washington's tariff indecision and the potential China decoupling, two major wars, worsening fiscal issues globally and renewed questions over U.S. central bank independence, the margin for error in risk assets at this time seems incredibly small. We continue to manage this unpredictable environment with caution and discipline. This approach allowed us to navigate the April downturn while adding equity risk back to portfolios in a slow and careful manner. As we enter the third quarter, we will continue to monitor these trends, hedge against fiscal and geopolitical risk and await opportunities in our preferred long-term themes.

Enjoy the summer!

Clara Basile   Ross Revenaugh

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