Avalon
CAPITAL MANAGEMENT

Q2 2026 Client Letter

Avalon portfolios were positive in the second quarter as investments in U.S. equities, international equities, and real estate more than offset weakness in precious metals and energy holdings. The two themes that shaped markets during the first quarter continued to dominate investor attention. From a business perspective, the artificial intelligence (AI) race is driving unprecedented investment in compute and power infrastructure, with implications extending well beyond technology to labor markets, national security, and the broader global economy. Geopolitically, uncertainty surrounding the Strait of Hormuz also remained a key market consideration. Although oil prices retreated sharply from their mid-quarter highs, a lasting resolution between the United States and Iran (and the resulting outlook for global oil supply and prices) has yet to emerge. While America's abundant energy resources helped cushion the domestic economy from the full effects of an oil shock, the U.S. military action nevertheless contributed to an almost 10% decline in the S&P 500. Although the immediate risk of supply disruption has eased, the broader geopolitical environment remains uncertain.

We remain invested in AI infrastructure given our belief that artificial intelligence has the potential to reshape large portions of the global economy and that we are still in the early stages of a multi-year investment cycle. That said, we have become more cautious on semiconductors in the near term. Following extraordinary gains across the industry (particularly among companies exposed to AI memory and compute) semiconductors now account for nearly 20% of the S&P 500, their highest weighting on record. More importantly, the market is now pricing these historically cyclical businesses as if they were secular growers, valuing them at levels that assume smaller swings in earnings and steadier growth than the industry has ever demonstrated. While many of these companies are likely to be long-term winners, stocks priced for perfection are vulnerable to any disappointment. In our view, the most significant risk is the source of the demand itself: the semiconductor trade, along with related beneficiaries such as power generation, ultimately depends on a small number of hyperscalers continuing to spend at this extraordinary pace.

The possibility of a pause in AI spending is a risk worth considering given the sheer scale of investment required to capture the potential rewards. Those hyperscalers (Alphabet, Amazon, Meta, Microsoft, and Oracle) have generated some of the strongest and most consistent free cash flows in corporate history over the past 15 years. They are now approaching a point where nearly all of that cash flow is expected to be reinvested, with annual capital expenditures projected to approach $1 trillion. While history has repeatedly punished investors who bet against these businesses, the scale of today's AI investment is unprecedented and still unproven. As they redirect that cash toward AI infrastructure, they are entering uncharted territory where the long-term returns on this level of investment remain uncertain.

Avalon
CAPITAL MANAGEMENT

To sustain market confidence, these companies will need to demonstrate a clear attachment between their AI spending and revenue growth. Next quarter's earnings season will provide clues as to whether the investment is translating into monetizable demand rather than capacity built on faith. And at some point, the market will expect them to do more than reinvest. They will need to resume delivering the free cash flow growth that made them such exceptional businesses in the first place. Until that link between spend, revenue, and cash flow is established, the risk of a pause (whether imposed by shareholders or by the companies themselves) will remain a live consideration.

Gold and other precious metals detracted from performance during the quarter, though our long-term conviction remains unchanged. Gold's decline during the quarter reflected higher interest rates and shifting expectations for Federal Reserve policy rather than any deterioration in its long-term outlook. It is also important to keep recent volatility in perspective; despite declining 14% during the quarter, gold remains up more than 70% over the past two years. It is worth remembering the context: gold was a prominent contributor to our returns in 2025 and again in the early part of this year and, following its significant appreciation, we began to reduce our exposure late in the first quarter. Persistent fiscal deficits, continued Treasury issuance, and ongoing central bank diversification away from the U.S. dollar continue to provide a favorable backdrop for both gold and gold mining companies. In our view, the fundamental drivers remain firmly intact, and we continue to maintain meaningful allocations despite recent weakness.

As mentioned in our introductory note, we are excited to announce that we have officially moved into our new offices in Menlo Park effective July 17. We are settling into our new space and look forward to welcoming many of you there soon.

Thank you for your continued trust and confidence in us.

Clara Basile   Ross Revenaugh

VISIT OUR WEBSITE

525 Middlefield Road, Suite 160, Menlo Park, CA 94025
Tel: 650.306.1500 • Website: www.avaloncapital.com