NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

BUILT FOR FLEXIBILITY AND A GOOD DEFENSE

PORTFOLIO PERFORMANCE

We are very pleased by the strong recovery in our holdings from the levels in March. For the quarterly period ended 6/30/2020 (Q2, 2020), Avalon client portfolios were positive as gains from holdings in US large cap technology stocks, gold stocks and other risk assets more than offset modest losses from equity hedges. For the first half of the year, client portfolios are at or near their all-time high valuations despite most major equity indices showing losses.

With the Federal Reserve helping to create a March 23 bottom in US risk assets, global stock markets embarked on a steady upward climb for most of the second quarter. All this against the backdrop of historically poor economic conditions. While economic uncertainty this quarter has never been greater, liquidity within markets can be a powerful force. As such, our models incrementally favored less defensive positioning given improving risk-reward ratios and improvements in investor sentiment from deeply pessimistic levels.

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As part of this re-positioning, we reduced our allocation to US Treasuries this quarter. While, during the first quarter, long-dated US Treasuries served as a ballast for client portfolios, yields on Treasuries dropped (as investors bid up the price) to where Treasuries became less attractive in our models. In March, the 30-year US Treasury fell below 1% (a historically low level). It currently offers a 1.4% yield. With the Federal Reserve committed to maintaining low interest rates into the future, our models do not indicate much risk to owning US Treasuries, but the return potential is also limited as the proximity to zero rates grows nearer.

We continue to favor large cap technology stock as well as gold in client portfolios. Large cap technology stocks and gold are some of the best performing asset classes this year and both continue to benefit from economic tailwinds. For large cap technology companies, the tailwinds include robust business models, the acceleration of secular digitization trends, as well as the current and expected low interest rate environment. For gold, the tailwinds include negative real interest rates, historic monetary easing from the Fed, and general economic and price level uncertainty.

THE JUGGERNAUT THAT IS LARGE CAP TECHNOLOGY

In many ways, the performance of large cap technology stocks has been the salve for an otherwise dismal year for US stock markets. While the Nasdaq has gained over 16% this year, broader market indices such as the NYSE Composite (down 15%) and the small cap focused Russell 2000 index (down over 12%) have lagged.

A different way to view this dichotomy is to look at the difference in performance between market capitalization weighted indices (which give more weighting to larger stocks) and equal weighted indices (which represent a value bias). The market capitalization weighted S&P 500 (where Microsoft, Apple, Amazon, Facebook, Google account for over 20% of the index value) is down 9% from its all-time high in February while the equal weighted index (where those same five stocks account for less than 2% of the index value) is down 13.6%.

While our momentum models currently find these technology companies attractive, there are some fundamental reasons for caution. One concern is based on government regulation risk. While these companies are nowhere close to violating current laws around US monopoly behavior (consumers are paying less for these services, not more), there is a drumbeat around the anti-competitiveness of these companies operating at such scale. Another risk is economic. As robust as are these business models, companies like Facebook and Google are still advertising dependent. While these platforms should take market share from traditional competitors, they are still susceptible to a larger reduction in total advertising spend as the coronavirus reduces aggregate consumer demand. The last and likely most important note of caution is based on high valuation – the market has begun to catch on to the power of these business models and their secular growth trends and is pricing in massive revenue growth. As companies with the loftiest valuations tend to be the most impacted in declining markets, we would be quick to alter our allocation were investor sentiment to change.

MARKET AND ECONOMIC BACKDROP

Economic uncertainty caused by the pandemic is running high. While the initial shock of being in a pandemic has subsided, the second and third order economic effects of a recession are starting to be felt. Within the US, an election year coupled with what is currently a binary approach to solving the pandemic (the federal government's almost sole reliance on the development of a vaccine as a silver bullet) is exacerbating this uncertainty.

In our Q1 2020 letter, we noted that falling case counts would help us become more comfortable with economic fundamentals, a long-term driver of corporate profits and the stock market. While there might be growing immunity to the ramifications of the virus, accelerating case counts are degrading our economic outlook. Rising case counts are driving consumers and corporations to make economic choices akin to wearing a mask and staying 6 feet away from our fellow citizens. For corporations, this includes curtailing quarterly earnings guidance, a build-up of cash balances, and budgetary cuts. For individuals, this means delaying discretionary purchases and record high savings rates.

The pandemic is also accelerating the trend towards de-globalization, a trend we noted in our Q4 2019 letter. In that letter, we noted the cultural and emotional factors driving de-globalization. As the pandemic has laid bare the fragility within our global supply chain, there is now even rationale at the corporate level for de-globalization based on the restructuring of supply chains.

While the actions above are prudent at the individual and corporate level, the aggregate effect of these economic actions implies lower growth and some uncertainty around current price levels.

LOOKING FORWARD

So how does one manage portfolios in the face of such uncertainty? By staying diversified and allocating to asset classes that have historically outperformed in the types of economic conditions we could envision. To borrow a sports analogy, this is a market built for a good defense. A defense designed to protect our client's purchasing power while having the flexibility to be opportunistically aggressive as conditions permit.

STAY THE COURSE

It has been nice to see many of you over the phone, videoconference, and in-person (6 feet away of course!). We recognize this lockdown has gone on much longer than any of us would care to see and yet the statistics with regards to the Bay Area COVID rates say we are collectively doing the right thing.

Keep up the good work! And please reach out if you have any questions about your accounts or this letter.

Regards,

Clara Dave Bill RNR

Clara Basile **David Rahn** **Bill Oberman** **Ross Revenaugh**

The opinions expressed are those of Avalon Capital Management as of July 13, 2020 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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