

NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

ENJOY IT WHILE YOU CAN

Investor euphoria is at new highs. There were no negative months for the S&P500 in 2017. Enjoy it while you can as the melt-up phase continues in the New Year. During the first 9 trading days of 2018, the S&P managed to exceed its 93-year average annual real price gain of 2.6%. Yes—net of inflation and before dividends, that's what stocks have tended to return over the course of an entire year. A historically-based quantitative study recently quoted on Twitter says that when the first five days of a new year are up +2% or more, the full year has been higher 15 out of 15 times, with an average +18.6% yearly return. We are not advocating that as a forecast, but it shows that when momentum is this powerful, returns are likely to continue. While we recognize the market is long overdue to see corrective price action we are not seeing evidence of it in current price activity or in our models. While we are on alert for noteworthy price indications to the contrary, it still remains a bull market until proven otherwise.

Currently we are fully invested in equities and net short bonds.

AVALON

CAPITAL

MANAGEMENT

Global growth is also entering the New Year on a roll. The global upswing in economic activity is strengthening, with growth projected by the IMF to rise to 3.7% in 2018 from 3.6% in 2017. Broad-based upward revisions in the euro area, Japan, emerging Asia, emerging Europe, and Russia more than offset slight downward revisions for the United States and the United Kingdom. For the United States, GDP growth will increase temporarily in 2018 due to the tax reform; it will end the year with growth between 2% to 2.5%. Household spending remains robust although slowing labor force growth will gradually constrain consumption going into 2019. Accelerating wage growth, due to a tightening labor market, could create strong inflationary pressures. New tax measures are likely to extend already high corporate profits by buttressing capital spending and business investment. **There will be no recession this year.**

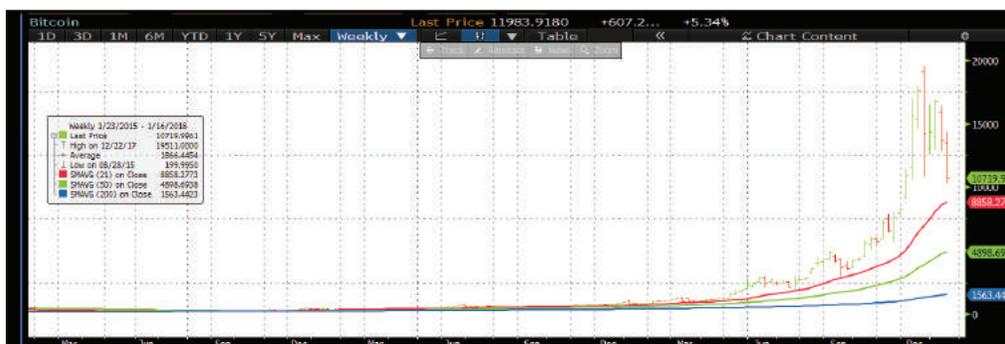
Wall of Worry



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BITCOIN GOES MAINSTREAM

2017 will forever be known as the year of Bitcoin — a mania that rivals anything in history. Because of the internet, it went viral on a worldwide basis at unprecedented speed. 70% of all trades take place in Asia and 40% of all trades take place in Japan. At its peak, on December 07, 2017, its market cap was higher than 98% of the companies in the S&P 500. Bitcoin can now be purchased thru Coinucopia ATMs throughout the Bay Area. It offers its services to anyone from existing bitcoin owners to people on the margin of society who do not have access to basic banking. The top 20 cryptocurrencies ended 2017 with a combined value of \$494 billion, a 2,891% increase from the 17.1 billion on January 1, 2017. There are now 1,100 different cryptocurrencies and more are being formed every day. Which will be the eventual winner is anybody's guess!



BITCOIN PRICES since 2015

In just five days after its December 07 high of \$20,000, it crashed to \$10,000. Since then it has rallied back to \$17,000 and is currently around \$11,000. It is being diluted by all of the new cryptocurrencies being formed -- coin owners now switch from platform to platform trying to catch the next hot trade. Ripple recently benefited from this switch, soaring 1,135% in one month. Companies are also trying to benefit from the mania, as they did during the .com boom. Eastman Kodak announced that they are looking at a block chain solution for their business and the stock rose 400% in one day. Easy money — why not give it a try!

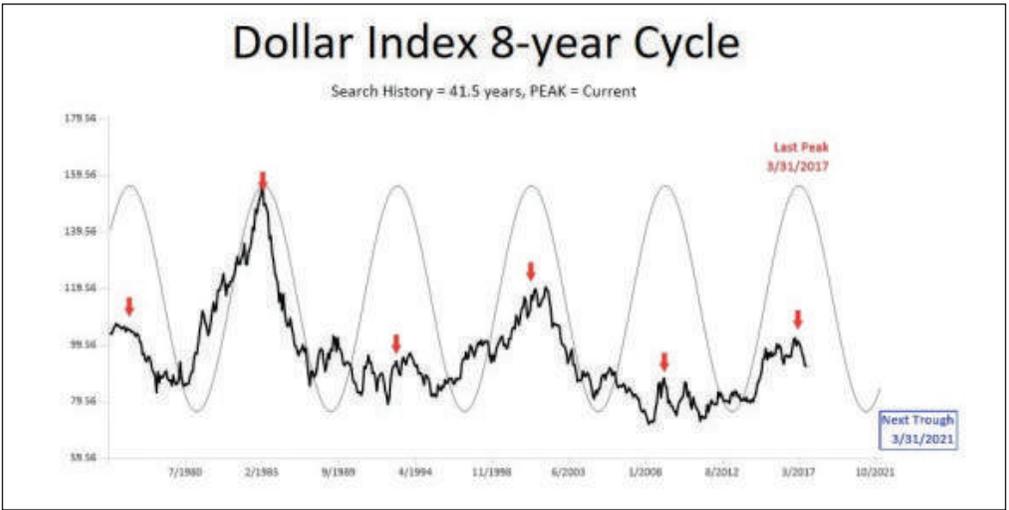
Investors tend to overestimate the impact of technology over the short term and underestimate its impact in the long term. We are skeptical about the short-term viability of Bitcoin for four reasons. First is increased competition, which we noted above. Second is government intervention. Regulators around the world are stepping up scrutiny of cryptocurrencies amid concerns over excessive speculation, money laundering and tax evasion. China has banned coin-mining companies and exchanges and South Korea is also considering banning cryptocurrencies. Third it fails the test of money: because of its volatility it is a poor store of value and lacks a stable unit of account. And its ownership is concentrated with about 1000 entities that own 40% of the market. Although we do not know what catalyst will cause it to crash, when it does, it could well be the sign that the current euphoria for financial assets may be coming to an end. It may be the canary in the coal mine; **it is for speculators only.**

TAX REFORM

Many of the tax changes from an economic viewpoint will be positive over the short term but will fade after a couple of years. Goldman Sachs estimates that because of the tax make over, real GDP will increase by 0.3% per year for a couple of years then fade rapidly. Over time, because of the \$1.5 trillion deficit built into the changeover, it may actually be negative for the economy in the long run. The biggest beneficiary is corporate America. Tax cuts should increase earnings 7% to 14% in 2018, less in 2019, and then fade away as well. So what is the stock market impact? Most of it has occurred in the last couple of months. Most notably, high effective-tax-rate sectors like consumers, industrials and financials rose strongly after passage of the bill. Ned Davis Research group estimates that the market has “priced in” roughly 70% to 80% of the tax cuts. That still leaves a little on the table toward 2018 gains, but much of it is now discounted. Tax reform for the individual has been widely disseminated by the media. For Californians it is still up in the air on whether the state conforms to the federal changes or passes legislation to try and counter those changes. **Chat with your tax advisor after they have had a chance to absorb all of the changes.**

U.S DOLLAR BEAR MARKET

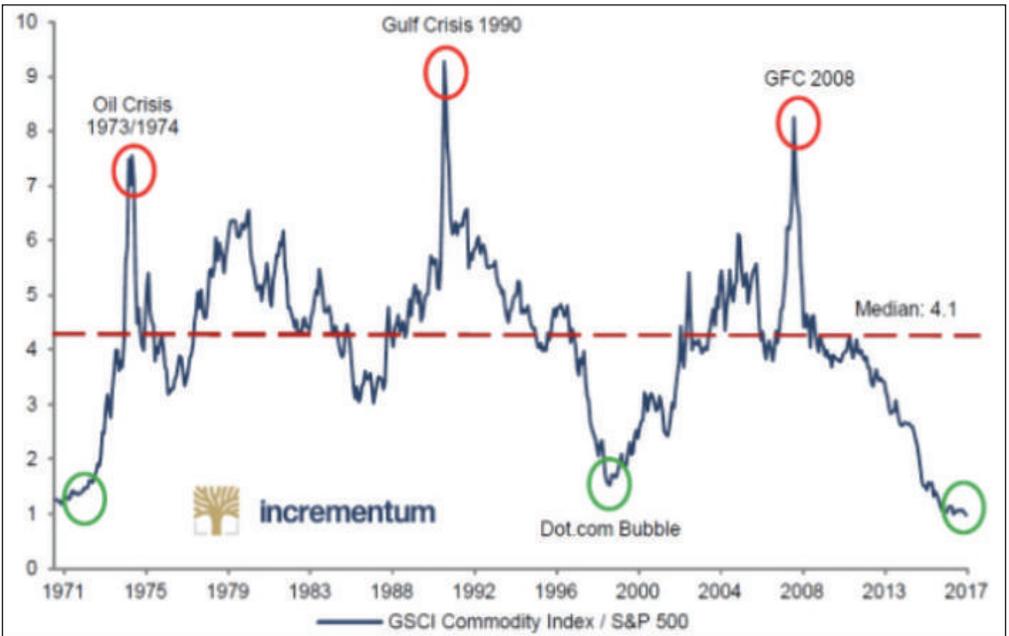
Large moves in the U.S. Dollar significantly impact asset classes, industries and individual stocks. The dollar is in a bear market and its effects are important to monitor. Observing the cycles in the dollar, the next important bottom is projected to be 2021.



The U.S. dollar is down 12.4% over the last year. It is close to breaking to a new low. **If it breaks down, it could decline another 10% to 12%.** What are the implications for a weak dollar? It exacerbates inflationary pressure, keeps upward pressure on interest rates and helps bolster commodity prices. A weak dollar favors international, natural resource and U.S. big cap stocks. It is not kind to bonds, bond surrogates like REITs and utilities or U.S. small-cap stocks. It supports energy, materials, industrials, technology stocks and health-related stocks.

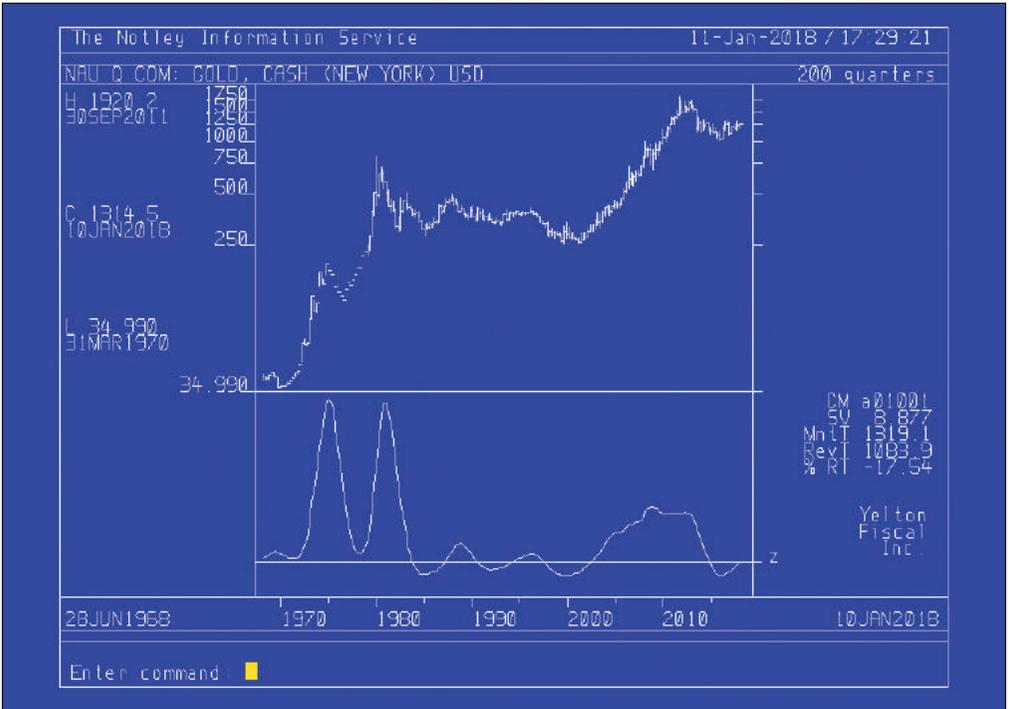
COMMODITIES, GOLD AND ENERGY

The value of commodities versus equities has reached an extreme, recently hitting a 50-year low.



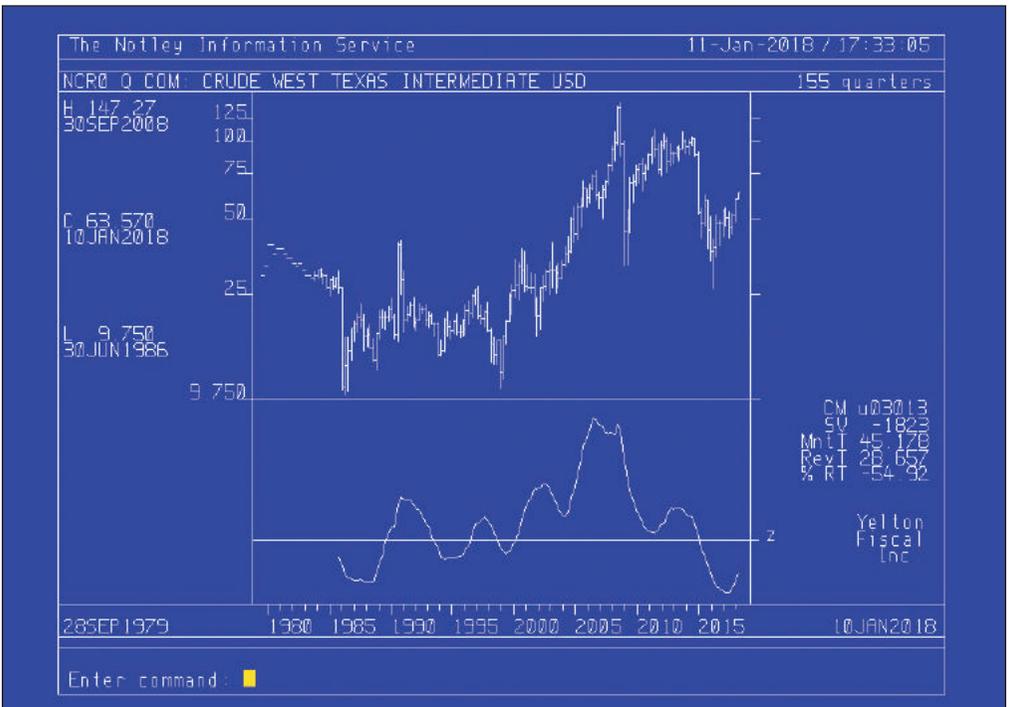
Source: [Incrementum AG](https://www.incrementum.com)

Natural resources have the best values among the major asset classes. While such a long term chart cannot be used as a short term timing tool, **we think 2018 could well be the year for commodities, natural resources, gold and energy.** From a sentiment viewpoint absolutely no one thinks that commodity inflation will come back again—investors have sold so it would just take some incremental buying to reverse the last ten year's trend.



Seven-Year Cycle in Gold Bullion

This is a chart of Gold Bullion since 1968. The bottom clip is our cycle smoothing. On average an up cycle will last at least four to five years. It only turned up last year, so we have another few years to the upside. Gold supply has been falling for the last five years. It should, at least, get back to its old high of \$1920. Gold tends to be counter to stocks and the U.S. Dollar. There are few bulls in gold at this time. After all, why would you buy gold when you can buy Bitcoin?



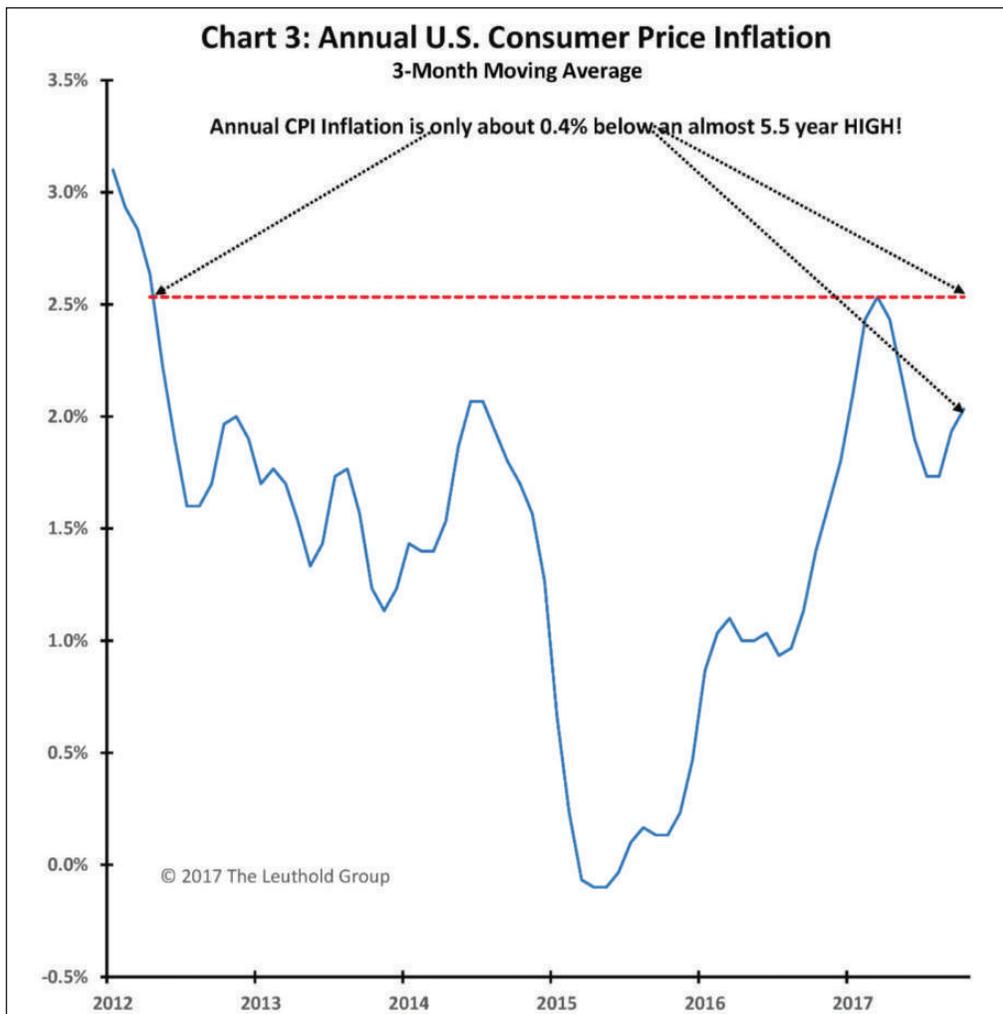
Seven-Year Cycle in Crude Oil

The same analysis works for oil and all other commodities. They are all in the same cycle position. Our analysis would say that \$80 (if not more) is a real possibility. Is there anyone on the planet that believes it could hit \$100?? WTI crude oil saw its fourth week of gains after Russia's oil minister said that global crude supply was not yet in balance, thereby assuaging market concern that OPEC's deal on production cuts is winding down.

Several factors suggest solid relative performance from energy stocks next year. First, we expect improved economic growth in the U.S., synchronized growth about the globe, and a weaker U.S. dollar to push crude oil prices above the three-year range they have been in since 2015. Second, for the first time in this recovery, energy stocks appear significantly undervalued compared to both stocks and the underlying commodity, which has been much stronger. Third, this sector is widely under-owned and represents a contrarian play with a positive potential catalyst (i.e., higher oil prices). Fourth, this sector has historically done well in the face of rising inflation concerns and higher yields, both of which we believe may characterize 2018. Finally, this sector offers the second highest dividend yield (3.39%) among the 11 sectors comprising the S&P 500 index. Indeed, it currently offers a higher yield than does the S&P 500 Dividend Aristocrats Index.

ACCELERATING INFLATION

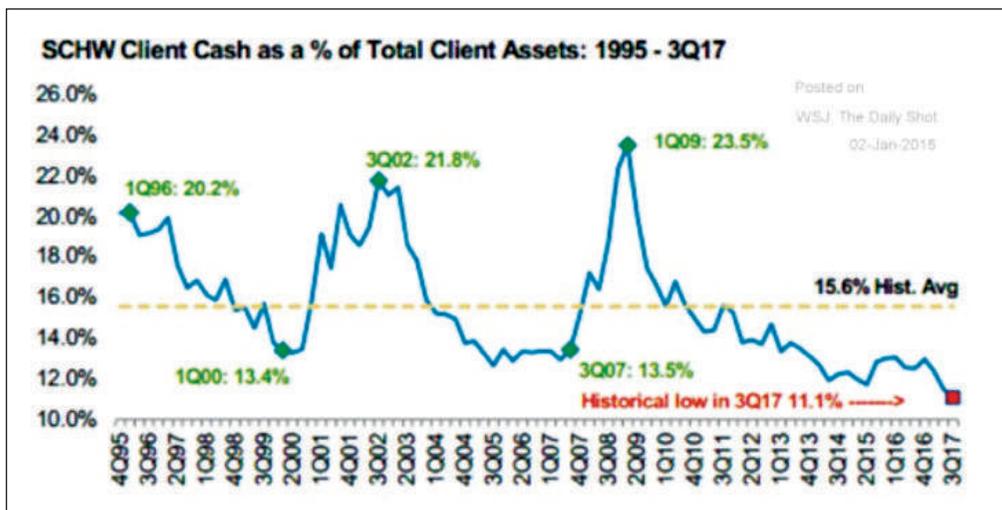
One of the stories for 2018 will be the acceleration of inflation.



Accelerating inflation is not expected by most economists and certainly not by the Fed. The current recovery has chronically reinforced the dual ideas that “inflation is dead” and yields are “lower for longer”. Because the dollar is weakening, commodities are surging -- wages are finally reacting to an economy that is back to full employment, **the recovery seems poised to eventually push the inflation rate above 3%**. Wage pressure is intensifying; overall wages will be increasing 3% plus for the U.S. as a whole but 5% plus for major urban areas. Annual U.S. Consumer Price Inflation is only about 0.4% below a 5.5 year high. Core prices jumped 0.3% in December, the most in 11 months. **On a six-month annualized basis, core consumer prices rose 2.2% in December, up from a 0.9% gain in July.**

INVESTMENTS

Global equity markets are in a melt-up phase. So far concerns have been swept aside and markets continue to advance. Our model agrees with the advancing theme. **We are fully invested in equities and net short bonds. All equity classes are overweight except for REITs where we have minimal or no exposure.**



The Schwab client base is “all in”, showing the lowest cash position since 1995. Other sentiment indicators show a complete lack of fear and similarly excessive bullishness. Sentiment is not good for market timing – it only demonstrates that the environment for investments is getting **over**/under confident and vulnerable to a **negative**/positive surprise. Indeed, we have a lot of data in support of short-term consolidation and/or pullback, but no indications confirming a major trend change; until it does, the data may be interesting, but remains non-actionable.

BONDS – We are net short U.S. Treasury bonds in most portfolios. A weak dollar is not good for bonds; surging commodities are not good for bonds; increasing inflation is not good for bonds. The chart green arrows indicate where to buy bonds and the red arrows indicate where to sell. The model is currently out of U.S. Treasury bonds, indicating that rates are likely to rise and prices to fall.



Avalon Capital Management US Treasury Bond Timing Model

REITs – All interest-sensitive stocks have been relatively weak the last couple of months. This has been particularly true for REITs. We have minimal or no exposure in the asset class. In more aggressive portfolios, we are short.

NATURAL RESOURCES – We overweight natural resources, favoring energy and gold.

INTERNATIONAL STOCKS – We are overweight international stocks, favoring emerging markets and Europe. A weak dollar enhances the return on your international portfolio. Emerging market earnings growth is 50% higher than U.S. growth while on a P/E basis it is 30% cheaper. The market is only 8% higher than it was at the top in 2007.

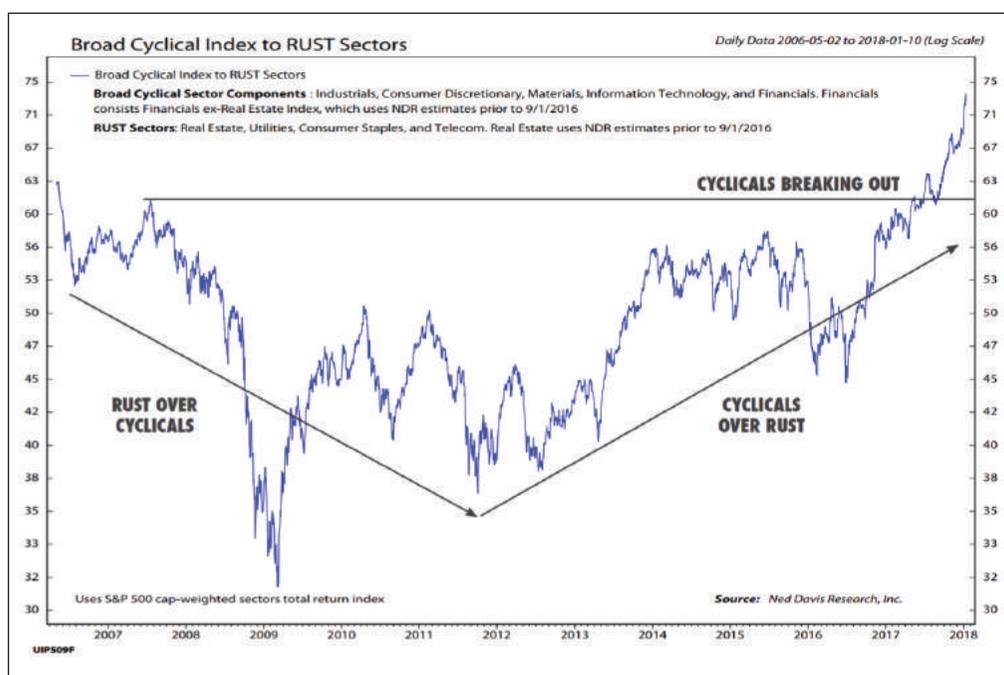


iShares Europe ETF represents the top 350 European stocks, incl. the U.K.

Europe is only 9% above its 2007 high and breaking out of a very long base. Earnings are likely to enjoy a second year of double-digit growth, after almost 5 years of zero growth. European companies tend to be more exposed to global growth than U.S. companies. Corporate balance sheets are improving and credit growth is quickening. This is helping fuel a rebound in business investment. European equities trade at a 35% discount to U.S. valuations.

U.S. STOCKS – We are overweight U.S. stocks. Valuations expanded over the last three months but the market keeps chugging along. Peaking earnings momentum and high valuations will eventually become a headwind for this market but improved capital spending and changes in tax policy will extend the advance for longer than normal.

Our strategy in the U.S. is pretty straightforward: we prefer big caps over small caps, growth stocks over value stocks and cyclic stocks over defensive stocks. Ned Davis Research Group did a study illustrating the power of cyclic stocks over defensive stocks. They compared a basket of broad cyclical sector components to a defensive basket. The broad cyclical components were Industrials, Consumer Discretionary, Materials, Information Technology and Financials. The RUST index consisted of Real Estate, Utilities, Consumer Staples and Telecom. The graph clearly shows that the Cyclicals are breaking out relative to the RUST index supporting our current portfolio allocation.



SUMMARY

Enjoy it while you can — global equity markets continue to roar into the New Year. Enjoy 2018 — the global economy will expand faster than it did last year. A recession is not yet on the horizon. Bitcoin has seen its peak and may be the canary in the coal mine for speculative fever if it crashes down to \$4,000 from its high of \$20,000. The U.S. dollar bear market has major implications for investors; namely, it favors international, natural resource and U.S. big cap stocks and disfavors bonds, REITs and U.S. small-cap stocks. We think 2018 could well be the year for commodities, natural resources, gold and energy. One of the stories for 2018 will be the acceleration of inflation. It will eventually take a bite out of the rally, but not yet.

We are fully invested in stocks and net short bonds. We prefer big caps over small caps, growth over value and cyclic stocks over defensive stocks.



Clara Basile David Rahn Bill Oberman

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