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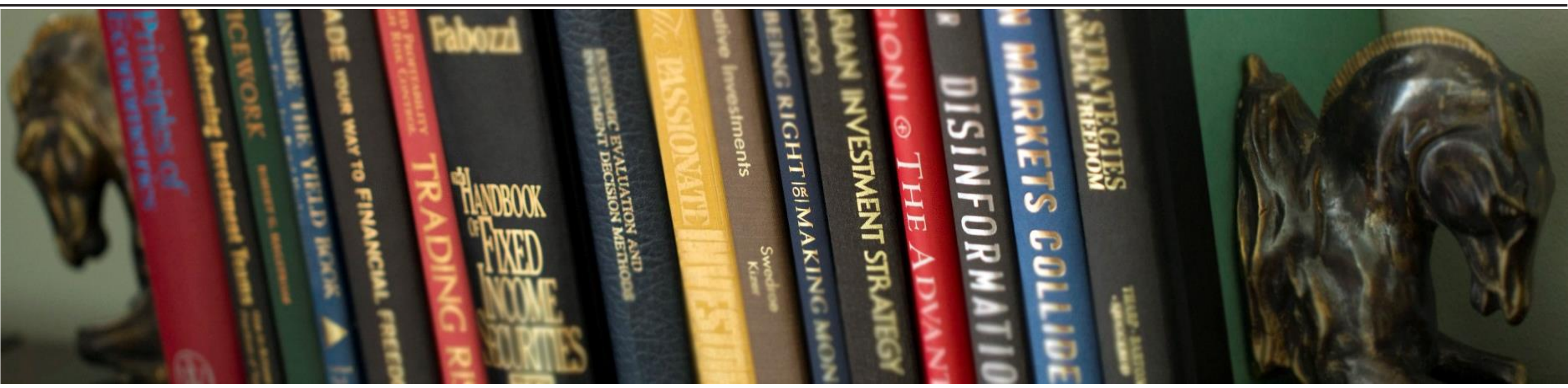
AVALON PERSPECTIVES

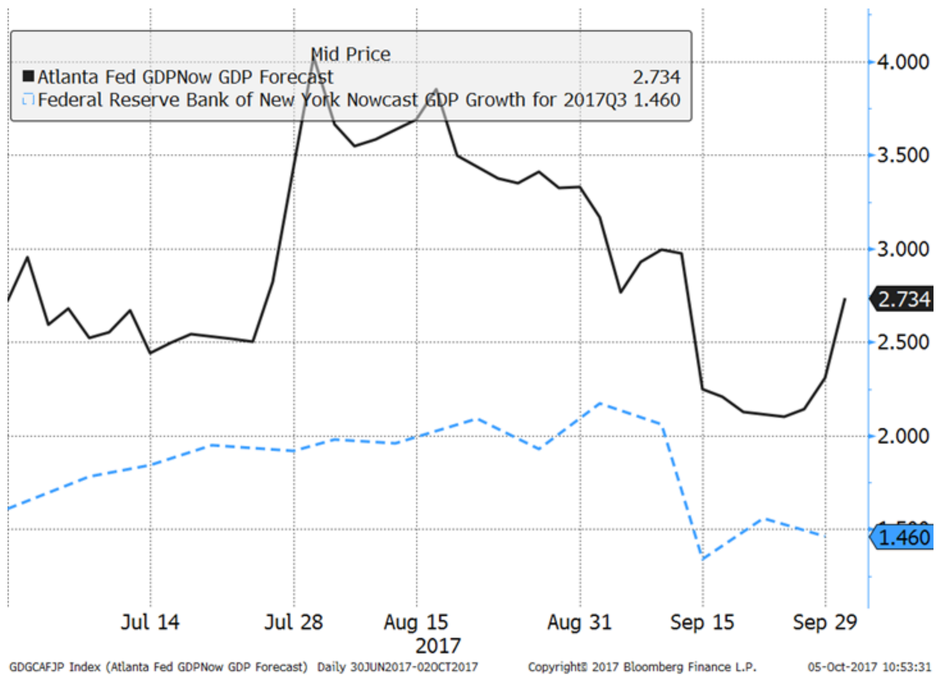
Quarterly Note

Q3 2017



Overview

Aside from two powerful hurricanes making landfall in rapid succession and tax reform rhetoric heating up, the third quarter saw numerous headlines that could affect markets in coming months. These include the changing of the guard at various posts of the U.S. Federal Reserve, the renegotiation of NAFTA, tensions on the Korean peninsula and the movement of central banks and other policy makers abroad. Markets performed well despite these potential pitfalls, even looking through the beginning of the Federal Reserve's reduction of its bond portfolio. The global economy is also healthy. Growth in Europe and Asia is stable or accelerating with only a few weak spots in crisis-stricken areas. The final quarter of 2017 is set to finish on a solid foundation of broad-based global growth, and there are few reasons to believe that the beginning of 2018 will not be a continuation of these fundamental trends.



Source:
Bloomberg, NY Fed, Atlanta Fed

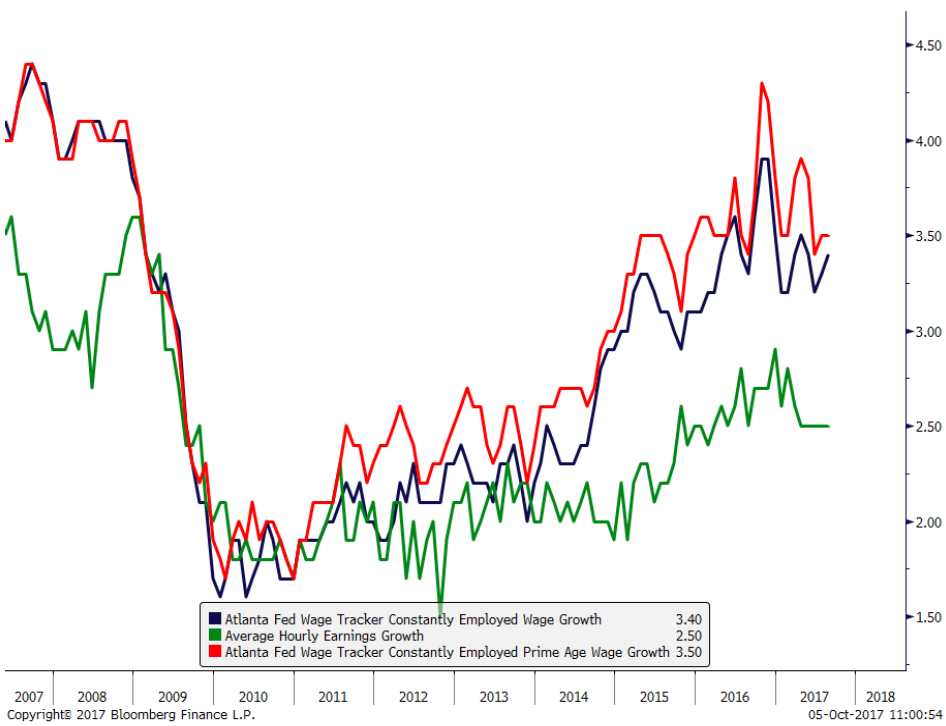
U.S. Economy

The hurricanes tempered expectations for economic growth in the near-term, but this effect was counteracted by the potential for increased inflationary pressures. On its own, tax reform could be a powerful driver of U.S. growth. Combined with rebuilding, there could be further near-term positives for the pace of U.S. growth, though rebuilding will not be a persistent driver of growth and its impact will quickly dissipate.

One potentially welcome consequence for the Fed is an uptick in rent, which is used to calculate shelter inflation and is roughly 40% of core inflation. Later in the year, the rent effect will probably begin to filter into the statistics. The question is whether it will be enough to push inflation higher or simply stabilize it.

Of course, there will be other inflationary pressures driven by Harvey and Irma, building materials chief among them. Irma could also increase food costs from orange juice to chicken. However, building materials are a small part of the inflation calculation and food costs are largely ignored when setting monetary policy. At any rate, the Fed may get a sooner than anticipated reprieve from weak inflation readings and further confusion regarding the direction of monetary policy.

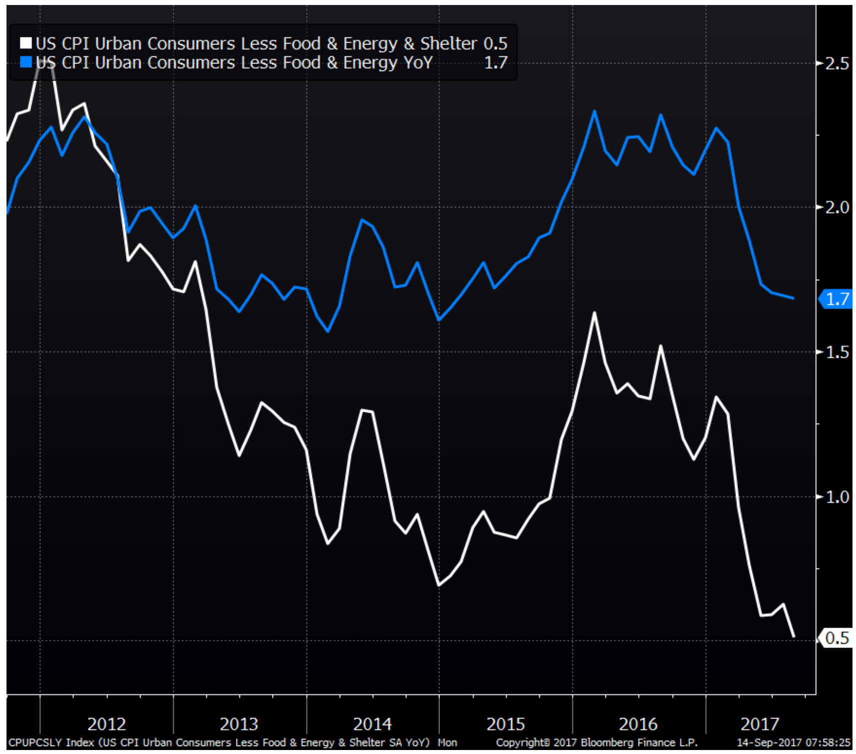
The hurricanes will also distort most of the major statistical releases for the next couple of months, if not longer. Jobless claims jumped initially before quickly returning to near pre-Harvey and Irma levels, but it is probable that employment growth will dip in the immediate term. These effects will show up in the next couple of months of data. Because of the amount of manufacturing and refining in the Houston area, industrial production and manufacturing indexes are also likely to face headwinds, though these should be relatively short-lived, and there should be a significant bounce in the fourth quarter.



Source: Bloomberg

Even then, reconstruction will probably not be a dramatic lift to overall U.S. growth. It will be a local boom. On a positive note, construction activity in Houston following the Super Bowl had slowed significantly and was becoming a drag on the Houston economy. Rebuilding will provide support to these jobs and there is already a robust workforce to undertake the project. Housing starts and permits data will also be affected due to the rebuilding but should begin to rebound in short order.

The acceleration in inflation could prove more problematic for Fed policy, as headline inflation accelerated for the second straight month. Even the core index that strips out food and energy appears to be stabilizing. It may be below the 2% target for the moment, but it is not that far away at 1.7%. With the effects of the hurricanes yet to be felt, the days of declining headline and core inflation may well be behind us.



Source: Bloomberg

But not so fast. If shelter is removed from the core consumer price index (CPI), the reading would be a paltry 0.5%, a new inflation low for the recovery and the lowest reading since 2003. In other words, inflation pressures are becoming increasingly concentrated in the shelter index. Because of the hurricane effects, the pace of shelter inflation is unlikely to decrease meaningfully anytime soon. Wage gains remain weak, but this is not a new phenomenon, especially for those not constantly employed or of prime age. The average hourly wage gains remain well below levels typically seen during a recovery.

The pivotal question for the Fed is how will they react to the data. The answer? At this point, the Fed doesn't even know. This is because the current Fed and the Fed of 2018 are wildly different entities. There will be numerous new policy makers taking their posts between now and 2018. This creates a significant amount of uncertainty around monetary policy over the medium-term.

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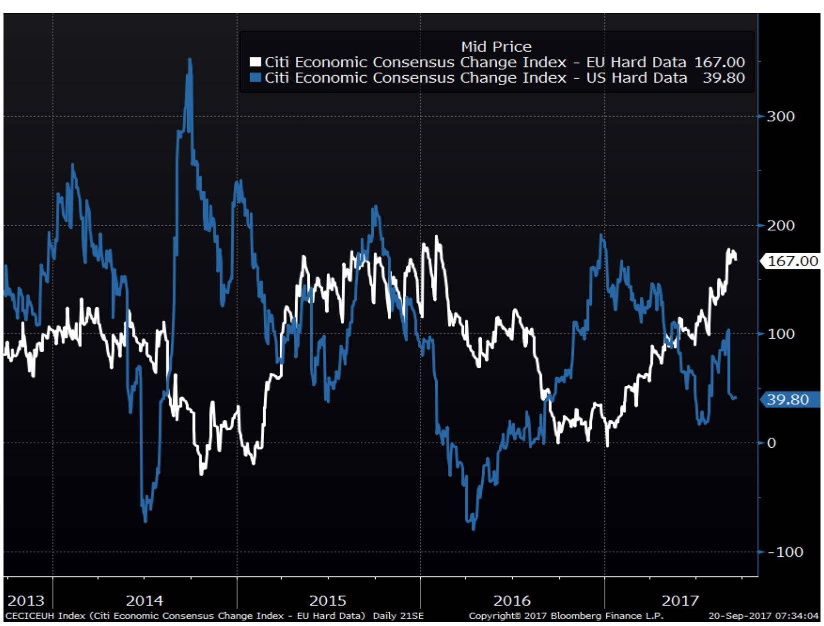
Global Economy

The global economy is benefitting from an uptick in growth emanating from emerging markets and Europe. This becomes apparent in looking at the Citi Economic Consensus Change Index, which measures the change in expectations about future data releases of "hard data", not the sentiment-driven data. By stripping out the "soft", sentiment-driven data, the direction of expectations can be a useful indication of the direction of economies and the differentials between them.

The direction of expectations shows a consistent improvement in the EU, but a consistent downtrend in the U.S. since late 2016. This divergence helps to explain the differential in enthusiasm between the two regions. Moreover, the U.S. dollar and the Euro have largely tracked the direction of the indexes in 2017. There is also the potential of a tightening of monetary policy in Europe due to the improving economy. Given the current level of improvement in the expectations for the EU economy, this may be justified.

So what is driving this growth? Turns out, it is fairly widespread. In the middle of 2016, growth for 2017 was anticipated to be only 1.2%. Now, 2017 growth is expected to be 2%. That is a significant acceleration in the EU's recovery. It is worth remembering that the EU as a bloc is nearly the size of the U.S. economy (or larger, depending on which economic output index is considered), and therefore, the contribution to global growth from such an acceleration is meaningful.



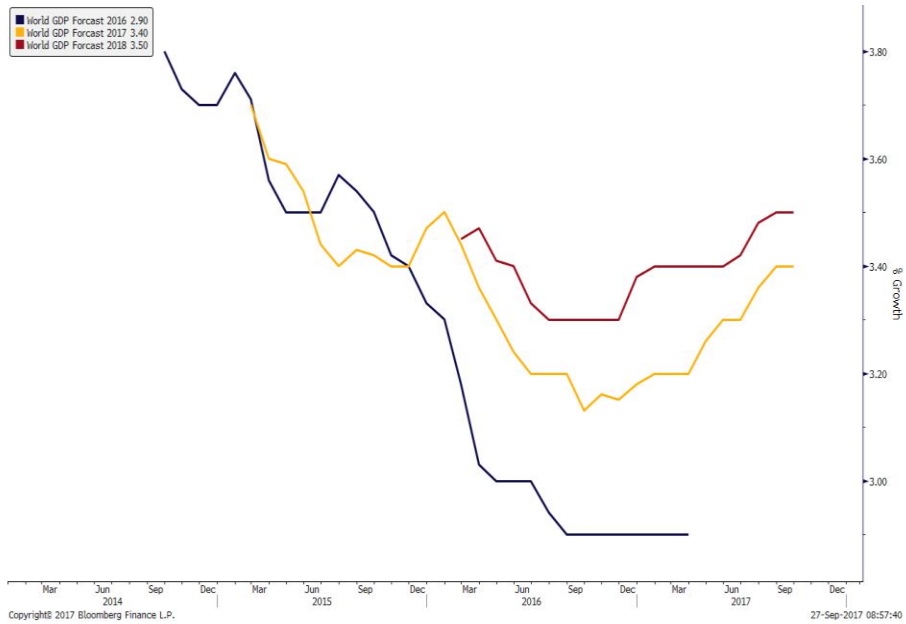
Source: Bloomberg

Global manufacturing has benefited from the European resurgence. In fact, the global manufacturing index has hit a new high recently and appears to be accelerating into the end of the year. China's manufacturing sector is growing again, and this should also extend the length of the global recovery.

In sum, there is currently little reason to assume that the global expansion is going to be derailed. Instead, it appears to be poised to continue a near-term acceleration, notwithstanding a significant disruption from recent U.S. natural disasters.

Outlook

There are a number of potential positives for the U.S. in 2018 with tax reform primarily benefitting growth next year and fading in 2019. This should push U.S. growth above its longer-term trend, possibly above 3% for a period. In other words, the current trajectory for the U.S. is generally one of strength. The global economy is in a similar position, and it does not appear to be at any great risk of deteriorating soon. This leaves the global economy in a sort of moderate sweet spot of accelerating growth and low interest rates. For the time being, the U.S. and global economy generally appear to be healthy. And this should continue well into 2018 on the back of U.S. tax reforms and a stable global demand environment.



Source: Bloomberg

Samuel E. Rines
Senior Economist

Equity Environment Commentary — Jeff Phelps (Avalon Equity Income Portfolio Manager)
Madison Woodward (Avalon SMID Cap Equities Portfolio Manager)

Although growth, technology, and cyclicals have dominated since November, the most recent quarter reflected somewhat of a broadening of the ongoing rally across most asset classes. The S&P 500 rose for the 11th straight month, the longest streak since 1959 per Ned Davis Research. The low volatility environment continued as the S&P 500 index has not experienced a 5% correction since June 2016, the longest stretch in 21 years.

The top asset class for the period was again emerging markets, while commodities – driven by crude oil – were a close second as both advanced. Although there was a meaningful rotation toward value stocks during the final month of the quarter, the NASDAQ – pushed by technology – still outperformed other domestic indexes.

As for smaller capitalization equities, the Russell 2000 had a large intra-quarter swing, going from a mid-single digit negative performance at its lows, to finishing the quarter in the positive mid-single digits.

The Russell Midcap Index intra-quarter swing was much less severe, with the index only dropping slightly at its lows and finishing marginally in positive territory. Potential tax reform and large inflows into the Russell 2000 ETF were the two largest contributing factors to small cap outperformance. For reference, smaller, U.S. based companies tend to have the highest tax rates, so they should be the most affected by potential tax reform.

Fixed Income Commentary — Charles Luke (Avalon Taxable/Tax Exempt Fixed Income Portfolio Manager)

Over the third quarter, treasury rates ended where they began, falling to an intra-year low on September 8th and closing out the quarter slightly above the highs reached on July 7th. Corporate credit continued to climb across the board with U.S. investment grade and high yield both steady. The current risk rally across credit markets since February 11th, 2016 is stunning with U.S. high yield performance nearly matching the S&P 500 gains.

Meanwhile, in the municipal market, concerns around the devastation in Puerto Rico and an S&P downgrade of Pennsylvania to A+ did not rattle the market. Tax-exempt yields as a percentage of their taxable counterparts continued to fall across the curve as market supply has dwindled amidst steady demand. As the overall U.S. fixed income market approaches year end and uncertainty abounds in spades at the Fed, the probability of sharp reversals will increase. Now is a time for caution.

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Publication Date: 10/6/2017