Source: Bloomberg, Avalon Advisors, LLC

Chart of the Week: One of the catalysts for the sharp decline in stocks was fear surrounding the inversion of the intermediate portion of the U.S. Treasury curve for the first time since before the financial crisis. In other words, two-year and three-year rates are now slightly higher than five-year rates (see chart). This means the market is now pricing in the end of Federal Reserve rate hikes and the beginning of rate cuts in 2021. Avalon expects the Fed to still hike by 0.25% this month. In addition, Avalon forecasts two more rate hikes in 2019. The two-year rate has not yet exceeded the ten-year (see chart), but it looks to be headed in that direction. While the inversion of the two-year and ten-year has a strong track record of forecasting future recessions, the timing and implications are more challenging. For example, this ten-year minus two-year inversion has historically happened about one and a half years before a recession and the S&P 500 has had positive returns post-inversion with average gains of more than 17% before peaking.

WEEK IN PREVIEW

- Geopolitical: President Trump and Chinese President Xi agreed to a 90-day pause in the trade war at the G-20 Leaders' Summit and markets were cheered by the higher probability of a negotiated end to the trade war. Subsequently, the CFO of China's Huawei Technologies was arrested at the U.S.' request which adds uncertainty about any possible trade deal. Markets will be monitoring the responses from both sides closely. The U.K. parliament is scheduled to vote Tuesday on the Brexit deal, but there are rumors that the vote could be delayed. While the odds still don't favor a U.K. exit from the European Union (E.U.) without a deal, the path to a solution remains unclear.
- Global Economy: December PMI data will provide a glimpse at the state of major economies. U.S. manufacturing PMI is expected to decline slightly to 55.1 while the Eurozone is expected to hold steady at 51.8 and Japan's reading should be around the 52.2 level from November. All should hold above the 50.0 dividing line signaling economic expansion but reflect slowing from peak levels.
- U.S.: November producer and consumer inflation should decelerate thanks to lower energy prices. November headline retail sales growth should slow due to lower vehicle sales and gasoline prices but should accelerate when excluding those items. 4Q GDP estimates from the Atlanta and NY Fed are 2.38% and 2.44%.
- Europe: Any data is likely to be secondary to Brexit, E.U. and the European Central Bank (ECB) headline. Italy should deliver their fiscal plan mid-week and E.U. leaders are scheduled to meet December 13 and 14. The ECB is expected to phase out additional asset purchases by year-end but continue to reinvest maturities with no increase in policy rates expected anytime soon.
- Asia: Japan's 4Q Tankan indexes are expected to see small declines in optimism due to trade and growth worries. China reports November retail sales, industrial production and fixed assets.
- The central banks of Brazil, Georgia, Philippines, Switzerland, Norway, Turkey, Ukraine, Peru and Russia meet with all expected to hold their policy rates steady.

WEEK IN REVIEW

- Sharp decline in stocks with the S&P 500 falling 4.6%. Defensive sectors and those benefiting from lower yields like real estate, utilities and consumer staples performed best. Small cap stocks underperformed with the Russell 2000 down almost 5.6%. Fears regarding the yield curve inversion and the impact of the trade dispute have caused worries about the future path of the global economy. U.S. November ISM PMI data last week continued to point to robust economic growth with levels consistent with 4+% U.S. GDP growth. The 10-year U.S. Treasury yield fell to 2.85%.
- WTI and Brent oil ended the week higher at $52.61 and $61.67 per barrel respectively. The OPEC plus Russia meeting delivered a larger than expected 1.2 million barrels per day cut to production.
- Both developed international and emerging market stock indexes were lower but outperformed the S&P 500 on both a hedged and unhedged-currency basis. The U.S. dollar was weaker against developed currencies which improved non-hedged returns from developed international stocks, but was stronger against emerging market currencies which hurt their non-hedged stock returns.
- As discussed in the **Chart of the Week**, the 10-2 yield curve flattened and ended at 13.2 basis points. Another curve measure of three-month yield six quarters forward – three-month yield narrowed to 38.1 basis points. The yield curve has historically provided an accurate forecast of future recessions when the difference in these measures turns negative. Yield curves are one of the major indicators that we monitor to judge recession risk, but these inversions typically happen a year or more in advance of any economic recession. In addition, stocks have historically had significant advances post-inversion. Please see our **Avalon Perspectives** publication, *The Yield Curve and Equity Returns*, from April 26, 2018 for more details.

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DISCLOSURES

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