Source: Bloomberg, Avalon Advisors, LLC

Chart of the Week: Last Friday's December global manufacturing PMI readings (See Chart) weighed on stocks as PMIs continue their fade from peak levels. The biggest concern is Europe which slid to 51.4 and saw France fall below the 50-level, signaling economic contraction at 49.7. While the U.S. data declined to 53.9, this reading remains nicely above the danger zone. In fact, U.S. November retail sales reported last week indicate that the Grinch has yet to steal Christmas. The U.S. consumer continues to spend which provides support for our economic growth. While any deceleration in economic growth never feels good and has likely contributed to market volatility, Avalon believes the probability of a recession in the next 12 months still remains low. The relative bright spot was Japan which saw a slight PMI increase to 52.4. This was an important development since Japan recently posted a decline in Q3 GDP growth, but it was partially attributed to weather disruptions. The global economy is slowing from peak growth rates, but it does not necessarily follow that the U.S. must decline into recession soon. Much attention this week will be paid to guidance from the Federal Reserve regarding future monetary policy as a policy error of excessive rate hikes could hasten a decline into recession and weigh on the markets.

WEEK IN PREVIEW

- Geopolitical: A partial U.S. government shutdown looms at the end of the week, if a stopgap deal isn't reached or appropriation bills approved by Congress. Government shutdowns are not generally large market moving events though. Markets will be more focused on any additional trade news regarding the negotiations between the U.S. and China. Chinese leaders hold their annual economic policy meeting, so any trade, economic policy and stimulus headlines could impact markets.
- U.S.: November housing data are on tap with starts, permits and existing home sales being reported. Housing starts should show slight improvement, while permits and sales are expected to decline. Durable goods orders should improve for November, while personal income and spending are expected to moderate. 4Q GDP estimates from the Atlanta and NY Fed are 3% and 2.42%.
- U.S. Federal Reserve: The Fed is widely expected to hike rates by 0.25% on Wednesday. Markets are pricing in over a 70% probability of a hike. More closely watched will be the future projections of the policy rate (dot plot) as investors continue to estimate the odds of a policy error which could prematurely send the U.S. economy into recession. Stock declines associated with recessions have historically been more severe than declines without a recession, so policy guidance will be key.
- Europe: The Eurozone reports November consumer inflation (CPI) which is expected to slow for the month and on a year-over-year basis. The German IFO survey will be watched for sentiment after the weaker PMI numbers as discussed in the **Chart of the Week**. U.K. reports both November CPI and retail sales, but the political drama around Brexit will continue to be a focus. The Bank of England meets and is expected to hold the policy rate and asset purchases unchanged.
- Asia: Japan has November CPI and trade data with both imports and exports expected to slow from the October pace. The Bank of Japan is expected to hold the policy rate and 10-year yield target steady.
- Central Banks: In addition to those noted earlier, the central banks of Hungary, Morocco, Thailand, Taiwan, Indonesia, Sweden, Czech Republic, Mexico and Colombia meet with only Thailand and Mexico expected to hike their policy rates by 0.25%.

WEEK IN REVIEW

- Modest decline in stocks with the S&P 500 falling 1.3%. Stocks were cheered through midweek with tame inflation data and better news regarding trade with China but faded into the end of the week with global economic growth fears weighing on stocks. Financials and energy were the worst performing sectors. WTI and Brent oil prices were both lower by about 2.5%. Since these sectors are two of the largest weights in the value index, the Russell 1000 Value index underperformed growth. Small cap stocks underperformed with the Russell 2000 down almost 2.6%. The 10-year U.S. Treasury yield rose to 2.89% and credit spreads improved slightly.
- 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 stronger against both developed and emerging market currencies which hurt their non-hedged stock returns.
- The 10-2 yield curve widened slightly and ended at 15.4 basis points. Another curve measure of three-month yield six quarters forward – three-month yield widened to 39.2 basis points. The yield curve has historically provided an accurate forecast of future recessions when the difference in these measures turns negative, also known as inversion. 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