Chart of the Week: Worries about the U.S. economy including a possible Federal Reserve policy error from hiking too aggressively were factors causing the sharp S&P 500 declines from the peak on September 21 (see chart). A reversal in those factors also is behind the sharp rebound in stocks with the S&P 500 posting its best January performance since 1987 at +7.9%. The Citi U.S. Economic Surprise index shows the strength of economic data reported relative to expectations. Since shortly after the market bottom, U.S. economic data has been much stronger than expected. This includes the January jobs report last week which showed a 304k increase which was almost double expectations. In addition, the GS Financial Conditions index (shown inverted here), which consists of a weighted average of short-term and long-term interest rates, the dollar, credit spreads, and stock valuation, reflected a significant tightening of conditions while stocks fell sharply. A large portion of this tightening in financial conditions can likely be attributed to the Fed's policy stance at the time. The change of tune in the Fed's forward guidance is also reflected in the sharp improvement in financial conditions. Just last week the Fed noted that it would be "patient" with future hikes and even expressed flexibility about slowing the reduction in their balance sheet if necessary. Some optimism about a U.S. and China trade agreement also likely played a part in the rally.

Source: Bloomberg, Avalon Advisors, LLC as of February 4, 2019

WEEK IN PREVIEW

- Geopolitical: Markets should continue to respond to additional news from the U.S. and China trade negotiations. President Trump delivers his State of the Union address with time running short before the next partial government shutdown starting February 15 unless another spending bill is passed.
- U.S.: Some delayed economic data will continue to trickle in due to the residual impact of the partial government shutdown. January ISM Non-Manufacturing is expected to decline to 57.0; still well above the 50 level which separates signaling economic growth from contraction. The latest 4Q GDP estimates from the Atlanta and NY Fed are 2.49% and 2.61%. Eight speeches by Federal Reserve members are scheduled with the primary focus on Chairman Powell's comments.
- 4Q S&P 500 Earnings: 46% have reported so far with 70% and 62% beating earnings and sales estimates respectively. Blended earnings and sales estimates rose to 12.4% and 6.6% year-over-year primarily due to some better than expected energy earnings last week. One hundred and three S&P 500 companies report earnings including GOOGL, EMR, DIS, LLY, GM and TWTR.
- Europe: The Eurozone reports December retail sales which are expected to extend the string of poor economic data. U.K. January Markit Services and Composite PMI readings are expected at 51.0 and 51.5. The Bank of England (BOE) meets and should keep monetary policy unchanged. The official Brexit date of March 29 is fast approaching but Avalon still expects a new referendum or extension rather than an exit without an agreement with the European Union.
- Asia: January China Caixin PMI for Services and Composite were reported at 53.6 and 50.9, reflecting their economic slowdown. Most markets across Asia are closed for all or part of the week to celebrate the Lunar New Year, the Year of the Pig.
- Central Banks: In addition to the BOE, the central banks of Australia, Thailand, Iceland, Belarus, Poland, Brazil, Philippines, India, Serbia, Czech Republic, Mexico, Peru, Romania and Russia meet with no expected major changes in monetary policy.

WEEK IN REVIEW

- The S&P 500 went back to its winning ways for 2019 with a 1.6% gain for the week. Energy, communication services and real estate were leading sectors. Both WTI and Brent oil prices were higher and reported 4Q earnings were better than expected which propelled energy stocks. Small cap stocks underperformed with the Russell 2000 up 1.3%. The 10-year U.S. Treasury yield fell to 2.68% and high yield credit spreads narrowed.
- Developed international stocks indexes underperformed the S&P 500 in U.S. dollar terms and on a hedged-currency basis. The U.S. dollar was weaker against both developed and emerging market currencies which increased their non-hedged stock returns to 0.9% for MSCI EAFE and 1.7% for MSCI Emerging Markets.
- The 10-2 yield curve widened and ended at 17.6 basis points. Another curve measure of three-month yield six quarters forward – three-month yield narrowed to nine 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. The three-month yield six quarters forward yield is now reflecting that the market expects at most one net hike in short-term rates over the next year and a half. Our view remains that the odds of a recession in 2019 remain low and expect perhaps only one hike from the Federal Reserve later in 2019. Avalon continues to monitor the data closely. Please see our **Avalon Perspectives** publication, *The Yield Curve and Equity Returns*, from April 26, 2018, for more details.

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