Source: Bloomberg, January 14, 2019

Chart of the Week: Global stocks posted their third straight week of gains leading to a strong year-to-date (YTD) return following the very difficult fourth quarter of 2018. In fact, risk assets in general including high yield bonds and loans have rebounded very rapidly. Oil has rallied by more than 12% YTD. As we have noted for some time, the short-term movements of stocks and other risk assets continue to be driven by sentiment regarding the strength of the global economy which is impacted significantly by the progress of the trade dispute talks between the U.S. and China along with expectations regarding the U.S. Federal Reserve's future monetary policy. As we noted when the S&P 500 was down close to 20% from its peak, the sell-off had likely gone too far if the U.S. avoided a recession in 2019 as we expected. In one sense it gets harder from here since less bad news is priced into the market now. While Avalon remains optimistic for stock returns in 2019, investors should continue to expect volatility as the market wrestles with a slowing economy and the trade dispute. Fourth quarter S&P 500 earnings should grow by more than 11% year-over-year. While current earnings reports will be important, the market is likely to be very sensitive to clues about future earnings growth or lack thereof. Thirty-four S&P 500 companies are scheduled to report fourth quarter earnings this week with many large financial companies along with Netflix being the highlights.

WEEK IN PREVIEW

- Geopolitical: Markets are likely to react on additional news from the U.S. and China trade negotiations. The partial government shutdown continues. Historically, and so far during this episode, there has been limited market impact. A vote on the Brexit agreement in the U.K.'s House of Commons is scheduled for Tuesday. The agreement is expected to be defeated which will likely send the U.K. back to the European Union looking for more concessions.
- U.S.: Some U.S. economic data will be delayed due to the partial government shutdown. December retail sales are expected to moderate from the very strong pace in November. Housing data should weaken somewhat in December with both permits and starts lower for the month. Consumer sentiment is forecast to decline slightly but remains at an elevated level. 4Q earnings reporting season begins in earnest. The latest 4Q GDP estimates from the Atlanta and NY Fed are 2.79% and 2.48%.
- Fedspeak: The Federal Reserve's Beige Book is released on Wednesday. There are seven speeches from Fed officials scheduled for the week.
- Europe: Eurozone and German final reading on consumer inflation (CPI) are expected. 2018 German year-over-year GDP should slow to 1.5% from 2.2% for 2017. Though likely overshadowed by the Brexit vote, the U.K. reports December CPI and retail sales.
- Asia: December Japan CPI, excluding fresh food and energy, should remain anemic at 0.3% year-over-year. China reported December trade data with exports and imports declining by -4.4% and -7.6% year-over-year respectively which likely reflects slowing economic growth. Money supply and Yuan loan data are expected from China later in the week.
- Central Banks: The central banks of Kazakhstan, Turkey, Indonesia and South Africa meet with none expected to change monetary policy rates. Although Kazakhstan may surprise with a hike.

WEEK IN REVIEW

- The S&P 500 continued its winning streak posting gains of over 2.5%. The Federal Reserve minutes along with Chair Powell's comments continued to reduce the odds of a Fed policy error. Avalon expects the Fed to only hike rates once in 2019 and not until the latter part of the year. Industrials, real estate and consumer discretionary were leading sectors. Both WTI and Brent oil prices were significantly higher which helped energy stocks outperform as well. Small cap stocks outperformed with the Russell 2000 up 4.8%. The 10-year U.S. Treasury yield rose to 2.7% and high yield credit spreads narrowed sharply.
- Both developed international and emerging market stock indexes outperformed the S&P 500 in U.S. dollar terms but developed international underperformed 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. Emerging market stocks outperformed last week on a local currency (currency-hedged) basis.
- The 10-2 yield curve narrowed and ended at 15.6 basis points. Another curve measure of three-month yield six quarters forward – three-month yield widened 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 an 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 essentially no net change in short-term rates over the next year and a half. Our view remains that the odds of a recession in 2019 remain low but 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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