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Avalon Advisors' Weekly Market Guide
Week of January 22, 2019

Source: Bloomberg, Avalon Advisors, LLC, as of January 22, 2019

Chart of the Week: On June 23, 2016, the U.K. voted to leave the European Union (EU) and the British Pound (GBP) fell sharply against the U.S. dollar (USD) and the euro (EUR). Since the referendum to leave the EU and the triggering of Article 50, the U.K. has been trying to negotiate an exit. Last week, the U.K. House of Commons defeated PM May's proposed Brexit agreement by the largest margin against a sitting government since 1924. Despite this brutal defeat, the British pound actually strengthened against the dollar and the euro. This indicates that the markets still place a low probability on a hard Brexit, a Brexit without an agreement, despite the deadline for an agreement of March 29, 2019, growing closer. Why is this the case despite the inability to reach an agreement so far? Primarily, the British parliament does not support a hard Brexit. The U.K. is likely to either ask for an Article 50 extension to negotiate a soft Brexit with an agreement or hold a new referendum vote regarding the U.K leaving the EU. If the new referendum votes to stay in the EU, the U.K. can unilaterally stop the Article 50 process according to a European Court of Justice ruling in December. The International Monetary Fund (IMF) highlighted a "no deal" Brexit as one of the threats to 2019 world GDP growth in their report this week, but Avalon places a low probability on a hard Brexit and expects the GBP to appreciate as an agreement is eventually reached.

WEEK IN PREVIEW

- Geopolitical: Markets reacted favorably last week to a reported Chinese offer to purchase $1 trillion in U.S. imports by 2024 and should continue to respond to additional news from the U.S. and China trade negotiations. The partial government shutdown continues with limited market impact historically and so far during this episode. The World Economic Forum is held in Davos. The IMF reduced its forecast of 2019 global GDP growth to 3.5% from 3.7% and left U.S. growth at 2.5%.
- U.S.: Some U.S. economic data will be delayed due to the partial government shutdown. January Markit manufacturing and services PMI reading are expected to soften to 53.5 and 53.9. While the PMI levels have been declining since May 2018 and reflect a slowing economy, the readings should remain well above the 50 level which separates signaling economic growth from contraction. The latest 4Q GDP estimates from the Atlanta and NY Fed are 2.79% and 2.57%.
- 4Q S&P 500 Earnings: Only 11% have reported so far, but 76% and 56% have beaten earnings and sales estimates respectively. Blended earnings and sales estimates rose to 10.6% and 6.0% year-over-year (Y/Y) primarily due to overall better than expected earnings from financials last week. Fifty-eight S&P 500 companies report earnings including some airlines, JNJ, INTC, SBUX and BMY.
- Europe: The European Central Bank (ECB) is expected to leave monetary policy rates unchanged. January Markit manufacturing and services PMI reading are expected to fall to 51.3 and 51.5. November U.K. monthly labor data expected, but likely overshadowed by Brexit news.
- Asia: Bank of Japan (BOJ) will leave monetary policy unchanged in the wake of the tepid consumer inflation reported last week. Japan December trade data is expected along with January Nikkei manufacturing PMI which was 52.6 in December. China reported better December retail sales and industrial production at 8.2% and 5.7% Y/Y, but 4Q GDP growth slowed to 6.4% Y/Y as expected.
- Central Banks: In addition to the ECB and BOJ, the central banks of Nigeria, S. Korea, Malaysia, Norway and Angola meet with none expected to change monetary policy rates.

WEEK IN REVIEW

- The S&P 500 posted its fourth straight week of gains, rising 2.9%. Fewer concerns about the economy along with good earnings reports, supportive comments from Fed members and better news from the trade negotiations with China helped propel stocks higher. Financials, industrials and technology were leading sectors. Both WTI and Brent oil prices were again higher which helped energy stocks outperform. Small cap stocks underperformed with the Russell 2000 up 2.4%. The 10-year U.S. Treasury yield rose to 2.78% and high yield credit spreads again narrowed sharply.
- Both developed international and emerging market stock indexes underperformed the S&P 500 in U.S. dollar terms and on a hedged-currency basis. The U.S. dollar was stronger against both developed and emerging market currencies which decreased their non-hedged stock returns to 1.1% for MSCI EAFE and 1.7% for MSCI Emerging Markets.
- The 10-2 yield curve widened and ended at 16.6 basis points. Another curve measure of three-month yield six quarters forward – three-month yield widened to 23 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 perhaps 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 only one hike from the Federal Reserve 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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