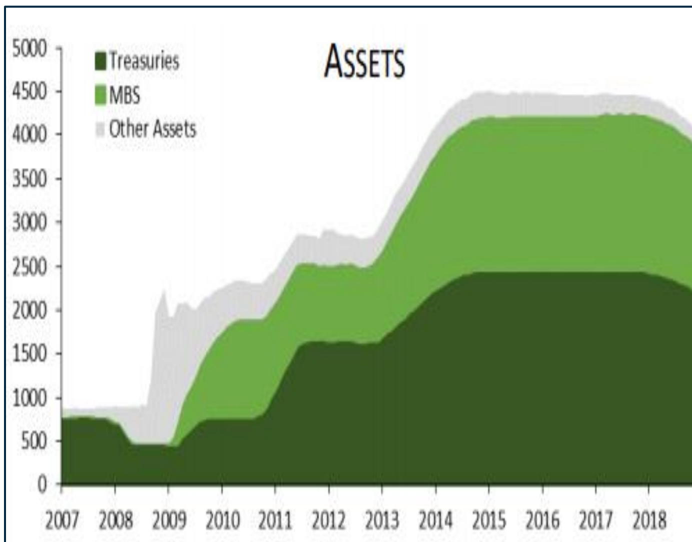

Source: Cornerstone Macro, Avalon Advisors, LLC as of January 28, 2019

Chart of the Week: The Federal Open Market Committee (FOMC) meets on Wednesday and is almost sure to leave policy rates unchanged with markets pricing in a 1% probability of a hike. With very little suspense around the rate decision, markets will be keen to glean clues about future policy from the Federal Reserve (Fed). Recall that worries about a possible Fed policy error from hiking too quickly were part of the toxic stew of global growth worries causing the sharp market declines at the end of 2018. Among the clues to watch are the tone and content of the FOMC statement and Fed Chair Powell's press conference following the meeting. In addition, there could be some discussion regarding the pace of runoff in the Fed's portfolio of assets (see chart). The Fed's balance sheet grew to $4.45 trillion following the financial crisis. In October 2017 the Fed began to allow bonds to mature and assets now stand at $4.1 trillion. The Fed currently has a cap of $50 billion per month on the decline in assets but is already running well below that pace. On the other side of the ledger are excess reserves, which are associated with liquidity in the banking system and have been declining much quicker than assets. While the possible decision to slow the runoff in assets is likely driven by a technical decision around excess reserves, markets may, in fact, interpret it as a wish from the Fed to slow the pace of stimulus reduction to the economy.

WEEK IN PREVIEW

- Geopolitical: Markets should continue to respond to additional news from the U.S. and China trade negotiations with China's Vice Premier Liu He in D.C. for trade talks. The partial government shutdown is over for now with a spending bill that runs through February 15. The U.K. parliament is scheduled to continue the Brexit debate and vote on amendments to PM May's Brexit deal.
- U.S.: Some U.S. economic data will continue to be delayed due to the residual impact of the partial government shutdown and overdue data should start to trickle in. 4Q GDP is expected to moderate to 2.6% growth from 3.4% in Q3. The January jobs report should see nonfarm payrolls rise 165,000 and the unemployment rate hold steady at a low 3.9%. January ISM Manufacturing should hold fairly steady at 54.2, well above the 50 level which separates signaling economic growth from contraction. The latest 4Q GDP estimates from the Atlanta and NY Fed are 2.72% and 2.57%.
- 4Q S&P 500 Earnings: 22% have reported so far with 71% and 59% beating earnings and sales estimates respectively. Blended earnings and sales estimates rose to 10.9% and 6.1% year-over-year (Y/Y) primarily due to some better than expected industrials and technology earnings last week. 126 S&P 500 companies report earnings including AAPL, MSFT, BA, XOM, CVX, PFE and MRK.
- Europe: The Eurozone reports 4Q GDP which should slow to 1.2% Y/Y from 1.6%. Also, headline consumer inflation (CPI) is expected to moderate to 1.4% Y/Y. U.K. Markit Manufacturing PMI is expected to decline to 53.5 versus 54.2, but most data will likely be overshadowed by Brexit news.
- Asia: December job market data from Japan should continue to reflect a tight market with unemployment at 2.5%. January official China manufacturing and non-manufacturing PMI readings forecast at 49.3 and 53.9, while the Caixin manufacturing PMI is expected to hold steady at 49.7.
- Central Banks: In addition to the FOMC, the central banks of Hungary, Chile, Ukraine, Bulgaria, Dominican Republic and Colombia meet with only Chile expected to change their monetary policy rate with a hike.

WEEK IN REVIEW

- The S&P 500 ended its winning streak after four straight weeks of gains, despite a rally on Friday with the end to the partial government shutdown. The S&P 500 posted a modest 0.2% decline for the week. Real estate, technology and utilities were leading sectors. Both WTI and Brent oil prices were lower which weighed on energy stocks. Small cap stocks outperformed with the Russell 2000 up 0.02%. The 10-year U.S. Treasury yield fell to 2.76% and high yield credit spreads widened.
- Both developed international and emerging market stock indexes outperformed 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 0.5% for MSCI EAFE and 1.4% for MSCI Emerging Markets. The ECB kept policy rates unchanged as widely expected and vowed no hikes through the summer of 2019, but markets don't expect a hike until April 2020.
- The 10-2 yield curve narrowed and ended at 15 basis points. Another curve measure of three-month yield six quarters forward – three-month yield narrowed to 21 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.

Henry J. Lartigue, CFA
Managing Partner

Samuel E. Rines
Chief Economist

Bill Stone, CFA, CMT
Chief Investment Officer

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