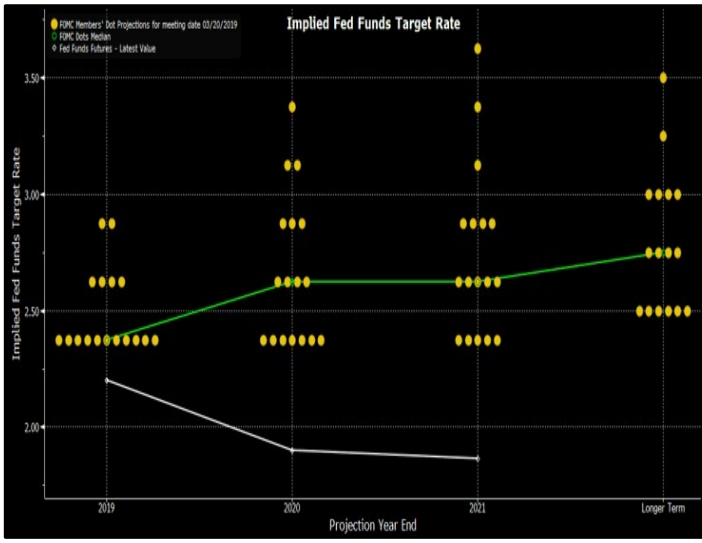

<u>Chart of the Week</u>: The Fed went above and beyond last week to dovishly surprise markets. First, FOMC participants see no hikes in 2019, more dots see none in 2020 than one more, and more dots see no more in the long run than one more. In other words, minus a few ridiculous outliers, the dot plot sees the Fed doing little on fed funds for a long, long time. Second, the balance sheet roll-off will be tapered beginning in May and cease to shrink by the end of September. Of note, maturing mortgage-backed securities (MBS) and interest payments will be replaced with U.S. Treasuries, and the distribution of the maturities will be like outstanding U.S. Treasuries. This means that regardless of how much the Fed needs to purchase to replace the MBS portfolio, the base case is for U.S. Treasuries being rolled in 2020 is $291B. That is not an insignificant figure at roughly 8% of the Fed's overall balance sheet (assuming the roll-off stops at $3.6T). This change seems most likely to show itself in a softer dollar and lower short-term yields. This week will bring lots of talk from Federal Reserve members with fourteen speeches scheduled. The Fed move initially gave a boost to stocks with no real threat from tightening on the horizon, but the weak PMI data out of Europe combined with U.S. 10-year falling below 3-month yields (inversion) spooked the markets on Friday. Avalon still sees very little threat on recession in the U.S. in 2019 despite Europe's woes.

Source: Bloomberg, Avalon Advisors, LLC as of March 25, 2019.

WEEK IN PREVIEW

- <u>Geopolitical</u>: Brexit activity continues with a possible third vote on PM May's European Union (E.U.) Withdrawal Agreement. The E.U. allowed a delay on the Brexit deadline until April 12 to facilitate a possible agreement, but the path to a final resolution remains unclear. Markets continue to monitor the progress of the trade negotiations between the U.S. and China with the U.S. delegation headed to Beijing this week. U.S. Attorney General Barr released a summary of the findings from the Mueller report which found no conspiracy or coordination between the Trump Campaign and Russia with no further indictments forthcoming and no obstruction of justice, which should on the margin remove uncertainty and improve sentiment.
- <u>U.S.</u>: February housing data is on tap with starts, permits and pending home sales expected to show slight declines. The third estimate of 4Q GDP is forecast to be lowered to 2.3% growth from 2.6%. February personal income and January personal spending should bounce back to the positive. 1Q GDP estimates from the Atlanta and NY Fed stand at 1.23% and 1.29%. Apple (AAPL) unveils new products on Monday and the Lyft (LYFT) IPO begins trading on Friday.
- <u>Europe</u>: After the dismal March Eurozone and German PMI data last week, Eurozone consumer confidence on Thursday and German IFO sentiment readings on Monday will be watched closely for signs of a possible rebound in hard data. German February retail sales and the March jobless rate are due to be released. Not much hard data out of the U.K. aside from February mortgage approvals, but that is just as well with Brexit continuing to demand all the attention from markets.
- <u>Asia</u>: Japan reports February labor data with the job market expected to remain very tight. February industrial production and retail sales for Japan are expected to grow after a decline in January. China has only a secondary report with February industrial profits expected.
- <u>Central Banks</u>: The central banks of Hungary, New Zealand, Nigeria, Kenya, Czech Republic, Mexico, South Africa, Egypt, Chile, Angola, Dominican Republic and Trinidad & Tobago meet with only Egypt expected to change their monetary policy rate with a cut of 1.00% to 14.75%.

WEEK IN REVIEW

- The S&P 500 posted a loss of almost 0.8% for the week with Friday's selloff responsible for all the losses. The proximate cause of Friday's plunge was concern about the global economy based on the very poor PMI numbers out of Europe and inversion of the U.S. yield curve. Consumer discretionary, real estate and staples were leading sectors while financials were the worst by far at -4.9%. WTI and Brent oil prices were mixed with energy stocks down slightly and MLPs up almost 1.9%. Small cap stocks underperformed with the Russell 2000 down almost -3.1%. The 10-year U.S. Treasury yield fell to 2.44% and high yield credit spreads reflecting decreased risk tolerance by widening.
- Developed international stock indexes outperformed the S&P 500 in both U.S. dollar and hedged-currency terms. On a hedged-currency basis, developed market stocks were up down -0.6%. The U.S. dollar was generally slightly stronger against developed and emerging market currencies. The non-hedged stock returns were -0.4% for MSCI EAFE and +0.2% for MSCI Emerging Markets. Asian-Pacific equities gained with Japanese and Chinese stocks higher last week.
- The 10-2 yield curve narrowed and ended at 11.8 basis points. Another curve measure of three-month yield six quarters forward – three-month yield continues to be inverted at -25.9 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 perhaps one net cut in short-term rates over the next year and a half. Much of the decline in the forward-looking three-month yield came on Friday in response to the weak European PMI data, so it might be an overreaction. Our view remains that the odds of a recession in 2019 remain low and no rate hikes 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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DISCLOSURES