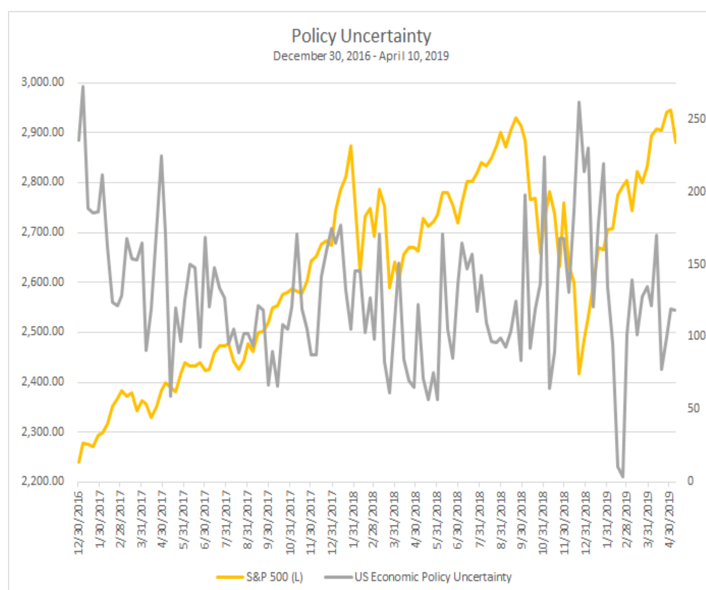

Chart of the Week: After the markets had begun to price in a high probability of the U.S. and China reaching a trade deal, last week broke the calm and reignited worries about a trade war along with the resultant impact on the global economy. While the U.S. Economic Policy Uncertainty index measures uncertainty beyond just trade, the data shows the decline in uncertainty while the S&P 500 rose this year then the recent uncertainty increase (see chart). Late last week, the Trump Administration increased tariffs from 10% to 25% on $200B goods from China. While the higher tariff rate is now in effect, there is a grace period until June 1 for goods already in transit so there remains time to negotiate before the impacts of the tariffs. President Trump also ordered preparations to raise tariffs on the $300B in imports from China that the U.S. has not yet targeted if negotiations do not proceed satisfactorily. The primary impact on the U.S. of the higher tariffs are 1) higher inflation and 2) lower GDP growth. Goldman Sachs estimates a negative impact of 0.1%-0.2% on U.S. GDP under the most recent changes and as much as -0.4% if the additional $300B of Chinese imports are targeted with tariffs. According to IMF research, Chinese GDP likely suffers even larger negative impacts. Avalon's base case remains that a trade deal is reached though markets could remain volatile during negotiations. If no deal is reached, expect further stimulus from the U.S. and China to offset the impact.

Source: Bloomberg, Avalon Investment & Advisory as of May 10, 2019

WEEK IN PREVIEW

- Geopolitical: Markets will closely monitor the progress of the trade negotiations between the U.S. and China after the setback last week. Please see our Chart of the Week for more on the subject. OPEC releases its monthly oil report with demand and production estimates. Large money managers must disclose their holdings of U.S. equities via a 13F filing.
- U.S.: U.S. April retail sales probably rose at a much slower pace than the 1.6% jump in March with the median estimate at 0.2%. April industrial production was probably flat. U.S. housing starts likely posted gains in April after falling six of the last seven months. May consumer sentiment likely improved slightly. Lots of Fedspeak with at least 13 Federal Reserve speeches on tap.
- 1Q S&P 500 Earnings: 90% of companies have now reported and 76% and 59% have beaten earnings and sales expectations respectively. Earnings are expected to decline -0.5% year-over-year (Y/Y) versus -0.8% last week, while sales expectations improved to 5.3% growth from 5.2%. The improvements were driven primarily by the communications services and financial sectors. This week has nine S&P 500 companies reporting including CSCO, WMT, AMAT and NVDA.
- Europe: March Eurozone industrial production is expected to decline to -0.8% (Y/Y). The German ZEW survey for May is expected to improve regarding the current situation and future expectations. The U.K. 3-month unemployment rate for March was steady at 3.9% as expected.
- Asia: China April industrial production is expected to slow to 6.5% Y/Y from 8.5% and retail sales eases to 8.6% Y/Y from 8.7%.
- Central Banks: The central banks of Poland, Romania, Indonesia, Mexico and Mauritius are expected to keep their monetary policy rates unchanged.

WEEK IN REVIEW

- The S&P 500 posted a loss of almost -2.2% in the wake of rising trade tensions between the U.S. and China. Please see the Chart of the Week for more on the trade dispute. All sectors were down, led by tech (-3.6%) and material (-2.8%) while staples (-0.4%) and energy (-0.6%) showed more resilience. Oil prices were slightly lower on the week but MLPs were higher thanks to M&A activity in the sector. The 10-year U.S. Treasury yield fell to 2.47% and high yield credit spreads reflecting decreased risk tolerance by widening.
- Developed and emerging market international stock indexes underperformed the S&P 500 in U.S. dollar terms. On a hedged-currency basis, developed market stocks (MSCI EAFE) were down -3.0%. The U.S. dollar was weaker against developed and stronger against emerging market currencies. The non-hedged stock returns -2.8% for MSCI EAFE and –4.6% for MSCI Emerging Markets.
- The 10-2 yield curve widened and ended at 19.7 basis points. Another curve measure of three-month yield six quarters forward – three-month yield continues to be inverted at -23.8 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 a cut 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 Avalon expects 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.

Phan Phan Duong	Henry J. Lartigue, CFA	Samuel E. Rines	Bill Stone, CFA, CMT
Senior Analyst	Managing Partner	Chief Economist	Chief Investment Officer

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Avalon Investment & Advisory
2929 Allen Parkway Suite 3000, Houston, TX 77019 | 713.238.2050
755 Mulberry Avenue Suite 105, San Antonio, TX 78212 | 210.694.4329
www.avalonadvisors.com