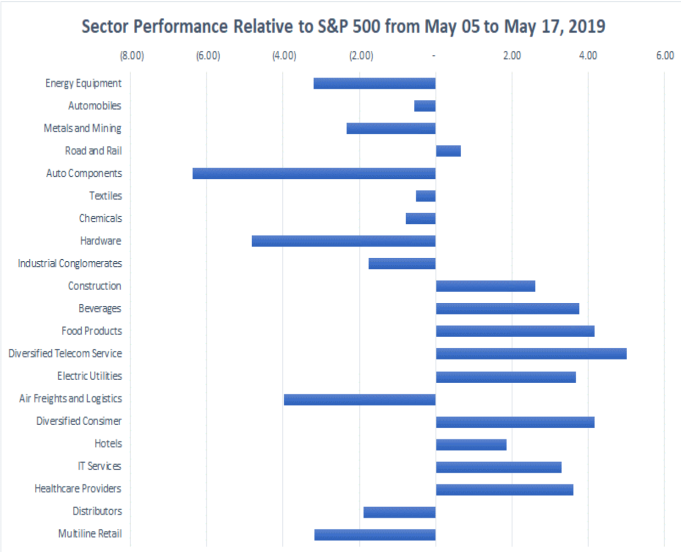

Chart of the Week: As trade tensions rose with President Trump's tweets the weekend before last, Avalon focused on the economic impacts of increased tariffs: higher inflation and lower GDP growth. This week focuses on the implications for stocks and earnings. Our chart shows the industries from highest to lowest reliance on imported inputs. While there are certainly other factors impacting the sectors, in general the sectors with the highest import exposure underperformed the S&P 500 since Trump threatened to increase tariffs on China. S&P 500 earnings would likely be negatively impacted somewhat by the additional tariffs on China. Only about 2% of S&P 500 sales are generated from China so the direct impact is small, but the larger possible impact is via the supply chain of S&P 500 companies. Goldman estimates that 18% of cost of goods sold are imported from China. The earnings impact is likely to be relatively small as companies pass through costs and adjust their supply chains to use other countries like Vietnam. Trump did pivot by delaying European auto tariffs and making NAFTA 2.0 more likely, so a trade war on multiple fronts became less likely last week. Currently, there are no U.S. and China trade talks scheduled and the heated rhetoric on both sides makes it unlikely that any agreement can be reached before Trump and Xi meet in late June at the G-20. Financial market volatility seems likely to remain elevated, but Avalon still expects a trade deal to be reached and no recession in 2019.

Source: Bloomberg, FactSet, OECD, Bernstein, Goldman Sachs, Avalon Investment & Advisory as of May 17, 2019

WEEK IN PREVIEW

- Geopolitical: Markets will closely monitor the progress of the trade negotiations between the U.S. and China. Please see the **Chart of the Week** for more details. The EU will hold continent-wide parliament elections. The OECD releases its updated global economic forecasts.
- U.S.: April existing home sales is expected to grow at 2.7% month-over-month from a decline of -4.9% last month. Markit US Manufacturing and Services PMI for May likely improved slightly, both remaining well above the economic expansion versus contraction level of 50. NY and Atlanta Federal Reserve 2Q GDP estimates are currently 1.79% and 1.17%. Fedspeak includes both FOMC meeting minutes and many presentations including Chair Powell on Monday. The minutes may contain insights on the inflation goal implementation and speakers will almost certainly speak to patience regarding policy with the downside risks from the trade spat.
- 1Q S&P 500 Earnings: 92% of companies have now reported with 76% and 59% beating earnings and sales expectations respectively. Earnings are expected to stay at a -0.5% year-over-year (Y/Y), marking the first Y/Y decline in earnings for the index since Q2 2016 (-3.2%); and sales expectations remain at 5.3% Y/Y growth. Avalon still expects 5% Y/Y earnings growth for the S&P 500 with the same downside risks as discussed in the **Chart of the Week**. This week has 22 S&P 500 companies reporting including HD, TJX, LOW, KHC, TGT with a heavy emphasis on the retailers.
- Europe: Both Markit Eurozone Manufacturing PMI and Services PMI for May are expected to improve from last month's low (Manufacturing: 48.1 vs 47.9; Service: 53.0 vs 52.8) while consumer confidence probably became less negative (-7.7 vs -7.9). U.K Y/Y April CPI probably rose to 2.2% from the prior 1.9% while retail sales decelerated to 4.5% from 6.7%. U.K internal government discussions about Brexit broke down leaving the British pound much weaker and no real path forward. The ECB publishes its account of the April monetary policy decision.
- Asia: Japan 1Q real GDP grew 0.5% Q/Q after a 0.4% expansion in the last quarter. The May Nikkei manufacturing PMI will give insight into the current state of the economy.
- Central Banks: The central banks of Israel, Pakistan, Nigeria, Iceland, Zambia, South Africa and Egypt meet with Pakistan expected to raise rates by 1.0% to 11.75%.

WEEK IN REVIEW

- The S&P 500 posted a loss of almost -0.8% as the market continued to gauge the impact of rising trade tensions between the U.S. and China. Financials (-2.1%), industrials (-1.9%), consumer discretionary (-1.1%) and technology (-1.1%) were the laggards; while real estate (1.4%), utilities (1.2%), staples (0.9%) are among the outperforming sectors. WTI and Brent oil prices were both up about 2% for the week helping MLPs to a 0.5% gain and the energy sector pacing the S&P 500. The 10-year U.S. Treasury yield fell to 2.39% and high yield credit spreads reflecting decreased risk tolerance and economic concerns by widening.
- Developed market outperformed the S&P 500 as the MSCI EAFE posted a 1.1% gain on a hedged-currency basis. On the other hand, emerging market international stock indexes underperformed the S&P 500 in U.S. dollar terms with a loss of -3.6%. The U.S. dollar was stronger against both developed and emerging market currencies. The non-hedged MSCI EAFE posted a 0.04% gain.
- The 10-2 yield curve narrowed and ended at 18.9 basis points. Another curve measure of three-month yield six quarters forward – three-month yield continues to be inverted at -29 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 despite the trade conflict 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.

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