WEEK IN REVIEW

- **Geopolitical:** Saudi Arabia’s Abqaiq oil plant was hit by an attack likely sponsored by Iran. Saudi oil production was significantly curtailed by the attack and markets will react to how quickly supply can be restored. As expected, oil prices are up sharply to start the week. With the significant increase in U.S. production capacity, this poses less risk to the economy than in the past, but Treasury yields should move lower in the short-term on a flight to safety. Markets will monitor the progress of trade negotiations between the U.S. and China after China’s most recent move to exempt U.S. soybeans and pork from tariffs which continued some de-escalation in tensions. Movement of the Yuan/U.S. dollar, tweets and the expected October face-to-face trade talks in DC will be closely watched for any signs of deterioration or improvement.

- **U.S.:** August building permits and existing home sales expected to move slightly lower while starts rise. Federal Reserve is almost certain to cut rates by 25 basis points with Chair Powell’s post-decision press conference monitored closely for clues regarding the future path of policy. The Atlanta Fed and NY Fed currently estimate 3Q GDP growth at 1.81% and 1.59%, respectively.

- **Europe:** Germany’s ZEW expectations survey should improve slightly but remain depressed. While Brexit is fast approaching on October 31, there remain many possible paths being explored including a deadline extension. U.K. PM Johnson is expected to meet with European leaders. U.K. August retail sales are expected to be stagnant. The Bank of England should keep monetary policy unchanged and stand ready to act in case of a no deal Brexit.

- **Asia:** Japan’s August trade readings are expected to reflect global trade. The Bank of Japan is expected to leave monetary policy unchanged. China showed year-over-year deterioration relative to July in both August industrial production at 4.4% and retail sales at 7.5%.

- **Central Banks:** The central banks of Pakistan, Brazil, Indonesia, Switzerland, Norway, Taiwan, South Africa and Ghana will meet with Brazil and Indonesia expected to cut rates. Avalon expects the global central banks will continue to ease policy after the European Central Bank delivered more stimulus than many expected last week, including an open-ended, 20 billion euro per month asset purchase program.

**Chart of the Week:** Yields on the U.S. 10-year Treasuries set a recent low of less than 1.5% on September 3 but have climbed sharply to end last week at 1.9%. Rising expectations of a trade truce between the U.S. and China along with better than expected economic data have helped lower the risk to the global economy. While the economic data in many regions is not yet better, expectations became so grim that stabilization and less-bad are good enough to lift yields. Also, the European Central Bank added to the upward pressure by surprising with more extensive stimulus than expected via the open-ended asset purchases. More optimism about the U.S. economy is also reflected in the increasing term premium. Term premium is the excess yield that investors require to hold a long-term bond instead of a series of shorter-term bonds. There is less risk of a more extensive Federal Reserve rate cuts to offset economic drag, which is reflected in a less negative term premium. Our view remains that the odds of a recession in the next 12 months remain low and Avalon expects one to two additional 0.25% rate cuts from the Fed in 2019 including a cut this week.
WEEK IN REVIEW

- The S&P 500 continued the rally with better news regarding trade and global monetary policy and closed +1% for the week. Value stocks were strong performers with growth and momentum stocks underperforming. Financials (+3.9%), energy (+3.4%) and materials (+3.3%) were the best performing sectors, while real estate (-3.2%), consumer staples (-0.9%) and information technology (-0.4%) were the laggards. WTI (-3.0%) and Brent crude (-2.1%) oil prices were down for the week, however, both the energy sector (+3.4%) and MLPs (+3.2%) were strong performers. Small cap stocks outperformed with the Russell 2000 up +4.9%. The 10-year U.S. Treasury yield rose to 1.9%. Consistent with increased risk appetite, high yield credit spreads narrowed.

- The U.S. dollar was weaker against both developed currencies and emerging market currencies. Developed international stocks as measured by MSCI EAFE outperformed the S&P 500 returns in both U.S. dollar terms (+1.98%) and on a hedged-currency basis (+1.95%). Emerging market stocks outperformed the U.S. as well with the non-hedged return of 1.85% for MSCI EM.

- The 10-2 yield curve further steepened at +9.2 basis points. Another curve measure of three-month yield six quarters forward – three-month yield became less inverted and ended the week at -22.7 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 more than a year 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 only one net 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 one to two additional 0.25% rate cuts from the Federal Reserve in 2019 including at the meeting this week. 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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