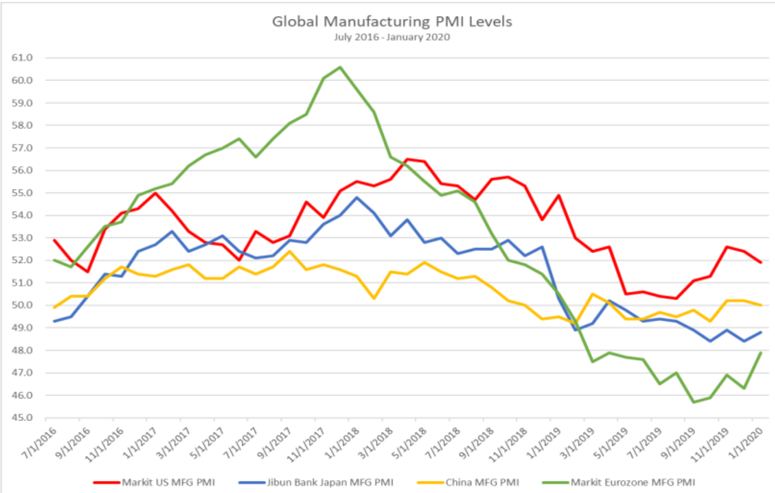
AVALON
INVESTMENT & ADVISORY

Avalon's Weekly Market Guide
Week of February 18, 2020



Source: Avalon Investment & Advisory, Bloomberg as of February 18, 2020

Chart of the Week: February PMI readings for the U.S., Eurozone and Japan are released at the end of the week. This is the first report since the coronavirus outbreak intensified, so all regions are likely to see negative impacts. The U.S. manufacturing reading should remain above 50, but Japan and the Eurozone should dip further below the 50 line of demarcation between growth and contraction. In 4Q earnings conference calls, many companies are noting the negative impact of the outbreak on 1Q estimates and consensus earnings growth has been reduced to 2.1% year-over-year (Y/Y). Of positive note, earnings and economic growth have typically bounced back quickly following similar circumstances in the past. While Avalon remains optimistic about stock market returns for 2020, elevated investor sentiment has again become a possible short-term headwind.

WEEK IN REVIEW

- Geopolitical: Developments regarding coronavirus spread and its potential impacts on the global economy and earnings will be monitored. European Union leaders hold a special summit in Brussels to negotiate the bloc's post-Brexit budget for the next seven years. U.S. markets were closed on Monday in observance of Presidents' Day.
- U.S.: January housing data is on tap. Housing starts should normalize after the surging to a 14-year high last month. Building permits are expected to rise 2.1% month-over-month (M/M) while existing home sales decline -1.7%. The Federal Reserve (Fed) releases the minutes for its meeting in December. Lots of Fedspeak to monitor with at least 10 other speeches by Fed members on tap, but very little additional information expected after Chair Powell's report to Congress last week. The Atlanta and NY Fed currently estimate 1Q 2020 GDP growth at 2.35% and 1.39%.
- 4Q S&P 500 Earnings: 77% of S&P 500 companies have reported with 71% and 67% beating earnings and sales respectively. The blended earnings growth rate for the S&P 500 for 4Q rose to 0.9% year-over-year (Y/Y). Multiple sectors were responsible for the improvement last week. This growth rate is above the -1.7% Y/Y decline expected at year-end. The earnings season is winding down with 51 companies scheduled to report.
- Europe: February Eurozone consumer confidence should decline. German ZEW expectations survey for February declined to 8.7 from 26.7. January U.K. retail sales are expected to improve M/M, while February Markit manufacturing PMI should fall below 50.
- Asia: Japan 4Q GDP contracted -6.3% quarter-over-quarter annualized with the increased sales tax and the typhoon weighing on growth. January Japan trade data should show a decline in exports at -7.0% Y/Y while imports expected at -1.8%. China's January credit data along with money supply are scheduled for release. Many economic activities in China remain shut due to coronavirus precautions.
- Central Banks: The central banks of Turkey, Zambia, Namibia, Indonesia, Guatemala and Egypt meet with Turkey, Indonesia and Egypt expected to cut monetary policy rates.

WEEK IN REVIEW

- Stocks posted another record high and closed +1.6% higher for the week with strong earnings helping stocks shrug off any worries about the coronavirus. Real estate (+4.8%), consumer discretionary (+2.6%) and utilities (+2.4%) outperformed the S&P 500, while energy (+0.3%), financials (+0.7%) and material (+0.7%) were the biggest laggards. WTI (+3.4%) and Brent (+5.2%) crude oil prices were up strongly for the week, but the energy sector (+0.3%) and MLPs (+0.4%) were only marginally higher. Small cap stocks outperformed the S&P 500 with the Russell 2000 up +1.9%. The 10-year U.S. Treasury yield rose to 1.59%. High yield credit spreads narrowed, reflecting increased risk appetite.
- The U.S. dollar was stronger against developed market currencies and weaker against emerging market currencies. Developed international stocks as measured by MSCI EAFE underperformed the S&P 500 returns in both U.S. dollar terms (-0.1%) and on a hedged-currency basis (+0.3%). Emerging market stocks underperformed the S&P 500 with the non-hedged return of +1.3% for MSCI EM.
- The 10-2 yield curve flattened to +15 basis points. Another curve measure of three-month yield six quarters forward – three-month yield closed the week at -18 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 reflecting that the market has begun to price in a possible insurance rate cut in the coming months in response to the economic dislocation from the coronavirus. Our view remains that the Federal Reserve is likely on hold for the time being and the odds of a recession over the next twelve months remain well below 50%. 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