ECONOMIC HIGHLIGHTS

The ISM Non-Manufacturing Index came in at 57.6 for December, still nicely expansionary. U.S. Consumer Prices were down 0.1% for December, and up 1.9% for all of 2018. Core CPI was up 2.2% for the year. Otherwise, it was a relatively light week for economic releases, partly due to the U.S. government shutdown.

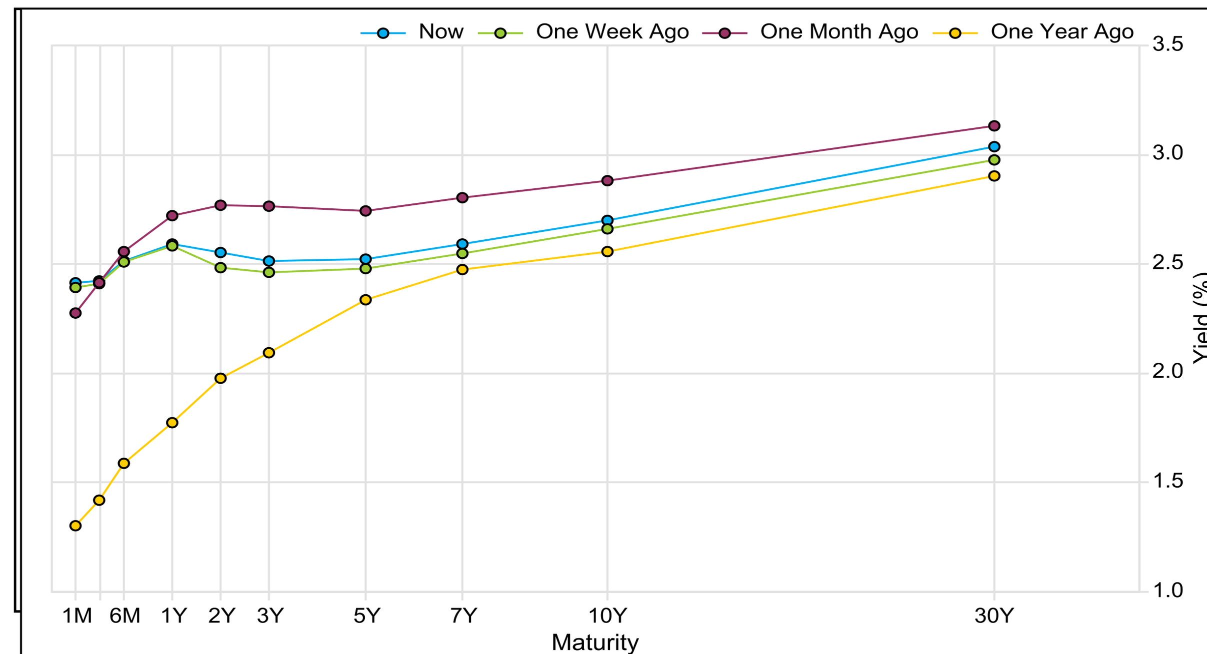
FIXED INCOME

The U.S. Treasury is exploring how issuance tied to a new benchmark designed to succeed Libor could fit into its overall debt strategy. The department asked primary dealers for their perspective on the potential debut of issuance tied to the Secured Overnight Financing Rate, or SOFR, in a questionnaire released Friday ahead of the Treasury's quarterly refunding announcement later this month. It also asked whether SOFR-linked debt would broaden and diversify its investor base, or reduce demand for and liquidity in existing securities. The Treasury Borrowing Advisory Committee in November recommended that the department begin to study how securities tied to SOFR could fit into its broader issuance profile. Should the Treasury decide to issue SOFR-linked debt, it would help legitimize the benchmark in markets. Since its April debut the new reference rate has been slow to gain traction as a viable replacement for the scandal-tainted London interbank offered rate, which regulators intend to phase out by the end of 2021. "It's too soon for the Treasury to be acting on it, but it's not too soon for them to be thinking about it, given the push from the broader regulatory complex to get SOFR up and running," said Jonathan Cohn, the head of interest-rate trading strategy at Credit Suisse. While trading in futures tied to the rate has steadily increased since their launch in May, larger volumes of trades are needed in order to develop longer-term SOFR-based rates, a key goal in expanding usage among market participants. "It's one thing for government-sponsored enterprises to do small value floaters to stoke the flames, but if Treasury were to do something with SOFR, there would be more eyeballs on it and the market would be more comfortable with it," said Thomas Simons, a money-market economist at Jefferies. "Right now SOFR is a black box to some people." A SOFR-linked note would be the Treasury's second floating-rate instrument. The department has been selling two-year floaters since January 2014, which are benchmarked to the three-month Treasury bill. Given that the infrastructure for this type of debt has already been laid out, Simons says the Treasury would only need about six months to begin issuing SOFR-linked notes. SOFR, which was developed by the Federal Reserve Bank of New York as a dollar-market alternative to LIBOR, has been gaining traction with financial institutions. Many money center banks as well as Fannie Mae and the Federal Home Loan Bank have sold securities tied to SOFR.

CURRENT GENERIC BONDS YIELDS

TREASURIES		AGENCIES		CORPORATES		MUNICIPALS	
3 mo	2.42%	3 mo	2.45%	3 mo	2.68%	3 mo	1.65%
6 mo	2.50%	6 mo	2.46%	6 mo	2.75%	6 mo	1.70%
1 yr	2.57%	1 yr	2.48%	1 yr	2.81%	1 yr	1.74%
2 yr	2.54%	2 yr	2.60%	2 yr	2.98%	2 yr	1.78%
5 yr	2.53%	5 yr	2.61%	5 yr	3.25%	5 yr	1.98%
10 yr	2.70%	10 yr	3.12%	10 yr	3.67%	10 yr	2.47%
30 yr	3.03%	30 yr		30 yr	4.16%	30 yr	3.30%

CHANGE IN TREASURY YIELD CURVE



EQUITY

INDEX RETURNS	LAST WEEK	YTD
Dow Jones Industrials	2.24%	2.93%
S&P 500 (Large Cap)	2.58%	3.63%
S&P 400 (Mid Cap)	4.72%	6.07%
Russell 2000 (Small Cap)	4.84%	7.36%
NASDAQ Composite	3.45%	5.09%
MSCI EAFE (International)	1.87%	3.83%
iShares Real Estate	4.49%	3.99%

Stocks fell on Friday but ended the week higher – wrapping up a third straight week of positive returns following the December 24 low. Breadth was strong with all 12 sector groups booking gains. Telecom and Industrials were the best two performing sectors – each rising 4%. Through the first two weeks of 2019, all 12 sectors have positive returns on a year-to-date basis led by Telecom which is already up 8% through Friday.

Crude oil closed down on Friday breaking its streak of 9-straight days of gains. Crude oil closed last week at $51 a barrel.

This year got off to a rough start as noted by Bespoke in a report they released last week. This year, the first two days were the worst start to a year since 2000 and the fifth worst ever. They noted in the five prior years where the S&P 500 saw a decline of 2% in the first two trading days of the year, the index went on to book solid gains on both an average and median basis going forward. In all cases going back to 1928, the average return for all years that started -2% on the first two trading days was +12.35%.

Heading into last week, sentiment indicators were still showing pessimistic extreme readings – a positive sign from a contrarian perspective. The *Investors Intelligence* weekly survey of bullish sentiment dropped to 29.9% from 39.3% - the 9.4% decline was one of the top five largest weekly declines in the last 20 years. For historical perspective, prior periods where bullish sentiment dropped below 30% were in October 2002, late 2008/early 2009, September 2010, and then in late 2015/early 2016.

Another reading that Bespoke noted reached historical extremes during the recent bear market was the number of 52-week highs and lows. On Christmas Eve, 48.5% of stocks in the S&P 500 hit 52-week lows, which was the highest single day total since November 2008. Forward returns of the S&P 500 following these extreme readings tend to be better than average with one major caveat – before the market started to head higher, it typically went lower first.

Adding credence to the retest hypothesis, data from Bespoke notes that in the 12 prior instances where the S&P 500 declined at least -15% in three months followed by a rally of at least 10% in the next ten trading days or less – the initial low before the rally marked the lowest closing price for the next year half the time. In other words, even though returns over the following year have been better than average, there was a 50/50 chance of the S&P 500 making a lower low at some point in the next twelve months.

For the week ahead, the corporate calendar will receive more attention as Q4 earnings season gets under way led by Banks and Financial Institutions. Results are expected from – Citigroup, JPMorgan, Wells Fargo, Bank of America, American Express, SunTrust, Netflix, Goldman Sachs, and CSX Corp. On the economic front we will see PPI data on Tuesday, import/export data on Wednesday, and the Michigan consumer sentiment data to cap off the week. Political news will be sure to stay in the headlines as the government shutdown lingers and U.S. and China continue trade negotiations.

The advance last week pushed the S&P 500 closer to the resistance levels around 2630 – which is the same area that acted as support all throughout the fall last year. We will continue to keep the Christmas Eve lows of 2351 in mind should a retest or slight undercut of those levels occur over the coming months. The index closed last week at 2596.

ASSET ALLOCATION

CURRENT SENTIMENT	
Cash	Neutral
Short Fixed Income	Neutral
Intermediate Fixed Income	Neutral
Inflation-Adjusted Fixed Income	Unfavorable
High Yield Fixed Income	Neutral
International Fixed Income	Unfavorable
Equity Income	Favorable
Large Cap Equity	Favorable
Mid Cap Equity	Favorable
Small Cap Equity	Neutral
International Equity	Neutral
Emerging Markets Equity	Neutral
Real Estate	Neutral
Commodities	Unfavorable

Below is a summery of our current stance on most asset classes:

Cash - Neutral weighting now that Fed Funds rate is above 2%. Any exposure is for defensive positioning or liquidity needs.

Short Term Bonds - Relative to Intermediate Bonds, the reduced duration is preferable given the outlook for higher interest rates.

Intermediate Term Bonds - The current trading range of intermediate bonds warrants a neutral position with limited upside potential. Some opportunities still remain present in floating rate securities.

Inflation-Adjusted Bonds - Low inflation expected in near-term providing zero real return.

High Yield Bonds - Spreads have tightened considerably and do not warrant exposure to unnecessary credit risk when compared to Treasuries.

International Bonds - Foreign bonds offer good diversification qualities and higher yield opportunities, however, risks have been elevated recently and investment should be made cautiously.

Equity Income - High quality and higher-dividend-paying companies remain attractive for long-term investors given their favorable risk-adjusted profile and current yield curves.

Large Cap Stocks - A favorable weighting is recommended. Growth continues to be a more favorable style and should be overweighed versus Value.

Mid Cap Stocks - Mid cap exposure remains an attractive market capitalization. Mid cap stocks continue to provide the "sweet spot" of market capitalization - large enough to provide stability, but small enough to be more nimble.

Small Cap Stocks - In broad market corrections, small cap stocks will suffer most with increased volatility. However, a recent divergence of relative strength between small caps and large caps warrants a neutral exposure.

International Stocks - Given most foreign investment is in developed markets and European countries, until sovereign debt concerns are alleviated, an underweight to neutral weight is recommended.

Emerging Market Stocks - Stronger balance sheets, less debt, and better growth potential make emerging markets more fundamentally attractive than developed countries longer-term. However, trade uncertainty and dollar strength provides a headwind for EM in the near term.

Real Estate - Pricing has stabilized and long-term valuations appear attractive. Real Estate has performed well of late and should continue to be a strong alternative to other asset classes.

Commodities - Global demand should support higher prices if the global recovery remains on track. Volatility will be higher and commodities will be susceptible to short-term price shocks, however, if used in conjunction with other asset classes, risk can be reduced substantially within a diversified portfolio. Used alone though is not recommended as the short-term outlook is not favorable.

Sources of statistical information are Bloomberg and Ned Davis Research.

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