

## ECONOMIC HIGHLIGHTS

Final Demand Producer Prices were down 0.2% for December 2018, and up 2.5% for the full year 2018 (Core PPI was up 2.7% for the year). Industrial Production was up 0.3% for December, with Capacity Utilization at 78.7%. Several other economic releases are still pending, given the U.S. Government shutdown.

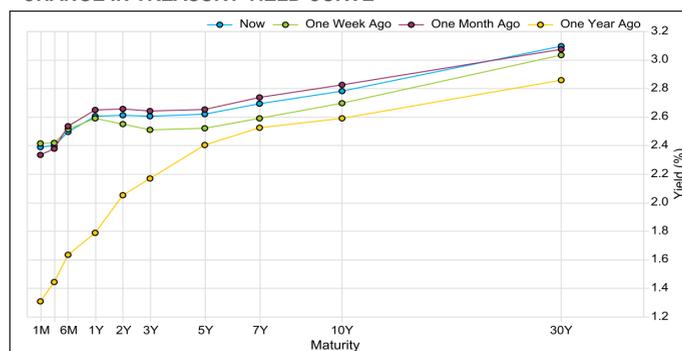
## FIXED INCOME

As the U.S. government blows through its crisis-era borrowing record, surpassing \$1 trillion a year in debt sales, it's relying on creditors who could make its deficit-financing even more costly. America's \$15.6 trillion government-bond market -- the world's largest and most liquid -- isn't necessarily losing customers. But the biggest growth in demand is coming from the private sector, rather than the public side. That matters because if these price-sensitive buyers start pushing for better rates, it could help drive up the average interest rate on the nation's debt, which is already close to a nine-year high. The shift in the investor base is evident in auction results for ten-year Treasuries, a benchmark for global borrowing. The share of foreign purchases has stagnated as international reserves have peaked. But the proportion of domestic bids has risen steadily amid an explosion in exchange-traded funds and other passive-investment products. U.S. funds bought on average about half of each monthly offering in 2018, compared with around a fifth in 2010. The international investor base is also evolving, away from official accounts such as reserve managers and in favor of private buyers who may be less compelled to show up at auctions if the price isn't right. About \$6.2 trillion of Treasuries -- around 40% of the market -- is in non-U.S. hands, making these investors' preferences crucial for America's finances. Foreign accounts still buy large chunks of auctions, but locals have outpaced them in recent years. Foreign official demand has stagnated in part because of a decline in global reserves, which peaked almost five years ago. The U.S. currency's strength has also played a role. Also, China's waning current-account surplus leaves them less to recycle into Treasuries, and sanctions may have driven sales, judging by Russia's actions last year. In the previous peak for government funding -- following the financial crisis -- the economy was still recovering from recession and Federal Reserve policy was pulling borrowing costs lower. Today's fiscal stimulus comes as those pressures are reversing, with the expansion in its tenth year and the Fed letting Treasuries run off its balance sheet. For now, at least one potential catalyst for a buyers' strike is missing: inflation. But some economists say further political dysfunction could unnerve some buyers. Investors' attitude toward U.S. debt may change if the political backdrop grows more toxic as debt-ceiling and budget deadlines approach next quarter.

### CURRENT GENERIC BONDS YIELDS

TREASURIES		AGENCIES		CORPORATES		MUNICIPALS	
3 mo	2.39%	3 mo	2.42%	3 mo	2.62%	3 mo	1.62%
6 mo	2.49%	6 mo	2.43%	6 mo	2.68%	6 mo	1.67%
1 yr	2.58%	1 yr	2.45%	1 yr	2.75%	1 yr	1.72%
2 yr	2.61%	2 yr	2.66%	2 yr	2.90%	2 yr	1.77%
5 yr	2.62%	5 yr	2.70%	5 yr	3.19%	5 yr	1.94%
10 yr	2.78%	10 yr	3.20%	10 yr	3.63%	10 yr	2.41%
30 yr	3.10%	30 yr		30 yr	4.16%	30 yr	3.38%

### CHANGE IN TREASURY YIELD CURVE



## EQUITY

INDEX RETURNS	LAST WEEK	YTD
Dow Jones Industrials	3.38%	6.02%
S&P 500 (Large Cap)	3.43%	6.63%
S&P 400 (Mid Cap)	3.67%	9.32%
Russell 2000 (Small Cap)	3.47%	9.97%
NASDAQ Composite	3.64%	7.89%
MSCI EAFE (International)	2.19%	5.61%
iShares Real Estate	2.55%	6.30%

U.S. equities were higher in Friday trading, getting a big boost on more positive headlines around U.S. and China trade negotiations; the S&P 500, Dow Jones Industrials, Nasdaq, and Russell 2000 all finished over 1% higher for the day.

A Bloomberg report Friday stated that China offered a path to eliminate the trade deficit with the US by 2024 during the meetings between U.S. and Chinese trade officials earlier in January. However, the offer was met with some skepticism by U.S. officials, reported Bloomberg.

The report followed a Thursday WSJ report that Treasury Secretary Steven Mnuchin has led an argument to ratchet back tariffs on Chinese imports to calm U.S. markets and to give the Chinese government an incentive to make deeper concessions in the ongoing trade negotiations. The markets were largely uninterested by United Kingdom PM May's resounding, but expected, Brexit defeat earlier in the week.

The major indexes also finished higher for a fourth straight week resulting in the biggest four week percent gain since Oct-2011. Financials and industrials led the market while defensive sectors trailed with utilities being the only sector decliner for the week. Oil was also higher, with WTI settling up 4.7% on the week. The S&P 500 is now up more than 14% since hitting its 52-week low back on 26-Dec.

Other Washington headlines included an announcement of a second summit between Trump and North Korea's Kim Jong-Un next month. The White House is also making preliminary steps toward another infrastructure plan.

The partial government shutdown entered its 28th day on Friday, with no sign the White House and congressional Democrats are negotiating. There was a noticeable increase in the tension as well, with House Speaker Nancy Pelosi suggesting to President Trump that he deliver his State of the Union remarks in writing due to the shutdown, and Trump responding by canceling her overseas trip to keep her in DC for negotiations and votes.

Analysts have started to take a closer look at possible economic damage. There was increased attention onto second-order effects such as strains on private contractors. Politico highlighted recent cautious analyst notes and argued a protracted shutdown could nudge the U.S. toward recession. The White House even doubled its estimate of the economic drag, saying it could potentially sap 0.1% from economic growth every two weeks (vs the 0.1% hit per month it had previously estimated).

NY Fed President Williams said economists believe the shutdown could cut quarterly growth anywhere from 0.5 – 1.0% depending on the duration.

In a holiday shortened week in the U.S., Q4 earnings season will continue with a number of regional banks and industrials announcing results during the week. Some notable reporters to look for include: HAL, JNJ, IBM, CMCSA, PG, BMY, GWW, INTC, SBUX, and DHI.

## 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 summary 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 overweighted 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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