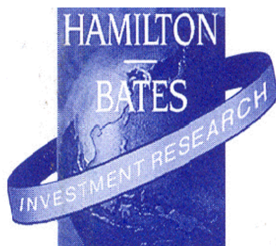

Hamilton-Bates
Market Update

December 22, 2014

December 22, 1956—a baby gorilla named Colo is born at the Columbus Zoo in Ohio, becoming the first-ever gorilla born in captivity. Before Colo's birth, gorillas found at zoos were caught in the wild, often by brutal means.

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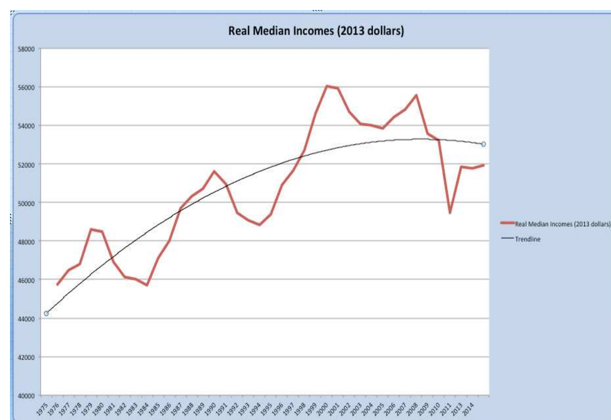
In our last **Update**, dated (12/10), we discussed the odds for a pullback into mid-month followed by renewed strength into the New Year. That outlook played out, with a bit more selling than we expected caused by the profound weakness in oil and oil stocks. The quick drop in the market of about 5%, reversed mid-week when once again the Central Banks came to the rescue. Starting off the week stocks put in their 4th straight up day and are now back to pressing up against the record highs set earlier in the month. The next week is one of the most bullish of the year, as stocks have been up 79% of the time during this holiday stretch.

The market does not seem to need much of a catalyst to rally, as having all the Central Banks behind asset prices is more than enough. However, we do get plenty of data this week as we'll get : Q3 GDP final revision, Personal Income and Outlays, Durable Goods, and Consumer Sentiment. It is very likely weak news will suggest more monetary easing (good news), while good news will also be greeted positively given the recent upside momentum. The next few weeks at least favor the bulls.

Interest Rates and the Federal Reserve

Last week we got the FMOC meeting, and the Fed came to the market's rescue once again by leaving 'considerable' period in the written statement, suggesting a rate hike was not likely until mid-2015 at the earliest. That in turn reversed the market weakness, sending stocks back to their December highs. The bottom line is that the central bankers are powerful. As long as the Central Banks' actions remain supportive, asset prices should rise. A massive market rally just because Chair Yellen kept the considerable time phrase in the FOMC statement!

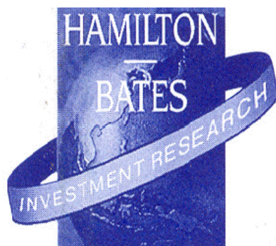
The Fed is doing the only thing it can, print money. But the bottom line is can print all the money you want, but it will never boost wages to keep up with prices. Since 2008 Central banks globally have been pursuing two goals: support asset prices and an expansion of debt which in turn will supposedly generate 'growth'. But despite squandering trillions of dollars, yen, and euros, there are few signs of anything suggesting self sustainable growth. Manipulated GDP aside, the problem with the economy is that the job creation we are getting isn't paying well or replacing the breadwinner jobs lost over the past decade. The chart below from *Of Two Minds* blog shows that inflation adjusted median income peaked in 2000!



And the 'recovery' since 2008 has been tepid and nowhere close to the prior peak. <u>Effectively wages have dropped since 2000.</u>

The problem is the Central Banks create 'bad' inflation, where costs rise faster than wages. This is in net a negative for consumers. 'Good' inflation is when wages rise faster than costs for consumers. We are seeing plenty of bad inflation but little real wage growth. That is why the economy still feels 'lousy' to most people. Costs have been rising, their pay has lagged, creating tightness in budgets. That is why nominal recoveries in GDP have little worth, as it does not take into account the negative affects of bad inflation on consumers.

Its not just here, it's a global Central Bank disease. In Japan, where the central bank and government have struggled for years with their economy and have been following the same prescription followed by our Federal Reserve, wages have fallen by 9% in real terms since 1997 according to an article from *Foreign Affairs*.



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The point is that Central Banks have been using the only tools they have to fight problems in the economy they cant fix. The result is a severe disconnect between the financial markets which rally in response to their methods while sustained growth in the real economy always seems 'just around the corner'.

Real household income has declined across the entire income spectrum since 2000. The lowering of interest rates to zero and issuing unlimited free money for Wall St banks to generate asset bubbles has had a negative effect on wages and household income. Central bank money-printing and bond-buying have not had any positive effect on wages because they cannot possibly have any positive impact on wages. If you could print your way to prosperity it would have already been done. As investors and managers it is important for us to distinguish between the market created by the central banks and the reality within the economy. Eventually they will mean revert, and when they do investors are not likely to enjoy the results. We'll take these gains as long as central bank actions remain supportive, but when they are not, or are no longer effective—watch out.

Valuations and Earnings

Looking at valuations may be so '1980's or 1990's' but we still do it, as eventually markets are mean-reverting. The problem is that 'eventually' can be a really long time (months/years) in an age where waiting five minutes feels brutal. Currently, valuations based on spreads between equity and bond yields are just neutral, and that is with interest rates being severely suppressed by all central banks. If interest rates were 'normalized' (allowed to float free) the stock market would be at nosebleed valuations.

We had hoped earnings would come through but the environment continues to be tough for the 'real' economy. With oil coming down it is dragging down capital expenditures and thus many outlooks have to be reduced for earnings. Declines in oil—when they are steep and deep, <u>and especially when the energy sector has been carrying the economy</u>—are more likely than not an overall negative for the economy. Aggregate earnings projections for 2015 have been coming down. We need to see this reversed and projections to start rising again, or stocks will have to rely on P/E multiple expansion once again for price appreciation. <u>That would in turn mean that the outlook for stocks depends nearly entirely on what the central banks say and do (in terms of rates and QE).</u>

The Real Cost of a Drop in Oil Prices

With oil prices off over 50% from their summer highs, the mainstream financial guru belief that the crashing price of oil is so 'unambiguously and unquestionably' good for the US is simply taken for granted.

But now the US economy is one with a significant energy sector component, and while a drop in crude oil may help consumers with energy bills, a crash in prices like we have seen may due more damage to a now key sector of the economy to more than offset any positive benefits. We mentioned this in the last Update, but here we found some data to put the oil price decline and its potential affects in perspective.

The drop in crude from $110 to below $60 has shaken the energy industry, putting expansion plans into doubt and crushing oil company shares. Projects in costlier regions like the deep waters of the Gulf of Mexico are predicated on high oil prices and may not be economic with oil at $60 a barrel. These projects will be cancelled or put on hold until prices recover.
We are seeing this already with many oil companies cutting capital expenditure budgets 40-50% or more for 2015. <u>These effects haven't been felt yet, but they will surely hit home in 2015</u>. You also have the financial impact that many shale oil drillers financed drilling with debt, high yield bonds that need high oil prices to make recovery possible. Oil below $60 will mean no new drilling for many shale oil areas once current wells are depleted (unless prices recover), and high yield bond prices for the energy sector have been crushed—effectively shutting these companies off from financing. These financial effects along with the cuts in budgets have not even been felt yet. That pain

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will be in 2015. But what is really scary is when you look into the data and see just how important the energy sector has been to job creation and growth.

According to data from the Financial Times, Texas has been home to 40% of all new jobs created since June 2009. In 2013, the city of Houston had more housing starts than all of California. Mention that to any left-coaster! And let those figures sink in for a minute. Nearly 4 in 10 jobs created during the 'recovery' have been in Texas, and are energy related. That number jumps to over 50% of all new jobs created if you add in North Dakota and its shale oil boom.

The truth is much of our job creation during the 'recovery' has been due to the energy sector, which is ironic to some extent given how adversarial the Administration has been to this key segment of our economy. Now a 50% drop in crude will absolutely hurt this sector, and budgets will be cut. We are already seeing plenty of news stories about companies slashing their production budgets. This means lower employment, with all of the knock-on effects. As an aside, the UK North Sea production is all but uneconomical below $70 a barrel. They are fearing major job cuts there.

While most people think of the huge, major companies when they think of oil, most people don't realize that energy is a sector largely populated by small businesses. According to a recent report from the *Manhattan Institute (*The Power and Growth Initiative Report), there are more than 20,000 small and midsize businesses that handle the majority of exploration, drilling, and engineering in the energy sector. In fact, the typical firm in the oil & gas industry employs fewer than 15 people. The shale oil & gas revolution has been the nation's biggest single creator of solid, middle-class jobs, exactly the type of breadwinner jobs we so desperately need.

For better or worse our economy is dependent on the energy sector for job creation. Should oil prices remain below 60-$70 a barrel for any length of time, we are likely to find out just how painful an oil price decline can be.

Market Outlook

The latest rally started last Wednesday, due to Fed Chair Yellen's dovish FMOC comments. Traders do not expect the first rate hike until the second half of 2015 when before these comments an earlier rate hike was on the table. Once again it's the Fed to the rescue as we remember the mid-October rally was ignited by with Fed's Bullard pumping the idea of more easy money if the market were to drop. In any case we were looking for the recent dip and expected a recovery to new highs, which we are getting. Some clues to its strength were the back to back breadth and volume 90% up days. This means 90% of the volume and issues were up on back to back days. Coming off a low this suggests strong initiating and further upside. The last back to back 1%+ gains came at the February lows, and prices moved higher for some time thereafter. With strong seasonal trends now in place for year-end and into early 2015, the bulls are clearly back in charge.

Investment Strategy

The momentum off of the October and December lows has been very strong, and with positive signs from the previously lagging small and mid-caps, is likely to persist into the first half of 2015. Short-term pullbacks aside, a significant top is not likely until we are past the seasonally strong next few months. We talked about buying the December dip and we did, although once again the 'V' bottom didn't let us get all our purchases as close to the low we'd like—the rally looks likely to last long enough that holdings and purchases are likely to see gains in coming weeks and months. We still have concerns in the fixed income area, especially in high yield bonds, which are not acting well. Normally this credit sector acts like a 'canary in a coal mine' for stocks. Should weakness in this credit sector continue we will have to be more cautious once the current rally runs its course. We remain invested in equities with balanced portfolios focusing on investment grade bonds over high-yield.

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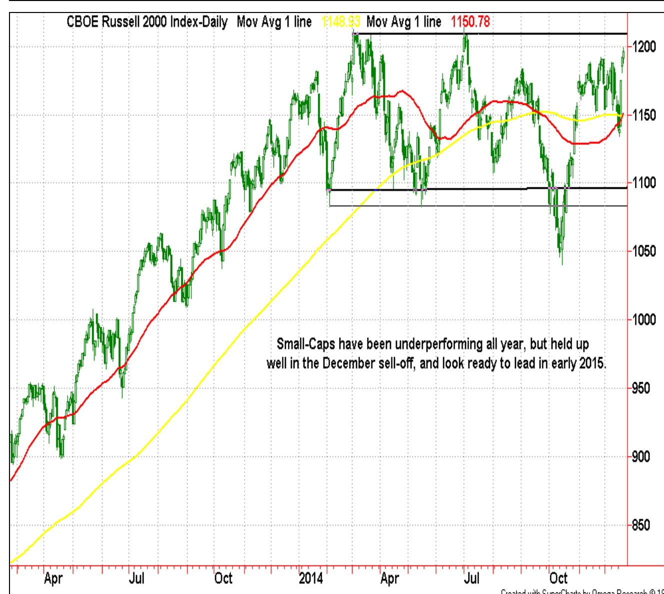
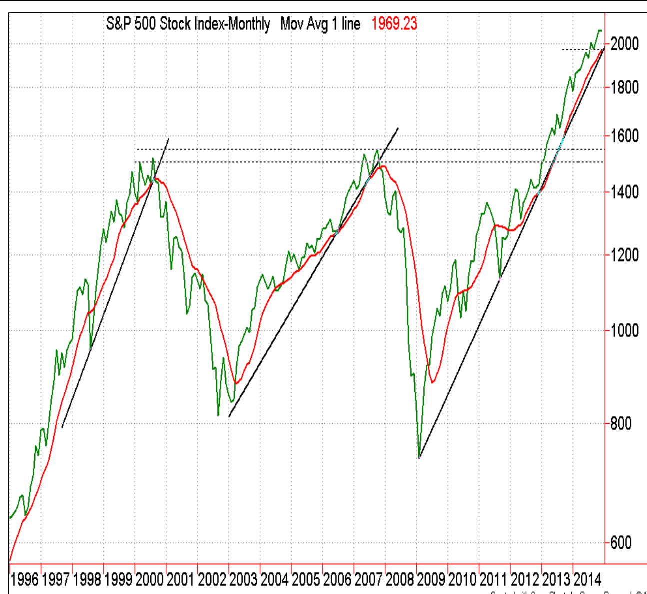
Charts—Long-Term Trend Still Bullish, Time For Small-Caps to Shine?





Small-Cap Russell 2000 (Top Left)

Small Caps are finally starting to look attractive after essentially being dead money in 2014 (+ less than 3% YTD). Looking at the horizontal consolidation area that has consumed much of the year (bounded by solid black lines), 2015 may be a good year for small caps. Heading into the 'January Effect,' where seasonality supports strong small-cap performance, we are finally bullish on this market segment and have taken positions there over the past week.

A breakout by the Russell 2000 over 1200 would be bullish not only for small-caps, but the market as a whole.

Long-Term S&P 500 Chart (Top Right)

The bull trend up from the 2009 lows remains intact, and the bought of mid-December weakness held once again at the important trend line dating back to the 2009 lows (solid black line far right).

A break of this long-term trend line along with the corresponding moving average (red line) happened in 1999 and 2007 and warned of the bear markets that followed.

The key market average and trend-line to watch are now around 1970 on the S&P 500 Index. As long as the S&P remains above that level the long-term trend remains intact.

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