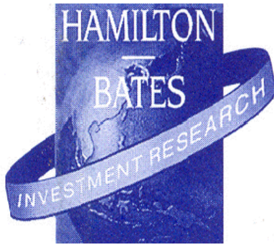

Hamilton-Bates

Market Update

February 2, 2015

February 2, 1987—On this day in 1887, Groundhog Day, featuring a rodent meteorologist, is celebrated for the first time at Gobbler's Knob in Punxsutawney, Pennsylvania.

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Stocks resumed their volatile ways last week, and have now sold off in four of the last five weeks. The reasons are varied and across the board—earnings reports, economic reports, Greek elections, and central bank news—–have all been prominent in recent weeks. Unfortunately the news has been negative or uncertain for stocks, and this has been giving investors reasons to sell not buy. The net result of all this volatility is that the market is back to where it was at the end of August, just as QE was ending.

Economy, Earnings, and Interest Rates

Last week 4Q GDP was released and it nearly reversed the strong Q3 GDP report of 5.0%. Additionally 25% of the 2.6% 4Q growth rate was due to increased Obamacare expenses—not quite the robust growth cycle many economists have been looking for. The GDP report showing a sharp deceleration of growth in the fourth quarter comes on the heels of a weaker-than-expected durable goods report, and coincided with news that the German economy was once again nearing recession. Once again it seems that sustained, healthy, economic growth remains 'around the corner' and yet to arrive, and its not likely that it will anytime soon given the weakness in the energy sector—**THE** driver of recent job creation.

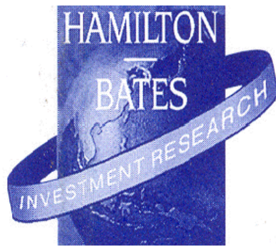
Making matters worse we had the FOMC announcement last week, which showed a shockingly hawkish tone and set expectations for a possible rate hike as early as June. Amazing that with the economy starting to show the negative affects of falling oil prices the Fed is talking about a rate hike. If they even get there it will most certainly be a one and done affair. Hiking rates now would probably only hurt the economy even more. Fed policy has gotten them so far down a rabbit hole it may be difficult to get out. With rates at zero they cant be lowered any more to help the economy, with QE the only option left should the economy falter. And that option hasn't helped the real economy so much as be a handout to Wall St. The market may be coming to the realization that the Fed is stuck in the corner and may not be of support to the market for some time, or until we see a more pronounced correction. Wednesday's announcement was met immediately with selling, followed by a weak rebound attempt Thursday, and a high volume decline on Friday. Its hard to imagine the Fed hiking rates while the rest of the world was nearing recession, and we would be surprised to see the Fed raising rates in the first half of 2015. Unless the market drops sharply, in which QE will likely be brought back, the Fed is likely to sit on their hands keeping rates low as economic weakness abroad seeps into the US.

Oil Prices

The drop in oil prices has been nearly universally viewed as a 'good thing' for the economy as it represented money in the pocket for consumers—and to some extent that is true. The problem is that the decline in oil itself reflects a slowing of demand—and thus a slowdown in global economic growth, as well as the severity of the decline is now affecting the one sector of the US economy that was driving economic growth and job creation. And now as we expected we are seeing the negative side effects of such a severe and persistent drop in oil.

Oil under $60 a barrel makes much of US production from new shale wells uneconomic, and prices below $50 will mean a lot of pain in the energy sector should they remain there. Analysts foresee a wave of corporate restructuring and acquisitions playing out over the next 12 to 18 months. Oilfield services companies are set to absorb smaller firms, while smaller exploration and production companies could disappear entirely as they become locked out of the debt market. Exploration and production companies have largely funded growth by borrowing on the high-yield debt market. The energy sector accounts for 1/6th of the high-yield bond market. With the drop in oil, the value of E&P firms' primary asset is depleting, so banks are willing to lend them less money, and liquidity is drying up.

While the large oilfield companies are likely to scoop up weaker middle-market players, most companies in the energy sector are small—with less than 50 employees. These companies will be hurt severely.



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For these companies restructuring will come not just in the form of layoffs and cost cutting, but in capital restructurings and possible bankruptcy. Keep in mind two energy states (TX and ND) were responsible for nearly half of all net job creation since 2008. That cycle is now set to reverse, and the job cuts have already begun to roll in from big oilfield services companies. Baker Hughes announced it would lay off 7,000 employees, or about 12 percent of its workforce. The same day, Halliburton told investors to expect more reductions on top of a previously announced 1,000 cuts. Previously, Schlumberger said it would shed 9,000 jobs. BP announced in December it would shed thousands of positions as part of a restructuring. And in our home state of Pennsylvania, Chevron said it will cut 24% of its workforce here. Sadly, we believe there is still a lot of economic pain yet to be felt from the drop in oil, which has now become much too much of a 'good thing'.

Market Outlook

Recently it seems like there has been a terrible mix of negative worries eating away at the confidence of investors, but the most concerning to us are the weakness of earnings and earnings expectations, and the potential for the Fed to make another 'mistake' by hiking rates. Earnings forecasts have plummeted driven by the crash in oil, along with the strong US dollar given the ugliness of most foreign currencies. Our economy isn't great, but it is compared to what is going on in Europe and Asia right now.

Optimistic earnings estimates for the S&P 500 for 2015 have fallen from around $133 to nearly $125, with most of the damage occurring as Energy profits will be cut by more than half. We are not even sure these reduced estimates will be met. Meanwhile, the strengthening US dollar, which will only get stronger as the euro drops, is hurting exports now and the sales and profit impact will only get worse.

Then we had one of the most steadfast doves on the FOMC, James Bullard, who has saved the market on more than one occasion with dovish comments; come out and say that "Zero rates are not right for this strong economy," on Bloomberg TV Friday morning. Not only do we not see the 'strong economy' the Fed sees, a rate hike would only exacerbate the recent dollar strength and hurt earnings more.

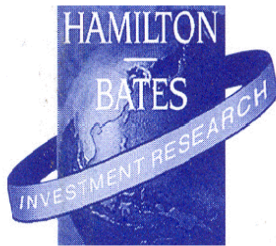
Investors have been paying up for our market expecting that the US will show growth in the face of weakness elsewhere. But if the profit picture drops much more that growth will be very unlikely. Couple weak earnings growth with a Fed that could possibly HIKE interest rates at the worst time, and you can see why the market is struggling. From a technical perspective the trend remains 'up', but the market is very close to flipping that too. Its been tough (and wrong) to count this market out before, so the market earns the benefit of the doubt for as long as the trend remains intact. But the way the market is acting, it seems to us like a drop to 1900 or below is more likely this than run to new highs.

Investment Strategy

The selling has taken the major indexes back to important support levels, and created potentially bearish patterns which, if support is broken, could lead to further downside of 3% to 6% or more.

We remain invested in our equity and balanced accounts, but cash has been increasing over the past few weeks as risk has grown. Unless the trends are conclusively broken, there is still the chance for the market to whipsaw the bears once again and rebound to new highs in Q1. Should nearby key support falter (more on this in the chart section), we could see cash increase and portfolios move to a clearly defensive position.

In the credit markets, we remain under-weight high-yield bonds (since July) and have shifted our focus toward higher quality bonds. This is a major change from as far back as 2009 when we favored high yields after the crushing declines of 2008. High grade bonds continue to do well and help offset the volatility of equity positions.



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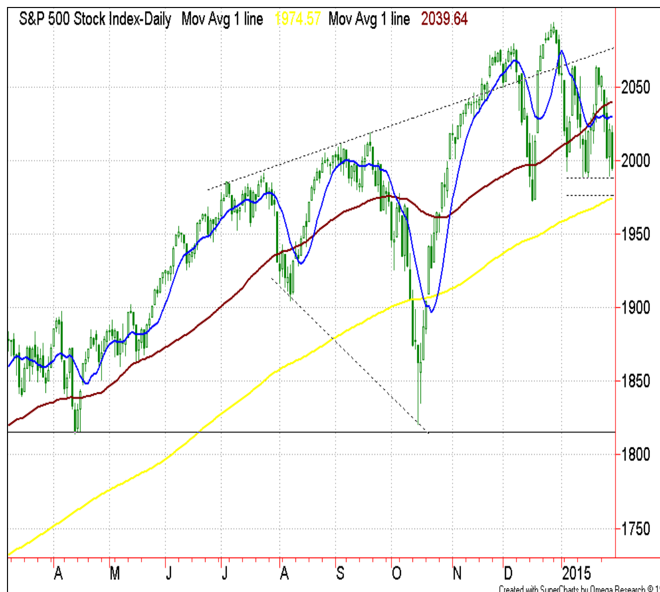
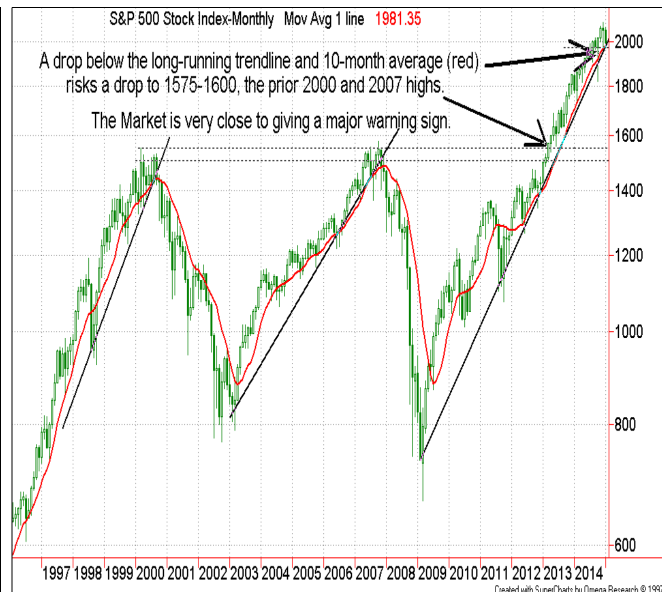
Charts—Market Diverges From Economic Tells; Volatility Up But Trends Still Bullish





S&P 500 Near-Term (Above Left)

The short-term view of the market is sort of like a Rorschach test—you can pretty much make of it what you will. The choppy action of late December and January could be taken as a healthy correction of the prior advance before the next run. But the inability of the market to rally during a strong seasonal period could also be a sign of a topping market unable to mount an advance.

The prior lows around 1975 to 1985 on the S&P 500 represent nearby support, and these levels are also important to the long-term view, giving them even more importance.

S&P 500 Long-Term View (Above Right)

Given the choppiness of the short-term charts stepping back to a long-term view can be helpful. Looking at the monthly chart of the S&P 500 we can see that the S&P has not spent much time below its 10-month average, nor has it decisively broken the trendline up from the 2009 lows.

We had a quick scare of a break in October, but the market quickly recovered. Once again though the market is threatening to break the monthly moving average and long-term trendline.

In the past two bull-markets, when this happened the bull market was over or soon to be over. A break of 1975-1985 on the S&P 500 to the downside opens up the risk for a much larger correction.

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