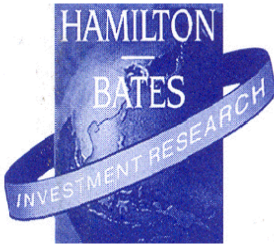

Hamilton-Bates

Market Update

June 29, 2015

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Jumping the shark is an idiom used to describe the moment in the evolution of a television show when it begins a decline in quality, signaled by a particular scene in which the writers use some type of gimmick in desperation to keep viewers' interest. The phrase is based on a scene from a 5th season episode of the sitcom *Happy Days* when the character Fonzie jumps over a shark on water-skis.

Greece Jumps the Shark—Nears Default

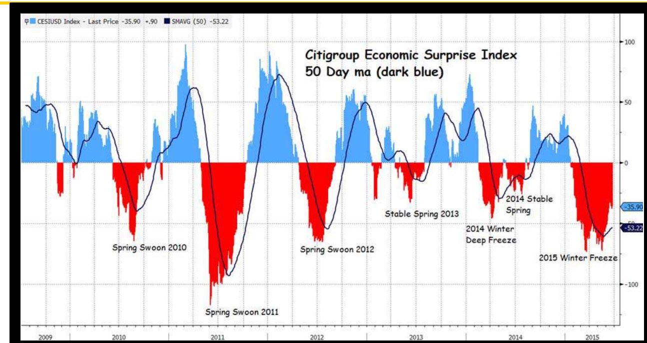
After not getting a deal that the ruling Syriza party could get through Parliament, Greece decides to shut down its stock market and banks for the entire week as the prospect of being forced out of the euro is getting closer. They will attempt to hold a referendum in a week's time on the course Greece should follow. Months and Years of kicking the can down the road may have ended for Greece. The only good news from the situation is that with things happening in slow motion for the past few years a Greek exit from the euro or even a default have largely been minimized. Most vulnerable European banks have smartly sold their Greek bonds to the ECB. Being relatively small, at just 0.20% of world GDP, Greece is also unlikely to materially impact the economic numbers of Europe or the US, meaning the effect on the financial markets is largely psychological. We do not see a Lehman-like contagion effect.

The Germans may be maneuvering things in order to force out Greece's combative government, but as German's like to say, "the soup is not eaten as hot as it's cooked." Meaning things may be as bad as they first seem. We'll let the initial knee-jerk reaction shake out, and re-evaluate once things settle as we keep an eye on key market levels nearby to current prices.

Economy, Earnings, & Interest Rates

Better US economic data has been lost in the background with all the attention on events in Greece. The better data from June bump the data from the brink of a recession back above the 2.0% moderate growth trend. While better data may give the Fed more leeway to hike rates at some point this year, the more important take-away for us would be the benefit to earnings from an economy that might be better than recently feared.

Bonds have weakened in 2015 as it seems the Fed is fairly determined to hike rates this year, and that economic data have rebounded from their recent negative trend (see Citigroup Economic Surprise Chart above right). We see the action in the bond market as



The month of June saw a rebound in economic data, turning the Citigroup Economic Surprise Index higher. This index shows that the trend of negative economic data surprises appears to be over, and past lows saw a rebound in economic activity once the Surprise Index has started to trend higher.

'sell the rumor buy the news'. We continue to avoid government bonds for anything longer than a short-term trade, expecting that the peak in bond yields could very well come right into the first rate hike by the Fed as investors look to get out ahead of time. Even with a rebound in activity its unlikely that the Fed is about to begin aggressively hiking rates, so we could see yields rising into the hike, only to fall thereafter. Given that the current Committee has no appetite for surprises, and current Greek uncertainty, monetary policy is likely on hold until next quarter if not beyond. More on bonds can be found in the section on bonds on the next page.

Market and Investment Outlook

The stock market continues to struggle to hold onto any new high breakouts and even to hold onto gains. The latest pop and drop over the past two weeks from 2015 highs back to 2015 lows exemplifies the whipsaw trading we have seen this year. This action has left the market right back in its prior range and once again testing key levels. Our short-term indicators are currently mixed, which is reflective of a sideways market. The long-term trend remains 'up', but the near-term trend has been choppy. (See chart section on next page). The important financial sector has been relatively strong, as have small-caps, both

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signs normally attributed to rising markets. Breadth has weakened however as rising yields have put pressure on REITS, MLPs, Utilities, and closed end bond funds. With seasonal and cyclical factors set to turn bullish in the next week, and the long-term trend still up, we look for a rebound from the current bout of weakness. This week could offer an excellent buying opportunity. We remain invested with a focus on stocks over bonds, and for corporate bonds over Treasuries on bond holdings we do maintain. We like preferred stocks for income purposes in this low-yield environment. Structurally the bull trend remains intact, and we expect the market to bottom this week and push higher into July and August, where a more significant peak is likely. While we look for a peak in the S&P around 2200, we wouldn't want to see prices break below 2070, or even worse 2050. Such a drop would be a major blow to the bull case.

Special Section—What to Do With Bonds in a Rising Rate Environment

With many types of bonds performing poorly in 2015, and with the Federal Reserve potentially set to raise interest rates, many investors and planners are wondering what to do with bonds. After a two decade plus trend of declining rates and bond-yields, it's logical to assume that longer term rates (on 10 year and 30 year U.S. Treasuries for instance) will start to move up. In fact they already have after bottoming in May. Even so we don't see interest rates soaring higher just because the Fed has begun deliberating a hike in rates. But, absent some sort of financial crisis, we don't see rates going much lower either.

As interest rates rise, bond prices typically decline. So, if you tried to sell your individual bonds or bond funds in a rising rate environment, you would likely get less than you paid for it depending on how long you held it. For individual bond holders, just hold the bond to maturity, and you'll receive your interest payments and principal (assuming the bond doesn't default). But, many investors don't own individual bonds, they own shares of bond mutual funds. Most bond funds do not have a set maturity date and if you want to get your principal back you have to sell shares of the fund. If you sell after yields have risen, you risk receiving a lower price.

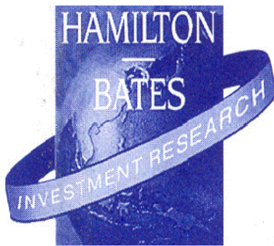
Duration of Your Bond Mutual Fund is Key
Rising rates affect the interest charged on most loans. Since bonds are like loans, their interest rates also increase—resulting in lower bond prices for bonds with lower coupon rates. The negative effect of rising rates is different depending on a bond's maturity, with longer-term bonds' losses normally greater than that of short-term bonds. To provide some illustration here is a hypothetical 'price impact' of a 1% rise in interest rates on the various Government bond categories:

Short-term 2 Year US Treasury:	**-2.0%**
Intermediate 10 Year US Treasury:	**-8.6%**
Long-Term 30 Year US Treasury:	**-17.8%**

You'll notice that the longer the duration of the bond, the more affected it is by rising interest rates. If you're holding on to a chunk of long-term government bonds, or have a significant allocation to long-term government bond mutual funds, you may want to consider the value they are adding to your portfolio—if any at all.

Bond Funds Could Still Do OK if Rates Rise Gradually
This is not a recommendation to sell bond funds. Bond funds do provide diversification and mitigate volatility on negative news days like today as investors flock to safety. Bonds also provide investors with returns two ways: price changes and interest payments. Historically coupon payments have helped offset the negative impact of price changes to moderate or gradually rising rates. Over the past 15 years, the Barclays U.S. Aggregate Bond Index has had a negative price (NAV) return in 7 of 15 years. But thanks to income payments the total return has been negative in only 2 of those 7 years. Interest payments can make up for modest declines in price or NAV.

Bottom Line for Investors
Some bond funds may be better able to weather the rising rate environment, especially corporate bonds with their higher coupon rates. **For managed accounts we have avoided government bonds in favor of corporate bonds for some time**. We also avoid long-term bonds. Investors should review fixed income allocations; understand their holdings, and think about whether some changes might be worth exploring. If anyone has questions or needs help analyzing bond holdings please contact us.



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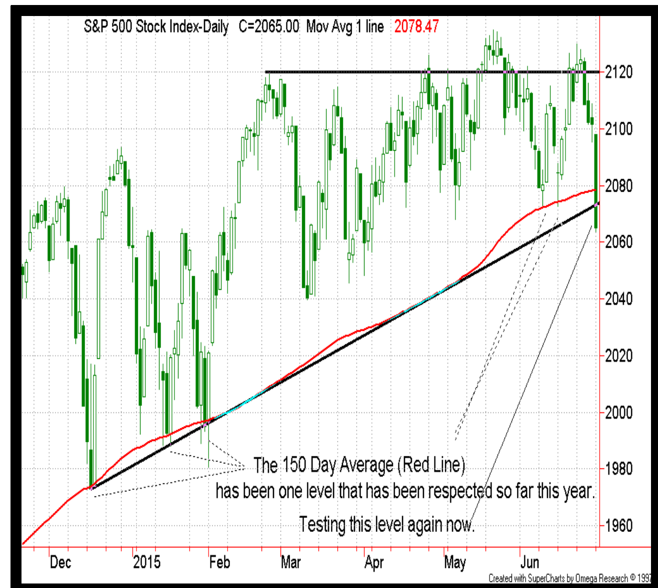
S&P 500 Charts—Key Test of Support but Long-term Trend Still Remains Intact

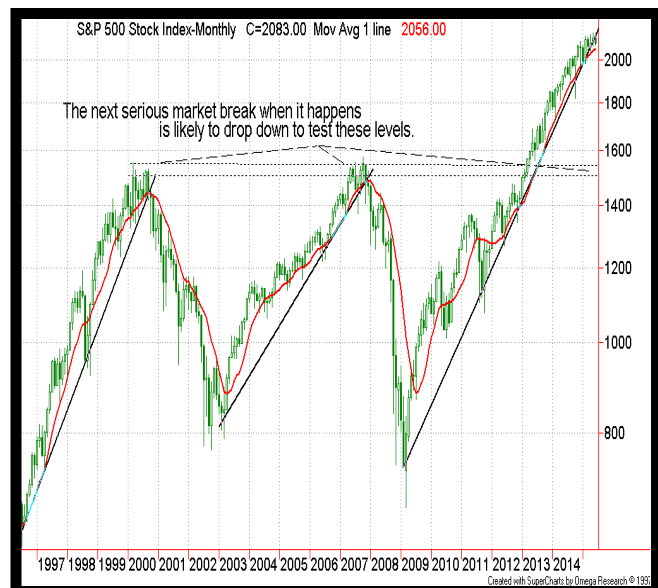
Near-Term S&P 500 Outlook (Above Right)
After bouncing from support at the 150 day average mid-month, the S&P 500 rebounded to attempted another 'breakout', which was again pushed back. In the wake of the Greek news all markets are in the red, and the S&P is now once again testing important support levels. This week will be critical for the market– key levels nearby must hold for the bulls.

The flat-top and rising bottoms pattern (bounded by the bold black lines) still has the look of a bullish trading pattern that normally resolves itself with a move higher. Seasonal and historical trends also favor a move up in July-August as long as nearby support levels hold. However, a drop below 2070-2080 that lasts for more than 1-2 trading days would downgrade the near-term outlook negative.



S&P 500 Long-Term (Lower Right)
The bull market remains intact but the S&P 500 is now trying to manage a 'high-wire' act balancing right near the long-term bullish trend line (bold line). After six years the long-term trend is very over-extended, and the next serious break that occurs could see the S&P drop back to the 'breakout point', which is the level of the prior highs in 2000 and 2007. That would be a 25% decline.

As long as the S&P remains above its 10-month moving average (now in the area of 2050-2060), the bull market remains intact. A drop below 2050 would be a very negative development. We would pay close attention to a month-end close below that level.



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