July 24, 1911—American archeologist Hiram Bingham discovered Machu Picchu, an ancient Inca settlement in Peru that is now one of the world's top tourist destinations. Tucked away in the rocky countryside of southern Peru, the city is believed to have been a summer retreat for Inca leaders.

Hamilton-Bates

Market Update

July 24, 2015

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Like a Mouthful of Bees

In the last Update the market was rebounding from key support as a calming of Greece and China (at least temporarily) allowed support to hold and for the decline to be replaced by an equally powerful move higher that took the S&P within a whisker of its 2015 high. But some weaker than expected earnings in key index components caused yet another stall to take place, with the market now in some danger of rolling over once more. 2015 has been a frustrating one for investors, with 13 short-term direction changes and 4 failed attempts to breakout above the early year highs. A looming rate hike, and bad news from Greece and China have added to the market's uncertainty. Clearly the year so far has been one that has not been enjoyable. Something happened this week that struck me as a fitting analogy for how the market feels this year—like a mouthful of bees.

Now I don't know what that is like personally, nor would I want to, but I did see firsthand the result; and it clearly isn't pleasant nor pretty. You see, we have a couple of new puppies from a rescue shelter, and like young ones of any kind they do dopey things sometimes which make you shake your head (we have young boys too). This week they decided to chase and eat bees (the puppies not the boys). Now I know that isn't smart, and now the puppies do too, after getting stung and one of them having an allergic reaction. Fortunately the dogs are fine, if not a bit wiser. Seeing the travail of my little pups though did give me an analogy of how the market 'feels' to me so far in 2015, like a mouthful of bees.

For now the rebound from the July low remains intact, and as long as this week's correction doesn't deepen significantly, our outlook for a summer rally still holds. Perhaps then, after dealing with 'the bees', it will be time for investors to enjoy 'some honey'.

Earnings, Economics, and Interest Rates

Economic data continues to show modest growth for the US economy and parts of Europe, but events in Greece and China could be denting the outlook. Heavy equipment maker Caterpillar (CAT) stated that global conditions remain stagnant. The CEO noted that many of the key industries they serve remain weak, and haven't seen any sustained signs of improvement. Prices for commodities like coal, iron ore, and oil are not signaling an improvement and continue to weigh. This matters because Caterpillar is seen as a bellwether of economic activity given that its machines are costly, and used in the kinds of projects (highway construction, large housing developments, mining projects) which are only undertaken if companies and governments are confident in the economic outlook and their financial health. This news from Caterpillar follows Apple's earnings report earlier this week, which hinted at the new biggest fear about the global economy: of a potential major slowdown in China. Caterpillar saw "continuing economic weakness in China," which runs counter to official government data out of China that indicates GDP growth held up better than expected. Other measures from China though, including auto sales and commentary from other large US companies, have not painted a pretty picture. That leads us to the $64,000 question, which is what is the true health of the Chinese economy, one that is likely to have an impact on the financial markets.

The Chinese Question

Although it has dropped from the news cycle, the decline in the Chinese stock market has the potential to be a catalyst for the global economy and financial markets. The sizable and draconian response by the Chinese government has arrested the selling (figuratively and literally), but the severity of the decline coupled with coincidental bubbles in credit and real estate, could have lingering psychological effects across the financial markets.

We continue to see the larger risk in China as *economic*, should their market decline exacerbate an already slowing Chinese economy. We are not alone in these concerns. This week Ray Dalio, head of the largest hedge-fund in the world, Bridgewater Associates, echoed our concerns. In a letter to clients

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he states that : "*it appears that the repercussions of the stock market's declines will probably be greater than initially thought. Because China has real estate, stock market, and credit bubbles bursting all at the same time, we are now seeing mutually reinforcing negative forces on growth. While at this stage it is too early to assess how strongly the stock market's decline will pass through negatively to credit and economic growth, we will be watching our short-term indicators of Chinese credit and economic growth carefully to see what the pass through to the economy of these developments is like.*

The negative effects of the stock market declines will come from both the losses and the psychological effects of the stock market bubble popping. Though stock prices are significantly higher than they were two years ago, the average investor in the stock market has lost money because more dollars were invested at higher prices. We now estimate stock market losses in the household sector to be significant—i.e., about 2.2% of household sector income and 1.3% of GDP. However, these losses appear to be heavily concentrated in a small percentage of the population as only 8.8% of the population owns stocks. Even more important than the direct financial effects will be the psychological effects. Even those who haven't lost money in stocks will be affected psychologically by events, and those effects will have a depressive effect on economic activity."

As we mentioned back in June, China has become very important for many stocks and sectors growth prospects; and China has become a vital market in a growth starved world. If Chinese demand weakens, it would have a very negative affect on global earnings. We will be watching the spillover effects of the Chinese market into the Chinese economy, and we will further insight in the few weeks as companies release earnings and forward guidance. If China can somehow avoid a negative economic spillover, the better the outlook will be. So far you can color us concerned.

History and Sentiment Favor the Bulls

Lest we get too negative, it is important to note that odds are that we will likely see a continuation of the recent rebound. This is the third year of in the Four year Presidential cycle. In those years, the next 21 trading days have rise 75% of the time since 1965.

We also have the year '5' decadal pattern favoring the market. Years ending in '5' far outperform any other year of the decade. Using data from The Stock Trader's Almanac, every year ending in '5' since 1885 has been bullish for the S&P 500. That's all of them folks, 100%. That is a pretty good record. Not only that, but the average gain has been an astounding 28.3% in years ending in '5'. Why this pattern occurs is difficult to explain, but part of the he reason could be that half of the years ending in '5' have been the years after midterm elections, which for political reasons are very bullish years in general.

Another factor favoring the bulls right now is investor sentiment, which not surprisingly has built up to negative extremes. The 8-week average for bulls in the American Association for Individual Investors (AAII) dropped to 25%, something it has done only two other times since 1995—2003 and 2009. Both of those years ended up being very strong ones for stocks. Unlike 2014 both years prior to those instances saw very weak markets (2002 and 2008), but the build-up of negative sentiment adds potential 'fuel' for a market rally.

Market and Investment Outlook

We remain invested and we expect an eventual continuation of the rebound that started last week. We have concerns with market internals though, as declining stocks have outpaced gainers, and new lows dominate new highs, even during the recent rally. Cash has increased due to some short-term sell signals, and we cut back on holdings that were affected by the Chinese market decline last week. **As long as the S&P holds above 2080, we'll look to put that cash to work in coming days, and we look for a rally that takes the S&P 500 to 2200, some 4-5% higher than current levels.**

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S&P 500 Charts—Market Stalls at Resistance Once Again

Near-Term S&P 500 Outlook (Top Chart @ Right)
2015 has so far been one of the most frustrating years we can remember. There have been 13 market swings (short-term) and 5 failed breakout attempts at 2120 for the S&P 500, with the June swoon seeing the S&P 500 drop below its 200-day average (yellow line) which managed to contain and prevent a major trend change. The rebound suggested a summer rally was underway. Once again though 2120 proved to be a stumbling block and stocks have dropped three days in a row. **The market has had a normal pause after last week's move, and should move higher from here, with 2200 a rough upside target (4-5% higher). Support at 2100 and 2080 should contain any selling. A drop below the 2070 level so soon after the last low would be bearish.**

S&P 500 Long-Term (Lower Chart @ Right)
The bull market continues to walk on a ledge, managing to hold above its key 10-month average (red line). With the long-term trend very extended after a 6 year bull market, any drop below this average could lead to a much larger decline.

Another move below the 2060-2070 range after breaking it once already and recovering would likely turn the larger trend negative. A month-end close below 2067 would be a technical 'sell' signal, although our models would likely already be defensive by that time.

The next 'bear market' is likely to see the S&P 500 drop to the 1550-1600 area, the level of the prior 2000 and 2007 highs.