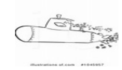
Hamilton-Bates

Market Update

August 3, 2015



August 3, 1958—American submarine Nautilus accomplishes first undersea voyage to the geographic North Pole. The world's first nuclear powered submarine, the Nautilus traveled 1000 miles under the ice-cap to reach the pole before traveling on to Iceland. Done during the Cold War, this was no doubt a show of American technology.

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Range bound but for how long?

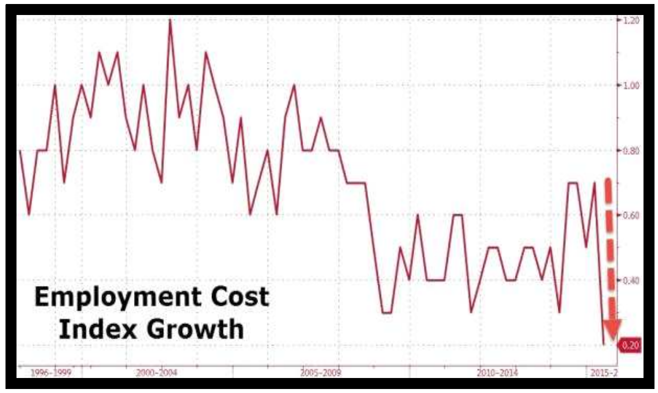
After month-end sell-offs in the last days of June (over the Greek crisis) and mid-July (over China), are market managed to rebound right at month-end.

The US equity market continues to be trapped in a violent range-bound mindset with extreme reaction to both good and bad news. The overall index has been moving with increasing volatility through the trading range that has trapped the market since February between support at 2040 (on the S&P 500) and resistance at 2130 as investors have constantly flipped emotions. Bonds have rallied sharply the past few week's after Fed Chairwoman Yellen seemed confident that it's about the right time to raise rates. It seems the market thinks otherwise and believes that economic conditions are not strong enough to support her call.

Earnings, Economics, and Interest Rates

Earnings season is now largely in the rearview window. According to Factset with 71% of the companies in the S&P 500 reporting for Q2, 73% beat estimates, roughly in line with the 5-year average. Due to companies beating earnings estimates in aggregate, the anticipated earnings picture for the S&P when all is said and done expects an earnings decline for Q2 2015 of -1.3%. The good news is that this is a much smaller decline than the estimate of- 4.6% at the end of June. Energy has been this largest drag on earnings while Healthcare had been the largest booster. The market will likely continue to watch for comments from companies regarding the impact of slower global economic growth, lower oil and gas prices, and the stronger U.S. dollar on earnings and revenues. Looking at future quarters, analysts are expecting year-over-year declines in earnings to continue through Q315, and year-over-year declines in revenue to continue through Q415.

Last week saw economic data including revisions to GDP, which bumped up Q1 activity from a –0.20% decline to a 0.60% gain, and showed Q2 has having a 2.3% gain. Prior year 2014 growth was slightly reduced. But by far the biggest economic news of the week was the Employment Cost Index. It showed that the increase in US wages was just 0.2%, well below the 0.6% rise expected and a meager 2% increase year over year. The meager year over year gain was the smallest in 30+ years and crushes hopes for improving wage growth among US workers (chart below).



Because the ECI tracks the same job over time, it removes shifts in the mix of workers across industries. This is important as our economy has seen a decline of 1.4 million factory workers since 2007 with a corresponding increase in bartender and server jobs, which tend to lower paying. Taking into account the changing job mix, this was the weakest US wage growth since records began in 1982. The weak ECI reading may put a September rate hike on the back burner if economic data due out this week come in soft. This week's reports include: *ISM Mfg, Construction Spending, Personal Income & Outlays, ADP Employment, ISM Services, and Friday's Non-Farm Payroll Report.*

Essentially these reports will give a good sense of whether the US economy can improve upon the +2.3% GDP showing in Q2, or if it is succumbing to spillover weakness in China.

This year's constant back and forth whipsaw likely market action is consistent with what Goldman Sachs observes as a speeding up of economic cycles and that negative or positive data points don't last very long, a consequence of massive intervention by central banks. Once again we see how unintended consequences have distorted market price discovery.

Seasonally August and September are lousy months for the US equity markets, in fact the two weakest of the year. But with negative sentiment so extreme it is likely investors wanting to sell have done so and there is a good deal of sideline cash. Last year was also an exception to seasonal trends with August gaining over 5%.

If this week's economic news isn't brutal, if China can hold together and not collapse further, and if oil can hold above its earlier 2015 lows, then it is very likely we'll see an August test of the highs—but can we break out? Ultimately we believe the answer lies with China.

The Chinese Question

Although the current earnings season has been decent, in so far as a decline can be considered decent, the results have not been strong enough to pull new capital into the market, just quick shifts within already invested funds. This buying and selling has been part of the reason the market has been range bound for 2015. This could of course change as it seems downside risks from Europe have diminished for now while risk for sectors connected to China's economy and equity market have risen to take their place.

The Chinese Shanghai Index declined 34% from its peak, with a modest bounce. The Chinese index is now holding key support around 3500 even with a likelihood of sellers building up in queues. If the Chinese market can avoid a severe decline below this key level we could see a 1987 style resolution with stocks testing the lows but holding with a sharp deterioration. This would mitigate somewhat the risk of psychological spillover into the other global markets, and suggest hope for a possible Chinese market recovering just as our market did in 1988-89 after a very scary 1987.

A quite separate issue for the US and other developed markets is the risk to corporate profits from lower Chinese sales. This will be very important to earnings since China has become a key market in terms of earnings and sales growth. If China can hold to the 1987 decline scenario meaning the worst if over, it would bode well for the Chinese economy. A further deep slide in the equity markets below 3000 on the Shanghai index would be negative for not only the local market, but could be taken as a very negative development for global earnings as well.

Market and Investment Outlook

Our concerns have been that the major averages were in some danger of rolling over was put off but not out of mind. Just like previous rallies the market continues to stall upon nearing the upper boundary of the price range and the latest rally proved no different. The S&P 500 and Russell 2000 continue to bounce from their important 200-day averages, but cannot seem to string together enough upside momentum to move up and out of the range. We now mark the 200-day average on the S&P 500 and also the recent swing low (2,065) as key support. A drop below that level could unlock further selling to the bottom of the 2015 range (2040 on the S&P 500) or even below it. In fact we'd prefer to see the S&P hold above 2097-2098 in order to solidify hopes of an August rally. In addition, we are noting increased volatility under the surface with a weakening of advances versus declines, and new highs versus new lows. This weakness internally makes key support at 2098 and 2065 that much more important. The only conclusive thing that can be said at this time is that the S&P 500 remains range bound until it breaks either way out of the sideways trading pattern (2,040-2,130).

We remain invested in equities as we look for an eventual continuation of the rebound that started the last week in July. Bonds have started to look better. We have concerns with equity market internals though, and cash has increased as we cut back on holdings that were affected by Chinese market volatility. **<u>As long as the S&P holds above 2065, we'll look to put cash to work in coming days, and look for a rally that takes the S&P 500 to 2200, some 4-5% higher than current levels</u>.**

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

Near-Term S&P 500 Outlook (Above Left)

2015 continues to be one of the most frustrating years we can remember. There have been 14 short-term market swings and 5 failed breakout attempts at 2120 for the S&P 500, with the June and July swoons seeing the S&P drop to test its 200-day average (yellow line). So far this key support level has managed to contain and prevent a major trend change.

Support at 2100 and 2080 should contain any selling. A drop below the 2060-70 level (the area of the 200-day average) so soon after the last test would be bearish.

500 Long-Term (Above 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. Furthermore, a month-end close below 2067 would be a technical 'sell' signal, although our models would likely already be defensive by that time.