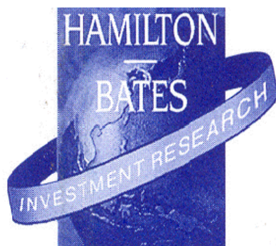
August 9, 1974—Vice-President Gerald Ford sworn in as 38th President of the United States shortly after Richard M. Nixon steps down in the wake of the Watergate scandal. Just minutes after his announcement, he waves good-bye from the steps of Air-Force One, and departs for his home in California.



Hamilton-Bates

Market Update

August 10, 2015

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The stock market remains in a trading range, once again probing the lower boundary. There is news enough, but none strong enough to make stocks go much higher or much lower than the top and bottom ends of the range we have been stuck in for six months—2130 on the S&P at the high end, and 2065 at the low end. We are however seeing a bigger disparity between the winner and lose stocks and sectors of late, with well-known names moving up or down big percentages in the wake of earnings. We are continuing to see a lack of upside leadership. Last week it was the media stocks that suffered, after Disney's earnings disappointment caused its stock to drop 10% and major pain across this popular sector.

Market volatility tends to move higher in late summer as trading volumes get thinner. We got a taste of that this past week as stocks sold off after nearing the top of the range once again, albeit on low volume. During these periods news tends to have a bigger psychological impact, and that is indeed what we are seeing. We are getting economic and earnings news that is not so hot, along with comments from the Fed that seem to imply they are 'dead set' on hiking rates in September.

Earnings, Economics, and Interest Rates
In general there is a pretty simple 'formula' for the economy and stock prices. And it is as follows:

higher economic activity = higher profits = higher share prices (over time) AND lower economic activity = lower profits = lower share prices (over time)

As of this weekend, 399 of the S&P 500 companies have reported and total earnings in aggregate are down -2.3% from the same period last year on -4.2% lower revenues. That is better than expected at the end of June but certainly not the picture we want to see. Now if you take out energy the picture improves to 5% earnings growth on 2% revenue gains, not bad, but taking energy out of the mix because it has been so weak can lead us to ignore the important message oil and the rest of the commodity sector is sending. Weak earnings are especially damaging in a year in which we expected the market to move more in-line with earnings than anything else. With the QE programs long gone in the U.S., and the Federal Reserve set to raise interest rates, its up to earnings to give the market its horsepower. Until now 'easy money' from the Fed has flowed into risk assets, driving up P/E ratios. Those days are behind us now we continue to believe the market needs real earnings growth to push it higher.

The problem is that the guidance we have seen from some key companies in the transportation sector were not glowing. UPS, a key bellwether, isn't very confident about the US economy. Why are the concerned? Forecast 2015 GDP growth went from 3% + to slightly over 2%. They see the continued strength of the US dollar and impending rate hike by the Fed as holding back some US growth. UPS' top-line revenue fell 1.2% over the last 12 months. That isn't very good.

Rolls Royce may be best known for luxury cars, but the key part of its business is making engines for jet airplanes. Along with GE, these two companies dominate the aerospace engine business. Rolls Royce just issued its fourth profit warning in the last 18 months and is shutting down its $1.56 billion share buyback to conserve cash. The problem is weak demand for its jet engines. While the passenger cabins remain full in the airline industry, the cargo freight industry is shrinking.

Trans-ocean shipping freight isn't doing any better. Asia to US and Asia to Europe shipping rates have collapsed, and the number of idle container ships has increased two months in a row. Part of the reason these transportation companies are struggling is over capacity—but a good deal of the problem is that global trade is weak. In fact trade is declining at the fastest pace in three years.

The World Trade Index, (which tracks import and export volume worldwide) fell to 135.1 in May. This drop can be seen in the chart below from Wolfstreet.com. The transport stocks prosper when the economy

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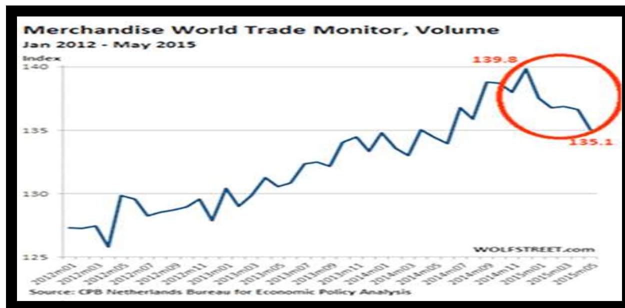
is rolling along. However, they are among the first to feel a business slowdown when things turn downward. And that is what we are seeing in 2015. The weakness in commodities has gone to far, and now is a signal of economic weakness that is becoming greater than most expect. With QE gone and a hike imminent, the decline in economic activity in China and elsewhere is hurting profits just when we needed it most.



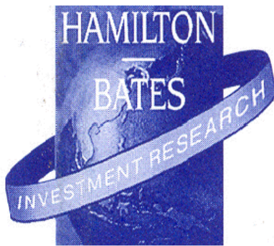
China China China!
Its all coming back to China. Everyone knows by now that China is having problems. Its stock market has crashed 27% since June. Its economy only grew 7% last quarter, its slowest growth in 25 years, but everyone also knows those numbers are likely highly overstated.

Now a stock market drop is one thing, but stock drop is now hurting the Chinese economy, as we feared it would. Bloomberg ran a story on how the market drop is now hurting car sales in China, the world's largest auto market. In fact China's vehicle sales may post its first annual decline in more than 17 years if things don't improve, according to the China Automobile Dealers Association. According to the story the stock market plunge hurt consumer confidence, as those who lost capital had to use funds to make margin calls, and those who didn't have put off purchases concerned about the economy. As a result dealers are sacrificing their margins and giving out big incentives to help attract buyers. This is now trickling down into earnings.

Volkswagen is the largest carmaker in the world by sales. It owns several luxury brands including Porsche, Bentley, and Audi. Its sales in China declined last quarter for the first time in ten years. Volkswagen's management called China an "increasingly difficult market environment." And VW is just one of many car companies warning about slowing sales in China. BMW and Toyota also warned about profits falling as the need for incentives increase. And its not just cars, China has become a key market for growth and profits across many sectors from industrials to autos to luxury goods and technology. Weakness in Chinese economy in the wake of its market decline is hurting profit growth. Continued weakness in the Chinese stock market would be a very bad sign.

We are seeing a bad mix of slowing earnings at a time when the Fed is talking about hiking interest rates. As usual they are wrong and late about the economy and the timing of the move. It will take a number of things going right for the earnings outlook to improve. First we need the Chinese stock market to stabilize if not move higher. Further meltdown would be a big negative for companies needing the Chinese market for growth. Second the Fed has to be one and done with hikes or not move at all. They are close to having missed the entire cycle and are now looking to hike as growth is potentially slowing. And these guys are the economic experts?! The final thing we need is for the dollar to stop rising—its move hurts profits earned overseas and continues to crush the commodities. We need both trends to reverse in order for growth to continue.

Market and Investment Outlook
Stocks remain in a frustrating range, but we remain invested and we expect an eventual rebound to and above the high end of the range. We remain concerned with the increasing number of new market lows, poor breadth, and cash has increased. Investment grade and better bonds have been acting well, as the bond market is doubting we'll see more than one rate hike if that. High-yield bonds continue to be weighed down by the energy sector, which has issued 15% of all HY debt since 2007. **The S&P is now nearing the important 200-day average at 2060-2070. The market needs to hold this key level for hopes of a rebound and rally.**



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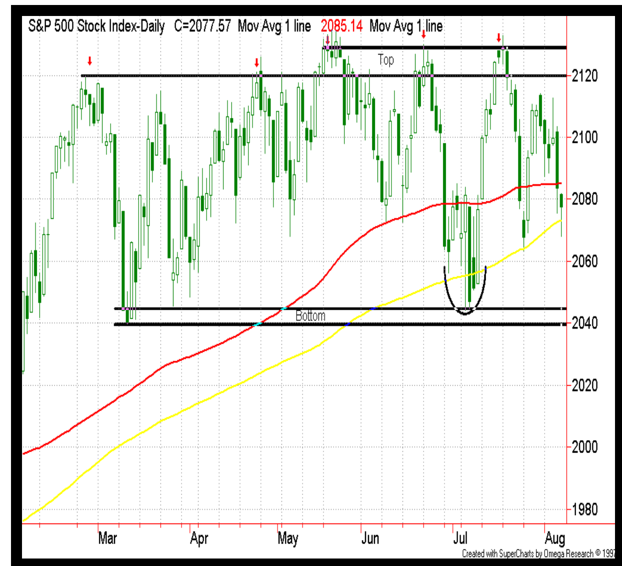
S&P 500 Charts—Market Back Near Trading Range Low

Near-Term S&P 500 Outlook (Top Chart @ Right)
There have been 14 short-term market swings and 5 failed breakout attempts at 2120-2130 for the S&P 500, as it remains locked within a six-month trading range. We have been expecting a move higher that would test if not take out the high-end of the range, but poor action in China along with weakness in oil keep weighing on the market. The market should rebound this week off the 200-day average, moving back up to the high-end of the range. **A drop below the 2070 level so soon after the last low, and without even making it to the upper end of the trading range on the last rebound rally would be very bearish for near-term trading. A drop below the 200-day average (yellow) could see a quick drop to the very bottom of the 2015 range around 2040.**



Transportation Stocks to the Rescue?
In May the DJIA was hitting its high of the year while the Transport stocks were down 7% from their highs (dotted lines in chart). We used this very chart to talk about the negatives of that divergence, and it has played out. The DJIA has now dropped 5.5% and is now down -2.2% for the year.

But just when things appear bleakest, the transports offer hope. While the DJIA has made three successive lower lows since early July, the transports have made three higher lows (see **bold lines** in chart). This suggests we could see a rebound in this beaten down sector and the market. How the transports fare (whether they manage a new high or just a lower peak) will tell us a good deal about the economy going forward. As bulls we'd want to see a strong surge in the transports. Should they roll over and join the DJIA at the lows—it would be quite bearish.

Disclosures:
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