Hamilton-Bates
Market Update

August 19, 2015

August 19, 1909—The first rave is held at the Indianapolis Motor Speedway, which would become the most famous racetrack in motorsports.

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Preparing for the Fall

Its that time of year, when the lazy late summer yields to the Fall, and children's' faces contort in pain as preparations for a return of the school year loom. This is something we know a lot about with 3 children of our own, two under 9. The September-October period is also an historically volatile period for the financial markets, and 2015 could be in store for some volatility as the year-long trading range finally gives way.

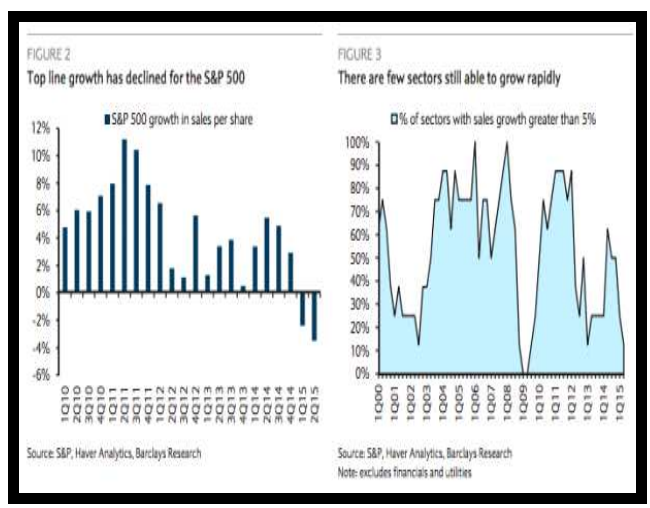
Last week China devalued its currency, resulting in its biggest one-day loss in 20 years, compounded by additional declines over the following few days. In overall terms the decline seems small at 3-4%, but in currency markets this is gigantic. This 'surprise' move by the PBOC roiled markets and triggered concern that other central banks would follow suit, creating a currency war. In shades of 1997-98, fears of an Asian currency crisis sparked selling in global stock markets. The latest weakness in trade data—China's July exports declined by 8.3 percent year over year, much worse than the 1.5 percent decline expected by the market—suggested that the reality in China is that the fundamentals were weakening enough that the People's Bank of China's (PBoC) was willing to risk the move.

Our equity market remains range-bound with the DJIA down few percent for the year, and the S&P 500 holding just above breakeven. This resilience in the face of turbulence in China and elsewhere is a sign of the strength of our economy and investors' belief in it, but we are still concerned that a downside breach of the range we have been in would risk further selling lower.

Economy and Earnings

Unlike China, economic data here in the United States is much better and is somewhat aligned with the Fed's desire for a move on rates, but not by much. It is likely their extreme desire to get off the zero bound is prompting their urge to move. Employment and Housing data have been strong, but wage growth has been stagnant. Revenue and company earnings have taken a clear hit. Stagnant global economic conditions, a strong USD, and lower oil prices have combined to cause revenue growth for the S&P 500 to fall. The first quarter of 2015 was the first quarter of negative sales growth for the S&P 500 since the financial crisis. 2Q15 is expected to be worse.

Few sectors have been immune to the slowing growth environment. Only health care continues to experience sales growth of more than 5% (Obamacare). Over the last 15 years the only other period when only one sector was able to achieve more than 5% sales growth was during the Financial Crisis of 2008. The trend of declining growth can be seen in the chart from Haver Analytics and Barclays Research) below.



Fed Rate Hike Likely in September

Even with the economy growing in the 2-2.5% range, and the concerns in China and elsewhere, the Fed is telling the market that it wants to raise rates soon. The exact timing could be either September or December, but most believe it will be this year. Of course, the Fed is retaining its data-dependency clause, affording it the window to change its mind. Whether the Fed moves in September or December—we know it is coming. As long as the economy is not in crisis they will move. They now believe zero rates are crisis rates, and that the need to start down the path to monetary policy normalcy is important to the future health of the economy. The Fed wants to try and make the move as transparent as possible, thus the many hints and suggestions about the time drawing nearer from many at the Fed.

We'd prefer September if they are inclined to make a one and done move, since it would get it over with quicker and allow the market to adjust and regroup during the seasonally strong year-end period. With the PBOC, BOJ and ECB all in easing mode, it actually makes it a better time to go.

Seasonal, Historical, and Cyclical Trends

We've entered the final half of August when many professional traders and investors take their summer vacation. Market-moving news and trading volume both tend to be light during the weeks before Labor Day. A low-volume market environment can be a double-edged sword. Low volume in summer can lend itself to a dull, narrow lateral trading range. It can also see big prices moves with such a shallow pool of buyers. Both low-volume summer rallies and sell-offs have been seen in the Augusts of past years.

September is historically a challenging month, and this year could see our market chop lower into a Fall low, given the inability for the market to mount a late summer rally. There are historic and cyclical trends that seriously favor the bulls at year-end however, should we see any weakness.

The fifth year of the decade has a strong bullish tendency, with zero declines in the S&P 500 in years ending in '5'. This has largely been due to the coincidence with those years being the third year of the Presidential Cycle, a year that also has strong bullish tendencies.

<u>Given that we have not seen the market show an ability to sustain a rally, the most likely time for a sustained market rally is now the fourth quarter</u> beginning in early to mid-October. Most recent year '5' years saw the equity market make its biggest gains in the fourth quarter. So if historic and cyclical trends repeat, we can assume that the sideways trading action of the last several months, even if we see some Fall weakness, is just in preparation for an upside breakout in the fourth quarter.

Market Outlook

For investors there seem to be pressing matters in almost every major global market. Declining oil prices pressure the energy sector here in the US. Europe faces a slowdown in consumer activity and a slowing export market in China. China is clearly slowing and facing a market meltdown. Japan's economy, already in recession, will continue to suffer as its largest trading partner, China, loses steam. The devaluation of Yuan also makes Japanese exports less competitive.

The depreciation of the Chinese currency will put more downward pressure on commodity prices, so we are not at the end of the road for oil or industrial metals. Regardless of a Fed rate hike, demand for safe-haven U.S. Treasuries is likely to remain for the next month or two as a result of all the global turmoil. We could see yields on the long-end fall well below 2%, even with a potential Fed rate hike at the short-end. Our economy, while clearly showing softness, is nowhere near recession territory. Money flows into the US dollar, treasuries, and our stock market from abroad is likely as our market is seen as a safe haven.

The bottom line is we are now into the dog days of summer. Given the light volumes and lack of new buyers, risk assets could continue to languish. Risks remain to the downside as new data, especially from overseas, seem more likely to disappoint than to support improvement in economic activity. Uncertainty that we see now could last into September, but should eventually lead to opportunity.

Negative currency surprises like the sudden decline in the Malaysian ringgit and further Chinese Yuan devaluation will continue to put downward pressure on commodity prices, which will probably spill over into stocks and corporate debt, especially those of commodity companies like energy and mining.

We do not believe the current uncertainty portends an immediate bear market for risk assets, although it could develop as such. Such a decline for go against some strong historical trends. More likely a serious decline of 15% or more will be a 2016 issue. But we have not had a U.S. equity market correction in over four years—it has been 1,471 days since the last correction started, more than double the historical average since 1928. A decline that takes the market back to its 2015 lows, or even lower, would not be a big surprise. Investors shouldn't be shocked that we would see weakness during this seasonally challenging time.

Investment & Portfolio Strategy
Stocks remain in a frustrating range, and have been bouncing from the 200-day average but have been unable to sustain a rally. The window is closing for a chance at a late summer rally.

We remain concerned with the increasing number of new market lows, poor breadth, and as a result cash levels have increased. Investment grade and government bonds have been acting well, getting well-bid as a safe haven. 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. We continue to underweight this bond sector.

We would expect that any downward pressure on risk assets will end some-time in September, possibly dove-tailing with the Fed's hike of short-term rates. Until then the environment should be supportive for longer duration U.S. Treasury notes and bonds. **Until the S&P 500 can sustain a move above 2100 (and 17750 on the DJIA), caution is the watchword**.

The market is now trying to bounce once again from the important 200-day average (now at 2077-2080 for the S&P 500). The market has managed to bounce from this level many times since June as corporate buy-backs increase on intra-day dips to this level. Last week Goldman Sachs reported its buyback desk had its busiest day since 2011.

Below the 200-day support at 2077-2080 on the S&P, the next level comes in at the 2015 lows in the 2040-2050 area.

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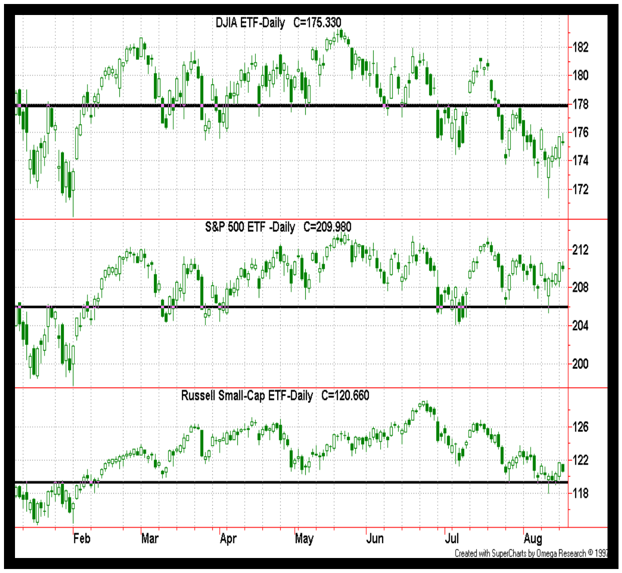
A Quick Look at the Major Asset Class Charts Year-to-Date

Equities (Top Chart @ Right)
The top-chart shows the DJIA, S&P 500, and Russell 2000 ETF's for 2015. The bold black line is the level of December 31, 2014. So far in 2015 the choppy sideways action is clear to see, with the DJIA down 3-4%, the S&P flat, and the Russell 2000 giving up solid gains and back to flat/down for the year.

This sideways action reflects a slowing of US economic activity and especially economic activity in Europe, China, and the emerging markets.

We are now likely to see some further weakness into a Fall low.



Fixed Income (Bottom @ Right)
The higher grade fixed income markets peaked in January, leading to weakness into the summer, until equity market declines saw flows move into high-grade bonds as a haven. We increased holdings in investment grade and government bonds in July. **High quality bonds remain an area of opportunity for investors, as do municipal bonds (not shown), which have held up well**.

High-yield bonds, formerly darlings of the fixed income markets, have fallen on hard times as troubles in the energy sector weigh on energy company bonds. We have already seen a number of bankruptcies, and we could see more as oil continues to decline. We had been long high-yield bonds consistently since 2009, but we have been underweight since May.