Hamilton-Bates

Market Update

September 1, 2015

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On Monday August 24th the market 'flashed crashed' on the open, with technical difficulties with pricing software due to extremely high trading volume taking some stocks and ETF's down to crazy levels. Once again we have computerized HFT (high frequency trading) programs to thank for the market mayhem, as 100's of thousands of small computerized trades overwhelmed the system. Even worse, many brokerage firms' trading systems were offline.

Even with the brutal open, the Dow managed to close down only 500 points on the day. Tuesday saw a brief bounce that faded, and the market closed slightly lower. As we wrote in the Special Update prior to last week, the market still made an early week low (even with the flash crash), and followed with a sharp rally that managed to erase the entirety of the week's decline. Now we are seeing weakness again.

But this week's softness is not seeing the same flight to Treasuries that last week did, and some equity sectors like semiconductors are actually holding up well off their lows. As long as this holds it is bullish. The same goes for many commodities like oil, copper, and gold, which led the decline into last week's low. They have since held up well above those lows. Their divergence says that for now, weakness that tests or slightly undercuts last week's lows will be followed by further and likely stronger rally attempts.

Market Outlook / Portfolio Strategy

We are likely in the 6th inning of the market's decline. But as any baseball fan knows the final 3 innings can take a long time due to all the switches and pitching changes that occur. That is what we see snow. A lot of the worst damage of this initial decline is over. Now we need time as the market finds the low. On balance we were already holding heavy cash and bond positions heading into last week, and managed accounts were buying last week's weakness. Purchases made at that time were sold this Monday for a quick gain. Over the next few weeks we'd look to buy on weakness.

Key Takeaways:

Last week's low represents the FIRST low of the volatility event. The 'final' low is likely within 4-6% from that level (around the 1800-1860 range on the S&P) meaning we are already closer to the bottom in price than most people think.

When volatility is increased the first or even second low isn't the final low, Volatility Events take time to work through and we'll likely see a few weeks of choppy trading. Generally speaking we would be looking to **buy** the low-end of the expected new range, which is the general area of 1800-1925 on the S&P 500, and **sell** on rallies to the upper end of the range in the 2000-2050 area.

Investors doing the opposite and selling en masse near the lows are simply handing their money to Wall St traders. Managed accounts already have 40-60% cash and bond holdings, and we look to take advantage of price weakness in coming days and weeks.

The low we expect in late September/October should lead to a quite strong year-end period. We will be using built up cash and bonds to buy near expected low levels over the next few weeks.

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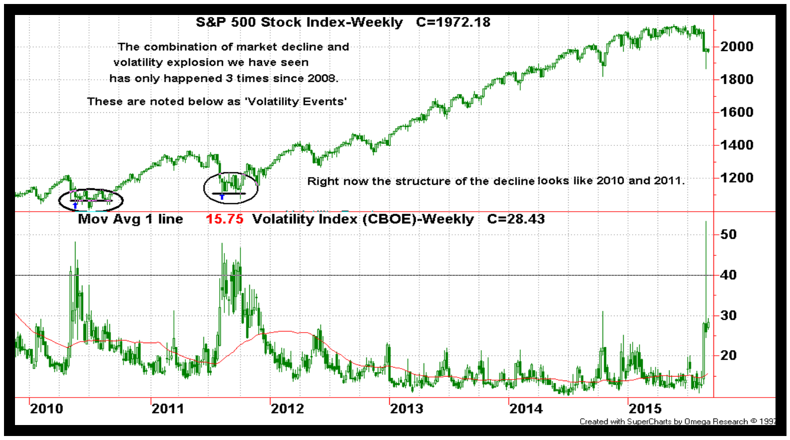
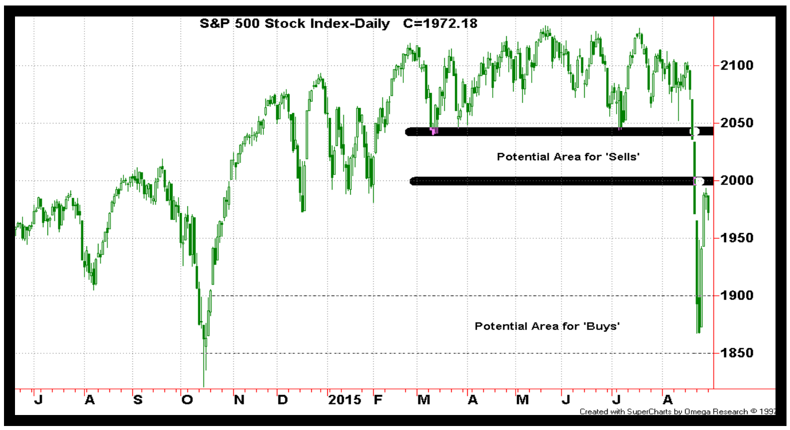
Volatility Events (Top Chart)
The market hasn't seen this combination of selling and volatility since 2010 and 2011. Those 'volatility events' as we are calling them took 4-6 weeks to shake out, even though most of the near-term decline is over. Investors should expect back and forth action into October as the market settles back down.



New Trading Range (Middle Chart)
The one year daily S&P 500 chart shows the breakdown from the 2015 range, culminating in last week's decline into the Monday-Tuesday lows.

We saw the start of a bounce, but it wasn't strong enough to take us into the top-end of the new expected range for the next several weeks. **Anticipating a good deal of volatility, we are looking to sell on moves to the top end of the range, and buy moves toward the low end**.



Bull or Bear? (Bottom Chart)
Whether the bull lives or not is up to debate, but technically the answer will come after a rebound that tests the now broken 10-month average. Even in 2000 and 2008, two of the worst 'bears' of the century, saw these rebound retests. We 'should' see a rebound in September. **If the market can recapture 2060 on the S&P, then the bull lives, if the rebound fails, investors should be defensive.**