Hamilton-Bates

Market Update

October 14th, 2015

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The stock market has rebounded a bit from the August lows, largely on the back of sentiment that the Federal Reserve will not be hiking rates anytime soon. The problem is that the reason they won't be do so is that the economic picture has deteriorated significantly and the risks of an outright recession have grown.

A relief rebound on delayed rate hikes will only carry so far if the underlying economy is now slipping into recession, which would crimp a weak earnings picture even more. Unfortunately the recent data has not been encouraging.

The Fed, the Economy, and Earnings

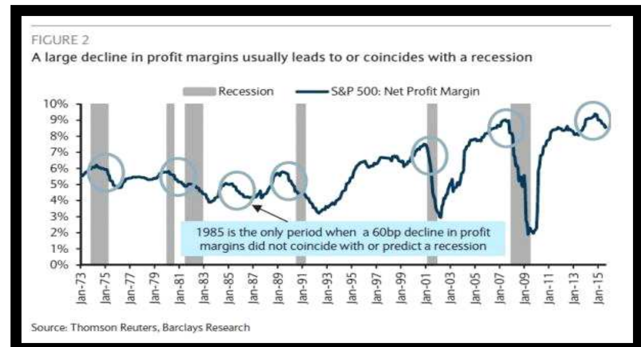
The most recent jobs report came in well below expectations with significant negative revisions to prior months. We also have the regional Fed surveys which shows all six regions in slowdown. But the data we are seeing now is suggesting risks of more than just a slowdown in growth, we could be looking at a recession at some point in the not too distant future.

A key indicator for the economy is business inventories relative to sales. If inventories rise relative to sales troubles follow, as inventories risk going bad or out of fashion. The inventory-to-sales ratio is now up to 1.37x - the highest in this cycle. **The last 2 times the ratio was at this level, the US was in recession**. See below.

The inventory to sales is one uptrend that is not our friend.

The slowdown is not showing up in earnings, which have started the latest quarter on a negative tone with a number of headline misses. The latest of which is Wal-Mart which has just slashed 2016 and 2017 earnings due to recent wage hikes. Wal-Mart is looking at a decline of 12% in 2017 earnings. Now they are looking at cutting even more high level corporate jobs.

Barclays looked at overall profit margins in relation to the economy. Margins have now shrunk 60 basis points over the past 12 months from a peak of around 9%. They came to the conclusion that such a drop in margins has come outside of a recession only once in 85 years. The chart below shows declines in profit margins from peak levels over the past 40 years—and just like the inventory-sales data, this trend is not our friend.



Recession?

Increasingly more economic data and earnings forecasts are suggesting the US economy is dramatically slowing down; and possibly heading into a recession. This can be seen in the Atlanta Fed's GDP

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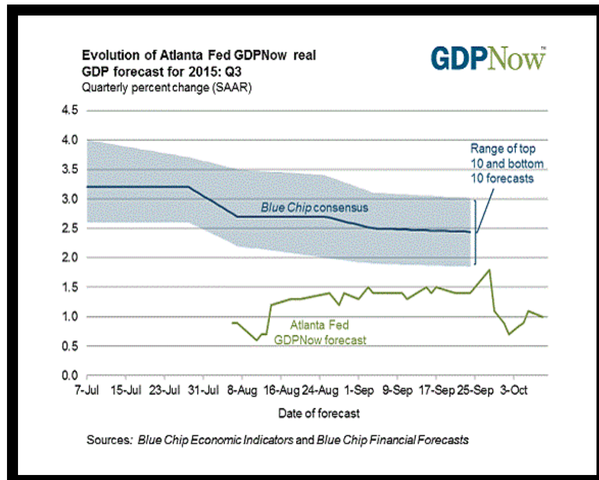
Now Model depicting a sharp drop-off in 3Q GDP to less than 1% growth, and this number could dip even further after this week's soft data.



The Economic Data has cliff-dived in the past month, staged a minor rebound, and then weakened once again. The next GDP forecast by the model (out next Monday) is likely to be well under 1%.

The economy may not slip into recession, but we believe investors can forget a rate hike, the next major policy move by the Fed is likely to be more QE or some other market supportive action.

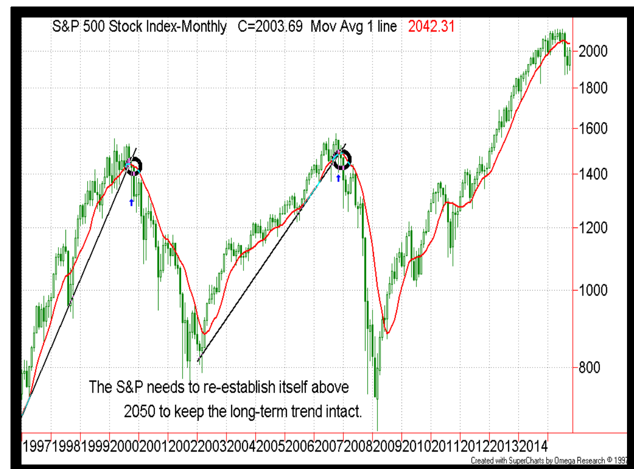
The problem with this is that the Fed has been proven to be wrong again on the economy, and continues to talk about rate hikes in the face of clearly weakening conditions. The Fed is at risk of losing all credibility, which would only serve to undermine the financial markets.

We believe the Fed is going to change their minds on rate hikes. Soon they will be talking about supportive actions.

Market and Investment Outlook

We became progressively more in August as weakness unfolded in both prices and fundamental conditions. In the wake of the decline we now have major monthly sell signals in place for the key market averages, as they are trading below their 10-month averages along with a key trend indicator in 'sell' territory.

Historically, the last few times this happened was January of 2008 and in June of 2000. We are not predicting a decline of that magnitude, just that the longer the market spends under the 10-month average, the more fragile it becomes. The S&P needs to close above 2040-2050 to reestablish the long-term up-trend.



Could We See a Bear Market?

There is a possibility that we see a 20% decline, which is defined as a bear market, but the market would be fighting some serious bullish historic trends and tendencies that suggest a strong Q4 after a poor showing in Q3. **We see the market staging a rebound (after a bit more volatility this month) into year-end with greater risk of weakness into 2016**.

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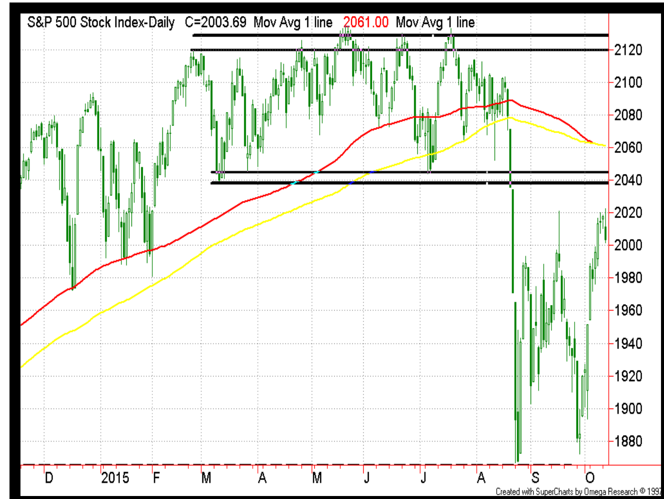
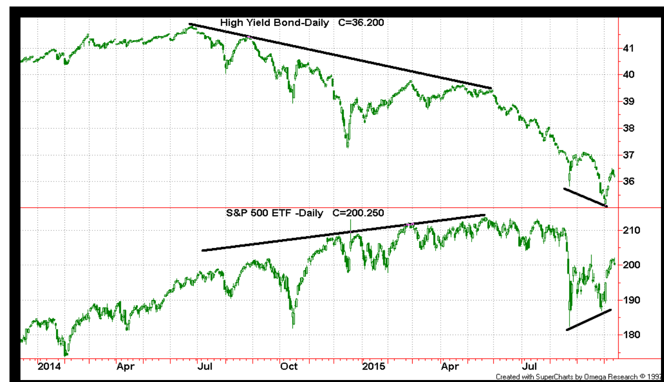
Investment Outlook : Preservation of Capital
With the long-term trend in question and with economic and earnings data weakening, we are firmly in capital preservation mode. Until we see conditions improve, and a new uptrend established, we continue to hold a larger than normal cash position along with investment grade bond positions for conservative portfolios. Portfolios that are more aggressive, and those more active by design, could see us taking long positions which could be flipped at short notice, but even in those portfolios we are holding more cash than usual.

Market Charts

S&P Short-Term Chart (Top)
The chart of the S&P 500 for 2015 shows a break-down from the range bound trading in August, followed by two short-term tops and two short-term bottoms. This August and September lows could be enough to see a rally, as the market is trying to form a **'W'** bottom, but there is still a lot of technical resistance from 2020 all the way up to 2060. Whether we will see enough buying in the face of economic and earnings weakness is still up in the air. If we see October weakness hold above 1900 that could be enough to see a rebound up into the 2040-2060 level or higher into year-end.



High-Yield Bonds Signal Caution (Bottom)
High-Yield or Junk Bonds, generally trade in the direction of the stock market, as like stocks they are very susceptible to economic conditions. The Junk bond ETF did not peak along with the S&P 500 in 2015, showing weakness well ahead of the market this year. Moreover it made a new low in September and has not be nearly as constructive as the stock rally. The weakness in junk bond prices could reflect investors worry over companies ability to pay in a slowing economy. When junk bonds do not confirm what stocks do it is a caution sign.



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