Hamilton-Bates
Market Update
October 27th, 2015

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The stock market continues its strong rebound from its August lows, with stocks ripping 5% higher this month, despite terrible economic data and sub-par earnings. The reality is the market is up because the data has been so bad. Why? We are back to a 'bad news is good news' market since bad news means no rate hikes and possibly more QE. Essentially what is bad for the average American is just great for Wall St.

Seasonality Favors the Bulls

Now heading into the strongest part of the year, the rebound is likely to continue into 2016. It seems that the double bottom was the intermediate-term low, and we didn't get the undercut of the low we were expecting. The market bottomed on the brutal payroll report last month and continued to gain on bad news. The trigger for last week's strong rally was the hint that the ECB would increase its stimulus. That's a pitiful excuse for a rally, but a rally is a rally. Then we had China cut interest rates because conditions there are weak, and again the market rallied on the news. All the central bank cutting and QE efforts have done nothing in China, Japan, Europe, or the US in terms of helping the economy. It is ridiculous to think that it will help the economy this time around.

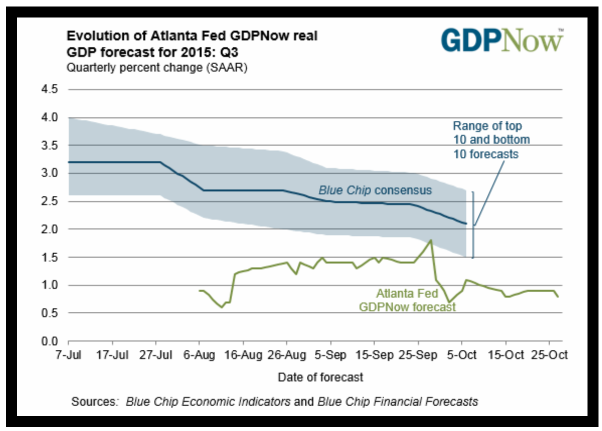
The reality is the market got really oversold into the recent low, and now its rebounding. The strong market coupled with a weak economy looks a lot like 2007-2008 where we saw a correction in October, followed by a recovery into year end; then weakness in 2008 as the economic recession became apparent.

But for now, any news of fresh QE or delay on rate hikes will support the stock markets. The bullish psychology will probably last into year end. But with the major averages back into resistance areas, it will be bumpy. We look for the NASDAQ to lead.

The negative counterforce will be continued erosion in the economy. The dollar could continue to strengthen, which will be a big headwind for US firms doing business abroad. This will become very apparent in 2016.

The Economy, the Fed, and Earnings

The economic data continue to disappoint, and the GDPNow model (shown below) reflects that with Q3 GDP projected at less than 1% growth. We are hardly at 'escape velocity' for the economy, and it continues to limp along at the worst pace for a post WW2 recovery.



Recession in 2016? It is a Real Possibility

The economic data had been drifting close to recession territory for much of 2014 and early 2015, but after a bit of reprieve during the summer, it looks to be happening again. The last non-farm payroll jobs report was the worst in months, as only 142,000 jobs were created last month, with August revised almost 40,000 jobs lower. Plus, labor force participation hit a new low at 62.4%. Overall, we've averaged 198,000 jobs per month in 2015, compared with 260,000 jobs in 2014.

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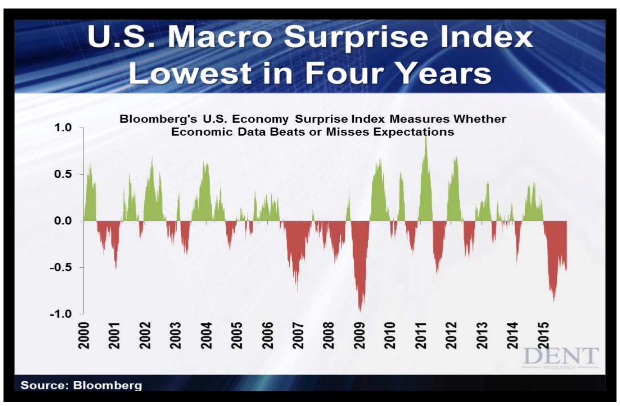
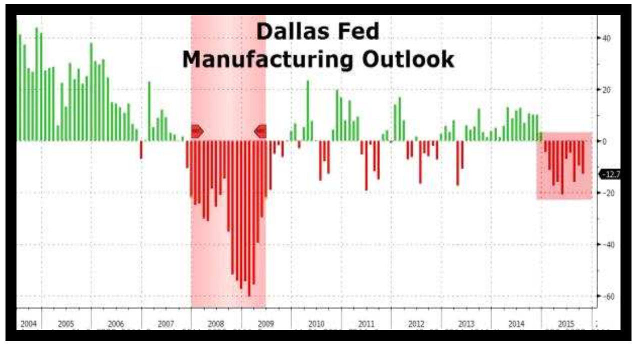
What makes the jobs report so concerning is that it's a lagging indicator, we could be even worse this month. Next week's Payroll Report will be very important. A week number could being talk of QE rather than a rate hike!

Not only the jobs report but other indicators point to the risk of a recession. The U.S. Macro Surprise Index (shown below) shows when indicators beat or miss expectations. Green is when data is better than expected. Red means the data has come in worse than expected. And you can see that 2015 has been a total miss. It's been negative all year, with early 2015 being the worst period since early 2009.



This past week the Dallas Fed also released its latest manufacturing outlook, and it continued a trend of weakness (chart top of next column). The Dallas Fed manufacturing data has been the weakest since 2009, like the Surprise index above. Data points similar to 2009 is not a good thing.

Weak job reports and weak economic data fit with regional Fed data which shows all six regions in slowdown. Again something that hasn't happened



since 2009. The slowdown is now showing up in earnings, which have started the latest quarter on a negative tone with a number of headline misses. We are in an earnings recession of two negative quarters in a row, and the rate of revenue misses hasn't been this bad since 1998 (another recession).

Market and Investment Outlook

In the long-run the stock market and the economy will move together, but there are periods when they diverge-such as now. They key is to not get caught up expecting the bull run to last forever. Stocks are rallying in hopes of more central bank largess, which really isn't something long lasting bull markets are made of. Still we could see stocks recover over the next few months and reach new highs, and perhaps even a 'blow-off' as tech stocks take-off.

We bought back into the market with some sideline cash earlier this month, with expectations that we'll see the market rally through year-end. Given the weak economic data we still believe bonds will do well. We expect the Fed will talk about raising rates (hinting that the economy is ok) but never do it (because it really isnt'). In that type of environment high-grade corporate bonds will do very well.

The latest stock market rally has been led by the blue-

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chips and large-cap tech stocks, while small-caps continue to lag. Historical trends strongly favor the bulls, and in order to decline the market would be fighting some serious bullish historic trends and tendencies that suggest a strong Q4 after a poor showing in Q3.

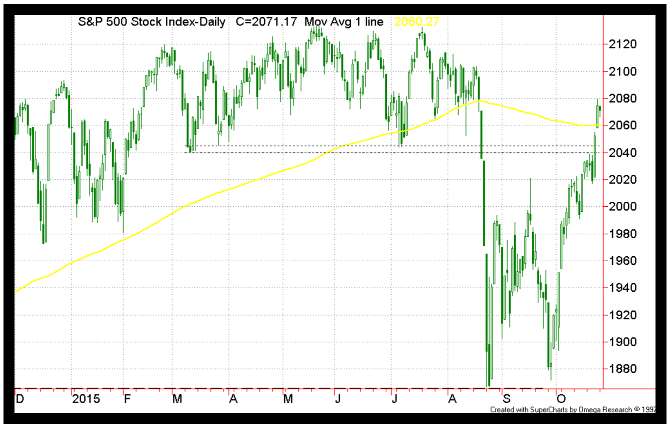
Investment Outlook : Cautious Bull
With the S&P back above its key intermediate and long-term averages, the trend is back to favoring the bulls. Until we see a change we will remain invested. We put cash to work in stocks but we still believe high-grade bonds will do well.

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 we continue to anticipate opportunity on the bullish side into year-end.

Market Charts

S&P Short-Term (Top)
The S&P blasted right through 'resistance' around 2040 and moved above the 200-day average (in yellow) around 2060 as well. The near-term trend now favors the bulls as long as the S&P holds above 2060.

A move to new highs and even 2300 is possible before year-end.



S&P 500 Long-Term (Bottom)
This month's strong rebound has moved the S&P back above its 10-month average (in red) around 2040. As long as the S&P stays above this average the long-term trend remains bullish and the threat of a bear market is averted.

A drop below 2040 on the S&P 500 would re-open the door for greater volatility.