Hamilton-Bates

Market Update *November 27th, 2015*

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This week has been a typical holiday week for the markets. That means modest stock gains on low volume. Everyone is off on Friday and out buying Christmas presents. There was some economic data earlier in the week; it showed strength in the services sector and continued weakness in manufacturing. Overall the news was neutral to positive and enough to keep investors in a festive mood.

The stars continue to align for a move back to the recent highs and a likely retest of the all-time highs at 2135 (on the S&P 500) before the year is out. Seasonal trends are very strong at this time of year and the concerns we have (such as action in the high yield bond market) will likely hold at bay until 2016. We should see some early year follow through strength, again following historical and seasonal trends, and mid-year next year could be when see start to see clearer signs the next recession appears on the horizon.

The Fed, the Economy, and Earnings

The recent jobs report was better than expected, surprising everyone, and the Fed is likely to point to the job market among the economic positives it sees if it begins to start the Fed rate increase cycle at the next meeting in December.

While the Fed talks about growth we see warnings of 'contraction.' Freight on major U.S. railroads fell 7% in Q2 of 2015 compared with the same period in 2014. That only happens in recessions. The Empire State (NY) Manufacturing survey plunged to -10.74% in November. Economists expected a drop of -6.50%. The number of employees in the survey fell -7.27% in November. The business inventory-to-sales ratio from the Fed of St. Louis which we mentioned afew weeks ago shows an ominous rise over the past year. This means that companies are getting stuck with inventories because demand has been less than the expected. There was a warning in 2008 when this ratio climbed at that time. From freight to industrial commodities, to heavy equipment demand and to inventories, we continue to see important signs that economic weakness is looming.

Recession Watch

We believe that recession risk for 2016 is growing. So far, as usual, the slowdown in the manufacturing sector has had only a minor effect on the economy. The goods-producing sectors employ only 14% of workers, while 70% work in the service sector and 15% for governments. The cyclical goods-producing sectors must slow a lot for the ripples to pull down the service industries. Services don't collpse until a recession is upon us.

There are many reasons to be watching for a recession in the next year. The age and weak magnitude of the recovery are both cautionary signals. Even more significant, real gross domestic income (GDI) on a seasonally adjusted annual rate basis has not just been below the 2% "stall speed" for the past 2 quarters but below 1%, an even stronger warning sign.

In 9 out of 11 post-WWII recessions, real GDI grew at 1% or less in at least one of the four quarters prior to the recession. The last time it did so in two consecutive quarters of Q2 and Q3 of 2012, which sparked the Fed to the third and largest round of quantitative easing (QE3).

What about the expected Fed action in December, starting the long "normalization" of interest rates? The Fed is capable of almost anything, certainly increasing rates in a weak economy and few signs of rising inflation. But I suspect they will do so only once, for the same reason children don't touch hot stoves twice. These are not normal times.

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Warning Signs from the Bond Market

The high-yield bond market is often considered the 'canary in the coalmine' for the financial markets, and it continues to show signs of cracking. The latest decline in junk bond values is one of the biggest red flags in the entire market. This weakness is the type usually seen prior to market declines. The bond market is where companies, countries, and individuals go to borrow money. It's far larger and more important than the stock market. The U.S. bond market is about twice as large as the U.S. stock market.

If an economy, industry, or company is in trouble, warning signs usually appear in their bonds long before they show up in the stock market. And in particular trouble shows up in the riskiest bonds first. High-yield or 'junk bonds' as they are known, are bonds issued by companies with shaky balance sheets. They're riskier than bonds issued by strong companies, so they pay much higher yields. When the economy slows down, companies in poor financial shape feel the pain first. That's why junk bonds often point out problems before other assets do. This happened in 2007-2008 ahead of the stock market decline in 2008. Once gain junk bonds have been very weak, and while stocks are back near highs, the junk bond etf dropped to its lowest level since July 2009.

The chart at the top of the next column shows high-yield ETF (JNK) performance since then. As you can see, it's been in a downtrend since June 2014. High-yield bonds normally trade with stocks, rising and falling in tandem. But not this year. JNK has fallen 9% this year, and it has lost 4% in the past three months alone. While stocks have rebounded, the high-yield bond market continues to weaken. This is a major red-flag for 2016.

Market Outlook—Seasonal Strength

We expect favorable markets the next few months as momentum takes over and fundamental concerns are put aside until 2016. The year-end period is especially strong in pre-election years, with just 1 decline in the last 50 years from mid-November through year-end (1967).

Investment Strategy

Excess cash built-up from the August-September weakness has largely been put to work, most of it in October. Accounts have also largely made-up any losses from that period. We could see solid gains from now until early 2016, depending on what the Fed does. If they refrain from moving the stock market could have a field-day through year-end as investos celebrate.

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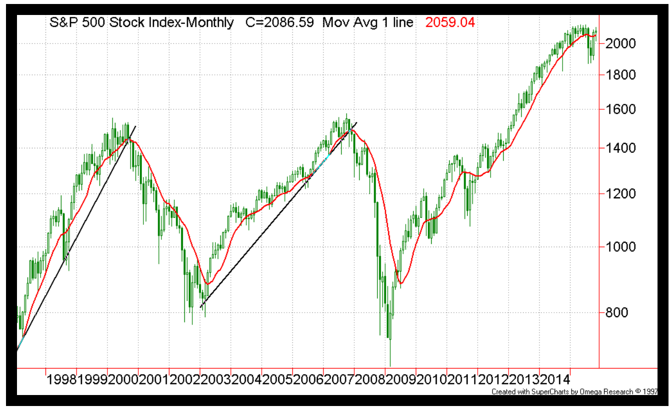
Market Charts

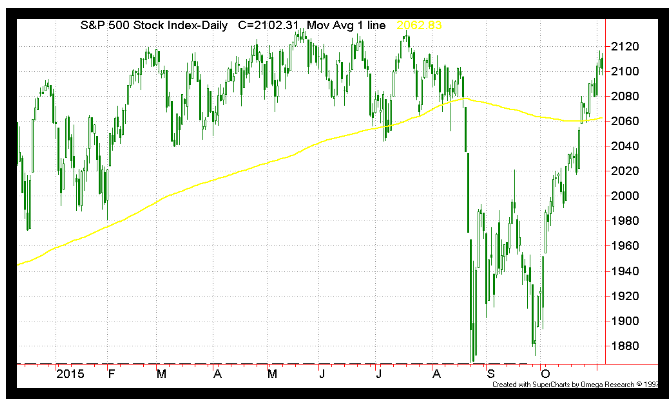
S&P 500 Long-Term (Top)
The S&P 500 has recaptured its 10-Month average (in red), thereby re-establishing the long-term uptrend.

As long as the S&P 500 holds above 2060 the bulls have control.



S&P 500 Near-Term (Bottom)
The S&P has moved back above its 200-day average, (in yellow) which is around 2060. This turned momentum back in favor of the bulls and should hold through year end.

We look for additional upside into 201 as long as the S&P holds above 2060, a very key level as both the daily and monthly moving averages are presently nesting at that level.



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