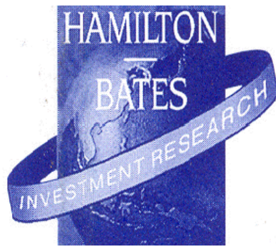


Hamilton-Bates

Market Update

December 14th, 2015

P.O. BOX 270 Newtown Square, PA 19073 877.768.4247 www.hbir.com

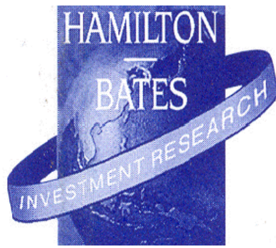
High-Yield Bonds 'Junk' the Stock Market
The big news last week was trouble in the junk bond market. It wasn't news to us or anyone reading these Updates. For months now we have been highlighting our major concern and its been the action in the credit markets, especially in the riskiest sector known as high-yield (junk) bonds. In the last Update we had a section titled *'Warning Signs from the Bond Market'* talking about the weakness in these bonds and what it could mean for the financial markets.

Thanks to the Fed's zero interest rate policy this sector has been flooded by investors seeking yield, pushing prices up and yields down, allowing weak companies to keep afloat by rolling debt over with cheap financing. This leads to mal-investment (as in the energy sector) and eventually the crows come home to roost. We had been noting the severe under performance of the Junk Bond ETF (JNK) and its divergence with stocks. Eventually the credit market had to improve or stocks would weaken as the trouble the high-yields were experiencing came to light. Unfortunately last week it was the latter.

Mutual Fund Blocks Investors From Their Money
Granted this particular fund focused on the riskiest corners of the junk bond market, but it's a move eerily similar to 2007's mortgage crisis, when funds from Bear Sterns collapsed and served as a warning sign for what was to come in 2008. Third Avenue Focused Credit invested in distressed debt of companies that were close to defaulting on their loans and ones that already had. Due to overwhelming redemptions and illiquidity in the bond market (thanks in part to the Volker Rule which illustrates the theory of unintended consequences) they were unable to sell assets at prices remotely close to the NAV they were quoting each day because they could not find buyers. Banks are now unable to trade for their own book. Bond market volume has collapsed. As a result they have locked down the fund in order to gain time to sell assets at reasonable prices. This implosion by a high profile manager in a good sized fund ($2.1 billion in July, $750 million+ last week) spooked already-rattled investors who were left wondering if there are more ailing funds in the horizon. Third Avenue said it will return a small portion of its assets to investors next week and then will focus on unwinding its investments. The fund anticipates it will take a year or more to fully liquidate. It blamed its troubles on the fast pace of redemptions combined with the lack of liquidity in the fixed-income markets.

It's important to note that this was not a typical mutual fund that invested in junk-rated bonds. It held very illiquid bonds. This type of distressed debt has gotten hammered far more this year than junk bonds. Still, it is likely the junk bond sector will remain weak and under pressure. Even legendary investor Carl Icahn warns of 'danger ahead' for the junk bond market. One wonders if there are more funds having similar distress? No doubt investors will seek to flee the riskier sectors of the credit market. Investors yanked $3.8 billion from high-yield bonds in the past week, the largest outflows in 15 weeks, according to Bank of America Merrill Lynch. This selling could eventually spill over to stocks as investors seek liquidity. Last week's news is just the latest sign of trouble in the riskiest parts of the bond market amid plunging prices for commodities. But its more than just the energy sector. More companies have defaulted on their debt this year than at any point since late 2009, according to Standard & Poor's. S&P warned that about half of energy junk bonds are distressed, meaning there is a real chance they default. **We have been underweight or out of junk bonds for some time, after riding them to their crest since 2009**. **We currently favor investment grade and government bonds.**

Disclosures:
This report has been produced and compiled by Hamilton-Bates on a best efforts basis, and is provided for information purposes only. Under no circumstances is it to be used or considered as an offer to sell, or a solicitation of any offer to buy. While all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, we make no representation as to its accuracy or completeness and it should not be relied upon as such. The investments referred to herein may not be suitable investments for all persons accessing these pages. You should carefully consider whether all or any of these are suitable investments for you and if in any doubt consult an independent adviser. This report is prepared solely for the information of clients of Hamilton-Bates and readers are expected to make their own investment decisions after consulting with their personal financial advisor and without reliance on this report.



Hamilton-Bates

Market Update

December 14th, 2015

"If Santa Claus Fails to Call,
Bears Could Come to Broad and Wall."
Stock Market Almanac

P.O. BOX 270 Newtown Square, PA 19073 877.768.4247 www.hbir.com

The Fed, the Economy, and Earnings

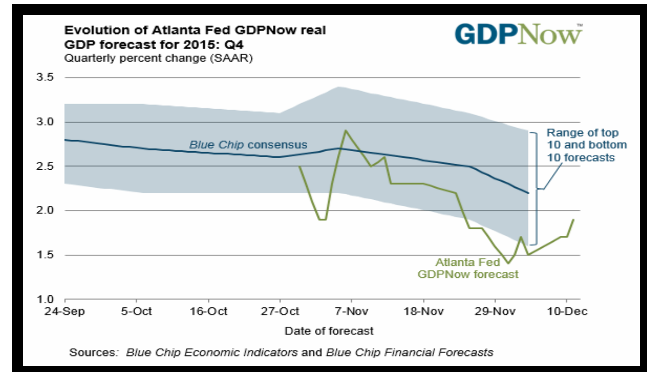
The Atlanta Fed's GDP now model (chart next column) showed a slight up-tick in 4Q GDP expectations to 1.9%, but that is well below a healthy 2.5-3.0% our economy needs to 'feel' like its growing. We would not be surprised to see this figure revised downward in weeks to come.

Recession Watch

Last week's trouble in the high-yield market could be a sign of things to come in the middle of 2016. Junk bonds are the canary in the coal mine for stocks. When credit tightens, the dynamics change for much of corporate America. Financial engineering gets more expensive and fizzles. M&A gets more difficult to pull off. Bond-funded dividends and share buybacks get cut or come to a halt. Companies start laying off workers. Companies unable to roll-over debt (which had been easy) wipe out shareholders as defaulted bond owners become the new equity owners. Suddenly, risk shows up on the scene as investors flee these risky companies' debt and equity. Eventually, stocks start chasing junk bonds lower. This could lead be a precursor to a recession in mid-2016.

Market Outlook—Seasonal Strength & Fed Watch

The long anticipated Fed rate decision comes this week, and we wonder if last week's drop creates enough concern in the FMOC to hold off 'one more time' to see what happens over the next few weeks. There is no doubt some concern in the corridors of the Eccles building and we read as much over the weekend. If the Fed were to delay a hike it may be enough for a Xmas goose for the stock market. Even with its strong seasonal bias December is known for having a bit of weakness mid-month. That we have seen. Even with last week's travails we expect to see some sort of rally develop over the next few weeks,



likely enhanced if the Fed holds off. As we noted before 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).* **Should a Santa Claus rally fail to appear it would be another warning sign for potential trouble in 2016. 2007 was also a year where there was no Santa Rally, adding to the similarity with 2007's trouble in the bond market.**

Investment Strategy

Excess cash built-up from the August-September weakness had largely been put to work, but we picked up a bit last week as we sold some lagging bond positions that held lower-tier investment grade credits. We continue to focus on high-grade bonds wherever possible as investment holdings. Accounts have largely made-up losses from the ugly August but 2015 has been a lackluster year. 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 robust rally as investors celebrate. **We are focused on blue-chip stocks with little debt as equity holdings, and investment grade bonds in credits.**

Disclosures:
This report has been produced and compiled by Hamilton-Bates on a best efforts basis, and is provided for information purposes only. Under no circumstances is it to be used or considered as an offer to sell, or a solicitation of any offer to buy. While all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, we make no representation as to its accuracy or completeness and it should not be relied upon as such. The investments referred to herein may not be suitable investments for all persons accessing these pages. You should carefully consider whether all or any of these are suitable investments for you and if in any doubt consult an independent adviser. This report is prepared solely for the information of clients of Hamilton-Bates and readers are expected to make their own investment decisions after consulting with their personal financial advisor and without reliance on this report.

Hamilton-Bates

Market Update

December 14th, 2015

P.O. BOX 270 Newtown Square, PA 19073 877.768.4247 www.hbir.com

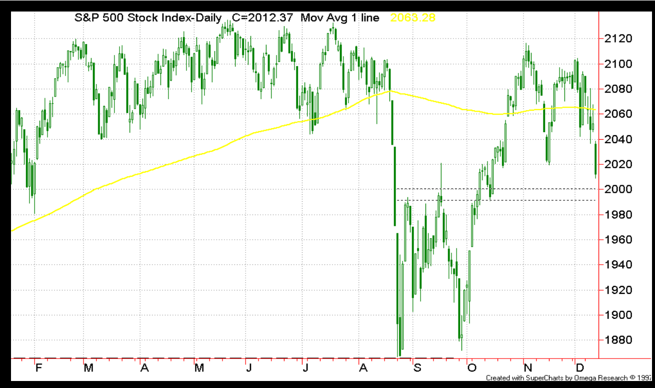
Market Charts

S&P 500 Long-Term (Top)
The S&P 500 dipped below its 10-Month average last week (in dark red), threatening the recovery if it cannot rebound above 2060. We would like to see stocks quickly recover this week, thereby re-establishing the long-term uptrend. Should the S&P end the month below this moving average it would be very negative for 2016.

If the S&P 500 holds above 2060 the bulls have control.

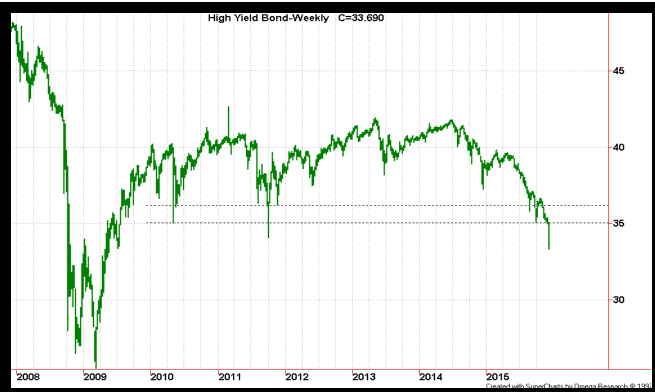
S&P 500 Near-Term (Middle)
The S&P moved back above its 200-day average (in yellow) then dropped below it. This whipsaw action was due to the concerns over the high-yield bond market, which threatens to derail the year-end rally.

The Fed could come to the rescue and not hike at this week's meeting, but would that trigger a rally, or spook investors as a sign that the Fed was very concerned about the credit market?



High-Yield (Junk) Bond Market (Bottom)
While stocks have recovered in the wake of the August sell-off, high-yield bonds got nary a bump, and resumed their weakness of the past year. This drop has taken the well-known Junk EFT (JNK) below its Fall low and to levels not seen since 2009.

Unless and until there is stabilization in this part of the credit market, risk hangs over stocks– even if the Fed comes to the rescue and there is a December rally.



Disclosures:
This report has been produced and compiled by Hamilton-Bates on a best efforts basis, and is provided for information purposes only. Under no circumstances is it to be used or considered as an offer to sell, or a solicitation of any offer to buy. While all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, we make no representation as to its accuracy or completeness and it should not be relied upon as such. The investments referred to herein may not be suitable investments for all persons accessing these pages. You should carefully consider whether all or any of these are suitable investments for you and if in any doubt consult an independent adviser. This report is prepared solely for the information of clients of Hamilton-Bates and readers are expected to make their own investment decisions after consulting with their personal financial advisor and without reliance on this report.