Hamilton-Bates

Market Update

What is Going on With the Financial Markets?

January 20th, 2016

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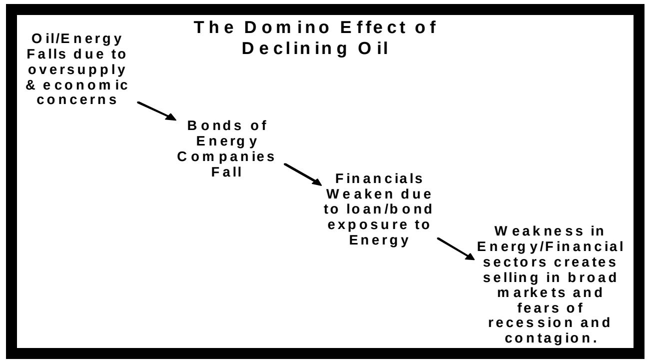
Around the globe financial markets are in turmoil. Alarming news out of China and a crash in the oil market is causing economic slowing and angst among investors everywhere. In the United States, the S&P 500 is down more than 10% since the beginning of the year, but many global markets are down far, far, worse. It seems the December Fed rate hike was indeed enough of a 'pin' to prick the asset bubble that had built up after years of zero interest rate policy. It is also earnings season and because of that many corporate buybacks have to be paused. That removes an important potential support for the market. Over the last year, companies buying back their own stock have put more money into the market than all public sources.

Oil's Role in the Decline

Initially the decline in oil was cheered, as cuts in energy prices can serve as a 'tax-cut' and that money can accrue as profits to companies and gains in spending power for consumers.

<u>The problem is that over the past decade the US has become an Energy producer, and many of the jobs created since 2008 have come directly or indirectly from the energy sector</u>. Oil price slides also hurt oil producing countries disproportionably more. Zero interest rate policy by the Fed also enhanced the production bubble by making cheap financing available.

Oil and other commodities rose to great heights, but have collapsed as economic demand growth in China and in the developed West could not keep up. Falling oil creates global disruptions and a domino chain of selling pressure (shown in the chart above right) as the decline reached 70%+ for oil. We are now getting selling due to hedge fund margin calls and from



Sovereign Wealth Funds of oil producers like Norway, Saudi Arabia, Kuwait, and Qatar. These countries need to dip into these wealth pools in the face of declining revenues, and have to sell financial assets to get that cash. The ultimate bottom in global equity markets will likely coincide or follow a bottom in oil, a bottom that has so far failed to materialize. Despite falling oil prices producers continue to pump in order to generate cash flow in order to pay debt. Oil could bottom today, as things happen quickly in the commodity markets. More likely is that we will need to see come contraction in production, possibly brought about by bankruptcy or voluntary shutting in later this year. Eventually demand will rise enough to outpace production, and prices will stabilize and begin to rise.

The Fed, the Economy, and Earnings

The economic data continue to show slowing. The latest Fed Survey from the NY region showed a drop from –4.6 to –19.4—the largest drop on record. Industrial Production fell 1.8% year over year, a pace that has historically preceded a recession. Weak data continue to favor investment grade and Gov't bonds. The Fed is unlikely to hike anytime soon. In fact look for market supportive comments beginning any day now.

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Market Outlook

Most major global markets have been a lot weaker than our market. Europe and Japanese stocks are now down greater than 20% from their peak, China is down 40%. In our market Small-caps are down over 25% from their high, transports too, and energy is down 40%. We might not do a lot of direct selling to China, but our trading partners do, and to expect our market to be completely immune from what is going on globally in unrealistic. The market has broken the last Fall lows, a level we were hoping would act as a floor for the market. Couple this with a market that is now well below its long-term moving average and we have a market that clearly is under pressure. But the market is also DEEPLY oversold right now according to our main overbought/oversold indicator, in fact registering our sixth most oversold reading since 1970. That is the sixth most oversold reading out of over 10,000 daily readings. That is oversold! Oversold markets can drop further, but that is usually within the context of a bear market, and normally in the latter stages of a bear market.

Will this become a bear market? Odds on that are 50/50 looking at past instances of greater than 10% market declines coupled with the extreme weakness in the high-yield bond market we are seeing. That means we have to prepare and utilize defensive measures. Even so stocks shouldn't go straight down. Looking back at the past two bear markets 2001 and 2008, both saw initial declines of 14-18% followed by rallies of 7-10% before further selling set in. <u>So even in the context of a bear market we should see some relief 'soon'</u>. If NOT in a bear market oversold readings like we have now were at the low or within days of the low. This market looks like it is sure building up for a low, even if its not THE low. The market should find a low within the next week, and see 7-10% rally.

Investment Strategy

An oversold low is due now, and if this is just a 'growth scare' would likely to prove to be THE low. Given the weakness in global markets and drop in the high-yield bond market, there is still the risk of further selling after a robust oversold bounce. We came into 2015 with a good deal of bond and cash assets, though in hindsight we wish we had even more. We need to both respect the market's weakness in 2016 in so far as it could lead to a bear market, while simultaneously not selling with reckless abandon as a rebound is very overdue.

The S&P could not manage couple closes above 1900 last week. This week's selling as broken the Fall 2015 lows, and the stock market is now even more deeply oversold than it was just a week ago. <u>A bounce that gives us a 5-10% move up could occur anytime now and is extremely likely in the next week</u>. A move back above the last fall low around S&P 1865-1880 would be a sign that rebound is at hand. We want to own blue-chip stocks with little debt, along with investment grade & government bonds.

Here is a listing of our major portfolios and where they stand. As you can see fairly defensive:

Portfolios & Positions

MPT Aggressive
50% Equity / 50% Bonds & Cash

MPT Moderate
40% Equity / 60% Bonds & Cash

MPT Conservative
27% Equity / 73% Bonds & Cash

MAC Growth
50% Equity / 50% Cash

Separate Accounts
50% Equity / 50% Cash

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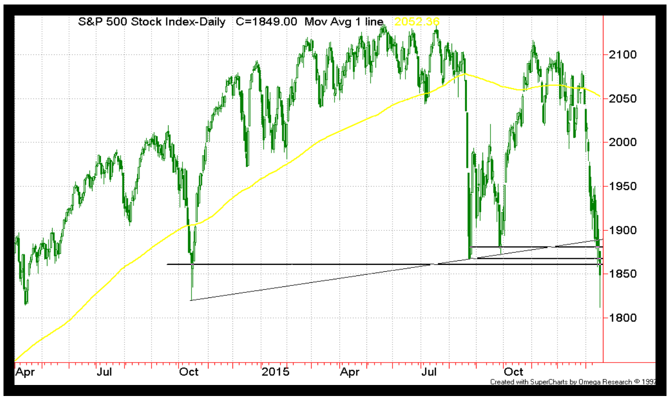
Market Charts

S&P 500 Long-Term (Top)

The S&P 500 remains below its 10-Month average (in dark red). As long as the S&P is below this level risk of a continued decline remains. A break of this moving average happened early in the 2000 and 2008 bear markets. This drop needs to be respected. The As long as the market is below its 10-month average <u>and</u> below the Fall lows (as happened today) capital preservation is paramount.



S&P 500 Near-Term (Bottom)

The S&P 500 broke last Falls lows in the 1865-1880 area in today's trading once again due to a huge drop in crude oil (which fell 7%). If we see a quick move above 1865-1880 it would signal a near-term rebound. Perhaps this week's drop is the final flush before the rebound we have been expecting.