Hamilton-Bates

Market Update

What is Going on With the Financial Markets?

January 14th, 2016

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In the wake of yet another dramatic decline which brought the blue-chip averages into correction territory, and kept the market on its pace for its worst start to a year in history, investors are clearly getting worried. We'll try to explain what is going on.

A confluence of factors including the continued devaluation of the Chinese currency, plunging oil, and a major slide in high-yield bonds have brought the major averages back to their Fall 2015 lows. Our market is at a make or break point for intermediate/ long-term market direction.

Market Index Returns Decline From Highs	
S&P 500	-11.17%
Russell 2000 Small Cap	-21.27%
High-Yield Bonds	-20.78%
Crude Oil	-70.23%
China	-40.50%
Euro-Stoxx Europe Index	-20.51%

You can see from the above chart is that our 'blue-chip' stock indexes have held up much better than other markets, but our market won't remain immune to a global decline. Outside the blue-chips the selling has been profound. Former high fliers like **Twitter (-62%)** and **GoPro** (camera on a stick) **(-71%)** have been taken to the woodshed.

The common denominator that connects all of the above is a fear and realization that economic growth is not increasing, and in fact the global economy may indeed be on the verge of a recession. We are having a 'growth scare'. Weak growth means weak earnings and 2015 saw 3 straight quarters of negative earnings growth, and Q4 could make it 4 straight. Even worse is that forward guidance remains murky at best. China's troubles continue and the hope that it will lead a recovery in growth has faded. If you start seeing 4-5-6 quarters of negative earnings growth then how could the economy NOT be in recession. That is the growing fear. How can stocks rise if earnings are going down? The answer is in the long-run they cant'.

The Fed, Earnings, and the Economy

The Fed is clearly having a credibility problem. Their timing for a rate hike could hardly have been worse. As each day passes the Fed's expectation for growth in 2016 looks further and further away, and odds for future rate hikes diminish. Just two weeks ago they were talking about 2-3-4 rate hikes this year. How could they be so off? The Fed has been hanging its hat on strong jobs numbers (the December report showed 291K jobs created) but when you dig into the guts of the job data it really doesn't add up. The seasonal smoothing factors and the birth/death adjustment, along with how the data is computed (if you lose a full-time job but work 20 hours a week in 2 part-time jobs the BLS considers that a job gained) make the data dubious. 280K of the latest jobs created were from the seasonal adjustment for cold weather. But we just had one of the warmest Decembers on record. In fact increased holders of multiple part-time jobs go a long way in reconciling the strong gains in 'jobs' with an 8-year decline in median income. Other than the jobs report other economic data show a weakening economy, especially in manufacturing, which tends to lead the service economy.

The Atlanta Fed's GDPNow Model (next page right column) has shown a clear deterioration in growth expectations. The Fed's real-time model is still well below Wall St's average expectation of 2.0% growth. These expectations are likely to come down. Our view that the economy remains at risk for a recession

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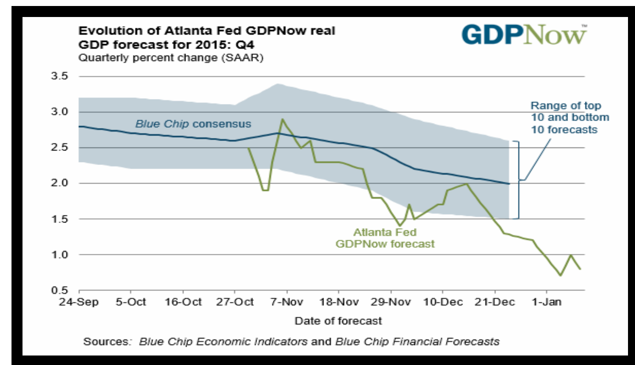
remains, and this year's action in the financial markets bears that out. We have said before that we do not expect further rate hikes; the Fed's next major move is likely easing/supportive policy action. But that won't happen soon. This week though members of the FMOC already came out and essentially took a January hike off the table.

The Market Outlook

I hate market declines, but after 22 years in this business I understand that they are a part of the natural pattern of growth and decay. But this market has been anything but 'natural'. The consistent intervention by the Central Banks to avoid any pain has caused a myriad of negative unintended consequences, such as mal-investment in the energy sector. Since the late 1990's the Fed and other Central Banks have taken it upon themselves to intervene anytime the markets flinch, but all they have done is make things worse.

Our economic rebound in the wake of the 2008-2009 recession peaked out back in 2012, but the Central Banks boosted stocks to continue to create the illusion of growth. Now this disconnect is cracking. All the QE we have seen around the world has amounted to nothing. No real growth anywhere. Japan, Europe, China, the US—all are slowing despite near constant intervention and zero percent interest rates. In Europe many rates are negative! As a result of Central Banks policy bubbles are created and assets rise to the moon and then crash back down-like Oil, China Stocks, and High-Flyers like Twitter and GoPro.

The market has now broken strong seasonal and historic tendencies for strength in the year-end period into the first quarter of the New Year. The declines have now broken below key long-term averages, and threaten key trend lines and last Fall's lows. <u>A break</u>



<u>of last Fall's lows by the blue-chip averages would be a strong negative sign and the market will be at risk of lower prices as long as the market remains below those levels.</u> **The level to watch is 1865-1870 on the S&P 500.**

Investment Strategy

We are focused on blue-chip stocks with little debt, and investment grade and government bonds. A slowing economy and a Fed forced to halt rate increases would boost these fixed income sectors. Bond holdings helped cushion portfolios in 2015 and so far in 2016.

Many indexes have broken their Fall 2015 lows. The Dow and S&P 500 have not but are testing them now. Stabilization in oil and or China would certainly help our financial markets.

The stock market is now deeply oversold. A bounce that gives us a 4-5% move up could occur anytime now. A drop below the key 1865-1870 level on the S&P 500 followed by a move back above it would be one sign the sellers have been 'washed out' and a market rebound is at hand. **A close back above 1900 on the S&P would be another early sign of a potential rebound. A snap-back rally is overdue.**

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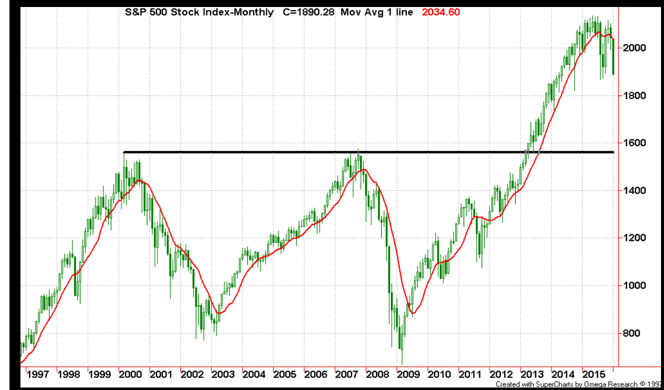
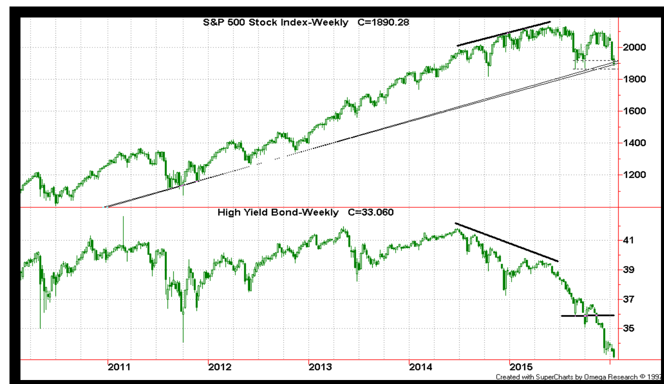
Market Charts



S&P 500 Long-Term (Top)
The S&P 500 has now conclusively broken below its 10-Month average (in dark red). As long as the S&P is below this level risk of a drop down to the prior 2000 and 2008 peaks is in play. A break of this moving average happened early in the 2000 and 2008 bear markets. This drop needs to be respected. The Fall lows need to hold, a market below its 10-month average and below the Fall lows would signal capital preservation above all else in order to avoid a 2000/2008 repeat.

S&P 500 Near-Term (Middle)
Any thoughts of a bullish flag pattern have been dashed, and the S&P is now testing the area of the 2015 Fall lows. Given how oversold the market is right now, this area is a logical level to see a rebound and relief from the selling. Some averages have already dropped below last Fall lows (like small-caps, energy, and transports), we do not want to see the blue-chip averages do so.



High-Yield (Junk) Bond Market (Bottom)
You can see in the chart that high-yield bonds have been much weaker than stocks, and stocks have finally fallen to get in synch with high-yield as these asset classes are normally highly correlated. High-yield bonds have broken their Fall lows but the S&P has not, and has managed to hang on to a trend line dating back to 2009. If the S&P can manage a close above 1900 we could be seeing the first sign of a rebound rally. A move by the high-yield ETF back above its Fall low would be a sign that this area has stabilized, and would allow for an even bigger rebound in stocks.

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