Hamilton-Bates Market Update

Portfolios <u>Defensive</u> as Market Remains Weak

February 8th, 2016

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Note : All of our portfolios went defensive as last week's bounce fizzled. See portfolio allocations on 2nd to last page.

The sense of calm which had descended on the markets for a couple weeks came to an abrupt end last week. Investors continue to rotate through a vicious circle of concerns on China, commodities US growth, and the US Dollar.

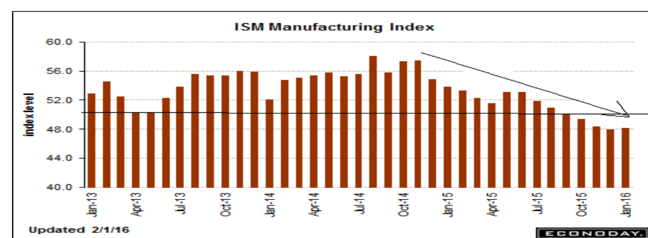
Last week the fledgling rally stalled, tried to recover, then was swamped by sellers. Small-Caps and the NASDAQ were crushed by large losses in stocks like Linked IN and Tableau software , with each losing near half their value in one day after poor earnings reports. Investor's appetite for risk has evaporated and only defensive sectors like consumer staples and utilities have held up.

The Russell 2000 and NASDAQ have broken last Fall's lows, and the S&P is struggling to hold its equivalent level around 1860-1880.

Weakness in financial stocks has only compounded our concerns with major world banks under pressure. We could very well be looking at another turn in the credit/economic cycle and risks for further declines have grown. The continued weakness in the high-yield bond market also remains a concern.

The Fed, the Economy, and Earnings

The economic data continue to show slowing. Friday's Jobs Report showed 150K jobs created in January, but 70% of those were in the food and beverage and retail sales sectors. Higher paying manufacturing and energy continue to lose jobs. Wages came in a bit higher due to the effects of minimum wage laws, and the unemployment rate was 4.9% as folks continue to drop out of the labor force. In terms of economic data last week we got the ISM Manufacturing and Service Sector Surveys shown below. They continue to show the trend of decelerating growth. The Manufacturing sector peaked back in 2014 along with energy and remains in contraction at 48.0 (a reading below 50 is contraction, above is growth).



Services make up 70% of the economy and while this survey is not in contraction territory yet, it sure looks like we could get there. The ISM Service Sector Survey peaked back in 2014, made a another peak in July, and has started to erode since then. The current reading is just a few points above contraction.

The type of declines we are seeing in the economic data looks like the declines we saw ahead of prior recessions. The action in the bond market dovetails with that view.

Unlike the Fed we do not expect any more rate hike's in 2016, and with many Central Banks heading to Negative Interest Rate Policy further hikes would only boost the dollar and hurt US corporate earnings more.

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Bottom Line: Weak data continue to favor investment grade and government bonds. The Fed is unlikely to hike anytime soon.

Market Outlook

One of the characteristics of the bull market cycle that began in 2009 was its 'buoyancy', the market just didn't want to stay down long, and would quickly recover losses.

The past few months have definitely showed a change in that 'character', as last Fall's low saw a decent bounce into November sold into, and so far in 2016 stocks have been straight down and unable to bounce even with 'oversold' conditions. The inability to bounce from very oversold conditions, coupled with the selling that seems to come in quickly on any bounce suggests investors' appetite for risk has changed.

No doubt some of the selling we are seeing is due to Sovereign Wealth Funds of oil producers like Norway, Saudi Arabia, Qatar, and Kuwait as they sell appreciated financial assets to pay for budgetary needs in the wake of oil revenue losses.

The January drop by the DJIA, S&P 500, Russell 2000, and NASDAQ below key long-term moving averages opens up the risk of more than just a bull market correction.

Investment Strategy

The market is oversold once more, but the last oversold bounce was quickly overwhelmed by sellers. The market's inability to sustain a bounce coupled with the continued weakness in 'risk appetite' market segments like small-cap, NASDAQ, and high-yield bonds points to the risk of a longer-term trend change.

As oversold as the market is right now, another bounce of 2-3% or even 5% is possible, but risk of further selling after a any such bounce remains.

We came into 2015 with a good deal of bond and cash assets, though in hindsight we wish we had even more. We need respect the market's weakness in 2016 in so far as it could lead to a bear market and preserve assets, while simultaneously looking ahead to the significant opportunity beyond.

Should the S&P 500 drop and remain below key support at 1860-1880 it would cement the idea that a larger decline was unfolding.

We want to own blue-chip stocks with little debt, especially in defensive sectors like consumer staples, telecom, and utilities. In fixed income we favor investment grade & government bonds.

Here is a listing of our major portfolios and where they stand. As you can see the holdings are very defensive:

Portfolios & Positions

MPT Aggressive
25% Equity / 75% Bonds & Cash

MPT Moderate
20% Equity / 80% Bonds & Cash

MPT Conservative
17.5% Equity / 82.5% Bonds & Cash

MAC Growth
12.5% Equity / 87.5% Cash

Separate Accounts
25% Equity / 75% Cash

Managed VA Accounts
25-30% Equity / 70-75% Bonds

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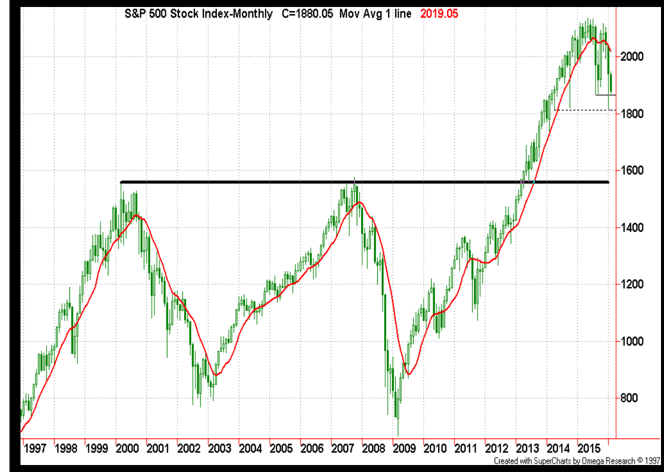
Market Charts

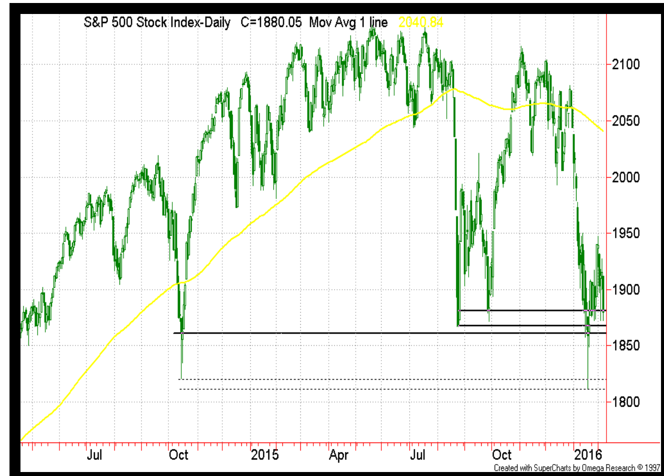
S&P 500 Long-Term (Top)
The S&P 500 remains below its 10-Month average (in dark red). January's month end was well below this key moving average. As long as the S&P is below this level risk of a continued decline remains. A break of this moving average happened early in the 2000 and 2008 bear markets. This drop needs to be respected. With the market is below its 10-month average <u>and</u> threatening the 2015 Fall lows capital preservation is paramount.

Ultimately we could see the S&P drop to 1600 which is the 'breakout' level of the 2000 and 2008 highs (**bold black horizontal line**).



S&P 500 Near-Term (Bottom)
The near-term chart zooms in on the period going back to last Fall's lows through now. The Russell 2000 and NASDAQ have broken last Fall's lows. As has the High-Yield Bond Index. Now the S&P 500 is in the process of doing so. The fact that the Small-Caps and Tech heavy NASDAQ are leading the decline is bearish, and shows a marked pullback in risk appetite.

The 1860-1880 level was and is a key level for the market (**bold black horizontal lines**). Below 1860 and the market is at risk of falling all the way down to the intra-day lows of 1810, or even below.



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