Hamilton-Bates
Market Update

Portfolios Defensive as Market Remains Unsettled

February 24th, 2016

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

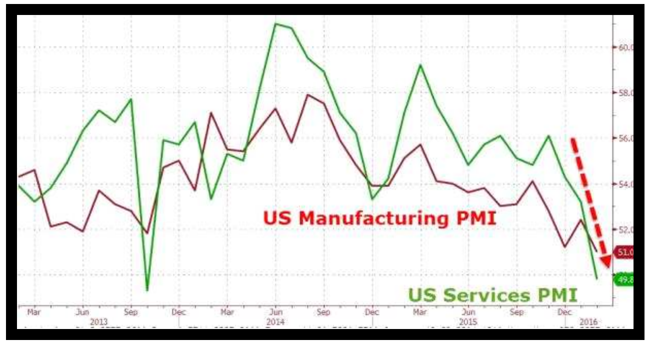
After some pretty trying weeks to start the year, stocks and other risk assets reversed sharply in mid-February after stocks 'found support' at the January intraday S&P low around 1812. From there stocks have staged what can be described as a spirited rally as shorts were caught off-guard and the S&P has been squeezed some120 points higher. That's a move of about 5% in 5 trading days.

We are not sure whether the most recent low is a lasting low, but there is still some room for upside as the selling had reached levels that rendered the market oversold and vulnerable to a reversal and that is what we got. Whether we have a low in place or just a temporary bounce has yet to be determined, but given the trading in the credit markets (which does not support a stock rally) we suspect more weakness is to come sooner or later.

The Economy, Interest Rates, and the Fed

Holiday sales were weak, the economic data has slipped since November, and the growth rate of the economy is slowing down. That much is clear. The bond market is pricing in the likelihood of much lower rates, hinting at recession. It doesn't guarantee we will see a recession in 2016, but the odds of one has surely increased.

We have already covered the slowdown in manufacturing as it has been going on for some time now, and that slowing continues as the **Markit US Manufacturing PMI** hit its lowest reading since 2012, firmly in contraction territory. More significantly we got data this week that shows the Services portion of the economy (some 85% of GDP) also threatening to head into contraction. Actually it did go into contraction as the **Markit US Services PMI collapsed into contraction at 49.8, well below expectations of 53.5**. See chart at top of next column.



If the service sector (which had been holding up well until recently) joins the manufacturing slide and we see more readings below 50, its not a question of 'if' but of 'when' did a recession start. Services PMI will be an important data-point going forward.

The Big Picture—Why Years of ZIRP and QE Did Nothing For the Economy

The US economy suffered a mortal wound when the trend of off-shoring middle class jobs took off in the 1980s, and has been dying a slow death ever since. Job off-shoring benefited corporate executives and shareholders, because lower labor and compliance costs resulted in higher profits. These profits flowed through to shareholders in the form of capital gains and to executives in the form of 'performance bonuses.'

However, off-shoring also 'off-shored' US GDP and consumer purchasing power growth. Despite promises of a 'New'Economy', new jobs have been increasingly part-time, and lowly-paid jobs in domestic services, such as retail clerks, waitresses and bartenders. The tech boom was a small upward blip in a large downward trend. When inflation is taken into account the median wage worker has made no net gain in over 40 years. Its why we could get by with just Dad

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

working in the 50's and 60's but by the 1980's Mom had to work to make ends meet.

Without growth in consumer incomes to drive the economy, the Federal Reserve under Alan Greenspan substituted the growth in consumer debt to take the place of the missing growth in consumer income. Under the Greenspan regime, Americans' stagnant and declining incomes were augmented with the ability to spend on credit. One source of this credit was the rise in housing prices that the Federal Reserves low intrest rate policy made possible. Consumers could refinance their now higher-valued home at lower interest rates and take out the 'equity' and spend it. Home equity withdrawal accounts for most of the 'growth' since 2000.

But debt can't expand forever, it has limits. The debt expansion, tied heavily to housing mortgages, came to a halt when the fraud perpetrated the financial system crashed the real estate and stock markets in 2008. Under Fed chairman Bernanke the economy was kept going with ZIRP and Quantitative Easing, a massive increase in the money supply in order to bail out the 'banks too big to fail.' Liquidity supplied by the Federal Reserve found its way into stock and bond prices and made those invested in these financial instruments richer. Corporate executives helped to boost the stock market by using the companies' profits and by taking out loans in order to buy back the companies' stocks, thus further expanding corporate debt. But once again debt cant expand forever, and the zero bound has put a limit on the leveraging of consumer and corporate balance sheets. With rates unable to go lower, leverage cant be added and the economy has slowed. We are now left to deal with a debt bubble whose limits have been reached.

Market Outlook
The market continues to try to rally from the very oversold conditions of two weeks ago, and that rebound could continue for awhile longer. Without confirmation that a durable trend is underway however, we remain defensive.

Investment Strategy
Aggressive holdings have been pared back, and 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

Hamilton-Bates
Market Update *February 24th, 2016*

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 has made much progress for some time now, forming a large rounding top (blue arc) over the past year. The drop in 2016 has the S&P testing a long-term trend-line back to the 2009 lows (black line). A decline much below 1900 starts to break this long and well-tested trend-line. A break would be a further signal of further consolidation ahead. Should the S&P fall below the recent lows at 1812 (dashed lines) we could see some panic-type selling.

Ultimately we could see the S&P drop to 1600 should recent support and the long-term trend-line fail.

S&P 500 Near-Term (Bottom)
The near-term chart shows the S&P 500 between two key lows at 1812 and two key peaks at 1950 (horizontal black lies). The most recent rebound stalled at this level which is also resistance in the form of the falling 50-day average (red).

A move above 1950 could see a rally toward 2050 or higher, while a drop below the bottom end of the range could see the S&P fall as low as 1700. Movement within the range 1812-1950 is just noise.