Hamilton-Bates Market Update

Portfolios Defensive as Market Remains Unsettled

March 14th, 2016

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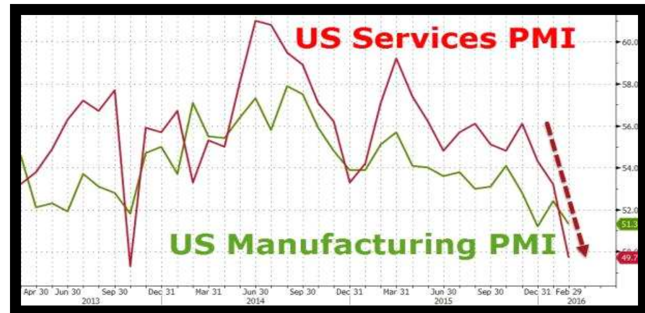
What a different four weeks makes. Four weeks ago, the S&P 500 had just taken out critical support. Everyone was panicking that the market was about to implode. At that time, China was continuing to devalue the Yuan as its economy collapsed. Europe was tumbling based on the ECB's inability to generate inflation and demand growth. The US economy was also slowing sharply as deflation arose courtesy of US Dollar strength and a Fed rate hike. Since that time, not one of those issues has been resolved. The only thing that has changed is that the S&P 500 has rallied 9%.

Earnings, Interest Rates, & the Economy

Jobs data has been good, but frankly the BLS data is suspect given the large numbers of folks who have left the workforce. Earnings have been weak. Indeed, if anything we are getting additional signs that fundamentals are worsening outside of the stock market.

Europe remains stagnant. China's economy is in a full-scale slowdown. Looking outside data that the Chinese government can manipulate (folks look at electricity usage) and you see that according to electricity consumption the country's economic activity is negative year over year. Other than the BLS Jobs report the US continues to post worsening economic data. US services have slumped into contraction and we believe manufacturing has been in a recession since mid-2015. In the charts at the above right you can see the dip in both the services and manufacturing PMI's (top chart) along with the slumping change in Factory Orders year over year (bottom chart). Factory orders have been negative for 15 months, something that has not happened outside of a recession over the last 60 years.



Be Careful What You Wish For—Rate Hikes Back on the Table

The early 2016 drop in stocks and commodities stayed the hand of the Fed, and as a result most market participants expected no hikes in 2016. But the recent rebound could change that and while a hike this month isn't likely, another hike in the 2Q could be.

At the core of the current rally has been a drop in the dollar and rebound in oil and commodities, which has boosted a broad swath of the market that had been devastated. Now that the market and many commodities have rebounded sharply, the Fed could be back in play for possible rate hikes this year. That is something that would in turn boost the dollar once again and hurt commodities, and potentially trigger the downside selling cycle all over again.

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Market Outlook
The recent rebound in the equity and commodity markets are sending signals that perhaps the bear market in commodities and the related bear market in emerging markets and the energy sector is over. If that is the case the market will continue to head higher from here.

This however seems very unlikely, as many of the indicators for commodity supply are still flashing red, and the issue of excessive capacity has not really been addressed. Big moves in commodity prices could be suggestive of government policies finally becoming effective in creating inflation and above trend growth. If that is the case we would need to see that reflected in corporate revenue gains, and so far that isn't happening. Should it happen we once gain are back on Fed Watch for rate increases.

More likely the rally from the February low has been extremely painful for a number of large macro funds, and has caused these funds to cut risk from the long and short book, which has in turn caused a wave of short-covering. This momentum was built on by stock buybacks, the main source of new flow for the market. If history is a guide, I would assume that we are nearly through this mean reversion trade and we could see weakness in the weeks ahead.

We are now back at a key point for the market, we are right back to levels that started the breakdown in January. If the market continues to move higher and re-establishes itself above its key moving averages, then the rally could continue for some time as money flow that left the market now returns.

Investment Strategy
Growth holdings have been added to a bit over the past two weeks, and we also added to bond holdings. 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
37% Equity / 63% Bonds & Cash
MPT Moderate
32% Equity / 68% Bonds & Cash
MPT Conservative
27% Equity / 73% Bonds & Cash
MAC Growth
25 Equity / 75% Cash
Separate Accounts
25% Equity / 75% Bonds/Cash
Managed VA Accounts
25-30% Equity / 70-75% Bonds

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Market Charts—The Moment of Truth for the S&P 500

S&P 500 Long-Term (Top)

The S&P remains below its 10-month moving average and thus the long-term trend remains negative, although the current rally has brought the market right back to this key level. Looking back to 2008 and comparing it to the current market, you can see there is potentially a similar pattern at play. In 2008 (far left) there was a breakdown and a first rally, and a second decline followed by a second rally that stalled right at the key 10-month average. From there the rest was history with a severe drop. The current patter shows a similar initial drop followed by a rebound along with a secondary drop (the 2016 decline) followed by a secondary rally back to the 10-month average. What happens next is critical. Should the market fail to move higher and re-establish the uptrend we could see renewed weakness– possibly below the February lows.

S&P 500 Near-Term (Bottom)

The near-term chart shows the S&P 500 rallying sharply from the February low, as a nearly 50% rebound in oil has caused a short covering rally across the beaten down energy and commodity sectors and momentum has built upon that. The most recent rebound has rallied nearly 10% in 4 weeks and has come right back to the key 200-day average, which is roughly the same as the 10-month average in the above long-term chart. If the market can get above its key averages on a daily and then monthly basis we would have to conclude the uptrend was back in force and the myriad of fundamental concerns we noted will be shrugged aside for now.

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