Hamilton-Bates Market Update

April 26th, 2016

Portfolios back to Balanced as Market Uptrend has been Re-Established

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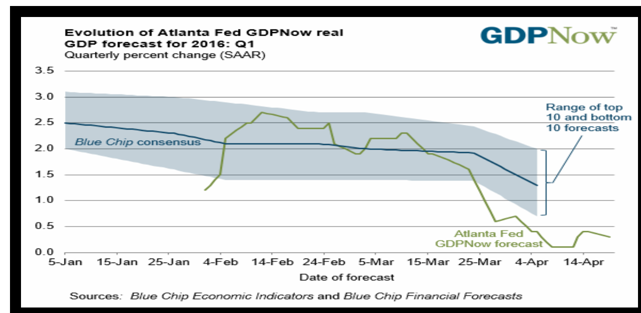
Stocks finished higher for the second straight week, helped by a batch of better than expected earnings reports, although those expectations have been ratcheted lower in recent weeks. Oil prices also remained firm, and have been a big driver of the rebound. Thus far, for first– quarter earnings, we are still on track for a 7% decline, not great news. But the rebound in oil has given investors some confidence that the beaten down energy sector can help corporate profits can regain the momentum that was lost in the last couple quarters.

Earnings, Interest Rates, & the Economy

The annual cycle of 'hope' has been with us since 2012 when the economic cycle peaked. Hope for growth at the beginning of each year that ends up being revised downwards, over and over and over again. But now we have reached the point at which the prediction of 3% real GDP growth would be a joke. Even nominal GDP growth isn't probably going to be at 3% this year. Actually, nominal GDP is at a level that has historically been a recessionary level (**see GDPNow Model above right**). It isn't this time because the inflation rate is close to zero. No one bothers anymore to project 3% GDP Growth and the Federal Reserve has basically given up on rate hikes.

Federal Reserve Chair Yellen essentially capitulated on March 29th. One official would say hikes are near, another would urge caution. Because there were contradictory statements being made, the markets were getting confused. Janet Yellen took control with her speech at the Economic Club of New York. She said that she is not going to raise rates at the next Fed meeting in April despite all these other Fed officials saying that April is a possibility. That is a huge signal from the Fed.



*The GDPNow model forecast for real GDP growth (seasonally adjusted annual rate) in the first quarter of 2016 is **0.3 percent** on April 19, unchanged from April 13.*

The Fed has already reduced its forecast to two rate hikes. We wont see that because we're getting close to mid-year and we doubt that they are going to do a rate hike in June. So in June they will probably just push thins out and signal two hikes by June 2017 and then keep pushing it forward. The Fed has pushed back such decisions for years. We were always going to see 3% GDP Growth and it always remained 'just around the corner'. We were always going to get to a Federal Funds Rate of 3% and it was going to be starting in six months. But it never happened. The Fed has punted on rates because it is all in on the asset market reflation trade. Rate hikes only create cracks in the dike which is already showing signs of stress.

Stock Buy-Back Plans Drive Market Higher

Companies buying back their own shares, often with borrowed money, are the main force in pushing up stock prices right now. But unlike other buyers, whether humans or algorithms, corporations are trying to be the high bidder. Their goal is not to buy low and sell high. Their goal is to push up their share prices. They have become the relentless and 'dumb money' bid with near limitless means (of borrowed money at

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low interest rates) – exactly what a market needs in order to soar beyond fundamental concerns.

Buying back shares also helps prop up stocks because it reduces the number of shares outstanding. By reducing the share count, buy backs increase earnings per share, and particularly ex-bad-items earnings per share, which is the metric Wall Street analysts and corporate chieftains want everyone to look at.

Share buybacks have some big advantages: they are not accounted for as an "expense" on the income statement though they suck up huge amounts of mostly borrowed cash. So from an income point-of-view, share buybacks are free. But from a cash and leverage point-of-view, they're very expensive.

When a company borrows money to buy back its own shares, the borrowed money doesn't get invested in productive activities that would help service that debt in the future. All the company ends up with is a pile of additional debt that might cause all sorts problems down the line. We are getting near that point where companies with weakening credit are having a harder time finding funding.

Market Outlook

Earnings and profit margins are dropping and companies basically are borrowing money to pay to buy back shares. That is non-productive borrowing and creates a bigger debt burden. Eventually the cost of borrowing gets high enough that companies stop buying back stock. There are also pauses in buyback programs during earnings season. Anytime we have seen an interruption in buy-backs, stocks have struggled.

But the Central Banks continue to try to avoid any set-back in the asset markets, and their latest kick-save has the US market back near its old highs.

Stocks are showing signs of fatigue but are by no means falling out of bed. In the midst of an overbought market, with arguably high valuations and high levels of complacency, attention will be the FOMC meeting this week. For now, the S&P 500 Index has clearly demonstrated loss of momentum as it attempts to rotate leadership away from defensives to what may be seen as relative value plays in healthcare, energy and financials. However, a failure of these latter sectors to take the lead could stall and reverse the rally. 2080 is first support and a close below there would be a further indicator that momentum is waning and may be due to reverse course.

Investment Strategy

Once again the markets have come back from the brink of a severe breakdown, thanks to the Central Banks. Growth holdings have been added to a bit over the past few weeks, and we also added to bond holdings. For as long as the uptrend remains in force (see charts on next page) we'll hold to equity positions. 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.

A listing of our major portfolios and where they stand is on the top of the next page. We are in a balanced position right now.

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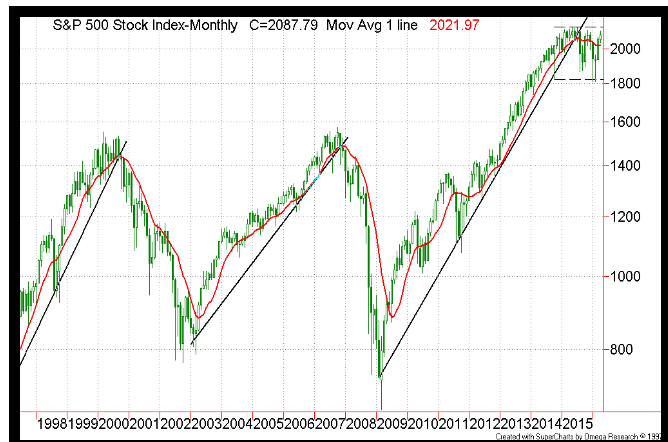
Portfolios & Positions
MPT Aggressive
40% Equity / 60% Bonds & Cash
MPT Moderate
37.5% Equity / 62.5% Bonds & Cash
MPT Conservative
27.5% Equity / 72.5% Bonds & Cash

MAC Growth
100% Cash
Separate Accounts
50% Equity / 50% Bonds/Cash
Managed VA Accounts
25-30% Equity / 70-75% Bonds

Market Charts—Blue-Chips Re-Establish Bullish Trend but Small Caps Lag

Small Caps Remains Well Below Peak (Top)
The shows the long-term view of the Russell 2000 Small-Cap ETF (IWM). The DJIA and S&P 500 have led the rebound and are near highs, but the 'average' stock, exhibited by the Russell 2000, is still well below their 2015 peak (some 13% below).

The Russell 2000 has recovered the break in long-term trend (dual diagonal lines) but has reached resistance from a down-trend line back to the 2015 peak. Also, long-term momentum (MACD in lower panel) has turned down. The Russell needs to break the downtrend to keep the rally intact.



S&P 500 Long-Term (Bottom)
The S&P has broken the long-term uptrend line back in 2015, but has not broken down like 2002 or 2008. It has instead moved in a sideways band (dashed horizontal lines) . So far the market has managed two recoveries, one last November-December and the current rebound since mid-February.

As long as the S&P holds above its 10-month average now at 2022, the bull trend holds. Below that levels warrants a DEFENSIVE stance.

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