Hamilton-Bates Market Update

Portfolios Balanced as Market Uptrend has been Re-Established

May 20th, 2016

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In recent weeks the US equity market has chopped around with little direction. No momentum came from earnings, and without QE little upside has been achieved. There has been plenty of intraday action but strong days have been cancelled out by weak days and vice-versa. The past week has seen some accelerated weakness with the release of the FMOC minutes and the potential for a June rate hike. Markets broke key levels on Thursday but Friday's rebound could repair the negative technical tone. This is the first meaningful pullback since the February low, but whether it is THE top or just a shallow pull-back remain to be seen. Given the quick rise of bearishness, a surprise summer rally is likely the 'pain trade'. And the market likes to inflict pain on the consensus.

Earnings, Interest Rates, & the Economy

Last quarter GDP was 0.5%, adjusting for inflation it was zero if not negative. Earnings have been measly, with aggregate S&P revenues (sales) negative for 5 quarters now. The US economy is limping along, just barely above stall speed. Only in the context of a global economy where most are WORSE OFF do we look good. Retailers are a prime example; large retailers like Kohl's, Nordstrom, Macy's, and Target are recording same-store-sales collapses ranging from 3.9% to 8.2%. Wal-Mart, the single largest retailer in the world, had its first ever year over year sales drop last quarter. Wal-Mart turned in decent earnings this week, but the larger trend is still negative. Something is rotten in retail.

The Unintended Consequence of Intervention

Since 2008 the Central Banks have tried to prop the world's economy up with easy money and QE—literally trying to get something for nothing. But it has not worked, and in fact easy money created lots of mal-investment which resulted in overcapacity in many sectors; and in turn collapse and contraction. Precisely the opposite effect desired. Sure asset markets have bubbled, but those returns from easy money seem to be diminishing. The Fed keeps saying growth is around the corner but the facts don't bear that out. Manufacturing is in recession. Retailing is now struggling. But they have talked themselves into a corner and now could hike rates again—and the markets won't like that.

Ongoing Central Bank intervention has become THE problem in the asset markets. Zero interest rate policy has destroyed the market's ability to discover the real cost of assets, credit, and risk. This ruined natural price discovery, forced investors to take risk they'd most likely rather not, and ended up crippling the economy. We see the legitimate role for a central bank to provide emergency liquidity in financial panics. In that sense we were ok with QE1 back in 2008-2009, even if it turned out to be a money mill for insiders. But it did help prevent a seize-up of the financial system. But the Fed didn't stop there, continued to blow asset bubbles, and never let the system reset.

All that was done was a bringing future sales/demand forward by lowering interest rates to zero, and this just digs a gigantic hole in future sales/demand. That is exactly what we are seeing. So much demand has been brought forward there is little left to get. So by trying to avoid ANY cycle pain we get an extended recession of weak demand and over-indebted households and enterprises.

Artificially low rates enabled massive speculation and overcapacity in basic materials and commodities sectors, as capital sought yield-especially in the energy sector. Yield-seeking created a capacity boom which wasn't supported by true growth, and a bust ensued. Manipulating interest rates creates a phony economy in which nobody can possibly discover the real price

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and risk of borrowing money. That had led to a hoarding of sideline cash and little productive investment. All we have seen are stock buy-backs and little capital expenditure. Now they are talking about negative rates. The Central Banks' policy boils down to obscuring the real price of assets, credit and risk with a wave of easy money/debt. This entails not considering risk or valuation, just buy and borrow. You don't solve a debt problem with more debt. The sooner the Fed gets out of the way the better off we'll be. We are just not sure that will happen.

But we wonder how long it can go on. Central banks have become the de-facto driver of the asset markets. The result is that debt-driven activity, encouraged by falling nominal interest rates, replaced the market-driven activity. But there are limits to excessive debt, and markets always win out in the end. The only question remains is just how far the Central Banks will go. If they want to they could print money and by equity assets across the board, and the stock market will go higher, but currencies will collapse, and inflation will rise. The economy will end up looking like Venezuela.

The situation in Japan and the Euro-zone is worse than in the US, and the destruction of their market economies has been more aggressive. Temporarily, the yen and the euro are strong, but that is unlikely to last. The reason the yen and the euro are strong is that liquidity in the shadow banking system is being squeezed by central bank purchases of government bonds, leading to an increase in cash demand as positions financed in these currencies are unwound. Should the dollar rise it would destabilize the system. The dollar is likely to rise as investors seek the best of the poor fiat currency choices. In the long-run all currencies are likely to decline thanks to their policies.

Market Outlook

The asset markets are rising and falling on central bank policy. With little hope or help likely to come from Washington in terms of fiscal policy, this is likely to remain the environment we must deal with.

A rally from here may still occur. Despite the pull-back and 'topping patterns' on the indexes, the market could still throw a curve ball and bounce back toward 18000 if it is perceived the FED won't raise rates in June. Because it is a Presidential Election Year, we would expect the FED to be reluctant to raise interest rates. For another, the April Jobs' numbers showed economic growth was weakening. Chair-woman Yellen could say the 'consensus' at the next FOMC meeting is whatever she chooses. Only if she is out-voted, would rates likely go up. So perhaps, the market will throw investors another curveball and try to rally again to 18000 from where it sits now. Still the markets remain vulnerable without and until there is some signs of increased upside momentum.

Another problem remains the overseas markets, which generally remain weak. As it stands most are down well off their highs, and below key moving averages. This calls into question whether their turnarounds can continue. If they do not soon recover, we could be right back in the throws of a deflationary scare. How long could our 'just above stall speed economy' hold up then?

Frustration with the economy is reflected in the rise of Trump and Sanders. Populism is against any more free-trade deals, and rightly so. All we have exported is good jobs. If talk grows of likely tariffs, it could scare the financial markets with similarity to the Smoot Hawley tariffs that many economists blame as a cause for the 1930s' world-wide Depression.

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Investment Strategy
In the current environment our work continues to favor fixed income and defensive equity holdings such as those in the staples, utilities, and telecom sectors. Even with the market's rebound since mid-February these defensive sectors have been leaders. That is likely to remain. We also like high-grade bonds and even preferred stocks.

Here is a listing of our major portfolios and where they stand. Holdings are Balanced with a slight emphasis on Fixed Income.

Portfolios & Positions

MPT Aggressive
40% Equity / 60% Bonds & Cash

MPT Moderate
37.5% Equity / 62.5% Bonds & Cash

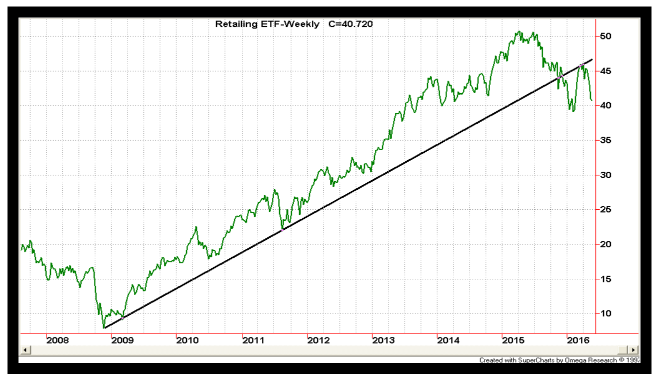
MPT Conservative
27.5% Equity / 72.5% Bonds & Cash

MAC Growth
100% Cash

Separate Accounts
50% Equity / 50% Bonds/Cash

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

Market Charts—Bearish Pattern on S&P and Retail Sector Breaks Down



Head and Shoulders Pattern on S&P (Above Left)
April and May have seen the S&P trace out a potential topping pattern called a 'head & shoulders' for its resemblance as such. The pattern is noted above. A clear violation of its neckline will occur on a closing below 2040 on the S&P (17400 on the DJIA). The downside objective would then be 16900-17000 for the DJIA and 1980 for the S&P 500. On the other hand, if the market can rebound and void the pattern, there is nothing more BULLISH than a failed bearish pattern. A failed head and shoulders topping pattern could see the S&P at 2300-2400 quickly. Between the Election and the Market it could be an interesting summer.

Key Retailing Sector Weakens (Above Right)
Since 2009 the Retail Sector led the run higher along with the overall market, but not something is wrong. Despite the government data saying retail is great, the 'recovery' is over in jeopardy as far as retail stocks are concerned.

The retail ETF (XRT) has taken out its bull market trend line dating back to the 2009 bottom. More importantly, the rebound has failed to reclaim former support. Instead of recapturing the trend line, we had a failing bounce before rolling over again. Trend has broken completely for this key sector and we're now in a consolidation period at best and a downtrend at worst.