Hamilton-Bates

Market Update

June 27, 2016

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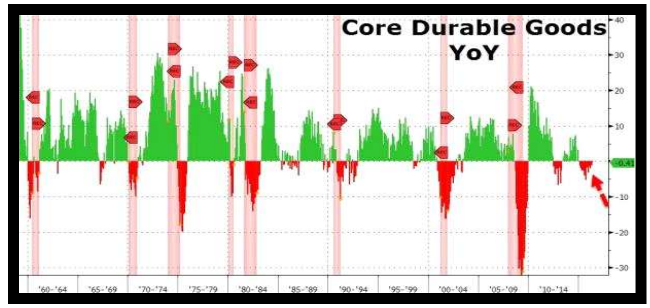
The U.K. vote to exit the European Union sent ripples through global markets. The exit vote caught the markets well off guard and the result was one the worst single days we have seen in years. Stocks were down sharply across the board on Friday, with Europe taking the brunt of the weakness. the German DAX was down 8%. For perspective, U.S. stocks were only down about 1.5% on the week despite Friday's big drop. It is impossible to know with which direction markets will head from here, this week's trading will be key to that. We could see a flight to US assets (including stocks) or we could see further weakness on contagion fears. We continue to see out-performance by defensive areas like Utilities & Telecom in equity, and Sovereign and Investment Grade in Fixed Income.

Earnings, Economics, and Interest Rates

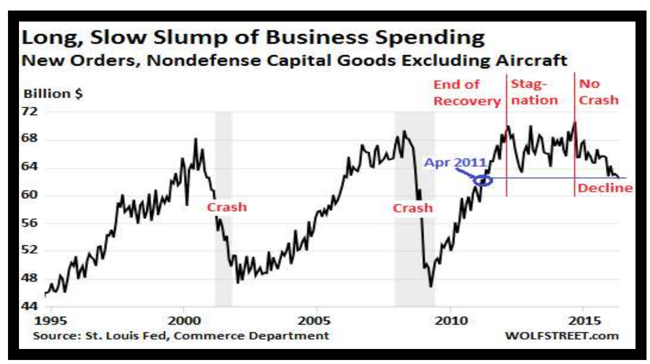
The Brexit Vote dominated news last week, but outside of that we had an FMOC meeting and testimony to the House and Senate from Fed Chair Yellen. Not only did the Fed leave rates unchanged, Chair Yellen used her testimony to reaffirm the recent 'dovish tilt' of the FOMC. There is a growing belief amongst the Fed in a 'secular stagnation' thesis, with growth and inflation remaining low. This basically is their way of saying that rates will stay lower for longer, with the FOMC willing to look through any suggestions that the economy is improving until clear inflationary pressures have started to build. We are not likely to see a rate hike anytime soon.

The little bit of data we did get last week was bad, as Durable Goods Orders cratered -2.2% in May, well below -0.5% expectations. There was disappointment across all aspects of the report, and it was the 17th month in a row of negative YoY Core Durable Goods declines. The drop in automobile orders is worrisome. After years of booming, the auto sector set an all-time record last year in terms of total unit sales in the US.



It's a huge sector, making up a big part of manufacturing and about 20% of total retail sales. If it weakens, the economy will lose one of its last strong pillars of strength. The 17 months of YoY decline (shown by the red arrow in above chart) is something that has never happened outside of a US recession (recessions are highlighted in red).

The Second Chart (below) is a long-term chart showing New Orders ex-Defense & Aircraft (from Wolfstreet.com an excellent site on market and economic commentary). The chart is a broad look at business spending (cap-ex).



Note the V-shaped recoveries in business spending after the Tech Bubble in 2002 and the Financial Crisis in 2008-09. The latest recovery peaked in 2012 and was followed by 2.5 years of stagnation and now the grinding decline that we are now in.

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When businesses don't invest and spend, they don't grow, and the economy has trouble expanding. Business spending is a crucial driver of economic growth. Everyone has been hoping that businesses would open their wallets and its not happening. Business spending (cap-ex) is now at the lowest level since April 2011. This lack of business spending is one of the reasons economic growth has been so weak.

Market Outlook
Last week's rally into the Brexit vote suggested the financial markets had a favorable outcome priced in, but that wasn't the case. That only exacerbated the 'shock' of the leave vote. In the aftermath, the equity markets have been under heavy pressure, with European Equity and the Financial sector in particular taking the largest hits. The Double Whammy goes to the European Financial Sector where the Euro Stoxx 600 index of European Banks is down nearly 20% in two days.

In our market the S&P 500 blew thru its 50-day average, but remained above its 200-day average, although it is threatening that key level today. We would prefer to wait for the dust to settle down a bit before trading, as this would allow the charts to regain their footing to get a better technical view. However, similar to what we saw in August 2015 and February 2016, charts take on an ugly skew during violent sell-offs.

Given that a Fed rate hike (which had been a certainty) is now nearly certainly unlikely, we continue to favor fixed income. The stock market has pulled back sharply, but as long as key support around 2020-2025 on the S&P holds, upside opportunity remains. Below that key level we are more concerned with a return of capital than a return on capital.

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. The market's rebound since mid-February has been led by these sectors. That is likely to remain. We also like high-grade bonds and preferred stocks.

Here is a listing of our major portfolios and where they stand as of last Friday 6-24-2016

Portfolios & Positions

MPT Aggressive
50% Equity / 50% Bonds & Cash
MPT Moderate
45% Equity / 55% Bonds & Cash
MPT Conservative
40% Equity / 60% Bonds & Cash
MAC Growth
40% Equity / 60% Cash
Separate Accounts
50% Equity / 50% Bonds/Cash
Managed VA Accounts
25-30% Equity / 70-75% Bonds

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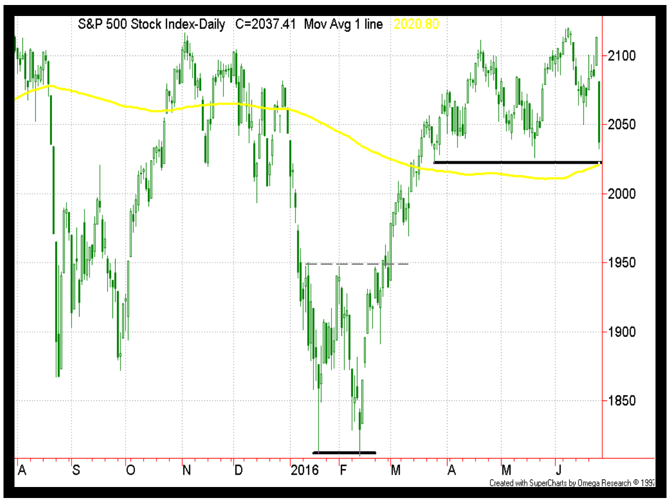
Market Charts—Brexit Vote Threatens Bull Trend



S&P Voids Head and Shoulders Pattern (Above Left)

The US market may have voided the bearish H&S Pattern of April/May, but it couldn't void the Brexit Vote which 'shocked' markets on Friday. We say shocked because the financial markets absolutely expected a 'remain' vote and rallied near 2016 highs on Thursday.

Friday's decline took back the move up from the May lows, and is now threatening key support from the 200-day (yellow line in chart above) and 10-month averages in the area of 2020-2025 on the S&P 500. A violation of that important level would lead us to consider the index weak again.

Long-Term S&P 500—Another Failure at the Highs

For much of 2015 and 2016 the S&P 500 has been stuck, going nowhere fast. Its no coincidence this period ties to the end of QE. With no QE, a sluggish economy, and lousy earnings, the market has simply stalled. **Small-Caps and High Beta names are down 10-15% from their highs.**

A breakout above 2150 would be positive for the bulls and could lead to a move higher through the Summer.

As long as key support around 2020-2025 on the S&P 500 from the 200-day and 10-month average (red in chart above) is not broken, the bulls have control. Those levels are being tested now and if broken defensive measures are required.