Hamilton-Bates
Market Update

July 15, 2016

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The global equity markets have remained buoyant, even in the face of the terror attacks in Nice France during their Bastille Day Celebration. Sadly that buoyancy is a sad testament to the fact that such attacks have come often enough that the market is no longer ‘surprised’ by them.

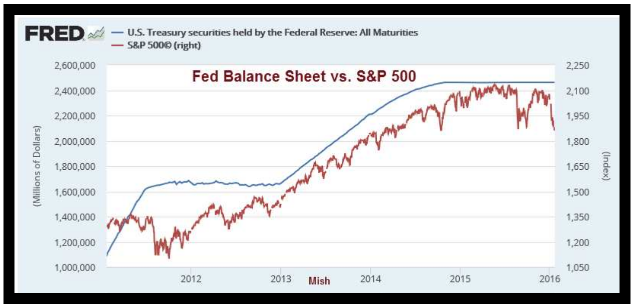
Earnings, Interest Rates, & the Economy
The June Jobs report came out last week and was considered ‘bullish’ by the markets as the NFP Report showed 287K jobs added last month, reversing last month’s brutal number.

While the quantitative aspect of the June jobs report was stellar, so stellar in fact that not a single Wall Street forecaster expected it would happen, the next question is what was the qualitative component of this unprecedented Establishment Survey beat.

The problem is that more than half of the jobs added were in sectors known for paying near minimum wage or just slightly above (Leisure and Hospitality added 59,000 minimum wage jobs , Education and Health also added 59,000 mostly minimum wage jobs, and Retail Trade added 30,000 certainly minimum wage jobs.

With more than half of job additions being minimum wage one can see why the June average hourly earnings increase was below expectations.

Overall our economy remains in a sluggish growth mode, but compared to the rest of the world our economy is going gangbusters. This is likely why our market has attracted foreign assets, along with the strength in the Dollar.



Does a Market Breakout Signal a return to QE?
The stock market has largely tracked the balance sheet of the Fed, as the chart above shows—with stocks going into a long sideways phase as QE ended. Now though it seems stocks are breaking out to new highs—does this mean the stock market sees renewed QE ahead?

The decision to spend, tax, and borrow is the very essence of state power. There is no possibility of democracy if these fundamental powers are given over to the Central Bank. It also opens up a Pandora’s Box of unintended consequences. It also relieves elected politicians entirely from their fears of the public debt, and from the responsibility of crafting sound fiscal policy.

QE, or ‘helicopter money’ isn’t new in monetary policy. In one form or another it is the monetization of government debt—–that is, purchase of government bonds with central bank credit conjured from thin air. It’s the ultimate in ‘something for nothing’ economics. Not only has it been tried before and not worked, it will also bury future generations in crushing public debts.

The objective is to somehow boost the economy by levitating the stock market. The theory seems to be that the ‘wealth effect’ of inflated asset prices stimulates demand in the economy. The problem is the premise hasn't really been proven. Sometimes investors feel better about things when the stock market rises. Some of them even buy flat screen televisions and cars. But businesses don't usually buy into this 'fake' expansion and there is little capital expenditure and income gains to support sustained growth. So it ends up being a short-term adrenaline shot.

If QE worked countries like Venezuela could print themselves to prosperity. But things don't happen that way as their currency takes the hit when the Central Bank runs the presses. There is also the myriad of unintended consequences. What happens when the Central Bank stops buying? What happens to a market of stocks when central banks become the largest shareholders?

So far our (US experience) with QE and the impact of the massive flow of new central bank credit has created asset bubbles that did nothing outside of Wall Street. It did not stimulate the main street economy one bit; it merely generated vast windfalls to the top the top echelons who own most of the financial assets.

The Japanese Example

The Japanese Central Bank has been intervening in its stock market with regularity for years. The problem is that once started if you stop—the market struggles on its own (as our market has since 2015).

A Bloomberg study found that the Bank of Japan through its purchases of ETFs, had become a top 10 shareholder in about 90 percent of companies that comprise the Nikkei 225. That should scare anyone who cares about free market price discovery.

While this has worked to boost the Japanese Equity market, their economy remains in the dumps with interest rates in negative territory. Neither zero percent interest rates, negative rates, nor QE has done a thin for their economy. It isn't likely to do so for our market or Europe's either, but QE WILL boost asset prices whenever and wherever it is employed.

Concerns : Rising P/E's and Falling European Banks

While the stock markets have seemed to shrug off both Brexit and the latest terrorist attack, there are a few concerns we have that we believe are worth watching.

The first is European Banks, which are getting decimated. Just two weeks ago the European Stoxx Bank Index hit lows last seen at the 2008-2009 low! The massive loss of equity capital by the large banks of Europe could trigger a capital crisis in the future. Deutsch Bank for example (DB), trade well over a 150 in 2007, it is now trading at 15. A loss of 90%! How could things be great if the largest banks are getting crushed. **We are watching Deutsch Bank as a proxy for bank fears, and a move of (DB) below $10 is likely to create some ripple effects.**

The next concern is that Market Valuations now leave little room for error. The P/E ratio of the

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S&P 500 companies is at 26. It spiked higher than that only three times over the last 136 years—1929, 2000, and 2007 just before the Financial Crisis. **All of those periods were times to be concerned and vigilant about the equity markets.**

Market Outlook

The market is now as ‘over-bought’ as it was ‘over-sold’ just after the BREXIT vote. But the market has so far managed to create a breakout to an all-time high above a key round number (Dow 18000) and a series of tops going back more than a year (See chart section on next page).

In the past similar breakouts from long consolidation patterns around key numbers led to very bullish conditions. There were similar breakouts in 1982, in early 1987, in 1991, in 2005, and twice in 1996. All saw bullish markets for months to come. The surpassing of 18000 by the DJIA could be similarly bullish.

While stocks have rallied government bonds are falling back. So far though we see no signs that yields are about to rise sharply. Utilities and Reits have held up well, something they wouldn’t do if the FED were about to raise rates. Municipal Bonds have also pulled back, but this likely owes to investors selling Muni’s where they have been parked to buy into the stock market breakout.

Interest rates will, of course, some day go up. But a lot of people have prematurely called for this to happen and so far they have been wrong. Our view remains that the FED will most likely not raise rates until after the Presidential Election in November. In any case, I do not think we have to worry about this until short-term rates start making a series of highs.

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. We will use pullbacks in both to add to current positions. There has been some signs of a bullish rotation to key cyclical sectors like Technology and Consumer Discretionary. If these sectors gain strength it could help the chances for a bullish breakout.

Here is a listing of our **Portfolios** and where they stand.

MPT Aggressive
63% Equity / 37% Bonds & Cash

MPT Moderate
55% Equity / 45% Bonds & Cash

MPT Conservative
40% Equity / 60% Bonds & Cash

MAC Growth
50% Cash / 50% Cash

SECTORS
80% Equity / 20% Cash

Separate Accounts
55% Equity / 45% Bonds/Cash

Managed VA Accounts
30%-40 Equity / 60-70% Bonds

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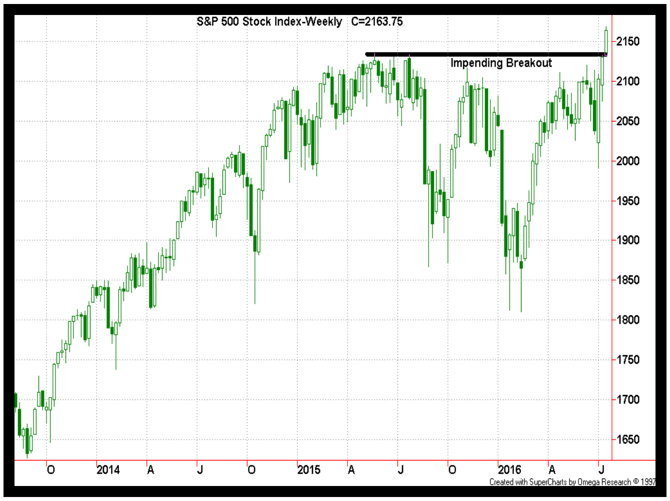
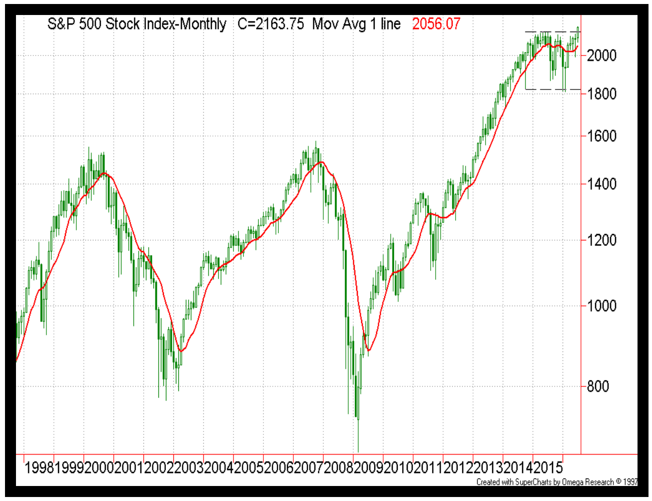
Market Charts—Market Nearing Major Breakout





S&P Impending Breakout or Fake-out? (Above Left)
Once again the major averages are trying to 'breakout' above the resistance that has held them back for the better part of a year and a half. This week's action has gone a long way in securing such a breakout. If it holds true we could see the major averages begin a run that lasts for much of the year.

On the other hand, a breakout/fake out would be the latest in a string of disappointing attempts to get out of the 18 month congestion pattern the market has been in (see box in long-term chart upper right).
This move has the look of one that could carry, even with fundamentals so poor. In fact such a breakout would indeed catch may investors off guard.

As long as 2130 holds on the S&P the bulls are in control. A legitimate breakout could see the S&P reach 2300 in 2016.

Long-Term S&P 500—Trying For Open Space
For much of 2015 and 2016 the S&P 500 has been stuck, going nowhere. Its no coincidence this period ties to the end of QE. With no QE, a sluggish economy, and lousy earnings, the market has gone nowhere. **Small-Caps and High Beta names are still down 5-10% from their 2015 highs.**

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

Key support on the long-term chart is at 2130 and then 2060 on the S&P. A move back below 2130 AND 2060 would likely signal the breakout was another fake-out.