Hamilton-Bates

Market Update

July 27, 2016

P.O. BOX 270 Newtown Square, PA 19073 877.768.4247 www.hbir.com

It's hard to ignore the current rally in U.S. stocks, as last week both the S&P 500 and DJIA hit 2016 highs. The S&P 500 has now climbed four weeks in a row and has erased the sharp losses from the Brexit vote. Despite the rally, which could continue for some time if the technical 'breakout' we are seeing holds, investors are not buying into a market that is 'cheap' or has great fundamentals buy any means. A number of risk factors signal that when this run is over the retrenchment could be deep.

Earnings, Interest Rates, & the Economy

The FMOC meets this week, and they are expected to keep rates unchanged. Central Banks policy has come to dominate the financial markets and nearly all the attention has been focused there. We could see one hike later in the year by the Fed if the market doesn't decline, but the Fed and the other Central Banks are clearly in the camp of supporting asset prices. They are all in.

Right now we are in the middle of earnings season, when companies let the world know how business is going. Many companies also give an outlook on next quarter's results. A good earnings season can send stocks higher and a bad one can trigger a sell-off. This current quarters' results have been very much under the radar.

So far, according to research from Fact Set, 25% of the companies in the S&P 500 reported results as of last Friday. Based on these numbers, the S&P 500 is on track to post a 3.7% decline in earnings. This would mark the fifth straight quarter of falling earnings. And that would match the longest earnings drought since the 2008–2009 financial crisis. Overall analysts expect a slightly negative quarter but results would need to improve a lot just to get to flat.

As recently as March 31, earnings had been expected to rise 3.3%, so it is clear to see that corporate profit expectations are rapidly deteriorating.

Why do stocks continue to rally as earnings FALL at levels not seen since the last financial crisis? One of the main reasons folks buy stocks is to earn a share of future profits, and in the long run prices follow earnings. Shrinking profits and earnings *should* cause stock prices to fall. Well, Central Bank rate policy has FORCED investors to buy even when fundamentals are negative because there is no alternative. With bond yields negative or zero there is literally no place to go. This may push stocks higher for awhile, but eventually there will be a price to pay.

Market P/E is higher than at any time other than the 1929 top and the 2000 Tech Bubble Peak

The Investing World is Upside Down

With 30-40% of the worlds bonds at zero or negative yields, investors can ONLY be buying bonds in the hopes rates get even more negative—they are making nothing in interest if not losing money due to negative yields. Investors are now buying bonds for capital appreciation and stocks for YIELD.

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Stocks may yield more than bonds, but dividends are not guaranteed. For example, the number of companies announcing dividend cuts exceeded the number of companies increasing dividends in the month of June. This is the first time since the Financial Crisis this has happened and only the fifth time in the last 12 years that Standard & Poor's has been publishing dividend data. What does this say about the 'health' of the economy? It tell us that Stock selection and investment needs to be done with discrimination so as not to fall into yield traps.

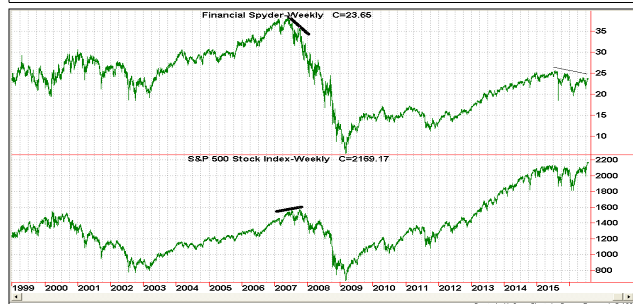
This is the unintended consequence of QE, ZIRP, and NIRP—too much Central Bank meddling. Such meddling has pushed up asset prices, thrown true price discovery into disarray, and done nothing for the world economy at large. Investors falsely believe the Fed can control the market's forever. Eventually rates will rise, and that will cause a lot of pain for investors not prepared.

Banks and Financials Lagging Like 2007-2008

Despite a market near all-time highs, the banks and financial stocks have been lagging (top chart above right). Some of this is due to interest rate policy, which hurts banks margins when kept so low for so long. Without participation from the financials a market rally is suspect.

In 2007 financials peaked ahead of the market and started to decline. Should financials begin to sell-off investors should pay attention. And then we have Deutschbank (DB), whose chart looks like a train-wreck (bottom chart above right). It has lost over 90% its value since 2007, and is well below its 2009 lows! If its stock gets below 10 it could be a sign of major trouble, which could spill over to the broad market. We'll keep watching this for what could be a tell on the broader market.

Financials Lagging In a Big Way



Market Outlook

The market has had quite a run from the Brexit vote lows, and remains 'over-bought'. But so far stocks have remained well bid as we head into the FMOC meeting. **We could see a pullback toward the breakout levels, say 2130 on the S&P and 18000 on the DJIA, and as long as those levels hold the bulls remain in control.** Government bonds have pulled back from Brexit vote peaks, but remain in an uptrend. We don't expect the Fed to hike rates until the 4Q if at all.

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. New highs in the NASDAQ and Russell 2000 if they happen will add to the bullish outlook.

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Market Charts—Market Trying to Build on Breakout

S&P Impending Breakout or Fake-out? (Above Left)

The S&P 500 is now going for three weekly closes above the old high, solidifying a pretty clear breakout so far. The old highs had held the market back for the better part of a year and a half. Should this breakout be true, it would suggest a rally of many weeks, taking stocks to levels most wouldn't expect.

Given the negative earnings and fundamentals we are seeing, a rally would no doubt be a 'surprise', but it is possible the market could enter a blow-off phase as money comes into the US because of the relative strength of the economy and the US Dollar.

The key level is the prior highs around 2130, 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 (Above Right)

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.

But QE seems to be back with the ECB and the Bank of Japan likely to expand their asset buying programs. Thus we are seeing stocks poking higher.

A breakout would be very positive for the bulls and could lead to a move higher through the Summer into the Fall. The key levels are 2130 and 2060.

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