Hamilton-Bates

Market Update

September 14, 2016

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After a very dull August, we were expecting things to pick up in September, and that has indeed happened. After seeing the S&P 30 day historic volatility drop to a two decade low, we have now seen a 35% volatility spike over the past few days.

We have now entered September which historically has the worst average market returns for any single month over the long term. However, over the last 10 years the return has been +0.33%, which is about average. We did have two brutal Septembers in 2008 (-9.1%) and 2011 (-7.2%), but in both cases we were in the middle of an unfolding 'credit crisis', that is not the case right now.

As to why stocks and bonds are falling together; what has happened is that the Fed started talking aggressively on rates at a time when most bond and stock investors where positioned for no rate hikes anytime soon. So the increased chatter over raising rates (even if its not supported by the economic data), has caused ripples in the equity and credit markets. Given seasonal tendencies, and the FMOC meeting next week, we could see investor uncertainty and market volatility last into next week or even next month depending on what the Fed does.

Earnings, Interest Rates, & the Economy

Earnings are soft and so is the economic data, but the Fed has increasingly talked of hiking rates. That chatter has overwhelmed all other news of late and it likely to occupy the market until the FMOC meeting next Wednesday. The Fed is really talking a good game, and it seems that it depends on what the Fed means by 'data dependent'. Recent weakness in the ISM surveys and BLS employment report are probably enough to keep the FOMC on hold and the market now prices a small possibility of a hike in September and a reasonable chance of one in December. If the Fed wants to show how 'independent' it is, then we could see a move in September and then probably none in December. A September move however could create a bit of volatility that lasts a few weeks as many market participants would be caught off guard by such a move. Thus, some de-risking and rebalancing by big players could ripple through the markets for awhile.

Market Outlook

Prior to the latest pullback the market had been in a solid uptrend, and so far the weakness we are seeing hasn't done anything to suggest anything more imminent than a fairly normal pullback. Breadth had been strong and growth oriented sectors had been doing well prior to this past week, and there weren't any of a number of technical warning signs that are typical of a major breakdown.

Still it is September, which has a history of market weakness, so we could see volatility and chop until early October if the Fed hikes rates next week and 'surprises' the market. If they pass, we could see strength build quickly and head higher into year end.

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Over the past week the aggressiveness of the hawks on the FOMC along with concerns that the central banks are 'tapped out' and can do no more (which is wrong they can print and buy assets forever) has markets on edge.

Government bonds and tax-free bonds have pulled back as have high-yield and most corporate bonds. **We believe the economy is weak and should the Fed hike rates and bonds pull back, they would be attractive for new funds**. We still see fixed income as an attractive sector, and believe that rate hike talk, or even one hike, will quickly be overcome by the reality of a weak economy. **The Fed will find it tough to hike more than once while the whole world cuts rates.**

As for stocks, it looks like there will be another attempt to rebound this week from support around 18000 on the DJIA (this is roughly equivalent to the 2130 support level on the S&P 500). If this level holds we could see higher prices into year end. If we see a faltering rally, we could see a more protracted pullback before a lasting bottom.

Investment Strategy

The 'breakout' by the market above its 2015 highs has not generated much enthusiasm, as August low volume rise has seen September turn into weakness. We could see a continued pullback over the next few weeks depending on what the Fed does, but we believe this market has higher to go. It is unlikely the peak will be with a whimper as August was, and we could see a very robust rally once the current correction runs its course.

Still we are within the framework of an aging bull-mark so investors need to be ready to shift portfolios should weak fundamental conditions synch with a weaker trend condition.

If things go well we could see stocks rally another 5-10% before year-end. We are seeing improvement in the technology and financial sectors, which could be getting ready to assume the leadership mantle. If so, it would have additional bullish implications for the market.

In the current environment our work continues to favor fixed income balanced with equity positions expected to do well should the market advance in coming weeks. We will look to add to holdings on any weakness that presents itself.

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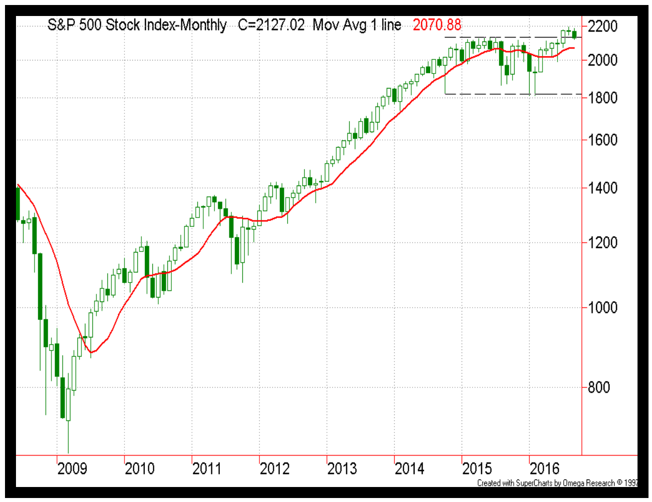
Market Charts—Market Testing Support



S&P Breakout (Above Left)
The S&P is now testing the old highs that contained the top of the 2014-2015 range (marked by dashed lines). This level has seen a brief bounce and whether it holds will tell us if the pullback is nearly over or has a bit more to go.

The S&P is below its 50-day average (in red) but above its long-term 200-day average (in yellow). We could see a decline to the 200-day average if the Fed hikes rates.

Market now at support around 2120-2130, key support at 2060-2070. A break of 2060-2070 would be a significant negative.

Long-Term S&P 500
For much of 2015 and 2016 the S&P 500 has been stuck in a large range, as shown by the dashed lines in the chart above. But we are now seeing the S&P trying to break above the top end of that range. August started off well, with a poke above the range and an attempt at a breakout. Rate hike fears have seen that move falter in September.

The S&P is holding the 2130 level, but even a drop to 2060-2070, which is the key 10-month average, would still not threaten the trend. A dip to 2060-2070 would be a level we would look to add to equity positions.