Hamilton-Bates

Market Update

October 4, 2016

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A dull August led to some Fall fireworks as stocks retreated from summer highs amid fears of a rate hike Reserve and renewed concerns over European banks. The trouble started ahead of the September FMOC meeting as a number of FMOC members talked of hiking rates 'sooner rather than later', and said that 'rate hikes are on the table'. We didn't think so then and ultimately the Fed continues to find it easier to talk about rate hikes than to actually hike. The past few weeks have seen a return to the headlines a name we mentioned earlier in the year—DeutschBank. Some months ago we showed a chart of this stock noting that it looked horrible (it was trading around 12), and that a break under 10 could cause spillover into the broader market. It had a brief bounce then but has since sold off once again. It is now about 12 bucks a share, should it break 10 we could see real concerns of another 'Lehman'. European bank concerns will continue to hang over the financial markets.

Earnings, Interest Rates, & the Economy

A stock market 'within a stone's throw' of an all-time high continues to mask a good deal of ugliness in the economy. GDP Growth expectations have gone from over 3% at the beginning of the year to something in the 1.5-2.0% range now. Earnings have declined for 8 quarters and continue missing growth expectations.

At 87 months this so-called expansion is extremely long-in-the-tooth, given that the typical recovery since 1950 has lasted only 61 months. Not only that, this recovery has been the weakest on record. This combination of fragility and age make the current cycle more vulnerable to a recessionary correction than normal. The current expansion was built upon QE, zero interest rates, stock buy back, a temporary global trade rebound, and the transitory effects of rising asset markets 'the wealth effect'. Most of these forces are now in the exhaustion phase, with buybacks drying up and the consumer tapped out. Business activity in the US economy is rapidly cooling. Year over year industrial production figures have been negative for over a year, the longest non-recessionary decline on record. With the Industrial Sector is already in recession, and a recent weakening in auto sales, a general decline in economic activity seems very possible in 2017.

The Fed continues to talk about hiking rates, and they may actually hike in December if the market continues to rise, but parsing the data shows a vulnerable economy. The Central Banks can continue to support the asset markets for some time, but the central bankers have not abolished the business cycle. That's why the current *25 times trailing earnings PE* on the S&P 500 is so absurd. Stock investors need to prepare for other the other side of the mountain in this economic cycle. Market volatility is likely to increase in 2017. Corporate earnings are already down 19% from their September 2014 peak, and that is before we have even seen the next economic downturn.

Forget Wage Growth—the Feds Own Report Debunks It

None other than the NY Fed published an article on its blog, Liberty Street Economics, about demographics and wages. Then it explained why 'negative growth', the new term for a decline, in real wages is going to be the new normal for an ever larger part of the labor force. This is why a large portion of American consumers are tapped out and having trouble spending more even with energy prices on the decline.

The Fed looked at the wages of all employed people aged 16 and older in the monthly Current Population Survey from 1982 through May 2016, and annual data from 1969 through 1981. They then restricted the

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sample to employed individuals with wages taking out the effects of bonuses and one-time payments. They wanted to look at living wages. Then they adjusted wages via the Consumer Price Index and looked at the sample by decade of birth, sex, race, and education. **For males in the 55-65 age bracket, real median income has declined 4% since 1973!** This is why so many families are struggling, even with dual incomes. Wages for one of the better paid sub-groups of the economy have been stagnant for 40 years.

Market Outlook

Near-term market moves tend to be dictated by news and technical factors. The key development recently has been a break of the 50-day average by the S&P last month, something it hasn't done since the Brexit vote. This break has led to 'heavy' and sluggish trading, and the market has so far been unable to get back above this key level. If history has taught us anything in this market, it's that the Fed has the market's back. With that fact and with technical factors such as breadth remaining strong, we continue to remain relatively optimistic the uptrend will continue into Q4. Short-term risk levels remain elevated, and we could see another week or so of seasonal weakness.

The key focus has always been the Fed but with the decision to leave rates unchanged in September, we have to look ahead to their December meeting. In addition, we have the U.S. Presidential Election which may result in some additional market volatility. Valuation concerns remain, and these concerns will grow should the Fed hike rates. This would hurt dividend paying stocks which had been an area of strength for the market. Q3 earnings will also be a large focus was we head into December. **FactSet estimates that earnings for the S&P 500 will decline 2.3%**. If we see a decline in earnings, it will mark the first time ever that the index has recorded six consecutive quarters of year over year earnings declines.

Companies are finding tough going, but the economy has managed to hang onto a slow growth mode. This has kept the Fed at bay, but they may move in December if the market rallies into year end. Volatility has picked up a bit, but global bond yields remain subdued, which has kept corporate liquidity high and yield investors starved for bond issuance. U.S. stocks are on the verge of 8 consecutive yearly gains, which is especially amazing given the decline in earnings. However all good things must come to an end, and 2017 could be a tougher road for stocks. The first year of the presidential term has tended to be the most difficult for equities: Going back to 1950, stocks were only up 56% of the time vs. 68% of the time for other years.

Investment Strategy

The S&P remains above the prior 2015 highs (see chart on next page), keeping the bulls in charge. But the so-called 'breakout' has not generated much energy, and we are seeing a bit of a buyer strike. The first two weeks of October are historically soft, but we believe this market cycle has higher to go. It is unlikely the peak will be with a whimper as August was, and we expect at least one more robust rally before any important top. We are seeing improvement in the technology and tech related sectors, which continue to dominate the leadership for the market. In the current environment our work continues to favor fixed income balanced with equity positions, and we will look to add to holdings on any weakness that presents itself.

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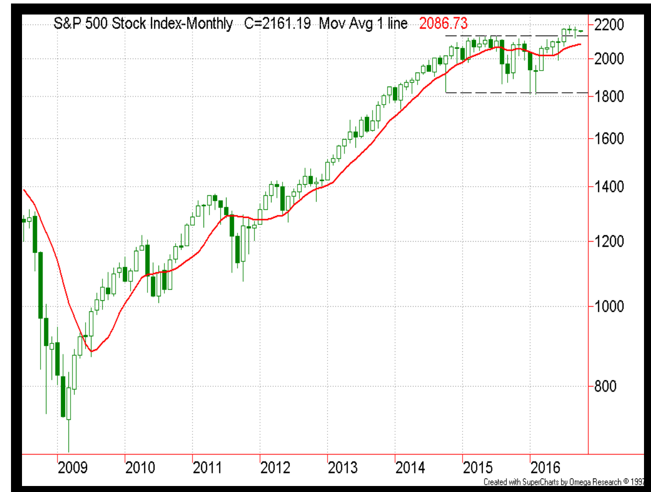
Market Charts—Market Holding Support



S&P Breakout (Above Left)
The S&P has managed to hold above the prior 2015 highs (dotted lines in chart) but has been below its 50-day average (red line) since early September, the longest period since the early year decline. Until the market retakes the 50-day, we could see continued weakness, with a dip down to 2100 or even 2080 possible depending on news flows over the next 1-2 weeks.

As long as 2130 holds the short-term trend is bullish.

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. The S&P has managed to push above that range but we haven't seen any pickup in energy from that move. August and September saw the market post 'Spinning top' candles, called that due to their resemblance to the children's toys of the same name. These candles suggest indecision and that is precisely what we have been seeing in day to day trading action.

The S&P is holding the 2130 level, and is well above the more important 10-month average now around 2090. As long as the S&P holds above that level the long-term trend remains bullish.

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