Hamilton-Bates

Market Update

October 20, 2016

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The majority of global markets remain gridlocked in trading ranges, with increased day to day volatility over what we saw during the calm days of August. Still the major averages have managed to hold above key support levels. Perhaps this is a function of investor indecision ahead of the Election, coupled with some possible apprehension over a likely rate hike in December. So we doubt that this is a permanent state of affairs, as the current indecision could easily be resolved to the upside.

The frustrating thing for observers of the current episode is there is little sign of the market tipping its hand, with the market unable to capitalize on the July 'breakout' but just as unable to fall further than the closest nearby support. Given that the longstanding trend is to the upside, and our belief that this bull will go with a bang rather than a whimper, we continue to give the upset the benefit of the doubt until proven otherwise. The key will be determining the point when any near-term surprises are past, election or otherwise, and the market ready for its next leg of advance.

The Economy, Earnings, & Interest Rates

Currently economists fall into two camps: Those who believe that the Federal Reserve should begin raising interest rates now so that it will prevent inflation from building up too much momentum, and provide them enough rate cutting firepower to fight the next recession. On the other side are those who believe that raising rates now will simply precipitate an immediate recession and force the Fed to battle a recession without the main tool it has traditionally used to stimulate growth.

Most mainstream economists/analysts believe that the economy can survive with more normalized rates and that the Fed's timidity is unwarranted. If this was true the Fed should raise rates immediately as there is no reason for the Fed to fear a stock market decline. The problem is that given the lackluster growth we have seen with rates at zero (1.5% GDP), higher rates would have seen an economy even weaker.

The problem is that the 'recovery' of the past eight years is largely the result of deeply negative real interest rates. Since 2009, when the current recovery began, GDP growth, business investment, labor force participation, and wage growth have all been significantly below trend. This has been the weakest 'recovery' since WWII. The real positives have been gains in the stock, bond and real estate markets. We have had an 'asset' recovery rather than a true economic recovery. A Wall Street recovery rather than a Main St recovery.

Asset price gains have been made possible in recent years because ultra-low rates via the Fed and other Central Banks have driven down the cost of borrowing, encouraged speculation, and pushed investors into riskier assets. Any rate hike could hit those markets hard and can tip the economy into contraction.

Look what happened this past January when the market had a chance to digest the first rate increase in 10 years. That move led to one of the worst January's in the history of the stock market. Since then, the Fed has held off from further tightening and the markets have rebounded and treaded water. Should the Fed press ahead too soon with a series of hikes we could see stocks tumble.

The current expansion is also getting old. At 88 months old it is already the fourth longest since the end of WWII where the average expansion has lasted 61 months (based on data from National Bureau of

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Economic Research and Bureau of Labor Statistics). So we have had one of the longest but also the weakest expansions on record. We have not had a single year of 3 percent GDP growth since 2007. More ominously, the already weak expansion is beginning to slow rapidly. GDP growth has been decelerating, averaging just 1% in the past three quarters. (Bureau of Economic Analysis) And while hopes continue to remain high for a rebound, economic activity and earnings estimates remain sharply reduced from the beginning of the year. The stock market has so far ignored the weakening of economic data and earnings, but at some point those factors will come front and center.

The Economists who argue to “keep rates at zero” argues that a return to 3% GDP growth is now nearly impossible to achieve. These believers a ‘new normal’ don’t expect such levels of growth to ever return. We are now stuck with rates at or near zero for the foreseeable future, with even ‘negative’ rates a possibility should growth slip further. They don’t believe the Fed will never be able to raise rates enough in the short term (without plunging the economy into recession) to gather enough ammunition to effectively fight the next recession. These folks want to consider things like negative rates, the abolishment of cash, and other draconian measures so that the Central Banks can better control the money supply in order to ‘force’ the spending of cash in order to create growth.

There is no doubt the Fed and other Central Banks are in a pickle. Typically rate-tightening cycles start in the stages of a recovery when the economy is still gathering momentum. We are seeing economic and earnings momentum wane, so a series of hikes now (more than just another one-off 1/4 pt hike) is bound to unleash problems. So we agree with those who believe that rate hikes now will bring on recession, but but the trick will be finding a path to higher rates that does not destroy the asset bubbles the Central Banks have created in order to stimulate economic growth.

The Fed will tread carefully here, the talk a rate hike game but haven’t found the courage to move again. We believe that if the market rallies solidly into year-end the Fed is likely to move another 1/4 point in December or January. As long as they signal the next move as more of a gradual process or ‘one and done’ rather than an immediate ratcheting of rates, the financial markets could accept it. The Fed has quite a balancing act in front of it in order to not upset the asset apple cart they have made.

Market Outlook and Investment Strategy

Not much has changed on the surface as our stock market has not managed to do much since the Summer ‘breakout’ other than drift back toward the breakout point. Perhaps this was due to rate hike concerns, or possibly even Election uncertainty, either way the market has done little but mark time. And that is ‘ok’ as long as key levels such as 2080 on the S&P and Dow 17,600 are not taken out to the downside.

We could see a continued pullback over the next few weeks heading into the Election, but we believe this market has higher to go. We will look to invest further assets once we are sure the near-term volatility is past. If things go well we could still see stocks rally another 5-10% before year-end. We are seeing improvement in more ‘growth’ oriented sectors, which suggests investor appetites could be on the swing back toward taking risk. The long term outlook remains the same: we are in an aging bull-market in an aging economic expansion. Investors need to be ready to shift portfolios should weak economic and fundamental conditions overwhelm the current bull trend, this could be an issue for 2017.

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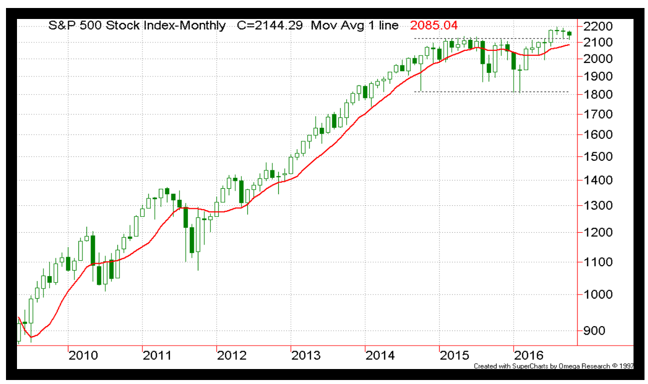
Market Charts—Market Treading Water Just Above Key Support

S&P 500 Near-Term (Top)
The S&P continues to churn just above the highs of the past year (marked by dashed lines). This level has So far held up twice suggesting that level is a key area for near-term action.

As long as 2120 holds on the S&P, the short-term trend remains bullish. After 2120 2080 is next support.

S&P 500 Long-Term (Middle)
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 at right. The move above the range in July has now pulled back to the prior highs, which as noted above have held so far.

The 10-month average is an important indicator of long-term trend. As long as 2080 holds the bullish trend remains intact.



Investor Risk Appetite Increasing? (Bottom)
Investors have flocked to low volatility products that promised to deliver income and appreciation with reduced price fluctuation. This caused higher beta investments to decline, as the S&P 500 High Beta ETF (SPHB) did from mid-2015 in the 2016. But risk appetite may be coming back, with the High Beta ETF tracing out what looks to be a very significant bottom formation. There is a price projection above the 2015 high, which suggests the 4Q and beyond will be good for risk assets (i.e. stocks).