Hamilton-Bates

Market Update

December 13, 2016

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FMOC Meeting This Week – Rate Hike Expected
Here we are on the eve of the FOMC's 2-day meeting, and 'everyone' expects a quarter point rate hike, including us. They have telegraphed it in their past comments, and it is overdue. There is room for them to hike even further, but they are not likely to do so. Standing pat for a year, and then suddenly moving by a half a point increment would make the FOMC look bad. People would say, "Why didn't you move in September?". The Fed likely don't want to have to face such a touchy question, which would reek of politics, and so they will likely just go a quarter point. Then we can all get back to going on about our business.

Financial Market and Investment Outlook-
Still Plenty of Cash to Push Market into Year-End!
Seasonal and Historical Trends Favor Further Gains
We are now in that time of year (mid-October through early April) that has seasonally been the strongest period for stocks. This year we also have the Presidential Election Cycle which also points to higher prices through the Inauguration. That duo of bullish tendencies certainly helps the bullish case for further December gains.

The rally has been strong since the Election, and by now most investors have gone full circle from cautious ahead of the Election to bullishness now. We had been looking for a post Election rally and like most we thought Trump's win would cause some volatility. It did, but it lasted only a few hours on Election night! Given the rally and its likely continuance into early 2017, bullish sentiment could be at an extreme sometime in January. With the possibility of tax-rate cuts for 2017, heavy selling isn't likely until the New Year, but very possible at that time. When everyone is positioned on one side of the market, it's usually a good idea to be careful.

Some sort of pause is likely in the middle of December, more likely a pause in the buying rather than selling pressure which causes the market to move sideways for a week or so. Perhaps it begins this week with the FMOC meeting or shortly thereafter. Small-caps and financials look especially extended, and these areas could see a 3-4% dip. Perhaps more muted on the broader averages like the S&P.

New Bull?
Long-gone is the memory of the early year decline, which actually saw the NYSE Composite slide 20% 2015 to early 2016. Was that perhaps a mini-bear market? The bulls could justify that, and thus conclude that the post-election up-move was the start of a new bull market. We have a hard time seeing that, and need to see more evidence such better strength from large-cap technology stocks, which have been lagging. Until then, we will stick with expectations for a move higher into early 2017, but cautious thereafter.

We are now into the seasonally strong time of the year. The Presidential Cycle also points higher into January. Even with the gains seen so far, the global stock markets are still in a position to move higher over the next several weeks. There will probably be pullbacks, but they are likely to find eager buyers. The January 2017 market will be exciting. You will have new allocation plans buy institutions and hedge funds, and delayed selling for tax reasons will hit. A good rally into and perhaps through the first week in January, followed by a correction is a good probability. We will look at our technical models to confirm that at the time. For now we expect higher prices.

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Market Charts—A Rising Dollar Could Derail Stocks in 2017

A Strong Dollar Hurts Overseas Profits

Most investors never pay attention to this huge market, but it has major effects on all the other markets. The US dollar is now making a new 14 year high. If interest rates trend up, the dollar index should continue to rise. At some point that would have some very important repercussions on other markets.

With a rising dollar, US firms that have a big portion of their sales abroad are more vulnerable to sales declines because their products, priced in dollars, get more expensive for their customers. That is the traditional correlation. So a rising dollar without some offset could hurt large companies that sell overseas.

However, if their costs also become lower, say through lower corporate taxes, which is the Trump plan, then this could change things. The rise in the dollar could be offset elsewhere. They would be able to lower the price of the products abroad, without diminishing profits, which would counter the adverse effect of a strong dollar. The firm **Factset** calculates that about 50% of sales for S&P 500 companies are abroad, compared to companies in the Russell 2000 which have only about 20%.

Back in 2015, when the dollar rose by 7% from January through March, the strong dollar wreaked havoc on the profits of US multinationals, whose earnings declined by about 11%. The strong Dollar in 2014 also hurt profits. There is a reason corporate profits peaked in 2013! The rising dollar since then has hurt business for multi-nationals. So if we see a continued rise in the Dollar without some offset, corporate profits abroad could suffer in 2017.

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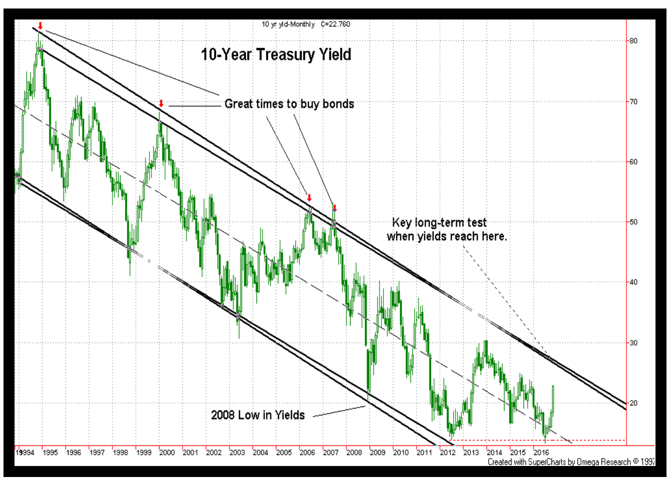
Market Charts—Election Triggers Rise in Yields & Rate Expectations

10-Year Note Yields Highest Since 2015

To give you an idea of how violent the reaction was in the bond market over the past month, look at 10-year yields. Yields are up 75 basis points since the Election (three quarters of a point), and are up 1.2% since the July low. In terms of price, the long-term Treasury ETF (TLT) is down 18% over that period.

But the decline looks overdone. Yields have come up too fast too quickly, and a pull-back is in order. The momentum indicator in the bottom panel of the chart at left is showing decreasing strength in momentum even as yields are still rising. This suggests a breather for the bond market is overdue. Conditions now are the exact opposite of the conditions in July (where yields were falling as momentum was improving), triggering the reversal upward at that time. Bond yields should fall, with bond prices finding a bid over the next few weeks to few months. Relief should be in sight for bond investors.



Long-Term Down Trend in Yields Being Tested

The long-term trend of falling rates has supported the financial markets for decades. The 10-year Treasury yield went from nearly 20% in the early 1980's to 8% in 2000, all the way down to 1.3% in July of 2016. That downtrend in yield is still technically intact, but for the first time it is at risk of changing. <u>If it occurs this would have huge ramifications for all assets</u>.

Treasuries have a little more room before the trend is 'broken', it would take a move above 2.75%-2.80% in yields that is sustained, which would be up 25-30 bps from the current 2.50% level. In the past moves to the top of the channel were great time to buy bonds, we will see if this time is any different (see red arrows in chart where yields immediately reversed upon hitting the top end of the trend channel).