Hamilton-Bates

Market Update

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

The inauguration fortunately went smoothly with the worst fears not being realized. The new President's speech was unusual but typical of his personality. Instead of the usual political speech, he gave substance, like it or not. He has now set the tone for his administration, in his words "America first". The stock market has rallied for the past two months in anticipation of positive changes occurring in Washington. Now comes the hard part, he must deliver.

Earnings, Interest Rates, & Economics

4Q GDP Misses

President Trump won't have the Economy at his back, at least not at first. Despite economists and the former Administration talking about how 'awesome' things were, the economy continues to struggle. The consensus forecast predicted that the US economy would grow at a rate of 2.2% in the fourth quarter. The New York Fed expected 2.1%, and the normally accurate Atlanta Fed's 'GDPNow' came in at 2.9%. However, the Bureau of Economic Analysis reported that growth in the fourth quarter was a soft 1.9%. That was down from 3.5% in the third quarter, and gone are hopes that the hollowed out US economy would *finally* emerge from its stall speed.

Instead ramping up it has slowed down. For the year 2016, GDP growth dropped to 1.6%. It was worse even than 2013, when GDP growth tottered along at 1.7%. And it matched the growth rate in 2011. Both 2016 and 2011 were the worst since 2009 when the US was in the middle of the Great Recession. 2016 was now the third year since the Great Recession when GDP growth dropped below 2%. The Fed's policies of eight years of cheap credit and 0% rates have enabled soaring debt levels among companies, governments, and consumers. Money borrowed from tomorrow that was spent today. Borrowing for productive investment is one thing. Borrowing for consumption is another. We got a temporary boost to growth but also a debt overhang with no productive assets to generate income to service that debt in the future. Debt service for prior consumption then acts as a burden on future consumption.

So the Central Banks' intervention created a catch-22. QE and ZIRP – blocked the essential process of economic and financial cleansing back in 2009, but has also kept the economy from taking off afterwards. So we are left wobbling along, over-indebted and heavily encumbered, and kept aloft hanging around 'stall speed' hoping for an economic 'Hail Mary'.

Over the past 50 years, anytime the economy grew less than 2% in a year, it was either already in a recession for part of the year, or there'd be a recession the following year. Hence the term 'stall speed' – a speed that is too slow to keep the economy from stalling altogether. We have now seen less than 2% growth twice since the Great Recession. Perhaps it never left, the Central Banks just masked it. The FMOC is meeting this week but they are unlikely to make a move at this meeting on the heels of this weak economic data.

Corporate Revenues Still Lag

The market is hitting highs, but when it comes to corporate revenues/sales, the picture looks more like the sluggish economy than the high flying market. The 30 DJIA component companies represent the leaders of their industries. They're among the largest, most valuable, most iconic American companies. New blood with booming revenues replaces the stodgy old companies. In aggregate, revenues should therefore

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rise if things are going well and the economy is healthy. But revenues peaked in 2011 and have dropped 16% since. A period when stocks were up sharply. The oil bust certainly has held revenues back, but even taking out the energy companies revenues only have grown at 2.5% annually, well below what the market has done. But revenues for the big energy companies peaked long before the energy bust. Besides, the DJIA hit 20,000 with the oil majors in the average. So in looking at the relationship between aggregate revenues and stock price movements, we need to leave them in the mix. We have continued to see some big earnings misses, as Retail has been the latest sector to cry the blues. If revenues/sales don't start growing the market cannot go up for much longer.

Market and Investment Outlook

Last week provided another new high water mark with the S&P 500, NASDAQ and DJIA all reaching records, including the Dow 20,000 milestone. This week is full with economics reports, earnings, and the FMOC meeting. The monthly jobs report will be released on Friday, now that the election is over will it be another weak report?

Price action in the market should be bullish for this week and next. The DJIA broke above 20,000, emerging markets broke above a key moving average, a traditional 'risk on' sign, so the market should move higher if the 'breakout' is for real.

Last week, the DJIA recorded its tightest one month trading range (1.1%) since the year 1900 (Bloomberg). Usually a tight trading range occurs before a strong move, but it could be in either direction. It should be higher, but judging by what we read and hear from money managers and CEOs of large financial firms, there has not been a big rush into stocks yet. There has also been a large wave of insider selling from the Banking sector. With technical confirmations of the breakouts to new record highs across the board, the outlook is near-term favorable unless the breakouts reverse, and there is no follow-through buying. Then you can have 'false breakouts,' which are negative for the markets. (See the Chart on next page).

The key to successful investing is to be flexible: become defensive when risks rise, and change again when the risk fades. When the facts change, our allocations change. We have never subscribed to the 'long term buy and hope' story.

We have had 7 years of Central Bank Intervention. Now that a new President with a totally different philosophy is making policy, it seems clear that there will be great changes in opportunities, and also new risks. We will work very hard for you to detect those changes.

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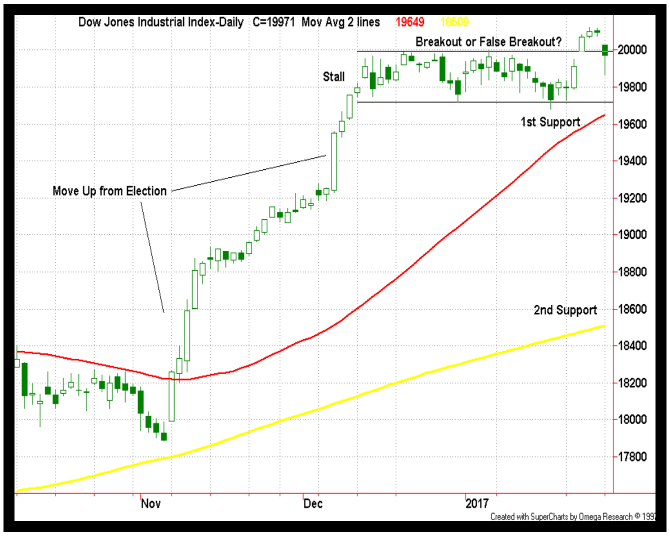
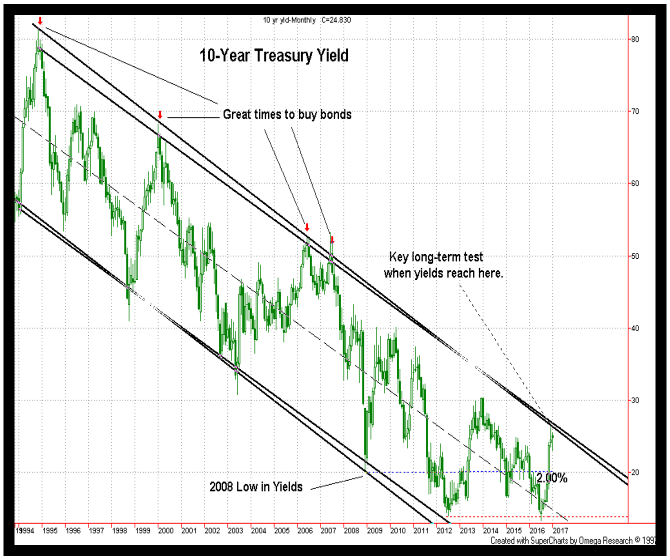
Market Charts—Failed Breakout Concerns Rile Stocks and Support Bonds



DJIA hits 20,000
The market moved up nicely after the Election, before stalling in December. Finally the DJIA popped above 20,000 last week. Market internals such as breadth and volume remain supportive, so as long as the DJIA doesn't immediate reverse course the trend should be higher.

'Failed breakouts' occur when a stock or market fails to follow-through on a 'breakout', and reverse quickly and sharply. A continued move below 20,000 this week would reverse the near-term bull-ish outlook and set the market up for its first pull-back of 2017. **A 'mild' pullback would be 1-2%, a more severe setback could see a decline of 4-6%.**



Still No Break of Long-Term Down Trend in Yields
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, down to 1.3% in July of 2016. That downward in yield is still technically intact, but for the first time it is at risk of changing in 2017. <u>If yields break this long-term down trend it would have huge ramifications for all assets</u>.

Economic and earnings concerns have seen dip buying in bonds, and yields have dropped back after briefly touching the top trend-line at 2.64%. We look for yields on the 10-year Treasury to fall back toward 2.0%, which would be helpful to bonds which have been battered in the second half of 2016.

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