Hamilton-Bates

Market Update

May 12, 2017

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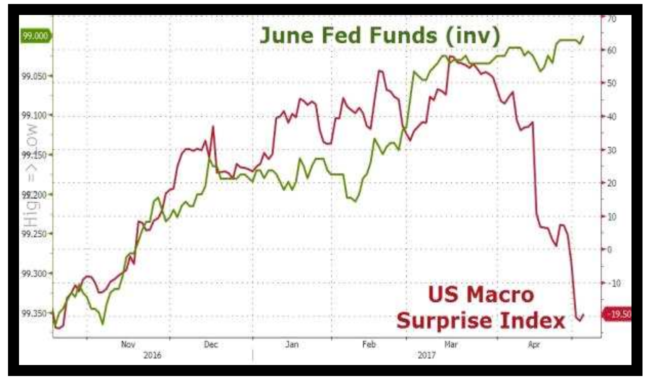
The US equity market has been range bound since late February, and it is now just over two months since the S&P 500 first poked its head just above the 2,400 level. This key index is now less than 1% away from this target and how it fairs this test is likely to drive the market into mid-Summer. Can it finally break out or will we see further chop? After a nice run from November, there is little reason to complain about the period of consolidation that has been needed after such a move. As we have covered in prior Updates, investor hopes for political relief were unrealistically high in early 2017 and we are much better off investing on the prospects of strengthening global data and improving corporate earnings than counting on anything from Washington.

Within the US equity market the technology sector has taken over the mantle of leadership with the NDX hitting all-time highs that comfortably above its 2000 peak. Technology now comprises 22.7% of the SPX index, making it the largest sector (the Financial and Healthcare sectors both have approximately 14%), it has been the greatest beneficiary of the massive passive flows into the index. The only hesitation we have is that other than Technology, not many other sectors are showing strong momentum, and there is a lot of 'sloshing around in a bucket' for the rest of the market.

GDP Slows, Earnings Grow, the Fed Hikes

1Q GDP growth slowed to less than 1%, with the economy losing some steam after the Trump hopes wore off. Earnings however did pick up with companies posting an aggregate gain of 12% in earnings in Q1. That is one of the better gains of the last 6 years. Whether this can be sustained if the economy doesn't pick up steam during the rest of the year could be a key point for the market in 2017.



The Fed hasn't been phased by the economic slowing of Q1, believing it is a statistical anomaly that will be reversed in months ahead. So it is likely to hike rates once again in June, with rate hike odds above 80%. Still it is somewhat shocking to see the Fed Funds rate rise as Economic Data weaken (see chart above), especially since the two largely moved together over the past 18 months. We hope the Fed is right but fear they are not, we continue to have concerns about the economy in 2017-2018.

Puerto Rico Files Largest Municipal Bankruptcy

It finally happened. After a decade-long recession and years of threats, Puerto Rico has finally been allowed to file for its own version of bankruptcy. And that move could impact US investors.

On Wednesday, May 3, Puerto Rico initiated the single largest bankruptcy filing the municipal bond market has ever seen. Though it's presently unclear just how much of the island's $70 billion of debt will be covered by the filing, so far it includes the $18 billion of general obligation bonds, backed by the full faith and credit of the island's constitution.

To put this into context, Detroit's 2013 bankruptcy filing, covered just $18 billion of debt total.

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So the PR filing could be much larger. Detroit bond investors were never made whole, but they did manage to recover 74 cents on the dollar in terms of what they were owed.

Puerto Rico's general obligation bondholders aren't likely to be that fortunate. Bondholders are likely to take a serious haircut as the bankruptcy unfolds. In the grand scheme of the bond market, municipal securities have always been touted as a far safer investment than corporate bonds. And within the municipal bond market, general obligation bonds have long been considered a step above, issuers are essentially obliged to go to great lengths to make scheduled payments. The fact that Puerto Rico's bondholders are looking at serious losses brings the sanctity and safety of general obligation bonds into question. This has reverberated somewhat into the general municipal market, but thankfully the funds we own have little or no PR exposure. The overhang however, could affect the muni-bond market for some time as investors realize the risks to over-indebted state and local governments. We are considering potential alternatives and options to mitigate risk in the municipal bond market.

Market and Investment Outlook

The market hasn't done anything 'wrong', all we have is a consolidation within a long-term uptrend (see charts on Page 3), but we are seeing the start of a concerning narrowing of market strength.

Most of the recent gains have been concentrated in a very small number of the mega-cap tech stocks – Apple, Google, Facebook and Amazon. Despite the absence of any real selling pressure the majority of stocks are struggling to keep up the momentum. A handful of mega-cap stocks are now masking a potential underlying weakness.

Even worse, nearly 1/3 of the rest of the SPX are in bearish phase – meaning they are down over 20% from 1 year highs, and we are seeing the number of stocks falling below 200 day moving averages (showing change in long-term trend) is growing. It is likely a majority of this weakness is from the Energy and Retail Sectors, both of which have struggled over the past year. Still the lack of participation is becoming a concern.

We believe the market will eventually break out and have a run into the Summer, with gains of 3-5% ahead of us, although these gains could be concentrated in fewer and fewer companies.

Managed Accounts Q1

Here are Q1 results for our portfolios:

Tactical Equity (MAC Growth)	**8.36%**
Tactical Sectors	**6.21%**
Tactical Income	**3.20%**
Balanced Aggressive (MPT Agg)	**5.35%**
Balanced Moderate (MPT Mod)	**4.40%**
Balanced Conservative (MPT Con)	**3.01%**
Indexes	
S&P 500	*5.50%*
NYSE Composite	*3.94%*
Russell 2000 Small Cap	*1.69%*
US Government Bond Index	*0.68%*

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Market Charts—S&P holds support in April—Now Challenging 2400

The last pullback bounced at the 65-day average, and the rally has continued. However 2400 continues to act as a wall that so far the S&P can't break. Since February the S&P has made no net gain.

We see this as a pause rather than a trend change, and the market seems likely to push above 2400 eventually, and when it does a move to 2450-2500 is likely, a gain of 3-4%. A thinning of market breadth and dwindling number of strong sectors though point to caution for mid-late Summer.

Indexes Pushing Up to Highs

The breakout from the 2015-2016 range projects a move to 2450-2500, about 3-4% higher than current levels. As long as economic data doesn't fall off a cliff that is our minimum target for the 1H of 2017. After four months of gains however, the market could need a pause.

Only a break below the 10-month average now at 2270 would turn the long-term trend down.