Hamilton-Bates
Market Update
June 1, 2017

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Over the past two weeks last markets have had to digest claims of impeachable offences against the President, and a vicious terrorist attack in the city of Manchester, UK. We had one big down day as a result, but overall the markets have absorbed these blows without any obvious change in trend. The resilience of global markets has been impressive. Markets that are able to ignore excuses to move lower have a much better chance of trading higher, and so far they have!

Clearly there were plenty of investors waiting for any sort of a pullback to deploy capital, and it is notable that the vast majority of indexes reversed higher before they reached obvious price or moving average support levels, suggesting an investor willingness to step in quickly as the sell off developed. That is a strong positive and suggests solid risk appetite.

Economic and Earnings Outlook

'Positive but certainly not strong' is what we can say about the economy so far in 2017, as final Q1 GDP growth came in at 1.2%, better than the sub 1% first print, but still far from the 2.5-3.0% escape velocity many are looking and hoping for.

Economic data has remained soft in Q2 although this hasn't phased the stock market at all, and the move higher in stocks coupled with the weak economic data have created quite a divergence between Bloomberg's Macro Economic Surprise Index and the stock market (chart upper right). Normally these data move together, but there has been a clear parting of ways in 2017.

US Macro Economic Data (in red) has fallen off a cliff in 2017 but it hasn't hurt the markets (yet).

Something has to give, stocks will come down to meet the data or we will need to see better data to close the gap with stocks.

Sector Selection Critical in 2017

The market averages are up nicely so far in 2017, but there is a marked disparity in the performance of the underlying industry groups (market sectors). Tech and tech-related stocks are the clear leaders, and this can be seen in the chart on the bottom of page 3 (in the chart section).

The technology sector is 'carrying' the market right now. Also doing well are Utilities, Staples, and Discretionary stocks. Many other sectors are weaker, such as Retail, Financials, and Energy. Financials are <u>negative</u> on the year and Energy is down nearly 20%! Being in the right sectors is what our **Managed Sector Portfolio** is all about, using relative strength calculations to remain invested in the strongest sectors, and avoiding the weakest. On top of strong performance in recent

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years, this portfolio is up 10.20% so far this year–helped by positions in Technology and Semiconductors.

Weakness in Financials a Warning?

As mentioned previously, the financial sector gave up all of this year's gains, and is now flat/down on the year. Some strategists say this is sending a message about the health of the economy.

The financial sector, composed of a range of financial services firms such as insurance companies and banks, was leading the market for part of the year, and was up 9 percent as of the beginning of March. But April and May have been brutal, and the drop is a function of long rates falling even as the Fed hikes short rates. There are also ongoing concerns about growth and the health of the economy.

The yield curve, a measure of yields in bonds across varying maturities, has flattened with short-term rates rising as long-term rates have fallen. The yield curve serves as a gauge of economic growth, and this flattening generally does not bode well for the banks, which rely on healthy net interest margins. Financials underperformance flashes a clear negative tone about confidence in the economy, and investors are now clearly putting a premium on growth sectors like technology. We see this divergence as a concern, and should it last it would be a warning sign. Alone it is not enough to alter allocations (other than to avoid Financials), but it should be taken into consideration should other negative developments unfold.

Market and Investment Outlook

With the long bull market still intact, and broadening into other global regions like Europe, short-term risk does not seem large enough to threaten the long-term trend. So for now we continue to navigate the small ripples. However, at some point the long-standing bull market will end, and whenever that happens it seems reasonable to expect some big draw-downs. We work tirelessly to make sure we will be positioned well should that time come. Passive investing, which has become popular once again (last time was 1997 ahead of a nasty 1998 and market top in 2000), will show its folly during the next downturn. One is coming someday. Our market hasn't had a 10 year period without a 'bear market' and 2018-2019 will close in on that time. So a drop will happen in our lifetime even though it seems otherwise. Although many talk about a 'crash' we doubt that the next US downturn will involve anything like the financial system distress of 2007/8. Things are never the same.

With many large hedge-fund investors trigger happy, and High Frequency Trading dominating volume, expect more dramatic sell offs from nowhere and the quick reversals that follow. We will do our best to sort out the news from the noise. If the S&P can pop above 2400, a move to 2500 or better this Summer is very possible. That would see gains of 3-4% from here. Not bad!

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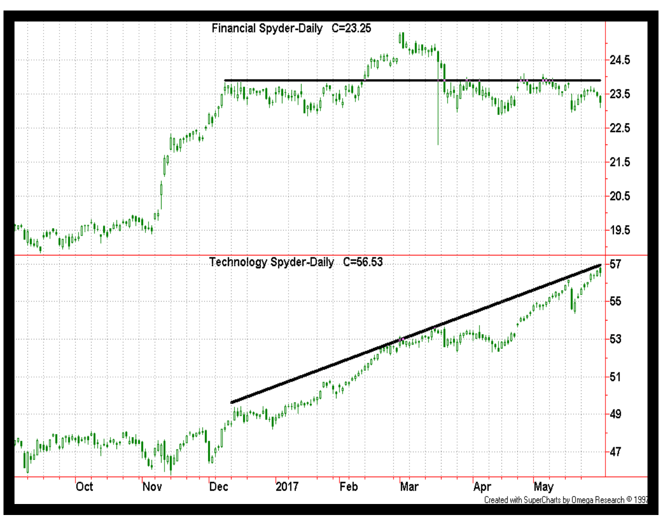
Market Charts—S&P Attempting Breakout Above 2400 ; Financials Lag

S&P 500

The S&P has recovered from last week's 'big' 2.0% one day sell-off, and has put in series of a higher lows (bullish). Since the most recent low the S&P has continued to the upside and is now pushing above 2400. The index is eating through overhead supply which we continue to believe will lead to a resolution of the price consolidation to the upside. **As long as 2400 holds a move to 2475-2500 over the next few weeks is possible. This would reach our targets given back before the Election.**

Key short-term support is at the recent low around 2350, and the March/April lows of 2330.



Financials Becoming a Drag

2017 hasn't been a good year for Financials. With the Fed hiking rates it was supposed to be the time when Financials shine. They have not kept up with the market and are now flat/down on the year (top panel). This is a sharp contrast to the Technology sector (bottom panel), which has continued to be the engine for the market's gains.

Bank of America and JP Morgan recently issued earnings warnings, and the outlook for the financial sector is guarded. A healthy market needs the financials, eventually a lagging Financial sector will become a problem.