Hamilton-Bates
Market Update

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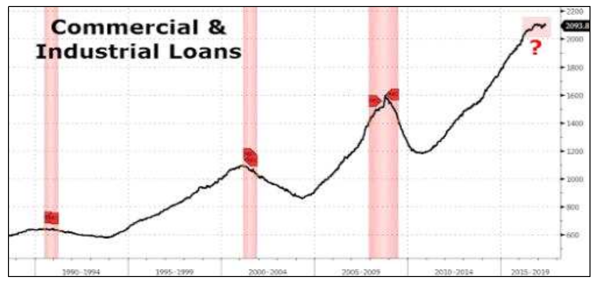
What looked like the start of another leg up and a Summer Rally for the NASDQ and tech stocks turned into a rout last week, with some key 'FANG' stocks dropping up to 10% from the opening pop on Friday. Some are calling it another 'flash crash' with the NASDAQ down 2.4 % on Friday and 4% from the intraday high. More likely the tech sector was just too extended given its 2017 run and ripe for mean reversion.

There was some good news, however, and that was that the panic in NASDQ did not become a pandemic by spreading to any other indexes. In fact, the Dow S&P and Russell 2000 have since hit record highs. Perhaps we are seeing a rotation, maybe the massive out-performance of growth stocks hit a brick wall, with the baton being passed to value. These stunning reversals, whether in current events or trading, used to be rare but are becoming commonplace these days. Investors seem to be moving like a school of fish-going one way only to suddenly dart the other direction then come back again. The key will be sorting out the short-term darts from the long trending moves.

Economic and Earnings Outlook

Even with data weakening and inflation below the 3% threshold the Fed did raise rates this week as most expected. Even if it was anticipated the fact that the Fed is openly disregarding the bond market, where the yield curve is flattening (the Fed is hiking short rates but long yields are falling) and suggesting a slowing of growth is a concern. In our opinion the Fed is opening itself up to a potential policy mistake, one which the bond market seems to be pricing in. The FED has made this mistake before, in 1929 and 1937 for example where they hiked as the economy was slowing. If the economy is truly weak, their moves will likely slow down an already anemic economy. Some other data points we are watching tell us the Fed should not hike rates any further. One of those is Commercial Loan growth. Since the 1960, every time Commercial & Industrial loan balances have declined (or simply stopped growing), whether due to tighter loan supply or declining demand, a recession was already either in progress or would start soon.



This can be seen on the above chart, which shows the correlation between loan growth and economic recession. Each of the last 3 times loan growth peaked (1990-1999-2007) a Recession was looming or in progress (shaded areas). US loans have failed to post any material increase in over 30 consecutive weeks, and suddenly we could be on the verge of a potentially ominous inflection point if this trend holds true.

Just as concerning as loan growth is the weakness in the Retail Sector, which is having its worst year since the Great Recession. So far in 2017 more than 300 retailers have already filed for bankruptcy, and it is being projected that a staggering 8,000+ stores will close in America by the end of this year. That would shatter the old record by more than 20 percent. Those closings mean job losses. Sadly, our ongoing retail wipeout appears to only be in the early chapters. With the US incredibly overbuilt in retail space on a per capita basis, more than triple the square footage of

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most western countries, one report recently estimated that up to 25 percent of all shopping malls in the country could shut down over the next five years.

Although we are trying not to be too dramatic or alarmist, a lot of ways this reminds us of 2007. The stock market was still performing very well then, but the real economy was starting to show cracks. This makes watching the credit market for clues important—the bond market should provide warning. In 2007-2008 high yield bonds fell while government bonds rallied. Despite the Fed's hiking policy most bond sectors have continued to do well. We continue to hold fixed income since it has both performed well AND serves as a hedge against economic slowdown.

Market Increasingly Dependent on Tax Reform
If economic growth is stagnant around 1-2% and at risk of slowing, the market will need Tax Reform to bolster earnings. After the election tax reform legislation was seen as a slam dunk, and some of the gains since then have priced that in. Money repatriated from overseas would find its way into stock buy-backs, and tax cuts would boost earnings and support earnings per share. This would help offset any bottom line weakness thanks to the higher rates from Fed Policy. If this legislation is put-off or not done, it will be a big risk going forward.

In the end even this is just a short-term boost. While you can goose bottom line earnings from tax cuts, the top line revenue cuts caused by higher interest rates, a stronger dollar, and a potentially slowing economy could eventually exceed the benefits companies receive from the tax reform. None of the actions go to solving the two things currently plaguing the economy – real jobs and real wages. We didn't even mention the last jobs report which showed significantly less job creation, negative revisions to prior months, and stagnant wages. Part-time and 'gig' work continues to replace lost full-time jobs. The Fed is going to have its hands full navigating rate normalization with a potential cyclical downturn in the economy.

Market and Investment Outlook
Following the election stocks rallied pricing in a strongly recovering economic environment driven by a wave of legislative policies. While the market advanced, the economic and fundamental realities haven't changed since the election and now we have the Fed hiking short-term rates. There also has been no supportive legislation other than some minor regulatory repeals.

Economic data is not showing solid growth. Data has continued to disappoint; from new and existing home sales to autos, inventories, and employment. The bond market is finding buying interest at the long-end even as the Fed hikes the short-end, suggesting bond buyers don't believe the Fed will hike-or if they do it will prove a mistake.

The stock market has done well in 2017, but it has likely hit a point where it needs some help. The Fed has changed policy and is now hiking rates, and up til now expected legislation supportive to the market hasn't come to pass. **Whether the market needs a brief pause over the next week or so, or something more, will likely be determined on the ability of the S&P 500 to stay above 2400.** Selling that takes this index back below that level coupled with the weakness already in tech, could have investors selling and suggest a more extended pullback is needed. **Bonds have continued to do well, and fixed income can be a buffer to help offset equity market volatility**.

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Market Chart—S&P Attempting Hold Breakout Above 2400

S&P 500

The S&P 500 hasn't been able to build momentum on the move above 2400, and with tech under some selling pressure the market as a whole looks tired. One thing we were seeing was that with the market near all-time highs was a lack of volume, among the lowest we have seen all year. That suggests buyers losing some steam here. Given the lethargic action above 2400, and the weakness in tech, we are likely to see lower prices over the next few trading sessions. Whether 2400 holds or not will determine whether the selling is over in just a few sessions or develops into something more.

***Key short-term support is at 2400**, and then March/ April lows of 2330.