Hamilton-Bates
Market Update
July 11, 2017

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It has been a choppy market since the last Update in mid-June, as the tech run-up ran into a bit of a wall amid what appears to be a re-allocation of capital that occurred around quarter end.

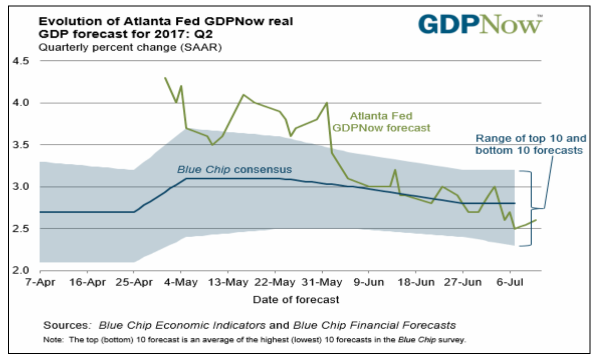
Volumes trailed off last week due to the 4th of July Holiday, but its to early to see the 'summer doldrums' . The general trend remains positive even in the face of ongoing volatility in specific pockets (especially Tech/Retail/Energy this year). We are seeing the consistent passive flows into indexes, and those minor distortions mentioned above caused by what is left of the active managers contingent that rotate through countries, sectors and bond maturities.

The rest of July should see a pick-up of activity before the market tails off in August vacation doldrums. Even with recent volatility from the tech sector, the intermediate and long-term trends remain 'up', and we look for higher prices through the Summer.

Economic and Earnings Outlook
First quarter GDP Growth was bumped up to 1.4%, but this is still a pretty sluggish number, and far below the 3% expected not to long ago by Wall St. Second quarter expectations are calling for a bump to 2.4%, a pretty healthy increase but still below the 3.0% number that has been the goal of the Trump Administration. You can see the trend of GDP expectations in the GDPNow Chart from the Atlanta Fed in the chart above left. Some form of fiscal policy in terms of stimulus or tax reform will likely be needed for the economy to have a chance at that 3.0% goal—and given what we are seeing from Washington—legislation of any type seems a long way off.

Even with a lack of help from Washington, earnings were very good in Q1 with growth of nearly 10%.

Atlanta Fed GDP Projection



This comes after a two year 'profits recession' that saw earnings come down to 2014 levels. The rebound in earnings is expected to continue in the second half of the year, with 4-5% growth. That number may be a bit of a challenge, since the lions share of growth this past quarter came from an unlikely sector—energy. Oil rebounded from its 2016 lows around $33 to nearly $50 a barrel, allowing a 600% gain in Energy sector earnings. Oil has settled into the 40's this past quarter, so even with hedging, expecting energy to continue to carry the earnings growth load might be asking for too much. Ex-energy, 1Q earnings were up 4%, not bad, but not near double digit home run we saw thanks to energy. As long as we see decent earnings coming over the next three weeks the market should be happy.

The Fed is No Longer Our Friend—But the Other Central Banks Are
The Fed has been tightening by raising rates and it has announced the unwinding of QE, with only the timing being still debated – whether at the July, September, or December meeting. Normally financial conditions would be tightening in response, and that is what the Fed wants—but that is not what has been happening. Since the Fed has started to hike rates **the opposite**

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has happened. Instead of tightening, financial conditions have been easing. Over the past few months, stock prices have advanced, and even bond prices have risen too, as longer-term yields have fallen and yield spreads have narrowed.

The Fed has noticed and members of the Federal Open Markets Committee (FOMC) lamented this disconnect at their last meeting in June and in more recent speeches. They have been fairly hawkish. Why haven't things gone the way the Fed wants if they are hiking and talking about unwinding QE? **Because other Central Banks like the ECB and JCB continue to add liquidity, so far this has continued to support the market even as the Fed tightens. The JCB and ECB remains the markets' best friends.** As a result overall liquidity remains supportive—for now.

The Fed is likely to continue its rate hikes into 2018, targeting a 'normalization' level of 3.0% (from 1.0% now) sometime in 2019. In addition they will allow current bond holdings to roll-off, or mature without reinvestment of funds starting some time this year. This in effect is negative QE. This will be gradual at first, but could also build as we head into 2018-2019. The fact that the stock market has held up has convinced the Fed that its strength is due to 'economic health' rather than the still supportive actions of the other Central Banks.

At some future point in time there will be a 'tipping point', where negative fed policy offsets the supportive actions of the ECB and JCB, and this point depends on both the pace of the Feds normalization and the continued levels of support (QE) the other Central Banks continue to provide. The longer and greater the Fed tightens the greater the risk of a policy mistake—and such a mistake is likely to be the cause of the next significant market disruption—but not until 2018. Given the levels of yield in the bond market globally we likely have some time before the Fed puts the market at significant risk. Of course with Central Banks you never know. If the JCB and ECB cut supportive actions sooner, the market risk window could move up earlier.

Market and Investment Outlook

So far in 2017 the market has had a solid year, with the S&P up 8.26% while Government Bonds are up 2.06%. Small-Caps have been laggards and are up just 2.40% barely beating conservative bonds. Money market has a gain of 0.38%, still puny but not the 'zero' it had been for some time.

The market hit a bit of an air pocket in late June as the technology sector saw selling as rotation into lagging sectors like transports, financials, and biotech occurred. This rotation is healthy, and if it proves correct and the other sectors take the lead from tech, all tech has to do is hang in for the overall market to proceed higher. We believe it will, and the second half has the potential to be as strong as the first if we avoid Fed policy mistakes and get any sliver of hope from D.C. If they can get their act together down there and provide a stimulus package for even modest tax reform it could end up being very bullish for stocks. Currently we believe the market has 'discounted out' legislative help, after pricing it in with a rally after the Election. Therefore if any positive happens in Washington it will be a net positive for stocks.

The long running expansion and bull market remain intact, but its getting late in the game and the Fed is serious about hiking rates. The bull can live into 2018 if other sectors help take the slack from technology.

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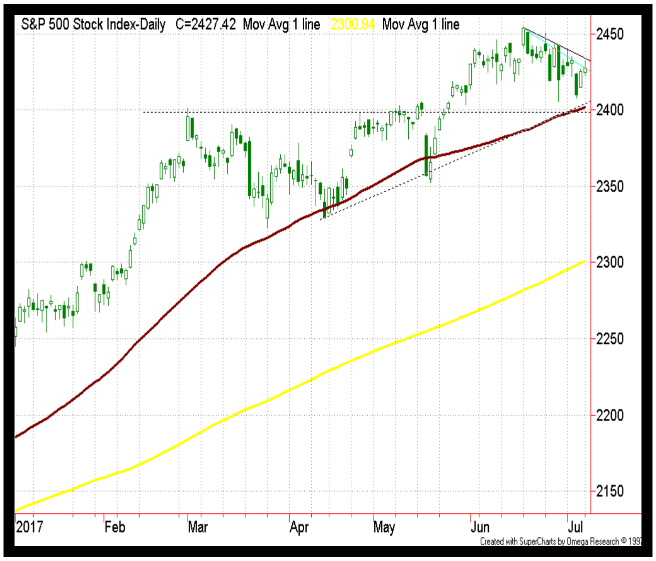
Market Chart—S&P Attempting to Consolidate Above 2400



S&P 500

The S&P 500 still hasn't been able to build upside momentum on the move above 2400, and with tech under some selling pressure the market as a whole is taking a breather as 'rotation' takes place.

The 2400 level on the S&P remains an extremely important pivot for the market. That level represents a confluence of support coming from the breakout point above the prior highs, and the 65-day moving average. As long as 2400 holds, and we expect it will, the market remains in a near-term uptrend. The next rally leg will likely coincide with a move above 2440.

***Key support is at 2400**

Transportation Sector ETF (IYT)

With technology and tech related sectors like the semiconductors taking a breather, it could be up to other sectors to carry the water for the bulls in the second half of 2017. Momentum in late June suggests that could indeed be the case for the second half. One key sector we look at is the Transports. This sector is highly economically sensitive, moving the goods and people that make things go—so strength here suggests some confidence that economic strength could build over the course of the year. Transports have moved out to a new high, and as long as we don't see an immediate reversal (suggesting a false move), we look at this sector as providing positive signs for the second half of the year.