Hamilton-Bates
Market Update
August 7, 2017

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

Other than the DJIA the major indices are now struggling to make new record highs. The S&P, NASDAQ, and Russell 2000 are about where they were four weeks ago. Given it is now August, the traditional vacation season and the 'dog days' of Summer. Low summer trading volume can make it easier to amplify moves, but so far we are not seeing much movement. We are still bullish on the market but we are seeing some very early signs that the current bull run from the 2016 lows is getting tired. For much of the year the market has been in a solid uptrend, but some key sectors (like Transports) are starting to lag, and when key they do its time to listen. We will keep and eye on that. For now, enjoy the rest of Summer as the Seasons go by all too fast.

Economic and Earnings Outlook
While the Fed and a majority of economists are talking about the economy strengthening, we continue to say that the ever-elusive 3% GDP Growth target is likely to remain out of reach.

The fact that the economy has yet to show signs of inflation nearly 9 years into a 'recovery' continues to make bonds a good investment. Should the economy weaken, high grade bonds will be a great hedge for equities. The Fed keeps talking about hiking but the bond market continues to trade favorably; and as long as Fed officials talk about hiking rates it will enhance concerns about the Fed producing a recession. We see each rate hike as another potential drag on future economic growth.

Speaking of GDP Growth, the current expansion has been the weakest on record since WWII. In addition it seems clear to us that the economy has 'lost something'. The Chart in the next column shows just that. It is a chart of GDP per-Capita, which takes into account population growth unlike 'nominal GDP'

GDP Per Capital vs Its Long Run Trend

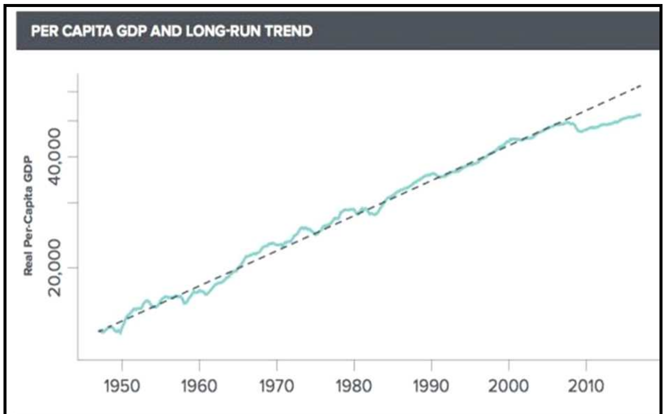

FIGURE 1 Real per-capita GDP and 1947-2007 trend. The figure shows that between 1947 and 2007, real per-capita GDP showed a stable long-run growth rate, but since 2007 it has fallen below this trend. **Note:** The scale is logarithmic, so a constant rate of increase appears as a straight line. *Source: BEA, author's analysis.*

you normally hear about. The chart also shows the long-term trend via a dotted line. The decline from trend during the 'Great Recession' of 2008 was unprecedented in terms of severity of its impact and duration for any period since 1947. It was the only period in the U.S. modern history when the long term path of real GDP per capita shifted (permanently) below historical trend. **Clearly something did change in the wake of the Great Recession, and the 'new normal' has not been a return to the old trend.**

Be careful about believing any economic statistics. We always try to look beneath the surface. The Fed has been talking about tight labor markets and fears that it will result in wage pressures. So far however, there is no sign of wage pressures, totally contrary to historic correlations. Does that mean the employment statistics are very wrong? Very possibly.

What is the 'Real' Unemployment Rate?
Friday's job report saw 209,000 new jobs added during July which was well above expectations.

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

Hourly earnings also saw a July again of 0.3% which was also pretty good. However, year-over-year gains in wages are a relatively flat 2.5%. That's higher than the inflation rate, but well below what we should be seeing at this point in the economic expansion.

The headline Unemployment Rate has fallen below its 2007 low of 4.4% to the lowest level in sixteen years. Economists at the Fed remain puzzled as to why wages aren't rising faster in the face of near full employment. But maybe they aren't seeing the full picture.

The headline rate known as (U-3) doesn't include people who have stopped looking for work, and counts part-time workers as fully employed. A broader measure of unemployment called (U-6) includes those unemployed or underemployed and currently sits at **8.6%**. That's twice as high as the headline number everyone is looking at. That 8.6% Unemployment rate also fits more with the feel and sluggishness seen in the GDP growth per-capita on the first page. The U-6 Unemployment rate suggests that we're nowhere close to real full employment. So does the low percent of workers participating in the work force.

Workers Just not Participating

The labor force participation rate currently sits at 62.9% which is close to the lowest reading since 1977. That rate measures the percent of adult Americans who are still participating in the work force. Prior to 2000, the rate rose consistently for forty years. It peaked at 67% in 2000 and fell more sharply after the 2008 financial crisis. It bottomed in 2015 at 62.4% and has barely budged since then.
Like the U-6 Unemployment rate above, it also seems to suggest that there's still a lot of slack in the work force. Something seems to have changed since 2000 and even more so since 2008. Slack in the economy and workforce would account for why employers have been slow to hire and more stingy with wages. The Fed believes that higher wages lead to higher inflation. Perhaps its inflation that leads to higher wage demands? It's harder for employers to raise wages when they can't raise prices enough to offset higher labor costs. That hurts their bottom line. Rising prices encourage more hiring and higher wages and we are not seeing any signs of steady inflation.

Market and Investment Outlook

US equities markets continue to move sideways as they have for the past month, treading water even as earnings (+10%) and headline unemployment numbers improved again (4.3%), showing that a recession is not imminent (that is a positive). Even with this recent sideways movement, the trend for stocks remains higher here, unless and until we see clear signs of an imminent change.

On Capitol Hill, President Trump had another rough week as he was forced to sign the Russian Sanctions bill; while at the FBI Special Prosecutor Mueller just hired a small army of investigators to take a gander into Trump's finances in a seeming expansion of the investigation. Helpful legislation or tax cuts coming from Washington seem far away right now. What a change from just after the Election.

On the stock front, one potential theme shift we are eying is a potential end to investors' long running affair with growth stocks. A hand-off from growth back to value is in the early stages, which hint at bottoming action in those forlorn and beat up value stocks. This is worth noting, as this development follows one of the most extended periods of underperformance for value investors.

Hamilton-Bates
Market Update

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

We could find investment opportunity in this shift from growth to value in coming weeks and months.

For the overall market, we believe that while a correction could occur between now and the Fall, as we are now entering a seasonally weak period for stocks, the final top in the long-running bull market doesn’t seem to be immediately at hand.

In the fixed income area, interest rates are not likely to rise as fast as the Fed thinks; growth remains below trend, inflation is tame, and action in the bond market remains generally favorable. If interest rates were a real threat the bond market would be acting much differently. As a result bonds remain a solid portfolio holding for income and a portfolio hedge for any stock weakness.

Market Chart—Dow Rising While Most Major Averages Struggle

DJIA OUTPERFORMANCE NOT BE A SIGN OF MARKET STRENGTH—The DJIA hit 22K this past week. That recent strength, however, is coming from just a handful of stocks, Boeing, Verizon, and Apple. While that's good for the Dow, it's not necessarily good for the rest of the market. **That's because Dow leadership has usually been more a sign of caution than confidence**. The Dow Jones Industrial Average is composed of thirty of the bluest of blue chip stocks. That's where investors go when they're looking for more safety. They buy lesser quality stocks and smaller companies when they're more optimistic. Right now, they're favoring the blue chips and that’s a sign of caution.

DOW TRANSPORTS ARE WEAKENING—(Bottom) Here's another problem for the market. Strong markets tend to see the Industrials and Transports moving together. Right now they are not. Transports are down nearly -5% over the last month, and have gone nowhere most of the year. Fortunately Transports are now bouncing from a technical support level, and we hope it continues. Further weakness in this key sector could weigh on the market.