Hamilton-Bates

Market Update

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Nothing, or rather nothing bad that is, has been able to stick to these seemingly 'Teflon' markets, which have demonstrated an astounding and even confounding resilience. In the face of North Korean missiles flying over Japan, a U.S. administration under investigation and unable to pass **any** legislation, and a Federal Reserve determined to raise interest rates with or without evidence of inflation; global markets have shrugged it all off, reaching all-time highs across a number of world markets. The DJIA had its eighth consecutive positive quarter, the first time in 20 years. The S&P 500 and Russell 2000 both hit record highs, and even the formerly lagging Emerging and International Markets are enjoying their best year out of the last seven.

Economic and Earnings Outlook

Economic growth is marching forward, not only in the US but around the world, and the outlook for further 'reflation' has been sparked. Growth and reflation moving together is a positive economic condition, and it suggests a healthy economic environment. There can't be growth without some inflation. Judging by the strong reaction in the bond market, the impetus for growth was tax cut, or rather the mere mention of tax cuts. In our view, tax cuts are the most meaningful pro-growth policy that unequivocally spurs economic growth. Please make sure its targeted to the middle class! If we get tax cuts it could help the economy and markets significantly. If not, it could be a negative shock.

Economic strength has been pretty broad with all of the OECD developed economies showing positive second quarter growth. Japan's Q2 annualized growth was the fastest growing at 4.0%. Euro-zone GDP recorded its strongest YoY growth since 2011 in Q2 at 2.2%, while the US checked in at 3.1%.

Solid growth goes hand in hand with good earnings, and that is what we have seen so far in 2017. Earnings season is once again upon us, and with growth globally we expect the strong trend of earnings to continue. Growing earnings allow the market to move higher as P/E expansion has probably gone as far as it can. As long as earnings continue to grow the market can move higher. The breadth and magnitude of this global expansion remains pretty solid.

Central Banks Bowing Out

Reflation (also known as benign or 'good' inflation), is always seemingly just around the corner but never shows up. Once again the market's believe reflation and growth are upon us. The Central Banks sure hope so as they have been trying to conjure growth since 2008 but all they have so far is a bunch of debt and overvalued asset markets. The Fed and other Central Banks are in the early stages of reversing the course of the past 8 years.

Fed Chair Janet Yellen is determined to begin shrinking the Fed's $4 trillion balance sheet and to raise rates without the backup of hard data, only expectations. Other world central banks see the same writing on the wall and will slowly and carefully remove their unconventional and extraordinary monetary stimulus. By the end of 2017 the massive tsunami of Central Bank funds will slow to a trickle, and begin to reverse.

Once they get out of the way free market capitalism will flourish once again, bringing interest rates and economic growth back to "normal" after a decade's hiatus. But after being supported for so long, how will the markets react to losing this 'boost'? This is the $64,000 question. It is also why tax cuts and other pro-growth economic policies are so important to

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implement. Tax cuts have a dual impact: first on the supply side, where they benefit business with lower costs; second on the demand side, where they benefit consumers with more discretionary money to spend. It is the only way economic growth and reflation will normalize to higher, historical levels in the absence of Central Bank stimulus. Our view is that tax cuts are likely to happen (hopefully before the end of 2017). It may be hard to fathom in this partisan environment, but elections are coming in 2018 and tax cuts are extremely popular with voters.

Market and Investment Outlook

Investors have continued to react to the market with the fear associated with horror movies and Friday the 13th (which occurs this week!). Markets are going up, yet retail investors are bailing out, which is baffling. The bears betting against the market declare 'markets are expensive' and they are right, but this hasn't stopped the bull market. Why? Because central bank money flows continue—and until they stop we believe the bull market everyone seems to hate is likely to continue.

The positive potential impact of a tax cut, on a market that is already regularly hitting new highs, is impossible to gauge. We would say the implementation of a tax cut is 'upside risk', if it happens the markets could kick into high gear during the seasonally positive October-April period. Tax cuts would also help offset the loss Central Bank support.

<u>The risks to the bull come in early 2018, as persistent Central Bank flows stop, and become a drain as they unwind QE policy. This will be the next major test for the markets</u>.

Market Charts—Small Caps Looking to Join the Bull Market Party

Small-Caps Coming to Life—2017 had been great for the blue-chip averages and large-cap tech stocks, but not so much for small-caps, that is until recently.

The S&P (top panel at left) shows a pretty clear and consistent move 'up and to the right' for most of the year. That's what we want to see. Small-caps (bottom panel) on the other hand, were lagging severely (boxed area) to the point of being **<u>negative on the year</u>** at one point in August! But things have changed in a big way since then, with small-caps charging out of that August low and leading the other averages higher. What happened? <u>Most likely it was the talk of tax cuts, which would be very supportive to the economy, and small-caps are very economically sensitive. Small-cap participation is bullish for the market, and for the economy, and is one reason why we see the bull pushing into 2018</u>.