Hamilton-Bates

Market Review & Outlook for 2018

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One would think that between the expectation of the usual Santa Claus rally leading up to Christmas Day, along with the enactment of lower tax rates, the market would have been roaring into year-end. One would have been wrong, however. Stocks finished slightly higher, but only because of a rather strong Monday.

The reality is that since mid-December traders haven't been overly excited and market returns have been rather muted this month. Part of that stems from the distraction of the holiday, and we also don't want to appear 'greedy', so lets acknowledge that overall 2017 has been a very good year. Most of the bullishness surrounding the market in general and the tax cuts were already baked into stock prices by mid-month. Even with a soft market in the last days of the year, it's not like the bigger uptrend is broken. We'll handicap the rally and the market's prospects in 2018, but first we want to look at the state of the economy, the potential impact of the tax cut, and the Fed rate hike cycle.

Economic Data

The housing market has been strong in 2017, with the trends in housing starts and building permits, along with existing home sales, all quite robust. It's not clear if the heating-up economy was the prod, or fear of rising rates since the Fed has begun a tightening cycle. Maybe it was the uncertainty of the new tax laws that drew people into purchasing a home, or maybe it was a combination of all three. Whatever it was, rising rates haven't hurt real estate yet, and the trend of the data suggest it will continue into the first half of 2018. The job market has continued to show strength, although the pace of wage gains remains less than we'd like to see. It would take 3 months or so of disappointing job growth to signal a potential turn in the labor market. We haven't seen a hint of that yet. Consumer confidence remained high in December, but slid a bit off its 17-year highs. However, despite the decline, expectations remain at historically strong levels. In 2000, the consumer confidence index was over 140%. Currently, it's at 122.1%. Highest it's been since 2000, but not quite at euphoric levels yet. Final GDP for Q3 came in at 3.2%, well above the 1-2% range we've seen for some time. Overall we'd have to put the economy in the 'plus' category heading into 2018, which gives a boost to corporate earnings.

Tax Cut Bill

Who likes giving money to the government? Not me that's for sure. To the extent we send them less we all should be happy. But will the cuts help the economy? Many economists believe that the cuts are 'very poorly timed'. Morgan Stanley's chief economist said that tax cuts are most effective when the economy is floundering, and may not necessarily be effective at this late stage of the cycle (More on the cycle length later on). The risks of the tax cuts, if there are any, is that the cuts could lead to inflation that outpaces economic growth. In that environment the Fed is more likely to hike faster and THAT could hurt.

On the positive side, about 1/3 of corporate executives say they plan to increase capital investment in 2018, which is four times more than just two years ago. It's too soon to know what corporations will do, whether they use the boon to buy back their own stocks, or invest in future growth.

We'll be watching for signs of inflation, which could lead the Fed to mistakenly move up the hike cycle. The problem is that inflation is a lagging indicator, and the Fed runs the risk of hiking too much too soon

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late in the economic cycle. Looking back to the last cycle the Fed raised the rates 17 times from 2004 to 2006. Those hikes came late in the cycle and by 2007 they hit the economy and market like a brick wall, and we all know what happened next in 2008. Consumer confidence is high, as it should be given the data, but not crazy high. The economy is not overheated yet, and we are very late in the expansion cycle.

The Current Expansion is Old and Weak on an Historical Basis

If you calculate the average growth rate in expansions since 1790, this is one of the longest-running expansions, but it's also the weakest (According to Data from CMG Capital). GDP has risen at 2.1 percent per capita since 1790. The last 10 years produced growth of just 1.0 percent. **Importantly and unfortunately, over the last 10 years the household sector has lagged very badly.** The rate of growth in real disposable household income per capita is only 0.9 percent per year. This is why many folks still don't feel like things are great. The high consumer confidence we are seeing largely reflects future expectations rather than reality for most wage earners.

The Bond Market is Starting to Believe the Fed is Serious

2017 was a transitional year for the bond market. Its been a 30 year bull market for bonds, but returns over the past few years have been diminishing as investors started anticipating a Fed policy change. 2017 saw a gain of only 2.07% for high quality bonds. It seems that the number of folks believing that the Fed is serious about tightening is growing. Already short-term yields are back to 2006 highs. Slowly long-term yields are turning up. If short-term yields move up too much, the yield curve could invert, a condition that has usually preceded recessions. Unlike prior incidents of an inverted yield curve, the Fed did not sit on $2.45 trillion of Treasury securities and $1.76 trillion of mortgage-backed securities. Back then, the Fed had no effective tools to get the market to push up long-term yields. Today it has those tools: the QE Unwind. If, in addition to hiking short-term rates, the Fed begins to more aggressively sell its long-term bonds, we could see rates move up all along the curve aggressively. This could see bonds and stocks sell off together, a highly unusual occurrence.

The Fed has already started to cut its balance sheet ever so slowly with the first steps of the QE Unwind in Q4 2017. The market seems to be responding, equally slowly, by selling off longer-dated maturities and pushing up yields. 2018 will likely be the year when the effects of the Fed's 'balance sheet normalization' appear more clearly. That could include a yield curve that changes course, and instead of inverting, may start to tilt up at the long end, as longer-dated bonds sell-off to catch up to the moves at the shorter end. This would put to rest the fears about an 'inverted yield curve', but the sell-off would be a painful experience for bondholders used to bull market conditions, AND a decline in bonds removes a safe haven option should the stock market decline in unison as a response to the negative pressures of rising rates. **The days of buy and hold investing in bonds may be over for awhile for the first time in a very long time**.

Rise of FAANG

By now nearly every investor has heard of the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Alphabet's Google) and their success. These 5 companies have nearly carried the S&P 500 by themselves. You can see the FAANG stock effect by comparing the Big 5 FAANG stocks to the S&P 500 with the performance of these five removed. Since the middle of 2013, the S&P 495 (the index minus FAANG) has generated an annualized return of **+6.1%**. By contrast, the FAANG companies have appreciated at **+57.3%** per annum over the same period. If you didn't own FAANG you got bit! Money has been flowing in a very concentrated manner in a form of performance chasing. Ultimately this narrowing of gains isn't good. This leads us to our next topic.

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Complacency, Greed, and BitCoin

Fed policy has been great for the stock market, and the rebound since the 2009 lows has been terrific. The highest correlation of the stock market has been to Central Bank balance sheets. But the length of the trend has started to breed signs of complacency, and in the case of the digital currencies like Bitcoin-outright greed. Companies who simply change their name to include 'block-chain' have soared in recent weeks as investors rush to cash in on the gains in digital currencies and block-chain technology. The fact that a shady company's stock could rally hundreds of percent on nothing other than a name change reeks of late 90's dot-com mania.

Now we think there is much to the technology that digital currencies offer, but the moves we are seeing now suggest an overheated mania. This sort of thing happens late in a market cycle, when returns are a 'given' and the belief that the stock market and other asset classes can only go up is entrenched. When 10-20% isn't enough, digital currency gains of 100-200-300% or more attract investors dulled from any sense of risk. Passive strategies rule, you can't beat the indexes they say. We have seen all this before too, back in 1997 ahead of the 1998 market wipe-out of 29%, and 1999 ahead of the dot-com bust.

Investors Wonder Why Their Portfolios Aren't Up More

There are many reasons why investors may be lagging the S&P 500. A fairly common reason is that they are classified as a conservative or moderate investor, and not an as aggressive investor. If one is willing to take more risk, they can potentially participate in more upside during bull markets like the one we are currently in today. The next column lists how the major indexes for stocks and bonds fared in 2017.

Indexes

*S&P 500 Stock Index***	*20.01%*
*NYSE Composite Stock Index***	*15.84%*
Russell 2000 Small Cap Index	*14.59%*
Balanced Portfolio 50/50 Stocks/Bonds	*11.03%*
Low Risk Bond ETF	*2.04%*
High Risk Bond ETF	*8.64%*

*****The difference between the S&P and NYSE Stock Indexes is the FAANG effect, both stock indexes but FAANG is a much bigger part of the S&P.***

Hamilton-Bates Managed Portfolios

Tactical Growth	20.48%
Tactical Sectors Growth	18.68%
Tactical Income	10.04%
Balanced Aggressive	14.04%
Balanced Moderate	11.10%
Balanced Conservative	8.59%

If you did 8-12% in a balanced portfolio, or 15-18% or more in an equity portfolio– chalk up 2017 as a successful year. If you didn't achieve these levels, or the returns weren't enough to meet your expectations, then you have the wrong investments or wrong investment mix. Making sure your portfolio suits your investment goals and risk tolerance is the key to successful investing.

Investment Outlook 2018—Have a Care!

As someone who spent all of my 26-year career in financial services and managing client assets, the one lesson I would impress on investors today is just how *unsuitable* many financial instruments are, and how risky buy-hold investing can be for average investors. Its time for investors to have a care and protect the gains the bull market has delivered! Leveraged assets abound, with 2,3, and 4 times leveraged funds and ETF's. These are fine, and we own a bit ourselves, but we use these with care, and they are not for the non-professional or long-term buy and hold.

Even simple 'buy and hold' investing isn't so simple. When you see the 1, 3, and 5 year returns of the S&P

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or other Index Fund, do you know how many people actually achieve those returns? Very few. Because most investors buy on the highs and sell on the lows. I'm not trying to be insulting, but just relaying the facts. There are numerous studies (one by Dalbar that's updated annually) and years of personal experience that back me up and show just how poorly investors fare on their own. The number of investors who hold a fund/stock/portfolio in good times and bad, dollar cost averaging on the way down as well as on the way up, is very small. For most, emotions take over and mistakes are made. Its normal, and natural, and takes years of experience to overcome. There are some things you don't necessarily want to do for yourself, like dentistry or giving yourself a haircut. For 2018 consider adding alternative and or active management to portfolios, even in fixed income portfolio.

If we have entered into an extended period of rising interest rates, and it sure looks like we have, the investment landscape will change. Historically, active managers and value strategies dramatically outperform during corrections, recessions, and in periods of rising interest rates. Blending active/tactical and passive/strategic investment strategies together can prove beneficial to investors over a full bull/bear market cycle. With both the stock and bond markets already late in the cycle, sooner or later the market will experience a decline lasting longer than a few days. Active strategies, out of favor for so long, could be ready for a comeback.

Market Outlook

The stock market enters 2018 on the heels of a solid 2017 with decent momentum and earnings that are on an upswing. The first half of 2018 should see a continuation of the bull market and in fact the stock market could continue its run for another year in 2018. However rising earnings expectations open up the risk of disappointment, and rising interest rates could boost the dollar and hurt earnings further. Stock market valuations are not priced for any disappointment.

The bond market looks a bit more concerning than the stock market at present, because it is very close to breaking/changing the long-term trend back to the early 1980's—its been a bond bull for that long! Any trouble in bond-land eventually finds its way to stocks, so equity investors also need to pay attention to what happens in bonds in 2018. High-yield and corporate bonds have done much better than government bonds, and we look for that trend to continue in the early part of 2018. Fed hikes generally hurt government bonds more than higher yielding corporate bonds. For fixed income investors we like flexible bond funds, floating rate securities, and preferred stocks for income. All have some level of protection from rising rates. The bond market is likely to prove tricky for investors in 2018.

We are watching the small caps, Russell 2000, Transportation and Retail (brick and mortar) sectors for clues on the economy. Best case we see continued GDP growth in the 3% range and the expansion continues. But its getting old, eventually all things end. If the Fed hikes too aggressively, whether to fight inflation or combat asset prices, we could see a stumble in bonds spill over to stocks. Fed policy-error is our biggest concern for 2018. Outside of market-based factors, geopolitical concerns with regards to North Korea are also on our radar.

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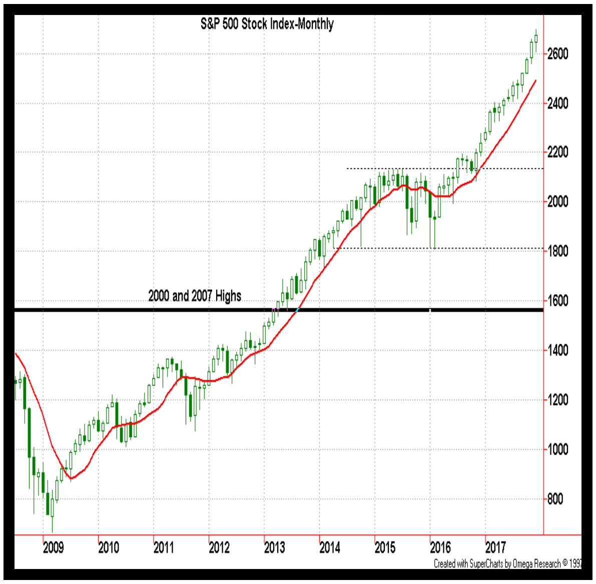
Market Charts : Stock Market Trend Intact but Bond Bull In Trouble



S&P 500 Long-Term View—'Up and to the Right' is how the long-term S&P chart looks, the definition of a bull market. Other than some sideways action from early 2015 to mid 2016 the S&P has recovered nicely from the 2009 lows. But those lows are far away now and the policy that has supported the market (Central Bank QE) is waning. The Central Bank tailwind is dying down and set to become a headwind in 2018. From here on the market will have to rise or fall on its own merits.
The major averages are trending higher and are well above the 10-month average (in red), that means the bull market is intact. Although the gap between the S&P and its average suggests we could see a little mean reversion in January. S&P 2500 is key support and as long as its above that level the bull market is intact.

Bond Market & Interest Rates—Just as the stock market has been up and to the right—the classic definition of an uptrend, interest rates have been the opposite (down and to the right) for a very long time. The bottom chart shows the 10-Year Treasury Bond yield all the way back to the early 1990's. The long-term trend in interest rates has been down. This has been a tremendous tailwind for all assets. Periodic rises in rates/ yields have been capped by the upper trend line each time it has been tested, and rates turned lower. Yields are heading up once again, and challenging that upper trend line. The double lows in place in 2012 and 2016 suggest the long-term trend in rates may be changing. <u>If that happens in 2018 it will affect both the bond and stock markets, and we will be prepared to make the appropriate portfolio allocation changes.</u>