Hamilton-Bates

Market Update

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

With nothing tangible to stop them, the bulls have been more than willing to keep on chugging as we move deeper into the new year. US markets even discounted the rancor on Capitol Hill and closed positive last week with a looming shutdown.
In fact, stocks seemed to like the prospect of a shutdown. Maybe our current governmental dysfunction is so damaging that a shutdown is an improvement.

Last week's gains put the total for the year so far as +5.0% on the major indexes, the best start in years. We are now way ahead of the usual pace of gains we'd normally see during the first half of January. Odds are good we'll pay the piper sooner or later for such a big move. On the flipside, given the strong momentum now in place, the profit-taking that's building up may not fully develop for a long while. More on that in the Market Outlook section.

From 'NAIML' to 'TINA' to 'FOMO' - Important Market Acronyms

Markets go through phases, and investor sentiment is often quite helpful in figuring out what phase you are in during a market cycle. Markets bottom on pessimism, and when pessimism hits an extreme in bearishness you can figure you are pretty close to the low. During the last Bear Market in 2008-2009, the sentiment for many investors was **NAIML**—Never Again In My Lifetime (will I buy stocks). Investors burned by the decline left the market, and missed one of the biggest bull runs in decades.

Eventually the fear of 2008-2009 faded, and after a good run of 7 years investor confidence returned in full, and with interest rates so low thanks to the Fed– **TINA** showed up. TINA, or There Is No Alternative, is what kept investors pouring assets into stocks as yields on alternative investments fell. This is where we were from 2013-2016 as bond yields hit their lows. Thanks to the Central Banks there were few places to go for yield other than the equity market. But buying stocks because 'there is no alternative' is hardly a great reason to buy. Clearly the rally is getting long in the tooth in this phase. But its not quite a reason to sell either.

In early 2018 it seems we have run head on into **FOMO-**Fear of Missing Out . This phase comes after an advance has come far enough and long enough that everyone is completely comfortable with stocks, risk is hardly a consideration, and at a time when the market may be nearing 'mania' levels. When folks invest because gains seem to be so good they fear missing out—some sort of peak isn't too far behind. This is the phase we seem to be in right now, but it could last awhile. And since this opinion is quite subjective, it is also no reason to sell either.

Historically though, the time to get concerned is about the time you feel the most comfortable with your investments. We've been with this market advance for about 10 years now, and as they say 'the trend is our friend'—and it has been. But just maybe its about to become more like a 'frenemy' than friend. We'll be keeping a close eye on Mr. Market in 2018.

Urban Dictionary: *frenemy*
The type of 'friend' whose words or actions bring you down. They may be nice...but you know you can count on them to bring you down again sometime in the near future.

Economic & Earnings Data

Earnings continue to come through, with solid gains nearly across the board. Retail sales were strong

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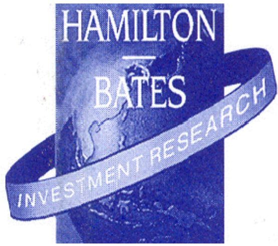

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during the Holiday season and are up 5% YoY. That's pretty good. The recent Tax Cuts didn't seem to be fully priced in, and there could be a considerable benefit to corporate America. In fact we could see a period of increased merger and buyout activity, which could help push sectors like Biotech, Healthcare, and Financial Services higher. This in turn helps the market as a whole.

In terms of the economy, we continue to see growth, somewhere in the 3-4% range seems right for 2018. This is well above the 2% levels of the 2008-2016 period, so perhaps less regulation has finally unleashed businesses to do their thing. Too much growth though brings inflation, and inflation brings the Fed, and the Fed is the ultimate 'party killer'. So inflation watching will be important in order to get ahead of what the Fed might do.

Inflation remains just above the Fed's target 2% level, coming in at 2.1%. If it moves too much higher the Fed may talk about hiking rates more than currently expected, or unwinding more holdings than expected. Either of these could send bond yields spiking and in turn hurt the economy along with the stock market. We want to see inflationary pressure level off enough so that the Fed will not have to increase its plans for three rate hikes this year. The Fed could kill the market rally if they hike too much.

The Bond Market Continues to be Restless

2017 was a transitional year for the bond market. It has been a 30-year bull market for bonds, but returns have been diminishing as investors started anticipating a Fed policy change. 2017 saw a gain of only 2.07% for high quality bonds. So far in 2018 Government Bonds are negative. Long-term yields are turning up.

Bond prices fall when yields rise. Investors stand to lose a lot if inflation rises further over the next few years because current low yields won't compensate them for the loss of purchasing power. And the action in the bond market suggests they're getting a little nervous about it. This has sent 10-year yields rising to over 2.6%, and possibly headed to 3.0% Nervousness will be one of the factors driving the 10-year yield higher. There are other factors too, including the increased supply of government bonds needed to finance the larger deficits following the tax cuts, along with the Fed's QE Unwind. If yields rise too much it will hurt the economy and stocks.

That is because the 10-year Treasury is the benchmark for consumer and business credit. As the 10-year yield rises, so will mortgage rates, interest costs on business debts, and the like. Borrowing will get more expensive. Companies will back off from expansion projects and hiring, reducing pressure on wages and costs. If inflation gets too hot this is exactly what the Fed will want to accomplish—to slow things down.

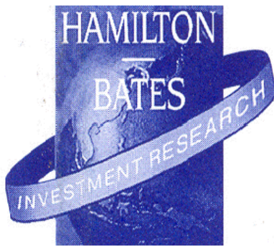
The 10-year Treasury yield is one of the transmission channels of the Fed's monetary policy into the real economy, and it has been slow to kick in. But it is starting to. If the Fed causes it to move too much, it will hurt not only bond investors but the economy and stock investors as well.

The days of buy and hold investing in bonds looks to be over for the first time in a very long time.

Market Outlook

Following the election of President Trump markets experienced a rush into allocations that were expected to benefit from a raft of legislative initiatives. This was generally referred to as the 'reflation' trade. It was a mix of equity sectors expected to do well with less regulation and increased economic activity. Dysfunction in Washington led to much of that early 'reflation' trade being rapidly unwound in the first half of 2017, only to see a resurgence over the past few weeks.

Market action suggests that a shift back towards a reflationary mindset has taken hold. This shift was overdue in our opinion, and represents an end to the 'deflationary' mindset that took hold during the 2008 Financial Crisis. With short and long-term yields



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moving up, it seems deflation has been killed for now. Significantly, the multi-year bear market in commodities and emerging markets ended in late 2016 and the ultimate low for yields was seen that year around 'Brexit' jitters. Our economy is clearly improving and we are not alone, we are riding a tailwind of a strengthening global economy.

Emerging markets and even Japan are outperforming the US, and along with commodity prices could be areas that lead over the next few years. We are increasing our exposure to Emerging Markets in 2018. On another positive note, the semiconductor sector recovered from its recent swoon and made new highs, while retail (XRT) is now a leading market sector, shaking off 2 1/2 years of malaise.

A casualty of the equity rally has been the dollar. It's been very weak, breaking a number of support levels despite rising rates. The Chinese Yuan and the Euro have moved up almost 15% against the dollar since 2016—really big moves in currency terms. In fact the falling dollar has started to eat up much of the recent gains for non-US investors.

Hedge Fund Legend Ray Dalio is Nervous
In a recent interview Ray Dalio, founder of Bridgewater Associates, emphasized that economics is now secondary to political issues. He also pointed out that income inequality is at extreme levels and 'eventually leads to revolution and heads on lamp posts'. Hopefully it won't get that bad.

Longer term, he believes the debt problems of the US Government and consumers, along with lagging wages, make the markets underpinnings weak. Like us, he is concerned the Fed could hurt the market. He has his eye is on the exits. Shorter term though Mr. Dalio sees the market chugging along.

At least on the last front we agree with him, as we see Mr. Market remaining helpful to investors for Q1 at least, and maybe longer if things break just right. Things may be getting a little 'too good' right now, and seasonally late January normally sees a dip, so some weakness could be expected.

The equity markets are following up solid gains in 2017 with gains of about 5% so far this year, and managed accounts are up right along with them. The market should have more gains ahead in early 2018, and we'll hold on. But its important to realize the market may be more **Frenemy** than **Friend** at some point.

Market Chart : Bond Yields Headed Higher

Bond Market & Interest Rates—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. That may be changing. Yields are heading up and now poking above that upper trend line. The double lows in place in 2012 and 2016 suggest the long-term trend in rates may be changing. This bears watching not just for bond investors but all investors. If yields rise too much it will eventually spill over to negatively affect the economy and stock prices. The bond market will be important to watch in 2018.