Hamilton-Bates
Market Update

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A Terribly Bad No Good Rotten Day

The Philadelphia Eagles won the Super Bowl for the first time in team history on Sunday. A friend who roots for another team said they can't root for the Eagles, because if they won the world would probably end. Now I'm sure they were speaking metaphorically, but at least for the financial world things seemed to be ending yesterday.

The market had already been correcting some of the rapid advance to begin the year, with Friday seeing the market lose about 2%. Monday the market started trading calm enough, moving between small gains and losses until the afternoon. At that point the selling started to pick up, reaching a crescendo just after 3 pm eastern time when the stock market fell about 800 points in 15 minutes to low for the day down about 1600 points (a 6% drop). From there the market moved around wildly, ending the day with a 4% decline. A bad day, the worst since 2011, but nowhere near the historically bad days of October 19, 1987 (-22.61%), or October 29, 1929 which culminated a two-day decline of (-25%).

The selling really occurred in the absence of any news event that might normally trigger this type of decline, but as the day unfolded we started to hear rumors and stories that ultimately proved to be the root 'cause' of the day's decline.

A Really Bad Idea

An obscure security designed to be a bet on a calm market has proven to be a bust and fuel for the recent stock market decline. An ETN called *VelocityShares Daily Inverse VIX Short-Term exchange-traded note* (XIV) (that really is the full name in italics) and a few similar funds were culprits. It was just another 'great idea' blowup. First of all, anytime you can't immediately and easily tell what a fund does by its name there's a problem. Keep it simple. Second, the idea behind this 'product' is a horrible one and is the kind of financial construct we warned about in our 12/31/17 Update. The ETN, symbol XIV (VIX backwards—how clever), is supposed to give the opposite return of the CBOE Volatility index (VIX), which is often referred to as the market's fear gauge. The markets since 2008 have been exceptionally calm, with few periods of selling, and those have been short and relatively mild, especially the past 2 years. This strategy was supposed to capitalize on that, and pay-off as long as volatility went and stayed low.

This bad idea is really just another unintended consequence of the Fed Bubble, and attracted assets from greedy hedge-funds dying for a place to generate returns. But just because it went up didn't make it a great idea or great investment. This type of strategy and others like it are known as 'widow makers', as they seemingly work for some time, but due to inherent flaws when things go bad they go real bad. Like carry you out on your shield bad—thus the moniker. Its like picking up nickels in front of a steam roller. It works great until you trip and then splat! The ETN in question XIV is going bust—all money essentially gone. And it attracted over $1.3 billion dollars as of a few weeks ago. Now those assets and assets in funds like it are headed to money heaven. Now I feel bad for anyone who put their funds in this thing, and its another example of why a financial advisor can be of help, especially one tuned into the nuances of these types of investment gimmicks. One of the ways we can help investors is to prevent them from harming themselves– by preventing them from buying this sort of thing.

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Another way advisors can help is by giving guidance during periods of exceptional market volatility, providing color and context to what may be a very confusing market. That's what we are trying to do here. This type of commentary isn't the sort of thing you'd get from a robo-advisor or some plain index manager. To them every day is the same, or all declines are equal. Sometimes that's not the case. In fact we read where a number of robo-advisor sites were unavailable or downright offline yesterday. Perhaps that was for the better, if it prevented investors from panic selling into the weakness.

Some declines 'mean something', and some just are noise. In 2008 the decline unfolded with a background of declining fundamentals and clear warnings from segments of the financial market (high-yield/ mortgage backed securities) that were already in severe stages of breakdown by the time the stock market selling began in earnest.

This time around, things are certainly not equivalent to 2008. Right now the economy is in good shape, and earnings have been down right stellar. Now that can certainly change, but a couple thousand Dow points won't change the economy. In fact, in 1987 the market declined over 20% in one day, with many at that time fearing a recession that was never to come. The next recession was three years away. Absent a decline in the economy and earnings, or clear warnings from other 'canaries' that serve as financial warning signs, this drop seems more like one that will eventually be calmed down with the passage of time.

Investment Outlook

We put out our 2017 year-end Update on December 31st (ok so we are not big partiers), and in it we stated that while 2017 was a good year- and that for 2018 we expected the bull market to carry on–our takeaway was for investors to **'have a care'**. We were expecting volatility to pick up in 2018. The Fed is no longer undertaking QE, in fact it is trying to reverse the process. The massive tailwind to stocks has diminished. We stated that the bull wasn't' over, but it was changing. That has indeed proven to be the case. The market doesn't seem impervious anymore. The big run-up to begin the year left the market vulnerable to a pullback. And that pullback became quite a bit more when underlying vulnerabilities in those poorly thought Volatility products (like XIV mentioned above) blew-up, making things worse.

With the market moving up strongly in January we were not chasing the rally, and were not investing 'new money' into the move. New clients and new deposits were held aside until last week when the market correction started in earnest. Into that weakness and what we have seen this week we have been trickling in sideline cash. We will continue to do so. We know what we want to own, and why we own it. What we are not doing right now is selling equities. Panic selling rarely works out.

What has become clear is that with computer trading algorithms taking over, with computers replacing people in trading pits, and with mindless indexing strategies becoming widespread, markets are trading FASTER.

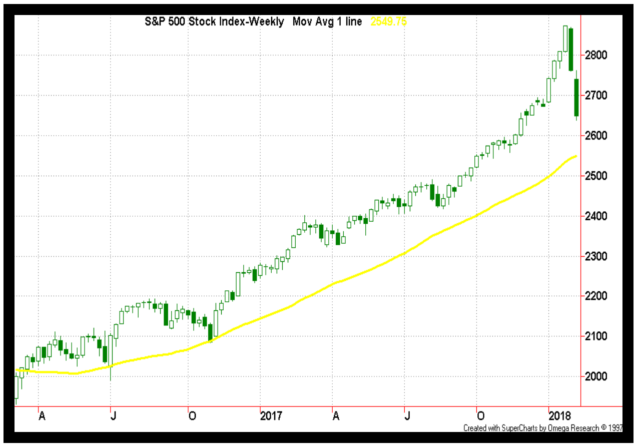
Its always been said that markets take the stairs up and the elevator down, that *up* moves take longer while *declines* are much quicker. That's always been the case and is likely to remain the case. But what really is a new phenomenon is that time compression is truly going on, the speed of technology and the widespread use of computerized trading is shrinking the time windows for market moves. Moves that used to happen over days now take hours. Moves that would once take weeks now take just days. That I suppose, is something that we'll have to get used to, and yet another reason to get good guidance.

The equity market has had quite a shock, and we wouldn't expect things to turn on a dime and 'V' bottom up and out. Normally bottoms are a process that sees an initial low followed by a little rally. Then another bout of selling that retests or even slightly undercuts that first low. We probably saw the first low on this morning's opening weakness, with perhaps a relief rally followed by some more selling and testing over the next week or two.

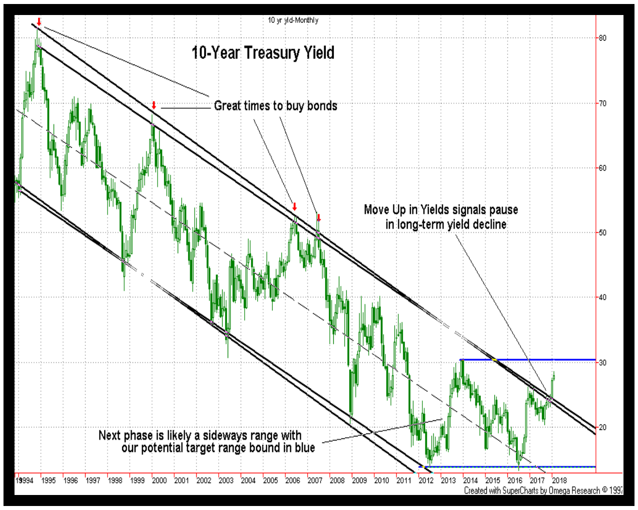
Our approach is to buy weakness here as much as possible, with purchases done as close to this morning's lows as possible. We will continue to deploy new funds on weakness over the next few weeks. The correction certainly has been more than we were expecting, but certainly not out of the ordinary. Recent market's have been extra ordinarily calm. Historically we get 1 10% declines in a year, and 3 of 5% or more. We haven seen a 10% decline since late 2015, over two years ago, and we had zero 5% declines in 2017. It seems the market was quite a bit overdue—just like our Eagles.

We think the current bull still has life, and that Q1 of 2018 will turn out to be positive. We think there will be a time to have a serious care, but later on in the year.

Market Chart : Stocks Back Off from Steep Uptrend—Bond Yields Headed Higher



S&P 500—The top chart shows the pretty smooth up-trend for the S&P 500 since mid-2016, and you can see right at the upper right where things 'got a bit cheeky' as the Brits say in 2018. The pop up got a little too vertical looking. The pullback certainly has been sharp, with the S&P declining back towards its long-term average (in yellow). **What we believe we are seeing is a wicked case of mean reversion**. We would expect the market to find and hold long-term support around that average, just a few percent below current levels.



Bond Market & Interest Rates—We have been showing this chart forever, noting the importance of the 10-year bond yield and that when yields rise it affects the pricing of everything. When yields popped quickly and sharply above the long-term declining trend line in 2018, the stock market finally noticed.

The long-term downtrend in yields looks to be at least on pause, and could very well be over. We think the next phase is some sort of a sideways range, with the top of the range 3-4% and the low 2%. Near-term, we think yields will peak around 3% at the top, and 2.4% at the bottom of the range.