Hamilton-Bates

Market Update

February 9, 2018

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Lightning Strikes on a Clear Day
It can happen on a perfectly clear day and its called a bolt from the blue. It comes from a thunderstorm about 50-100 miles away and strikes from the top of the cloud and extends miles out ala why it looks like it came out of nowhere.

What's happened in the market is a lot like a lightning strike on a clear day—you may know that storm is out there– but the nearby risks seem remote—then pop the lighting strikes.

There was some concern with the market, as our main 'theme' for 2018 from our Year End Update was **'have a care'**. The market seemed to throw that one in our face as stocks started 2018 right where the left off 2017—by gassing higher. The market ran until it got too over-stretched—and the implosion of some obscure volatility trading strategies magnified the selling snap back.

We do not believe the bull market in equities is over just yet, based on the fact that we were not seeing any of the major warnings that would normally accompany a significant market even like 1999 or 2007. The long-running bull market in bonds is probably over, or least on a long hiatus, and rising rates affect prices for everything-including stocks. So we are now more actively managing fixed income holdings.

Fight or Flight
The **fight**-or-**flight response** is a physiological reaction that occurs in **response** to a perceived harmful event, attack, or threat to survival. The market just punched everyone in the mouth—and now we each have to decide what to do about it.

Ideally it would have been great to have avoided the whole thing, but sucker punches cant be avoided. With the clear absence of major warning signals (fundamentals have shown no signs of cracking) and a long-term market trend that was very much intact (and still is), selling anytime would have been a completely subjective decision. We run accounts based on mathematical tools that have by and large served us well—and we'll continue to use them.

What We are Doing & Not Doing Right Now
Even when a decline can't reasonably be avoided, having an advisor and the right to tools can be a guide through the 'storm'. We try to bring color and clarity to the situation. One of the key things that we can do is to help one not hurt themselves. We might not have been doing a lot of selling in January, but we also weren't buying additional holdings either. Furthermore, new deposits and new clients have been sitting waiting for a better time. We were not buying the high.

We are NOT selling equities on big down days. That is a flight response that may seemingly make one temporarily feel better by getting out of the market—only to lock in losses and miss out on any eventual rally. Most folks on their own sell the lows and buy the highs. In fact our 'fight response' (dictated by our objective tools and experience) tells us to do the exact opposite. We are selectively buying stocks and funds we want to own on big weakness.

-We ARE selling bonds on big up days. Why? The bond bull market is likely over so we are selling on strength to reallocate to other income securities we believe are better suited to this environment. The nature of the market decline suddenly has made a number of stocks much more attractive. Simply put

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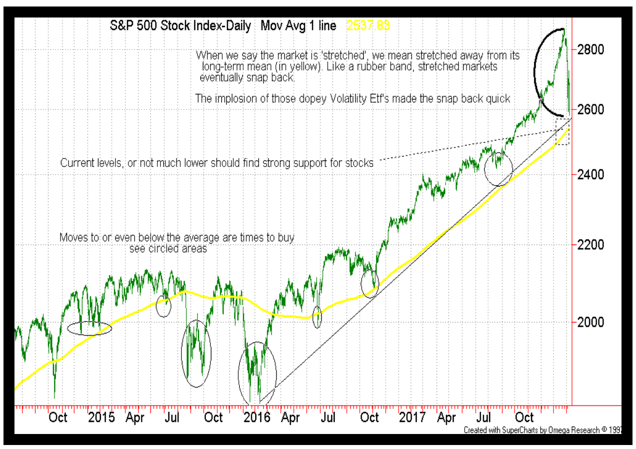
there are better opportunities elsewhere. At some point bonds will become very attractive—its just not right now.

Market Game Plan

The market has had two 4% declines sandwiched around a 3% rally this week. That's a lot of volatility. We may or many not have seen THE low this week. What we want to see is for things to calm down, we don't want to see continued big intraday swings. The big volatility was due to FORCED selling from MARGIN calls on those dopey Volatility ETF's, and from investors over-leveraged to them. Once we see that selling start to wane we'll be seeing the first signs that this selling squall is over. The market needs stability, seeing a number of minor up and down days would go along way in doing that. Fast moves UP or DOWN should be faded.

We are seeing mean reversion, the market was over stretched and is snapping back toward its mean (see S&P chart below). We are buying equity dips toward long-term mean levels (again see S&P 500 below) but we are being judicious about doing so. There is no need to rush. When we finally see the 'all clear' we'll pass it on. We might not be there just yet, but we are a lot closer to the bottom than the top.

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



S&P 500—The pullback certainly has been sharp, with the S&P declining back towards its long-term average (in yellow). **What 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. We might be close in price, but perhaps a bit further off in time. The bottoming process will probably we in terms of weeks rather than days. Once we see day to day swings calm down, the worst of the selling squall is probably over and a basing process can begin.

Bond Market & Interest Rates—Still the most important chart in the world –we have been showing this chart forever, noting the importance of the 10-year bond yield. When yields rise it affects the pricing of everything. 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. **We do not want to see yields push above 3% right now, that would be a major risk off signal for nearly all assets**.