Hamilton-Bates
Market Update

May 31, 2018

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

Rolling Series of Concerns and Listless Markets

Its been a few since the last Update, but little has changed in the markets except the 'concern du jour'. We have been in a cycle of worry-market decline—worry overblown-market rally—repeat the cycle.

In fact it is now almost 4 months since the S&P, DJIA, and NASDAQ recorded their highs in late January, and the vast majority of global equity indexes remain some distance below their January peaks. Exceptions include France which remains in the honeymoon phase with Macron, the UK which has a heavy weighting in energy and mining, and the Russell 2000. Of those, small-caps stand out because they have suffered a long period of under-performance, which now seems to be ending. Small cap equities have been used as a haven from trade risks, as they tend to be domestically focused and won't be hurt by trade wars or a stronger dollar. (*We have been noting this strength and have been adding small-cap exposure since April– for the first time in years.*)

For the much of the financial world this has been a long period of weak performance for the vast majority of local equity (and bond) markets. At the same time since the initial February plunge, the corrective forces have rolled through a selection of different sectors and countries at different points in time, with selling pressure driven by a variety of factors and leading and lagging performance switching places with remarkable rapidity. As we mentioned above, the concerns seemed to pop up one after another just as the prior concern was pushed aside. In other words this has been a generally confusing period that has lacked an obvious single focus. We have seen few periods in time that have born much if any similarity to the current period in time.

Dow Jones Industrial Average (above)

The DJIA is pretty indicative of most markets and market averages for 2018, with a peak in January, followed by listless trading since then with a few minor bounces from the lows...however there are signs things are picking up... 1) despite the litany of concerns key support levels have held- the market hasn't made new lows 2) down trend lines (diagonal lines down from peak) are starting to be broken 3) key indexes and sectors (not shown here) are perking up.

Economy, Earnings, and Interest Rates

Economic Data

The economy seems to be humming along pretty well, even as the stock market jerks and lurches from one concern to another. GDP growth for the year is expected to be 2.5-3.0%, which is solid but not spectacular. Sadly we haven't had an annual 3% GDP growth figure since 2005 (3.3). Above 2.5% is what we want to see, as it keeps us out of stagnation. Last month's retail sales were strong, though not as strong as March's growth. With or without automobiles factored in, retail spending grew 0.3% for the month. That's still on the order of 4% on a year-over-year basis, a really good number, and one which is more than enough to keep the consumer-driven economy humming.

Payrolls processor ADP reported today that the U.S. added 178,000 private-sector jobs in May, continuing the trend of solid monthly jobs growth. Hiring was broadly spread across industries and company size. The U.S. unemployment rate stands at only 3.9%. The latest Federal Reserve "beige book" was upbeat and pointed to moderately strong economic growth with muted inflationary pressures. U.S. companies are awash in cash from the Trump tax cuts. That's good news for shareholders, as more firms initiate stock buyback programs. With first-quarter earnings season largely in the books, research firm FactSet reports that the blended year-over-year earnings growth rate for the S&P 500 was 24.6%. That is pretty strong and suggests a solid base for the economy.

With the Fed hiking rates a lot of attention is on housing, which is starting to show signs of concern. Home prices are still on the rise and inventories are still lingering near multi-year lows, so we are seeing just modest starts and permits. The problem is rate hikes are killing affordability, eventually hikes will hurt and the question is how much will this filter into the broader economy. The next few months, the heart of the summer buying season, should still be strong however. We are concerned about the Fall and beyond.

Finally, as far as the economy is concerned, we continue to follow the Federal Reserve's report on capacity utilization and factory production for April. Both were up, again, more or less in line with expectations. The capacity utilization and industrial productivity trends coincide amazingly well with corporate earnings, and therefore coincide with the broad market. Though it can't cause or prevent short-term gyrations, it can reverse them when they move in contrast to the bigger-picture. The fact that both continue to trend higher is a bullish sign for stocks.

Any major concern we have about the economy stems from a concern the Fed will hike rates too much too soon and mess things up, or needless trade wars.

Trade Wars or Trade Bluster?
Trade conflict remains a cloud over stocks, as the international system of commerce devolves from multilateral treaties to arbitrary protectionism. US vs. China, US vs. Europe, US vs. NAFTA etc…

U.S. Treasury Secretary Steven Mnuchin declared with great fanfare last week that the trade war with China was ‘on hold.’ Yesterday, that statement suddenly seemed goofy, when the White House declared that it would proceed with its plan to impose 25% tariffs on $50 billion worth of imported Chinese goods within the next month.

It's not just China. The Trump administration is running out of time to deliver a renegotiated North American Free Trade Agreement (NAFTA). Those privy to the talks, including government negotiators, trade experts, industry lobbyists, and lawmakers, report that little progress has been made on the because U.S. demands greatly exceed what Canada and Mexico are willing to accept. The three parties are now racing to conclude before the Mexican presidential election on July 1, which could usher an anti-American government into power. If that happens, all bets are off. The White House's demands include a requirement that 50% of the value of North American vehicles originate in the U.S., and the automatic renegotiation of NAFTA every five years. Mexico and Canada are balking and suspect that Trump's America First economic team is angling for a pretext to quit the pact. If NAFTA blows up, stocks will suffer collateral damage. The same with China, or Europe.

When governments tinker with tariffs, businesses must scurry to adapt because they're linked into global supply chains. We believe that cooler heads and smarter minds will prevail, and some accord will be

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

reached that avoids truly damaging tariffs. Whether you're a Republican or a Democrat, remember this: trade wars are bad for stocks and the economy. Even if we agree that America has had a bad deal for years on trade, it would be difficult if not impossible to try to change things overnight. American companies have $8 trillion of capital invested abroad. Foreign firms have sunk $7 trillion in America. Trade wars would hurt everyone.

Market Outlook and Investment Strategy

Once again the market's popped higher and recovered the prior day's losses on the battering of Italy's bond market. Stocks moved up after Italy staged a successful bond auction and there is renewed faith that Italy will somehow sidestep collapse. Why does Italy matter? Because it is one of the largest bond market's in the world and were it to continue to slide the knock-on effects would spill over into European financials, and then into our financials, and then into the broad market. But once again the problem in Italy can be traced back to Central Bank shenanigans. Italy's bonds have traded well below US bonds in terms of yield (which it should NEVER do), thanks to the ECB's buying program. Central bank meddling eventually comes undone. Italy's bond market is simply playing catch-up to reality. It just did it in a few days and spooked a whole lot of folks. If the Central Banks would stay away the markets would be better off in the long run. Ah the ego of man.

The constant good news/bad news cycle and continues to keep investors on edge, and, and is causing financial markets around the globe to lurch one way or another with frequency. We still see upside for this aging bull market, as long as economic growth remains on track. You will notice the market's have largely moved about on geopolitical mayhem and maybes rather than economic reality. As long as the global economy moves ahead (albeit fitfully), we will focus on markets, sectors, and stocks that still have plenty of room to run.

Investment Strategy

We are seeing potential emerging trends in real estate and small-caps. We are also holding multinational leaders with rock-solid balance sheets, products that everyone needs, reasonable valuations, and superb growth potential.

The DJIA and S&P are still below their January highs, but that doesn't mean stocks are in dire straits. All things considered, the market is holdings up well given all the concerns, and has had many opportunities to break down seriously but hasn't. The major averages are holding their own well enough at a rather important support and moving averages. And now we are starting to see strength in key areas like small-caps and transportation stocks. Strength in these areas seems to confirm the economic data that the economy is still doing 'ok' if not possibly on the way to 'better than ok'. The good news is that the bulls seem to have the advantage, and with major averages continuing to at least hold key support (if not showing signs of breakouts like small-caps, transports, and NASDAQ), the overall market should on balance move up with the global economy. It may continue to be in fits and starts given the news cycle, but an upward move doesn't have to be perfectly linear to be rewarding.

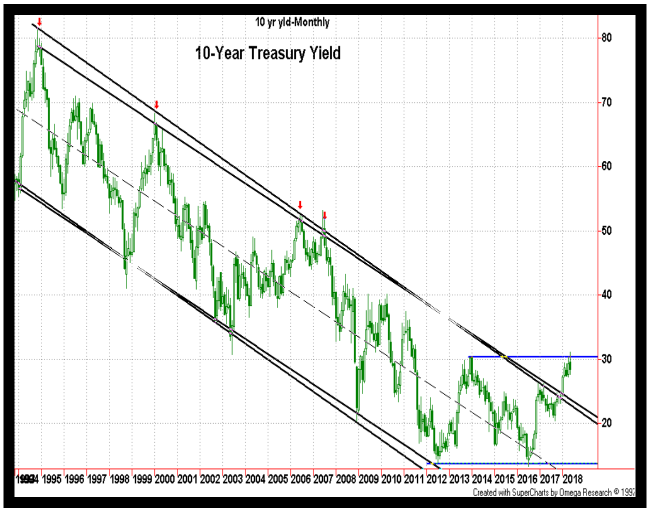
We may be in that time of year that historically hasn't been great for stocks, when its tough to muster interest from traders/investors when there is much else (ball games, graduations, vacations) on their minds, but we still see a decent possibility that bullishness could reignite. We are probably in the minority on this, but that's ok. Based on what we see in terms of the number of stocks advancing vs. declining, the strength in key sectors like transportation (a virtual pulse on the economy), and the breakout by small-caps—we believe another upward leg in stocks is coming. If we can work our way through the trade minefield the round number 3000 on the S&P 500 seems like a reasonable goal (that's about 10% higher).

Hamilton-Bates

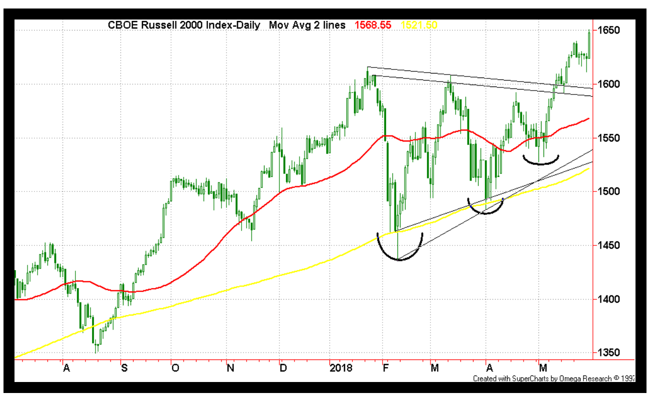
Market Update

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

Market Charts : Key Charts for Bond and Equity Markets



10-Year Bond Yields (Interest Rates)-This is the key chart—it's the pivot upon which the financial world revolves. Rates drive currencies, currencies drive trade/flows, and trade/flows drive stocks & earnings. What this chart shows is that the very long trend of falling rates is threatening to change into a sideways pattern (bound by blue lines). Yields moved up above the long-term down-trend just this year as the Fed has been hiking rates. Its no coincidence that the peak in global stocks and bonds occurred around the same time as the yield breakout. 2018 has been a year of volatility around the globe– as markets adjust to this new interest rate reality. It will be ok as long as rates don't move too much higher from here. Above 3.25% would be bearish in our opinion.



Small-Caps Surge to Life —After what seems like years of lagging and languishing in a world dominated by mega-cap FANG stocks—small-caps have finally showed some pep. While the DJIA (chart on page 1) has a more flat look to it, small-caps have made a series of higher lows and higher highs– the very definition of an upward trend. After breaking out this month, the outlook for the rest of the year is looking good for small-caps. Small-caps also tend to correlate well with the domestic economy, and are fairly insulated from trade war concerns.

Transportation Sector—If you sell it you have to move it , either to get it to the store or the customer, so the recent strength in the transportation sector also suggests good things for the economy. If this key sector can build on the mini-breakout above 195 we could see a run to new highs. We think this sector is hint as to what could be coming for stocks in general.