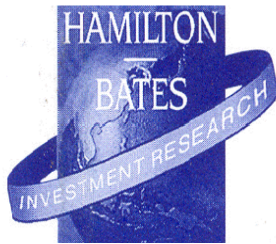


Hamilton-Bates

Market Update—1st Half Review

July 6, 2018

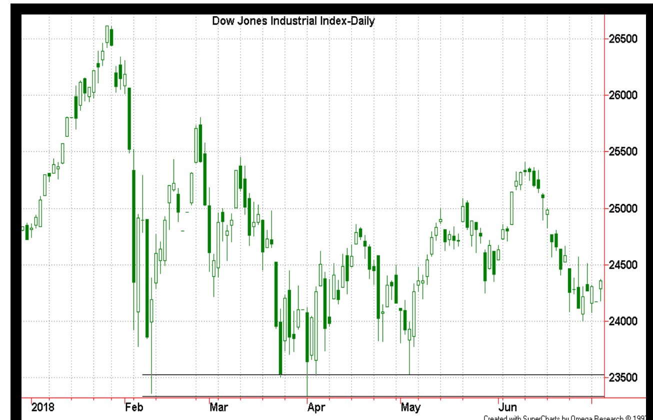
P.O. BOX 270 Newtown Square, PA 19073 877.768.4247 www.hbir.com

Global Stocks Suffer Worst 1st Half Since 2010 As Emerging Markets, Intl Stocks Struggle

That headline above makes 2018 sound far worse than it has been in reality, as the period since 2010 has been 'very good', so the 'worst year' since then really amounts to just a slightly down year for most stock and bond market indexes-but not a lot of deep red. For the first half the Total World Stock Index lost -0.40%. In comparison every other first half since 2010 (other than 2010).

The primary cause of the declines comes from the Central Banks, as financial conditions have tightened significantly due to Fed rate hikes, and balance sheet reductions (A reverse QE). By selling bonds from its balance sheet the Fed removes liquidity (cash-flow) from the system. Money that is used to buy the Fed's bonds can't be used elsewhere (like to buy stocks). In the past, during QE the Fed bought bonds, and the cash investors had from selling those bonds to the Fed was recycled back into the stock market. That positive cycle lasted from 2009 until 2016 and its now over. The Central Banks are now draining liquidity from the financial system. Liquidity to the financial system is indeed like water to plants—start to remove it and eventually things begin to 'wither'. That is what we have seen so far in 2018.

The amount of that wither seems to be based on how susceptible a market was to negative asset flows, or how robust demand was for particular assets. Those markets very susceptible (China, Emerging markets, High-Yield, Crypto-currencies) suffered the most. One funny thing is that with all the talk and concern over a trade war with China, it has been China's market that has suffered worse (and by far) so far in 2018.



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. The DJIA ended the first half with a modest loss, but has faired much better than other World Indices.

Here is a listing of various assets and how they did in the first half.

China	-13.90%
Emerging Markets Index	-7.49%
Dow Jones Industrial Average	-1.80%
World Stock Index	-0.40%
S&P 500	0.95%
Government Bonds	-1.01%
High Yield Bonds	-0.89%
Aggregate Bond Index	-2.75%

Weakness was pretty much across the board in the first half, with notable exceptions in small-caps, parts of the tech sector, and a few other US mega-cap names.

Disclosures:
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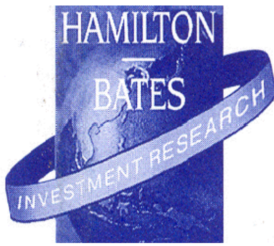

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Economy, Earnings, and Interest Rates
Economic Data

The economy remains on track so far, with GDP growth averaging about 3% for the year so far. Even with trade concerns and market choppiness, earnings have been terrific, with growth in the teens. The key question will be whether earnings and the economy can withstand both the Fed hiking rates AND increased trade tensions (and tariffs) with China. With earnings season coming up we'll be more concerned with corporate outlooks than with the current quarterly numbers. As long as outlooks don't turn bleak with sharp downward revisions our market could have a strong second half.

So far so good, as the latest Labor Market Report coming in better than expected and reversing a string of two slightly worse than expected reports. In fact, it has been China's financial markets and economy that has taken the worst of it from the trade tensions. Given the disparity of economic and market performance it may end up to be that China needs us more than we need them at the moment. Lets hope the bluster ends soon, as the quicker it does the quicker the market will likely get under way with a second half rally.

Market Outlook and Investment Strategy

Despite being very late in the current market cycle, we are not yet observing the type of excesses that would signal the imminent demise of the rally in US stocks. Rising interest rates and on-going trade friction support a stronger US dollar, which will likely depress international equity returns and overseas earnings for multinationals, likely for the remainder of the year. It is unclear at this time whether the aggressive US stance on trade policy is aimed at eliminating trade deficits, or just a negotiating tactic aimed at more balanced trade agreements. The uncertainty surrounding the impact of potential tariffs weighs on the market and coupled with a strong dollar, may cause assets to seek areas less sensitive to these things, namely small-caps and select technology names. We saw this developing and have positioned assets accordingly.

We remain optimistic that over the next 6-12 months US stocks will do well given a monetary policy that is accommodative even as it heads to neutral, thanks to tax cuts and increased federal spending. However, it would be naïve not to anticipate a downturn sometime thereafter, as monetary policy tightens and earnings slow. At some point the current cycle will indeed end, something we'll be keen to look out for– but likely a 2019-2020 issue.

Investment Strategy

We think the environment is likely to favor stocks over bonds for the next six to twelve months. This view stems from our belief that earnings will continue to grow, even if that growth rate starts to slow; and that rising interest rates will hurt bonds, even though it will take some time before these interest rate increases begin to restrict growth. Our preference for stocks is relative, however, and will change should the economy stumble—at which time bonds would offer much better opportunity.

Although US equity returns for the first half of 2018 have been lackluster, this is not atypical for US stock market returns in a mid-term election year and is usually followed by a strong rally after the elections. Fear of escalating tensions between the U.S. and its trading partners may have led investors to favor the stocks of companies that are less dependent on sales outside the U.S. (smaller-caps). Small-cap stocks may continue to outperform so long as trade tensions persist. We believe the rest of 2018 will be much better than the first half; however given the **potential** for a change in inflationary expectations, trade policies, the pacing of rate hikes, and slowing in corporate earnings, it behooves investors concerned with market fluctuation to diversify and to hold some core fixed income, bond alternatives, and actively managed strategies (our specialty) in order to limit losses when inevitably the current cycle ends.

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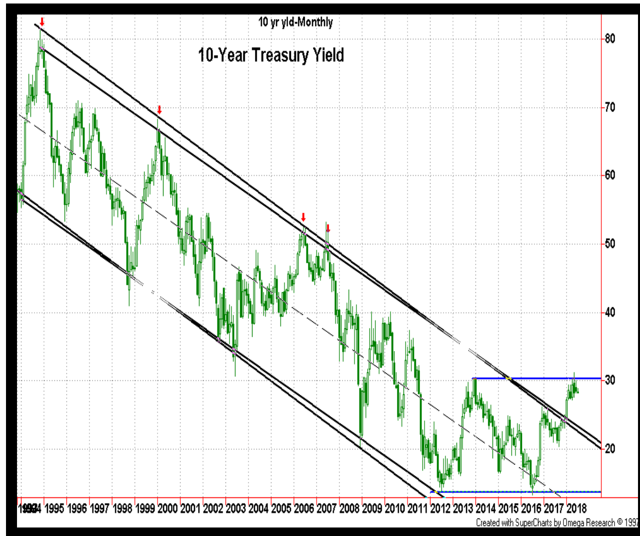
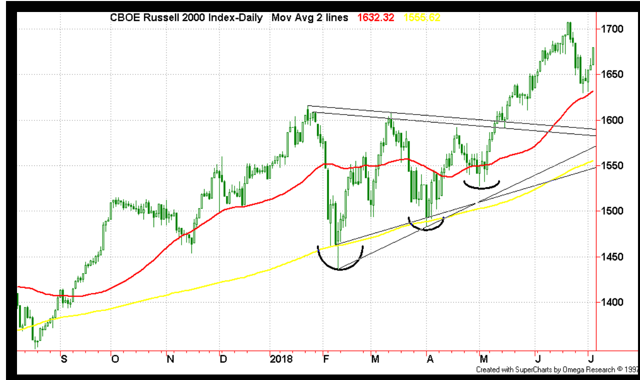
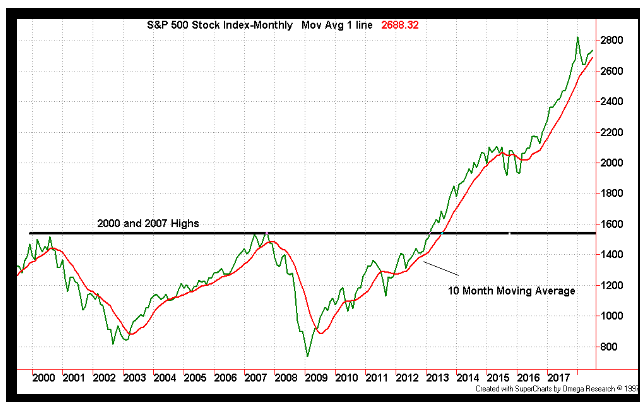
Market Charts : Key Charts for Bond and Equity Markets



10-Year Bond Yields (Interest Rates)-This is the key chart—rates drive currencies, currencies drive trade/flows, and trade/flows drive stocks & earnings. Yields spiked in the first month of 2018, breaking the long-term downtrend that has existed for nearly 30 years! This created a lot of uncertainty in the financial markets, and is why nearly all markets are sideways to negative for 2018—with the exception of those that are able to withstand higher yields (floating rate bonds), or are domestically focused (small-cap stocks). The good news is that yields seem to have peaked for now, and have fallen back below the 3.0% level. A sustained break above 3% would be a negative sign for most financial assets. We will continue to watch yield levels closely, but we expect a drift down towards 2.5% for the second half of 2018.



Small-Caps Remain Strong—Small-caps have lagged big-cap stocks for over 7 years, but finally seem to be getting some time in the sun. While the DJIA (chart on page 1) has a more flat/down look to it, small-caps look much better and could be an area that carries the market in the second half. Small-caps also tend to correlate well with the domestic economy, and are fairly insulated from trade war concerns. Money could continue to move to this area.



S&P 500 Monthly Chart —The 'big picture' view of the US Stock Market remains positive, even with the recent volatility. Since 2000, good things have happened when the S&P 500 has been above its 10-month average (red line in chart), and bad things have happened when it was below it i.e. (2000-2002) & (2008-2009). The S&P got too far extended during the January 2018 rally, but has held above this key level during this year's weakness. As long as the S&P 500 stays above this average (now around 2688) the bull trend remains intact.