Hamilton-Bates
Market Update
July 30, 2018

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Two Steps Forward One Step Back
Nobody can honestly say they were surprised the market hit a wall after the release of the GDP report on Friday. There are a number of things in question here, such as the trade war with China and now concerns over the FANG stocks. Stocks were ripe for a little profit-taking, so the would-be sellers were content to lock in their gains headed into the weekend. It doesn't mean the broad market's in complete pullback mode. It could certainly turn into that. But, thus far, Friday's tumble isn't anything more than a normal pullback.

One area we are paying close attention to, and have some concern about—are the famed 'FANG' stocks—Facebook,Amazon, Netflix, and Google.

Will Confidence in FANG Fade?
As we head into the back half of the year, "Long FANG" is still the most crowded trade on the planet according to Bank of America's Global Fund Manager Survey.

Over the past few years, investor capital has been increasingly concentrating into the FAANGs while the rest of the market has been deteriorating: As portfolios have become more and more FAANG-dominated, more and more investors have come to see those five stocks as "unstoppable". They have unnaturally performed as both "risk-on" and "risk-off" havens for years -- delivering consistent share price growth when markets move higher, while holding steady when they don't. As a result of this piling-in by investors, the five FAANG stocks collectively now have a whopping market capitalization of $4 trillion. They comprise nearly half of the NASDAQ index's market cap.

Could the FANG Stocks 'Nip' the Market?
The famous FANG stocks (chart above) are up nicely in 2018, as they continue to attract funds simply due to their size and index weightings. However, their rise has become much more choppy this year as earnings questions, ethics questions, and concerns over valuation have what had been a steady trend stumbling a bit. The uptrend since the April low remains intact, but momentum waned at the latest peak, and last Friday's reversal was severe. If the near-term uptrend is broken it would likely signal weakness for the market as a whole.

Recently however, the FANG stocks have showed some cracks. For example, over the past two weeks: Netflix (NFLX) is down 10% after issuing disappointing subscriber growth and Q3 guidance. Facebook (FB) is down 20% after delivering lower user and revenue numbers than the Street was expecting. Amazon (AMZN) is flat despite posting blowout Q2 EPS yesterday, offset by a revenue miss.

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Google (GOOGL) only managed a meager 3% rise after reporting earnings & revenue beats. This begs the question—are the FANG stocks losing their bite?

This is an important question because as go the FAANG stocks—as goes the market—at least for the short-term until new leadership can develop. These stocks are also dominant in the indexes, as the FAANGs (FANG+Apple) are the largest five companies in the S&P 500. And they were responsible for 80% of that index's growth over the first seven months of this year (without them, the S&P 500 would have negative return in 2018). We will continue to watch these leadership companies closely, as any major breakdown would be negative for the broad market.

Economy, Earnings, and Interest Rates
Economic Data
Global politics have stolen media headlines during the past several months, with trade wars between the U.S. and China at the forefront. Thanks to the constant tweets and headlines from both sides, it's been easy to overlook Q2 corporate earnings for S&P 500 companies that are rolling in. Thus far, almost 20% of S&P 500 companies have reported Q2 2018 earnings and the results have been overall good. More companies are reporting actual earnings per share (EPS) above estimates (87%) compared to the five-year average, according to FactSet. Sector wise, positive surprises in sales are being led by companies in the financial, industrial, and technology sectors. All three groups were the largest contributors to the increase in the S&P 500's revenue growth rate over the past week. Meanwhile, all eleven S&P 500 sectors are reporting (or are projected to report) year-over-year growth in revenues.

Looking ahead, Wall Street's analysts currently project earnings growth to continue at about a 20% clip through the remainder 2018. Nevertheless, they forecast lower earnings growth during the first half of 2019, and increasingly it will be that 2019 guidance that moves the markets.

Market Outlook and Investment Strategy
The rhetoric around tariffs and trade talk continue to go back and forth and dominate the market's short-term swings. Even with all this discussion, markets have traded mostly up, with the NASDAQ breaking out to fresh highs before selling off at the end of last week. The S&P 500 moved to a five month high, and is trying to push back toward those January highs. **For the S&P 500, 2,800 has been and continues to be a level of pivot for long and short traders/investors. Above 2800 is 'risk on', below 'risk off'.** Tech has been dominant, but other sectors have been rotating in and out of favor, and since our last update, relative leaders are Utilities, Staples, and Healthcare, more defensive in nature names.

However, aggressive sectors are still hanging in there and with earnings currently in full swing, we could see a recovery if earnings deliver. Small-caps have started to lose some ground relatively to large caps, and look ready for a consolidation of recent gains. We took some profits in this area last week, moving assets toward large-cap equal weight indexes.

Interest rates continue to hover around support, with no real accelerating or decelerating moves to take note of. The 10-year yield is staying comfortably above the 2.80% level, but hasn't broken above the key 3-3.10% level (see chart next page). Bonds remain the one asset class that remains negative year-to-date.

Long-term the market remains positive with the S&P above its 10-Month average. This is a simple measure, but is very effective. Breadth is remaining strong, with no underlying issues that need to be pointed out. A pause here and there is generally looked at as healthy, and until there are more significant developments among the leading stocks and sectors, the overall trend should be considered bullish. **The market may be suffering some seasonal weakness (Aug-Sept), but there is also a very strong tendency for a market rally at year-end, especially post election during mid-terms.**

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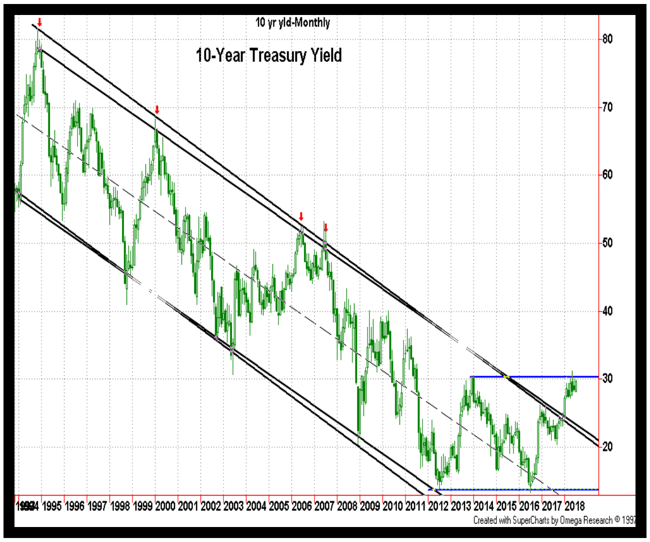
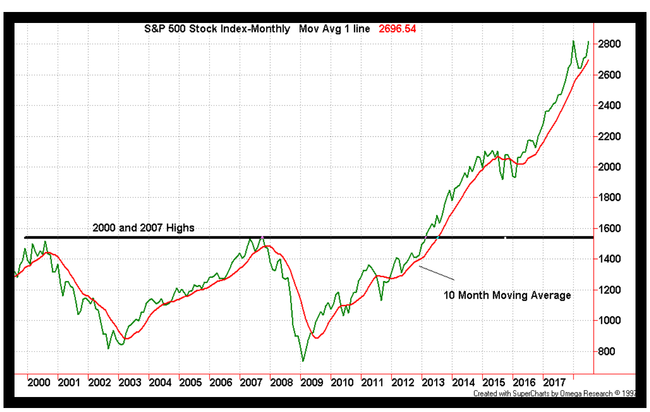
Market Charts : Key Charts for Bond and Equity Markets



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 three decade downtrend. This created a lot of uncertainty in the financial markets early in the year, which the they have been struggling to overcome. Yields seem to stabilized for now, backing off the 3-3.10% level. We believe a sustained breakout above 3% would be a negative sign for most financial assets, as housing has already started to feel the bite of higher rates. We look for rates to bounce between 2.5-3.0% in the second half of 2018.

DJIA—The Dow moves to a 5-month high, finally pushing above levels that have held the index back. The mini breakout above 25,000 projects gains of 5-7% and new all-time highs if it holds, so we'll be watching to see if the Dow holds above 25,200-25,250 support.



S&P 500 Monthly Chart —The 'big picture' view of the US Market remains positive, as the S&P bounced from the 10-month average and has pushed toward 2800. 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). As long as the S&P 500 stays above this average (now around 2700) the larger bull trend remains intact.