Hamilton-Bates
Market Update

October 11, 2018

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"The Bond market trades like an adult while the Stock market trades like a child."

The above quote perfectly describes the difference between the equity and bond markets, and keep in mind the bond market is multiples of times LARGER than the stock market in terms of capitalization. Like a 'child' though, the stock market gets all the attention, makes emotional moves, and is prone to tantrums. The larger (adult) bond market toils in the background, and generally moves in more measured and rational fashion. Ultimately though it's the bond market that makes all the decisions.

What we saw yesterday was a clear *emotional* trade as we saw a large unwind of leveraged long positions into weakness by hedge-funds (according to market data from Morgan Stanley). These funds dumped long positions pretty much all at once, triggering a capitulation day where everything was thrown out. Much was made of interest rates and the Fed being the cause of yesterdays decline, and the Fed is an easy scapegoat to blame with their rate hikes. The truth however is a bit more nuanced. The Fed is just the most obvious culprit, but not the only one. A blackout of corporate buy-backs due to earnings season is also to blame. With buy-backs locked out THE key buyer (companies) is out of the market. We also had a drop below a key technical level on the S&P 500 which triggered a lot of technical and programmed selling. And finally we are in a period (Sept-Oct) that has very poor seasonal tendencies for the market as a whole and technology stocks in particular. With hurricane Michael hitting the Gulf Coast we hate to use weather references, but yesterday was really a 'perfect storm' of several negative factors. We have been writing for some time that the Sept-Oct period was one that we'd look for volatility to pick-up if it was to do so at all. It took awhile but it finally has albeit later than usual—as the market always has a trick to play. Before we get into what we expect for the market for the rest of 2018, we'll review the fundamental outlook.

FANG Sell-Off Finally Bit the Market

We noted concerns with FANG back in late summer, but FANG kept chopping higher through September. October saw the FANG stocks take a hit as the waning momentum we noted finally took effect. The tech sector also tends to be weak in the Fall, and that is what we are seeing. But now that the media and CNBC is finally 'noticing' the decline we are likely well on the way towards its completion. The FANG group is nearing its 200-day average and is oversold, which suggests the bulk of the selling is likely over.

Economy, Earnings, and Interest Rates

Economic data and earnings have been fairly resilient this year, with GDP growth hovering between 3-4% and earnings coming in with double digit percentage gains. This background is incredibly supportive for stocks and earnings have grown by over 15%. The concern that many have is 'is this as good as it gets'; and if so how much of a pullback in earnings will we get due to tariffs and rising interest rates.

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The economy still looks pretty good. Job creation and unemployment data continue to show a very strong labor market, with historically low unemployment data suggesting jobs are plentiful and easy to get. On the other hand housing and auto sales have started to weaken, which is to be expected as these purchases are financed and thus susceptible to rising rates. Manufacturing and Services data split the difference, with both showing middling growth with services the stronger of the two. None of the economic data show any negative trends of concern, but housing is the area we look at the most. A profoundly weak housing market, were it to develop would be a big economic drag.

Concerns we have revolve around the *fragility* of the expansion we now enjoy. It has largely been built on debt purchases of houses, cars, and stuff. If consumerism is choked-off, if the economy is too fragile, rising rates will hurt earnings, as will tariffs. That is the crux of the fundamental concern right now—everyone knows that tariffs and rising rates will trim growth—but how much? Investors will look to earnings guidance over the next few weeks for clues. Past cycle peaks have shown that economic data and conditions can change very quickly and catch most folks (even the pros) off guard. With everyone now focused on the market going DOWN, lets go the other way and take a look at what could set the market up for a big rally into 2019.

Things That Could Send Stocks Higher

When the market declines the easiest thing to do is to extrapolate the current situation and come up with reasons that the decline can or will continue. We prefer to do the opposite, and look at events and triggers that could not only stop the decline—but send it sharply higher. This helps to take the bearish edge off and keep perspective when the market declines. Lets take a look at a few:

1) The Fed could provide some comfort to markets. They could acknowledge the deterioration in financial conditions and soften their hawkish tone. The Fed's recent rhetoric suggests this is unlikely, but a combination of the scale of the market move and even President Trump's vocal criticism's may put some heat on them. The Fed governor, perhaps a little full of himself, offhandedly stated that the Fed has 'a ways to go to get rates normalized'. This comment hammered bonds, sent yields higher, and in turn hammered stocks this week. This was a 'rookie' mistake. This Fed crew aren't all academics, and they aren't dopes. We believe its very possible they moderate their tone in coming days and weeks. We just hope the President's tone doesn't prevent the Fed from doing so for appearance sake. Trump may be partially right but his style ma

2) De-escalation of the US-China trade/tech war. There has been a ramping up of US rhetoric against China and not just on trade but on corporate spying as well. This has spooked markets – just as the threat of limiting Chinese investment in US tech did earlier this year. Given the effort the US administration has devoted to 'winning' this, a de-escalation seems unlikely. But a market decline could temper that mood. China's economy and market have been getting crushed. As unlikely as it may seem, there is mutual benefit to getting a deal done. If one happens the market would likely rally 10% or more quickly.

3) Stock buybacks return. We are currently in the 'lock-out' period for US corporate stock buybacks ahead of earnings seasons. THE biggest buyer of US stocks since 2009 have been companies themselves. With earnings season starting this Friday, we will see a return of buybacks over the next month or so and it could be very bullish for stocks.

Market Outlook and Investment Strategy

Absent clear signs the trend is breaking down, the economy is faltering, or the Fed is making a major policy mistake, the market is setting up the potential for what could be a pretty strong rally into 2019. Concerns over the Fed was a trigger to current selling, but we believe it is very likely these concerns are overblown. We stated in the last Update that we'd be a buyer of weakness, and that is exactly how things seem to be shaping up. We have been writing for some time that the market was due for a correction and it has finally come. We do not yet see the fundamental deterioration that would concern us for the long-term, or a breakdown in the long-term market trend. Furthermore, the coming five months (November-March) are historically the most bullish of all periods for the 4 Year Cycle. The period after the mid-terms into the following Spring have seen significant market rallies. Year-End is also the strongest seasonal period of the year. Its tough to get too bearish ahead of such trends. The next few weeks could be volatile, but we believe the things will

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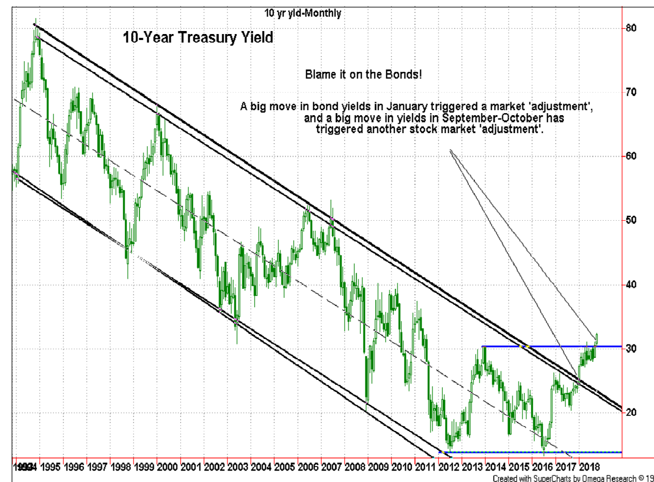
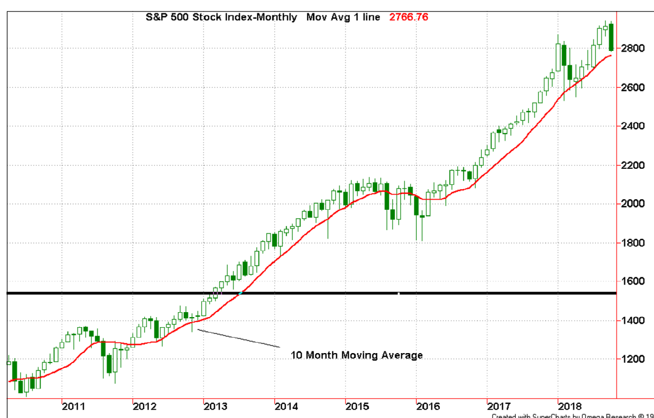
ultimately fall in place for a rally into early 2019. That rally could be very strong if one of more of the bullish triggers on the previous page unfold.

Nearly all of our portfolios have bonds and/or cash, which had been a drag until this past week-where they really paid off. Over the next few weeks we are anticipating unwinding some of those positions in order to increase stock exposure should the bullish scenario we expect unfold. **It's not time to panic, its time to anticipate the unexpected—a rally.**

Market Charts : Key Charts for Bond and Equity Markets





10-Year Bond Yields (Interest Rates)- TOP
The Fed's rate normalization program along with an end to QE has broken the long-term downtrend in interest rates. The bond market broke that downtrend in January– triggering the stock 'tantrum' seen in February. Yields chopped gradually higher after that, allowing the stock market to settle down, but this month's push above 3.0% (blue line in chart) triggered the stock 'tantrum' we are seeing now. We don't believe yields can or will rocket from here. Everyone is now pricing in much higher yields. If they don't spike higher and instead settle down, stocks can certainly rally into 2019.

S&P 500 Long-Term — BOTTOM
Lots of chop in the short-term , but not so for the long -term. The 'big picture' view of the US Market remains favorable, as the S&P remains above its key 10-month average (red line in chart) even with this month's decline. As long as the market remains above this key average, it is historically bullish for stocks. There hasn't been a break yet, and so far this week the stock market has slowed its decline as it approached this key level around 2760 on the S&P 500. Until there is a break, and there hasn't been, the long-term is intact.