

Hamilton-Bates

Market Update

November 20, 2018

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Stocks continue their October weakness as major markets across the globe fall as worries over softening demand for the iPhone batter Apple and Apple related suppliers; and continued selling in the FANG names triggers follow-on selling worldwide. What was largely a tech-led decline was broadened out in recent sessions. We are now exactly two months since the S&P hit all time highs, and after a mild bounce stocks have once again been caught in a stiff decline. Key bellwethers struggle for support as some of the technology companies that helped drive the S&P 500 tumble amid a slowdown in consumer sales and fears over regulation, many of them entering a bear market. In fact, the formerly high-flying FANG stocks (Facebook, Amazon, Netflix, Google) are now down over 25% from their recent peak. Just as 'one bad apple ruins the bunch', weakness in Apple and other technology names has spilled over into other sectors, and now fully 40% of the stocks in the S&P 500 is down over 20%.

Economy, Earnings, and Interest Rates

Earnings season is winding down and while the most recent quarterly results were on the whole great, the market continues to weaken on concerns about the next few quarters, and whether or not peak earnings growth has been seen. So the market continues to fall on any signs of softness or even cloudiness in forward looking guidance, even as the indicators that cover the broad strokes of the economy continue to remain strong. Inflation remains tame, albeit slightly higher than the 2%, but not high enough to concern the Fed. This is a Goldilocks report, in that inflation is neither too hot nor too cold. The Federal Reserve could be slightly less hawkish with rate-hike plans if it wanted to, though it doesn't have to back off. It just needs to not get overly aggressive in 2019.

Disclosures:

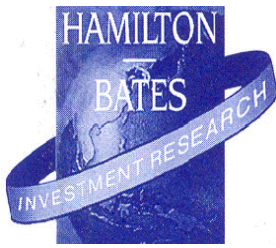
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FANG Sell-Off Continues to Batter Stocks

We noted concerns with the FANG names back in late summer, but it took until October for those concerns to come home to roost. From the September peak to the current low the formerly high flying FANG stocks (Facebook, Amazon, Netflix, Google) are now down an average of 25%. The weakness in these tech names has spread to the broad market, and as of yesterday 40% of the S&P 500 companies are down 20% or more from their peaks. The only 'good' news is that given the weakness-most of the decline in the FANG names has likely run its course. Major support just below current levels should halt the FANG decline.

Also this past week we got last month's October retail sales data. It was also good, and better than expected. The knee-jerk interpretations of the report aren't quite as optimistic, with critics pointing out that spending growth for the past couple of months has been lower than the growth pace seen in the middle of the year. What's being lost in the discussion is that the recent comparisons are up against tremendous spending growth in September and October. Finally, capacity utilization and industrial productivity (arguably the



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most important barometers of economic activity among the economic data, and one of the most highly correlated with corporate earnings), continue edging higher. As long as both data sets keep trending upward, it will be difficult to not remain a bigger-picture bull in terms of economic activity.

Growth Scare

There can be no question that the stock market is suffering a 'growth scare' right now. With the Fed hiking rates and with a potential trade war with China, the stock market has become especially sensitive to any hint that future growth will be anything but strong. Any company that hints at any concern, or even slightly adjusts forward guidance, has been battered. With the FANG stocks now down over 25%, and even a fundamentally strong and stable company like Apple beaten down, its clear nearly all the market's former heroes have been taken down. Is the sell-off in stocks justified? Normal corrections of 5-10% are pretty common, even if they haven't been in our market for some time. But the current sell-off is now reaching the outer limits of a 'correction', with the NASDAQ off about 15% from its peak. If the economy is headed into a recession in the first half of 2019 then no the selling isn't overdone. But absent a recession, and right now we don't see signs that one is that imminent, the decline seem very much overdone.

Market Outlook and Investment Strategy

Stocks are falling as if fearing a recession. From what we see right now, none of our 'recession warning indicators' has triggered. We watch high-yield bonds, homebuilders, and bond yields for clues that a recession is building. While high-yield bonds and homebuilders have been weak, the weakness has not been to a level consistent with prior economic cycle peaks. Homebuilders have actually started to act much better, and unless they take out their recent lows there is no trigger there. Finally there is the 'yield-curve', which measures the difference between the interest rates on short and long-term bonds. The yield-curve does not show the inversion or

'negativity' that has preceded each of the past several recessions. We conclude that a recession is not in the cards until 2020 or later.

The stock market managed a slight bounce from the October low, but that low is once again being tested by the major averages ahead of Thanksgiving. The major averages are also below their 200-day averages, a sign that an uptrend has not been established. Putting things into perspective, the market is now trading water around the October lows. Until we see the major averages recapture their 200-day averages the market is on the wrong side of long-term trend lines. So the trend, to be blunt, isn't actually all that bullish, even though this time of year usually is. The longer that lasts the more of a concern it will become. We are now in a period that should be very favorable for stocks. The market still has time, and we should see a rally develop between now and year-end, but the longer it takes the more closely watched and critical we'll become of it.

Portfolios

It has been our intention of rotating assets from asset classes that have held up better than stocks into the market weakness seen in October, as we believed the market was setting-up for potentially strong rally into Year-End. So far however, the market's inability to build a rally has persisted, and the assets that had been earmarked for stocks have continued to build as sideline cash. We are OK with holding cash in the face of a declining stock market. That cash position, along with sizable bond holdings, has helped over the past two months. **Our actively managed portfolios have had 40-50% of their assets in areas OTHER than battered stocks.** That has made this decline only slightly more palatable for us-as we abhor market declines even though they are necessary.

Even though its taken longer to materialize we still believe a market rally is not only overdue but imminent. We'll look to redeploy cash when the market has built a stable base, and in time to catch the next leg higher.