Hamilton-Bates
Market Update

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Has Spring Finally Sprung?
The weather is finally starting to thaw for most of the country, and temps in the 60-70's should melt our leftover snow-cover. So far 2021 is starting off better than 2020 did. With states and locked down economies starting to open up, and vaccinations on the rise, it seems the economy is one the verge of trying to get back on trend. We still need to recover many millions of jobs to recoup those lost during Coivd, but things are looking up in Q2. The economy could grow as much as 6-7% on an annualized rate, thanks to re-openings and stimulus. But its just that potential growth that has the bond market rattled.

Interest Rates and the Economy
Interest rates are like the heartbeat and pulse of the economy, they rise as activity picks up, and fall as the economy slows. If rates move up too much, or fall too far, it usually means something isn't right. For example, in the Fall of 2019 (before anyone had even heard of Covid-19) interest rates dropped precipitously, and coupled with something called a yield curve inversion, this drop in rates hinted at something very wrong—a prediction proven true by the recession of early 2020.

This time around it's the opposite, interest rates have risen along with economic activity, which is normal and healthy. However, the past few weeks have seen rates accelerate higher—over 50 basis points in 4 weeks. That is too fast a pace for the stock market's liking—and this has caused trouble for some stocks, primarily high-flying growth names like Tesla. The overall move has seen yields rise from 50 basis points to 1.6%, a move higher of over 1 full percentage point.

This rise in long-term rates has caused the second worst bear market in government bonds since WW2. And this rise has reverberations across the financial markets, from boosting mortgage costs to decreasing the valuation of stocks. When interest rates rise, the present value of the future growth potential from companies like Tesla falls, which is what is happening now.

When rates rise too much too fast—you get the very nasty correction that we are seeing across many growth stocks. Aforementioned Tesla dropped 40% from its peak, and many other growth stocks and sectors have dropped 20-30-40%. The good news is that relief is in sight for this beleaguered group.

The bond decline (and rise in interest rates) that precipitated this heartburn for growth stocks looks to be nearing its end. We see bonds as being close to their low, which should resolve itself this month. That forecast also dovetails with seasonal and historical tendencies, which show volatility into March but strength thereafter into the early summer months.

Market Outlook
It hasn't been all bad for stocks to start 2021, as areas that benefit from a reopening of the economy and anticipated economy growth—known as cyclical stocks– have done well. This includes travel, airline, transportation, hospitality, and energy stocks. These have been lagging groups that are finally getting their time in the sun.

We expect that to continue in Q2, although beaten down growth names should recover as well, as soon as bonds stabilize. We don't see yields rising

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much from here, and we expect to see stocks rally along with the economy in the second quarter. The Dow recently hit a new high on the strength of its cyclical components, we expect the other averages to hit record levels in the coming months as well.

We believe bonds are attractive at current yield levels, and we'll add to those holdings soon. We believe there is 5-10% further upside potential for stocks in the second quarter of 2021, which should be strong for both the economy and the stock

Market Charts (below)

The top chart shows the S&P 500 Index, as it rallied into February before correcting, weighed down by rising bond yields. The lower chart shows treasury bonds, and you can see the decline started long before the correction in stocks, back in the Fall of 2020, with stocks only paying attention recently. The point is the bond market decline looks about done, and once bonds firm up, stocks should rally.