Hamilton-Bates
Market Update

January 17, 2022

"Toto, we are not in Kansas anymore."
Dorothy, Wizard of Oz

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2021 ended with a relative whimper, a bullish whimper but a whimper none the less. A strong November saw the market decline in the first half of December; before rallying during the last week of the month and into the first couple days of the New Year. Technically, we did get the Santa Claus Rally, but he came late and left early, and the market has struggled ever since. The start of 2022 has seen a sharp shift in relative performance, as sharp declines for high multiple technology and growth issues were somewhat offset by strength in cyclical and value names. The choppy action to start the year has done little damage to the S&P, but the NASDAQ has had its worst start to a year since 2009. The DJIA has found support around 35,700, with S&P 500 support coming in at 4600. These levels have held twice so far and give hope for a bounce as traders return after the MLK holiday.

The Economy, Rates, and the Fed

The economy was still on a growth track as we ended 2021, but that track was begin to show signs of wobble as the unfolding of the Omicron wave, coupled with continued supply chain troubles threatened to put a lid on both growth and corporate earnings. We see growth settling in at around a 2% rate as the year progresses, which is ok but not great. On top of this, the market has to confront a Fed that is no longer providing constant stimulus. QE will stop in March and at some point those flows will reverse– taking liquidity from the market. Interest rates are also expected to rise beginning in March, with 3-4 hikes anticipated for 2022.

The market even now is grappling with the idea of the Fed stuck on a rate hike trajectory, even if it means a market decline. The 'Fed Put', which is the belief the Fed would come to the market's aid after even a mild 10% decline, may no longer be in effect. After 13 years of having the Fed and its extremely pro-growth policies at its back, the Fed's policies in 2022 will change. To paraphrase Dorothy in the Wizard of Oz—the market is no longer in Kansas anymore. The 'training wheels' so to speak are coming off. How well the market adjusts to this new Fed stance will determine the success (or failure) of the market for this year and beyond.

Market Outlook

The strength of the Santa Claus rally typically lasts throughout the month of January as new money flows tend to boost stocks to start the year. However, after such a string of solid years has we have had, its not unusually to see the market hit a bit of a wall as investors rotate into different sectors based on a changing economic outlook. That is what we believe we are seeing so far. We are seeing a very sudden and sharp rotation away from expensive growth stocks into value and cyclical names as investors are trying to anticipate future Fed moves. Rate increases favor financials along with energy and cyclicals—which get boosts from pricing power in this part of the cycle.

Investment Strategy

Investor fear and rotation out of growth may be getting too extreme, and we should see stabilization in the near future. While we expected 2022 to see an increase in volatility (which it has indeed), its too early to say this is the end of the bull. This could very well be just a mid-cycle correction and rotation to new names which will carry the load. This is normal. What we will be watching for are signs the January dip will be more lasting, which would include a sustained push below recent support levels, and tepid rally attempts. Furthermore we will be watching the bond market, where yields have risen sharply. A further spike in bond yields, after an already sharp move, would un-nerve investors. A flattening out of the move in yields would provide fundamental support for stocks to rebound.

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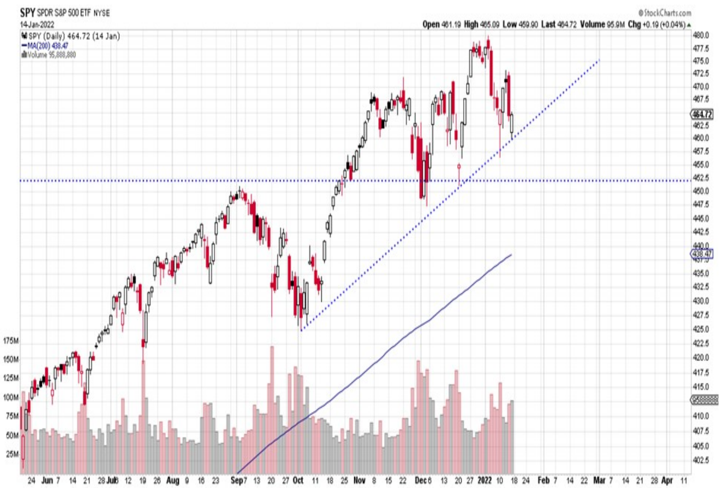
Summary
We will watch bonds for clues on the timing of purchases into equity market weakness. We believe 2022 can be a positive year for stocks, but there will be more peaks and valleys than investors are used to given the removal of Fed support. The bull isn't dead but there will be bumps in the road.

Market Charts

S&P 500
The S&P continued its march higher, but the move has become VERY choppy of late. So far support at the breakout above the prior high (shown by the horizontal blue line) has held twice. There is also a small stair-stepping trendline move in place (shown by the diagonal blue line). 4500 is the near-term line in the sand for the bulls. A move below which would open the door for a more protracted correction led by the weakness in growth names.



Interest Rates—10 Year Bond Yield
After being surprisingly tame given the inflation we are seeing yields finally re-acted as the year turned. 10-year yields spiked nearly half a percentage point in a short-period, and are now pushing right up to our 'concerned' and 'caution' levels noted months ago in a prior Update. A move above 1.8% would suggest the fear that the Fed has lost control of inflation and the bond market, creating even more volatility. Yields could even push above 2%, but if they do we believe this would be a brief move and worth buying.