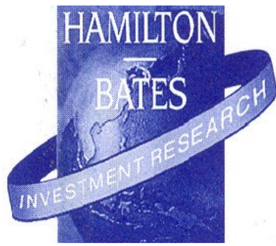

Hamilton-Bates Market Update

January 28, 2022

"After big declines come even bigger rallies."
AB

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Volatility Has Returned
The Fed announced its future policy changes last November; and after some brief consternation the market went about its business and rallied into Year End. However, barely had the New Year turned investors began clamoring for the exits as if the upcoming policy changes were a shock. Since the first week of January we have seen an unprecedented move away from Growth stocks and into Value and defensive names. This move has picked up steam as the month has progressed, and market volatility has skyrocketed. Each day this week has seen a market move of 600 points or more intraday.

What Is Going On?
Its all about the Fed. After 13 years of constant monetary support to stocks that policy is ending in 2022. By March the Fed's purchases of bonds will end, removing a constant flow of funds that has been supporting the market for over a decade. In essence the 'training wheels are coming off'. We expected 2022 to see an increase in volatility, but the speed of the market's move this month is pretty amazing. Nearly all at once investors are moving from growth stocks that benefitted from the Fed into value stocks that have been unloved an overlooked since 2008. Its been a monumental and financial markets shaking type of move. Its as if a decades worth of rebalancing is occurring in one month. So OUT are expensive, overvalued companies with no earnings. IN are steady, stable businesses that in most cases pay solid dividends. Former high fliers like Peloton are getting crushed in favor of boring banks and insurance companies with attractive dividends.

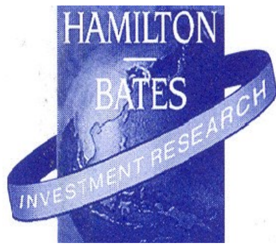
Fortunately for us the latter has been the type of companies and funds we tend to own. Blue-Chip, dividend paying names, value funds, and growth-income funds have been a stable for our portfolios. It hasn't eliminated portfolio volatility in the worst month since the heart of the Covid crisis in 2020, but it has helped cut drawdowns significantly.

The Economy, Rates, and the Fed
<u>All of this market volatility is being driven by the bond market, which came out of the gate in 2022 ripping rates higher</u>. Part of this is being driven by Fed funds expectations, as the Fed is now expected to hike four times this year, along with the end of QE by March.

GDP growth for 2021 came in at the strong level in decades. The economy is strong and expected to remain so. Unfortunately so has inflation. The tremendous fiscal handouts coupled with supply chain disruptions caused supply to drop while demand remained high. Thus we have inflation pushing prices up. Sadly, inflation has remained high as have energy prices. Under this framework, it would seem that interest rates are probably going higher. Market participants are probably pricing in too many hikes.

The important thing to understand about the bond market is that since it's been starved for yield for so long, a 2% yield will look really attractive to some people, and corporate yields will be higher. You can bet people will pile into bonds at that level. We expect that to be the case. <u>The current rise in bond yields that is spooking the stock market is making both bonds and stocks more attractive</u>. <u>The trick will be in the timing</u>.

What are Interest Rates?
So, what is an interest rate? An interest rate is a price, like the price of a coke. But it is the price at which you can borrow or lend money. **And it is the most important price in the entire economy.** The level of interest rates directly affect the price of everything else—especially things that need to be financed like homes and cars. Interest rates are the base of the economic food chain that can drive the cost of nearly everything we buy and consume. They also affect



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the value of financial assets and market prices. When rates go down—prices of financial assets go up. When they rise-financial assets and real estate often go down.

That is the dilemma the market is battling right now—after a decade of low rates and no hikes; the financial markets are facing the first series of rate hikes in a long time. A market that has been used to Wild Turkey is going to have to go Cold Turkey. And that adjustment has been painful. As long as rates do not move up too quickly in the bond market, investors and markets will adjust to the new reality, we'll just have to get through this current bout of financial market rotation.

Market Outlook
For the U.S. stock market, **January 2022** is turning out to be the second worst-performing January in 42 years. Whether the weak performance portends a negative full year for the market likely depends on whether the U.S. economy slips into recession, and this, in turn, depends on Federal Reserve policy. Right now investors seem to be panicking as if the Fed will make a policy mistake and tip the economy into recession– we are not so sure about that. That seems a bit premature. We watch the bond market for clues of future economic activity, and while the yield curve has flattened, the typical flattening and yield curve inversion (where long-term rates are lower than short-term rates) is not close to occurring. We believe that fears of an immediate recession are overblown right now.

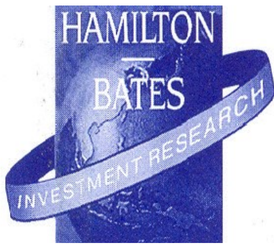
That said, the stock market averages have put in technical reversals on their monthly charts, and all four key indexes have broken key support levels that we monitor. Until we see stabilization and recovery of those levels, current volatility will remain.

Investment Strategy
Our portfolios are generally diversified, holdings a mix of equity, bonds, real-estate and cash. The last three components have helped this month, even though bonds have declined as well—just much less than stocks. Our equity holdings have always focused on Blue-Chips, we favor companies that make real things and make money doing it. Dividends are an investors best friend.

The majority of our equity holdings are in top names with rock solid balance sheets, even in the technology sector. Amazon, Apple, Microsoft, and Google, all have the cash and ability to withstand any market turbulence. These are attractive right now and we are buying, along with some key names in the semiconductor sector like NVDA. All these names have resiliency in their product and service demand. Other sectors like financial services, banks, insurance and consumer staples have also held up, and most of these companies also pay healthy dividends.

In terms of fund holdings, the types of companies that we like and that have held up well can be found in value, dividend income, equity-income, and allocation funds; all core holdings in our portfolios right now. These, along with bonds and cash, have allowed our portfolios to fare much better than the bear market declines in the NASDAQ and Small-cap Indexes. Speaking of cash, cash has been increased earlier this month as the market started to stumble. We'll sit on it, along with our bond holdings—until we believe the worst of the current market adjustment has passed. And it will pass, we just have to be patient and wait for our indicators to line up.

While market adjustments and corrections are never enjoyable, keep in mind that after every correction is an even bigger rally.



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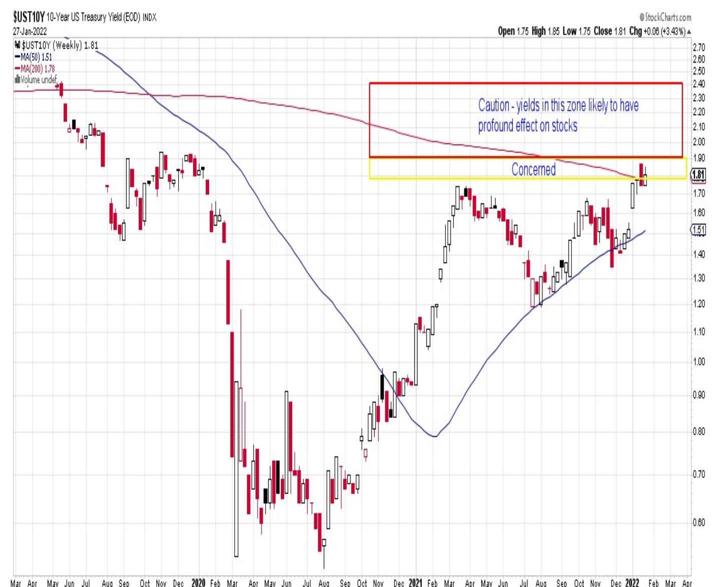
Market Charts

S&P 500

After nearly two years of rising markets following the 2020 Covid shutdown, the financial markets are suffering their worst decline in the 'post-Covid' era. So far the decline looks like a 'little blip' on the monthly chart at right, but it has been painful none the less. The problem is the S&P has broken key support around the 4300-4400 level on the monthly chart. That move puts us on a slightly more
defensive footing. Until that level is recaptured it remains susceptible to further volatility.

Interest Rates—10 Year Bond Yield

Here is the culprit for all the trouble, the rise in the 10-year yield. Its been a quick move in 2022, a jump of 40 basis points in 8 weeks. This has pushed yields above the prior 2021 highs and firmly into levels we previously identified as troublesome for stocks. Right now yields are around 1.80%, and this has given stocks fits. If yields move toward 2.0%, and they could—volatility and weakness in growth stocks will continue—and pressure the markets. **We don't believe yields will rise much above 2.0%, and believe such a move will make bonds attractive to ourselves and other investors– helping to stabilize rates. Bonds are setting up for an attractive BUY, as are stocks.**



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