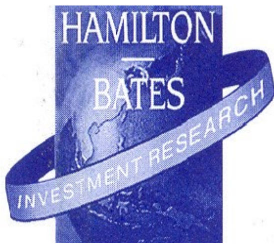


Hamilton-Bates Market Update

July 7, 2022

Good Bye and Good Riddance to Q2. Stock Market Posts Worst 1st Half Since 1970. What is Next?

P.O. BOX 98 Mertztown, PA 19539 877.768.4247 www.hbir.com

Stocks recently closed the second quarter and first half of the year on a sour note. For the quarter, stocks fell 10 out of 12 weeks. It doesn't get much worse than that. Q2 was the worst quarter since the brunt of the pandemic in 2020, and the first half of 2022 was the worst for stocks since 1970. The S&P ended Q2 down 21.5%, and the NASDAQ 100 was down 30%.

Rising inflation has been behind much of the slump for the broader market this year as businesses raise prices on everything from food to clothing and consumers are squeezed tighter. The Fed has started hiking rates, but so far inflation remains stubbornly hot. A measure of inflation that is closely tracked by the Federal Reserve rose 6.3% in May from a year earlier, unchanged from its level in April. We are also seeing some affect on sentiment, as high energy and good prices suck the optimism from the US consumer. Consumer confidence slipped to its lowest level in 16 months. Investors are worried that the U.S. could slip into a recession as inflation hurts businesses and consumers. A key concern involves the Fed's interest rate hikes, which could slam the brakes on economic growth too much and actually bring on a recession.

The Economy, Earnings, Rates, and the Fed

The U.S. economy shrank 1.6% in the first quarter and weak consumer spending was a key part of that contraction. The economy had been chugging along fairly well until June, which has seen the economy hit a proverbial iceberg. Real-time data suggest the economy could post negative growth in Q2 as well—the technical definition of a recession. But with inflation remaining stubbornly high—the Fed is still forced to combat this foe with at least one more rate hike this month.

The combination of inflation and rate hikes has pressured the financial markets that have been used to a friendly Fed that had been supportive and stimulative for over a decade! With the Fed forced to hike and unable to pause until inflation is tamed—Treasury Bonds have posted their worst first half since 1788 based on estimated from Deutsche Bank. That is not typo! Down 11% on the year bonds have been little help so far in 2022.

The good news is, and there is some good news, is that the bond market looks like it has finally stabilized, with prices firming and bond yields coming down a bit. This has helped mortgage rates pull back from the 6%+ level, and allowed stocks to finally stabilize with the pressure of rising rates abating for now. The problem and the fear of course, is that bonds yields are falling because a recession is imminent.

We really are in uncharted territory, as the economy is indeed showing signs of slowing, but employment remains strong. Jobs are plentiful and unemployment is low. If the labor market holds strong in the face of slowing growth, we could avoid recession (or at least a bad one), and this in turn could help stocks avoid a brutal decline in earnings. If that is the case, the market could be very near an important low already. In our opinion the labor market is the point on which the economy and market will turn.

The Fed is likely to hike rates again this month, possibly by 75 basis points. Given that many commodities including oil have now declined significantly—this may give the Fed to pause its hike cycle after this month's move. So if inflation is finally moderating it may allow the Fed to become less aggressive on rates and give the market further room to stabilize and rally.

Investment Strategy

For much of 2022 we have been tightening up our portfolio holdings, owning just the funds and individual stock names we had the highest conviction on. We still have not started to

commit significant new cash into the market, even though we expect a relief rally in coming weeks. The reason is that we believe it is still too early to declare any 'all clear', which will only come as we discern the nature of what is happening in the labor market. As we get clarity there, it will allow us to flesh out our expectations for the economy and earnings—and get a better feel for where stocks could bottom.

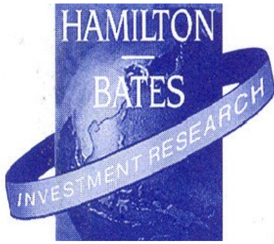
We still prefer investing in companies that are reasonably priced, pay dividends, and have a solid balance sheet and cash- flow. These company's are more resistant to liquidity downturns, and have the wherewithal to withstand a tough environment. Thus these companies can handle economic weakness.

This means in terms of mutual funds we like- **Growth-Income**, **Equity Income**, and **Balanced Funds**. When it comes to individual stocks, for those accounts that own them, the type of companies we are focus on are leaders now and likely to remain leaders five years from now. Apple, Home Depot, Johnson & Johnson, Pfizer, Lilly, Amgen, Abbvie, Microsoft, Chevron are examples of the types of companies we want to own, and are the types of companies we want to see inside the funds we own. These companies are worth owning now and into the future.

We mentioned previously that 2022 has seen the worst first half of a year since 1970, and the worst first half of a year for bonds in like forever (or at least since 1788). That is a lot of pain for the financial markets. The good news is that if we can avoid a recession, a lot of the damage has been down and stocks are likely to bottom and rally over the next few months. Furthermore, a bad 1st half has seen stocks gain 5%+ on average in the second half, and the 4Q in mid-term election years have been very strong. We believe there is double digit upside into year end, and if the market weakens any further from its recent lows, it would definitely be a time to begin adding to positions. If we have a recession, it will be an odd sort of recession. First of all, nobody is losing their jobs; the labor market is quite strong. There are still two job openings for every applicant. I think this is a function of the lagged effects of the pandemic spending, and it will return to normal over time. But right now, we have leading indicators, slowing while the job market is still pretty strong.

The Fed is still fighting inflation but will likely pause after the next hike or so. If inflation does moderate we believe stocks will rally significantly. While we believe it is still too early to come out of a defensive stance, its not too early to start planning and grabbing select long opportunities as prices dictate. Arguably, now is the time to plan on getting long stocks. Remember, the stock market follows liquidity, and if rate hikes are peaking or in the process of peaking, buying stocks becomes a much better risk-reward. 2022 has been a painful year so far, we believe that we are nearing the end of that pain. At times like this keep in mind that after big declines come bigger rallies. It sounds like a silly market trope, but its true and for long-term investors is very important to keep in mind. Declines are opportunity for the disciplined.

Editor's Note : As always, if anyone reading this has specific concerns about the market, inflation, and their portfolio—please contact us.



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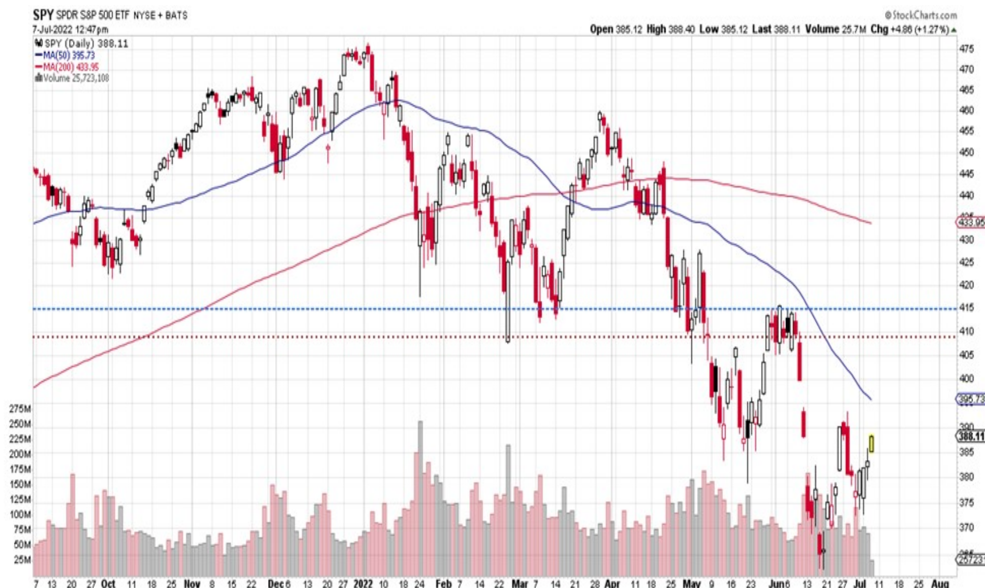
Market Charts

Bond Yields (Top)
Finally it looks as though the relentless trend of rising yields has been broken—at least for now. The 10-year yield has dropped over 60bp from 3.4% to 2.8%, allowing mortgage rates to come down and taking some pressure off of stocks. Bond yields moderating is key stocks having a good chance to rally.

S&P 500 (Bottom)
The correction got Underway pretty much right out of the gate in 2022, and ended the second quarter with the S&P down 21%. With yields finally starting to come down, the stock market has been able to stabilize in early July. We believe July and Aug should see strength in stocks, with the S&P likely to rise toward the 4000 level and possibly above.



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