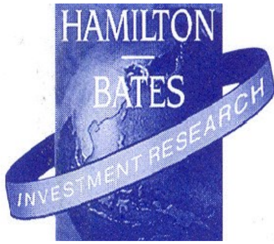

Hamilton-Bates
Market Update

August 19, 2022

Rebound Comes As Expected
Stalls at Key Level
Next Few Weeks Will Set Up Q4

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The Summer Has Been Hot & So Has Mr. Market
Market bulls have been on an historic roll since the mid-June lows. The market was **extremely oversold** and sentiment was terrible at that time. Everyone was positioned bearishly so conditions were ripe for a face ripping rally and that is exactly what happened. All it took was a slight downtick in inflation, which saw more traders bet on a taming of future inflation and a less aggressive Fed. The S&P 500 is up roughly 17% since June 16, in the wake of a growing belief the Federal Reserve will ease its pace of rate hikes. Whether inflation is tamed or not, will likely direct the course of trading into year-end.

The Economy, Earnings, Rates, and the Fed
US GDP has registered 2 consecutive quarters of negative growth. In my 30 year career this has been defined as a recession. Suddenly whether we are in a recession or not is a debate. Honestly is really doesn't matter. The economy is indeed slowing, that much is clear. Its in GDP, its in sentiment, and its in regional and national PMI services and manufacturing reports.

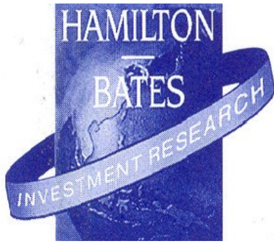
On the positive side, the labor market remains quite strong, suggesting anyone that wants a job can get one. It is pretty hard to have a deep or lasting recession without a contraction in the job market. That said, labor is a lagging indicator and job losses may be ahead, but so far there hasn't been a sign of that. We will keep on the lookout for this in particular. Notably we could even see a bump in economic activity given the back to school season and the year-end Holiday period.

We do think any market expectation of a rate CUT are very premature. There is still inflation, and European inflation is running amok. The Fed is still likely to continue its hiking cycle into early 2023, especially now that the stock market has rebounded so well. While the market has rallied on a less aggressive Fed, the markets move only gives the Fed more leeway for hikes!

The Fed is now trying to thread the needle, hike enough to tamp down inflation without sending the economy into a recession. The market is acting as if this has been accomplished but the Fed's track record for doing this isn't so good. The reason is the big lag between rate hikes and its effects on the economy. As the Fed continues to hike rates, each hike takes roughly 9-months to work its way through the economic system. Therefore, the rate hikes from March 2020 won't show up in the economic data until December.

Likewise, the Fed's subsequent and more aggressive rate hikes won't be fully reflected in the economic data until early to mid-2023. As the Fed hikes at subsequent meetings, those hikes will continue to compound their effect on a highly leveraged consumer with little savings through higher living costs. Real-time economic data suggests the economy is moving from economic slowdown toward recession. The signals are becoming clearer from inverted yield curves to the 6-month rate of change of the Leading Economic Index (not shown). The media and the White House may proclaim victory by stating the first two quarters of 2022 were not a recession, but only an economic slowdown. However, given the lag effect of changes to the money supply and higher interest rates, indicators are pretty clear recession risk is growing for 2023. Its possible we can avoid a tough recession, but it is still too early to tell, or for anyone to make victory laps and say the coast is clear.

Investment Strategy
What a wild year. We had thought coming into 2023 that bonds would struggle, and that stocks would weaken mid-year after some 1Q gains and end up anywhere from modest losses to modest gains. The market threw up on that plan right away, by dropping out of the gate as investors raced ahead of the Fed's tightening. The stock market dropped over 25% in the first two quarters as investors priced in a severe economic slowdown. That hasn't materialized and bearish investors have been caught offside and stocks levitated as shorts covered and hedge funds got long again. Absent an immediate recession, Q4 should end favorably, but after a big run the market is due for a rest. We'll gauge the next few critical weeks for signs regarding the outlook into year-end. For now we'll stay nimble and lighten up if needed, or even add if we get those 'all clear' signals.



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Market Charts

Bond Yields (Top)
A slight down-tick in inflation was all it took to send bond yields falling (blue arrow in chart), giving room for risk assets like stocks and crypto to rise. As long as yields stay below 3.0% the bond market wont be exerting negative pressure on stocks.

S&P 500 (Bottom)
After two down quarters in a row, we expected Q3 to see a rebound but even we have been pleasantly surprised at its strength. The big move from the lows simply reflects a market that was priced for an immediate severe contraction that simply isn't there (yet). So far the market rebounded to a key average and stopped. If it can move up from here the bulls will be back in charge!

Disclosures:
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