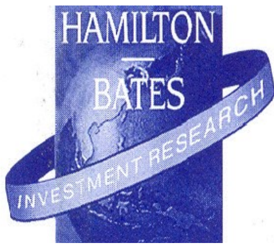

Hamilton-Bates Market Update

October 14, 2022

There is Light at the End of the Tunnel and Its Not a Train

The Seeds of the Next Bull are Being Sown

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Market volatility in 2022 has been relentless. Inflation, and the Fed's desire to combat it, has been THE story of the year for the financial markets. In September, the S&P 500 posted its biggest one-month decline since March 2020. The catalyst for this volatility has been the recent move in interest rates. The 10-year Treasury note yield last week reached 4% for the first time in more than a decade. Since then it has dropped to 3.60% and then moved back up to 4% as this is being written. Those moves come as recession fears linger, thanks in part to strong inflationary pressures, and higher rates from the Federal Reserve. The financial markets continue to be hit by the crosswinds of inflation and a potential recession.

That said, the bigger picture is starting to tilt favorably for the bulls, and we will cover that in this Update. The outlook for 1-year or more out for stocks and bonds starts to look pretty good.

The Fed, the Economy, and Interest Rates

In the last Update everyone was thinking about the Fed Pivot—or lack of one. When or if the Fed would pivot away from rate hikes which would in turn take the pressure off of stocks and let the market bounce.

This past week that noise got even louder as another hot CPI print and the release of the last FMOC minutes seemed to push any idea of a PIVOT way off. At this point, the Fed looks determined to over-tighten rather than under-tighten. Unemployment sits at multi-decade lows. The job market remains strong and as long as it does it gives the Fed cover to keep hiking rates. On this flipside investors remain worried about a recession. The fear is that the Fed will hike too much and push the economy into a recession if we are not there already. GDP growth has been negative 2 quarters in a row and the current quarter is trending at a small gain. Earnings have started to come down but overall have done better than one might expect given the inflation bottlenecks energy hurdles the economy has had to deal with.

The Fed may continue to hike the economy into a recession, but the minute they signal a pivot—stocks will explode higher. Investor positioning is negative and investor sentiment is very bearish. Clearly the negatives are all out there and well-covered by the financial media. We have found that during such periods, and in such cases—maximum pessimism and bearishness comes right near the lows.

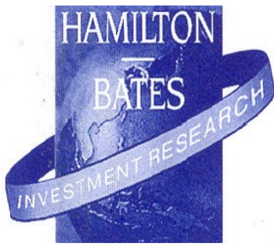
The Stock Market During a Recession

The average decline for stocks during a recession since World War II has been 31%. The duration has been about 13 months. At this week's lows we were 11 months into a decline of 27% on the S&P 500. That is a lot of negative news ALREADY priced in. The market low may not be right here right now—but it might not be very far away either. We believe the bear market low will be in this quarter or possibly Q1 2023. The market will likely bottom before the economy turns up.

The average return following a recession have been for a gain of 20% in the S&P in the year following a recession. With total gains of 50% by year 3 and 100% with 5 years of a recession based on the S&P 500. The turmoil of recession leads to big gains in subsequent years. Our goal is to get through the last bits of market volatility so that assets can be positioned for what we know will be great gains once the bear is over.

Stock Market Outlook and Investment Strategy

Everyone knows the stock market has struggled in 2022. Almost under the radar bonds have as well. 2022 is the worst year for bonds ever. Most bond indexes are down 20% or even more. That type of decline is almost unheard of for bonds.



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But that is what happens when the Fed starts hiking sharply after keeping rates at zero for a decade. Normally, bonds rise in price when stocks fall, acting as a stabilizer for a balanced portfolio. Not so in 2022. That has made this year even trickier than usual and one of the most challenging of our 30 year career.

We were underweight bonds coming into 2022, and have favored cash over bonds for defensive positions. That has worked out well so far. Municipal bonds are the only bond category that we favor right now. We believe tax-free bonds are very attractive at current yield levels for investors who need tax-free income.

We remain defensively positioned for client accounts, holding large cash positions in lieu of bonds, and with defensive positioning in our stock holdings. We own large-cap, cash rich, dividend paying companies (and funds that own these type of companies) in our stock holdings.

We will continue to remain defensive until the weight of our models tells us that the market tide has shifted, but while overall bearishness seems to be hitting a crescendo—we believe its important to remain grounded and remember that what comes next—after this bear market—is the next bull market. Its not time to think about what to sell, but what to buy when the turn comes.

Market Charts

S&P 500

The S&P 500 is trying to hold the lows around the levels made in June. In addition to that level, which is around 3600, there is the proximity of the 200-week moving average (red line in chart) at 3500, which stopped declines in 2016 and 2018 (although 2020 saw a brief dip below). The market bounced from this key average at this week's lows. As long as this level not broken, we could see a surprisingly strong rally or rallies in Q4. If we are not at the market lows, we believe we are 2/3 or 3/4 of the way there.

Disclosures:
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