Hamilton-Bates

Market Update

August 29, 2016

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"Its Quiet Out There…Too Quiet"

The above is a line heard in many a movie, usually of the war or western genre , where the characters note the unnatural stillness of their surroundings. Shortly thereafter something dramatic ensues. That quote seems to be appropriate for the market right now, as the 'dog days' of summer have seen an historic collapse in volatility. The trading range of the S&P dropped to less than 1% over a 30 day period at one point. That pushed seasonal volatility to levels not seen in 20 years. But as life often imitates art, such extreme stillness is usually followed by something dramatic; the only question for us what direction that dramatic move will be.

Volatility and volume should soon pick up after Labor Day, and the markets could soon move quickly and away from their narrow range. The recent breakout above 2130 on the S&P coupled with a new high in the Advance-Decline line tell us the move could and should be higher. The Fed keeps talking up rates which creates uncertainty, but we wonder if they have the guts to back the bluster. For now they seem to find it easier to talk about rates rather than hike.

One scenario to be wary of would be for a rally after Labor day that takes the market nicely higher, making the Fed feel comfortable enough to hike a 1/4 point next month in something of a surprise move. Wall St things they Fed would never dare 'surprise' them, so this would cause a big increase in Sept/Oct volatility. If the market rallies over the next three weeks and the economic data is better than it has been, we'll need to watch out for a Fed curveball at their September FMOC meeting.

Bullishly, beneath the surface it appears that the market is making a rotational shift from defensive sectors to growth oriented sectors such as technology and finance. While the recent strength in banks could signal a possible hike, it also suggests a severe decline isn't likely. If it were, banks would most likely be falling as they were in 2007-2008. For now the up trend is intact and still favors the bulls, even as fundamental factors such as the economy and earnings continue to lag badly.

Earnings, Interest Rates, & the Economy

Fundamentals do matter though, and what we continue to see now is a dramatic deviation from what is happening and what was expected to happen. A suspect jobs report has been followed by weak Regional Fed Surveys from the Richmond and Dallas Regions, and GDP expectations are in the area of 2%.

We were supposed to be seeing a full blown recovery right now on the idea that QE would create a successful and sustainable economy. But in 2014, the trend in earnings deviated sharply. What was supposed to be $145 in 2015 S&P 500 trailing 12-month earnings turned out to be about $87—a near 50% deviation miss to the downside. That is a big spread between what was expected to happen and what did happen. In the past, such earnings slides were followed by stock market declines. So far we have seen only a couple quick dips. This outright drop in earnings since 2014, now a two-year earnings recession, has caused P/E valuations to reach levels seen only just before 1929 and during the 1999 Tech Bubble peak.

The stock market usually follows the long-term trend of earnings, as can be seen on the chart on the next page. The Blue line is trailing earnings and the Green line is the S&P 500. Through the Great Recession and beyond they generally moved together—until 2014. Since that time earnings have steadily declined. The

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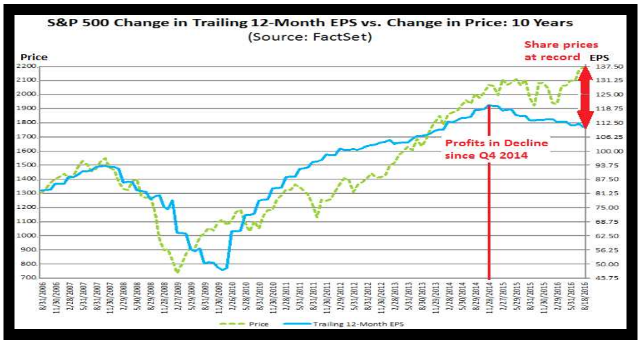

stock market has had two significant breaks, but recovered quickly due to Central Bank intervention. A market moving up while earnings trend lower is highly unnatural and atypical.

Stock market aside, the economy itself is not getting better, and certainly not at a pace that would generate a return to earnings growth. Economists and analysts have been expecting earnings to recover, but they don't, and this has happened for two years and we are yet to see an earnings recovery. At some point, if earnings don't improve, market participants will realize recovery isn't just around the corner.

Market Outlook

Last week the vocal aggressiveness of the hawks on the FOMC caused a bit of volatility on Friday. The Fed finds it easier to scare the market on rates than to actually move. Last week we heard that the Fed, or at least Vice-Fed Governor Fisher, is talking seriously about two rate hikes this year. Considering how much the market has risen largely due to very low interest rates, he can't simply be ignored. Even if we completely disagree with his assessment (and we do), Fisher seems now to have gathered support in the FOMC while at the same time, doves like Chairwoman Yellen appear increasingly quiet. Talk of rate hikes has seen the Utilities sector break their short-term uptrend and generally look vulnerable. Government bonds and tax-free bonds have pulled back in sympathy but only just modestly. High-yield and most corporate bonds, along with preferred stocks, continue to act very well as investors continue to search voraciously for yield. We still favor fixed income, and believe rate hike talk, or even one hike, will quickly be overcome by the reality of a weak economy. The Fed will find it tough to hike while the whole world cuts rates.

One problem for Wall Street and for investors listening to Wall Street, is that the Central Banks have created a belief once again that they will *always* bail them out. No matter what. And no matter what the cost to the real economy. This has led to investors taking more and more risk as rates have fallen in search of yield. Way back in the 1990's there was the 'Greenspan put', a feeling that he would cut rates if anything bad happened and stocks would rise no matter what. This 'Greenspan put' led to the tech bubble, when stocks crashed in a dizzying manner. This gave rise to the 'Bernanke put' in the mid-2000's that included QE and zero-interest-rate policies. Since then, every time stocks or bonds hiccupped at all, central banks around the world stepped in to rectify the situation with policies that make little rational sense in a 'free market'. Now much of the sovereign bond market has negative interest rates.

Fundamentally markets are more precarious than ever, with nose bleed valuations and an historic debt overhang, along with an earnings recession. Sure the central banks are all in on boosting asset prices to make things seem great and encourage spending. This could continue for some time. <u>But consider this: stocks crashed twice since 2000, despite the Central Banks' efforts and the so called Fed puts. Why? Because reality eventually catches up</u>.

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In an environment of high P/E's and weak earnings, aggressive over-reaching in an aged and stretched bull market isn't good investment sense. Balanced portfolios with an eye on risk management should reality catch up to the Fed is prudent for investor assets right now.

Investment Strategy

The 'breakout' by the market above its 2015 highs has not generated much enthusiasm, as yesterday's rally saw the lowest volume of the year. Clearly vacation season is part of this, and we look for more volume next week. and above the trading range it has been in for over a year. If the current breakout holds, and investors come back from vacation in a confident frame of mind we could see stocks rally another 5-10% before year-end. We are also seeing improvement in the technology and financial sectors, which could be getting ready to assume the leadership mantle. If so, it would have additional bullish implications for the market.

In the current environment our work continues to favor fixed income balanced with equity positions expected to do well should the market advance in coming weeks. We have added positions in more growth oriented areas like technology and even small-caps, as relative strength there has improved markedly.

Here is a listing of our **Portfolios** and where they stand.

MPT Aggressive
67.5% Equity / 32.5% Bonds & Cash

MPT Moderate
45% Equity / 55% Bonds & Cash

MPT Conservative
42.5% Equity / 57.5% Bonds & Cash

MAC Growth
80% Cash / 20% Cash

SECTORS
80% Equity / 20% Cash

Separate Accounts
70% Equity / 30% Bonds/Cash

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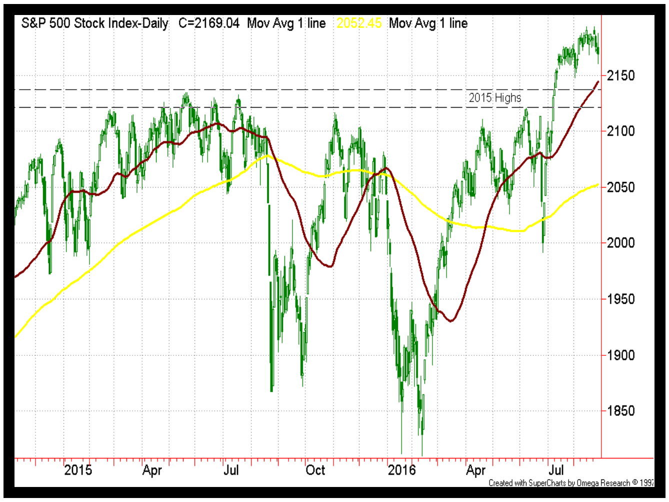
Market Charts—Market Trying to Build on Breakout



S&P Breakout (Above Left)
The S&P has moved sideways over the past three weeks now, but remains above the 2015 highs noted in the chart above. We continue to expect support around that breakout point and the 50-day average to hold. Anything more than an intra-day dip below the 50-day average would be a concern.

Long-Term S&P 500—Trying For Open Space (Above Right)
For much of 2015 and 2016 the S&P 500 has been stuck, going nowhere, as shown by the dashed lines in the chart above. But we are now seeing the S&P trying to break above the top end of that range. If we can see the market hold above the top level, around 2130, we could see money come pouring into US stocks pushing the S&P to 2300-2400 before year end. A Fed hike may help push foreign money into our market as a hike would strengthen the dollar.

As long as 2130 holds the charts favor the bulls. The key levels are 2130 and 2060.