HAMILTON
CAPITAL MANAGEMENT
Future In Sight™

capital markets review

Fall 2017

Economic Outlook

Despacito (Slowly)

Executive Summary

With sympathy for our fellow citizens in Puerto Rico, we decided to use part of the island's musical popular culture in the title of our commentary, especially since it serves our outlook rather well.

One of the hallmarks of this recovery has been its apparent lethargy. Comparisons to historical rebounds by some have it coming up short, even as it's cut unemployment to very low levels and is approaching record durability.

In the context of possible tax cuts from this Congress, recently some signs (perhaps more hope than evidence) have emerged that hint at greater strength. But we think it's also noteworthy to point to an apparent slowing in consumer spending – with an outright contraction in autos – and an easing in housing growth as possible harbingers of things to come.

We think this turn could take several quarters. But, in the context of growing evidence of a policy "tightening" of our borders, this slow slowing has our full attention.

So, has one more quarter of economic data shed any light on whether things are looking up or down?

You won't be stunned to hear that the latest data is mixed, and has not materially altered the economic landscape in the U.S. – at least not convincingly and permanently. But there are some hints worthy of note. Outside our borders, the news is largely positive, which, not coincidentally, is occurring in the aftermath of a rather uniform and meaningful dose of monetary easing.

Monetary policy really is a reliable causal factor nearly everywhere, and we're seeing firsthand and in real time how it can impact economic fortunes.

"Some hints worthy of note." OK, we'll bite. Tell us all about that.

You know, consistency is usually a virtue. But when we play tennis and consistently hit the ball into the net, it doesn't feel so rewarding. Similarly, the most recent U.S. economic releases remain consistently mixed. But seldom dull.

On the positive side of the ledger, we've seen some factors actually strengthen. These include the Leading Economic Indicators series, the Chicago Fed's National Index and several surveys of business purchasing managers. They aren't enough to persuade us to expect stronger growth to emerge. But they also suggest that we aren't on the edge of recession – not for a little while, anyway.

OK, hold it right there. Couldn't we just leave it there and focus on the positives?

Continued on back

The Interviewees

Matt Hamilton, CFP®
Chairman
& CEO

Tony Caxide, CFA®
Chief Investment
Officer

Srinath Sampath, CFA®
Managing Director
Portfolio Management

The content in this issue of *Capital Markets Review* was taken from an interview with Hamilton Capital Management Chairman & CEO Matt Hamilton, CIO Tony Caxide and Managing Director, Portfolio Management, Srinath Sampath shortly after the end of the third quarter of 2017.

Equity Portfolios

Restraint Today May Avoid The Morn's Headache

Executive Summary

Equity markets have remained robust, both in the U.S. and abroad.

Outside our borders most central banks have maintained low interest rates, which support both earnings growth and the multiples that equity investors apply to those cash flows. Further, fiscal policy – or various governments' net budget positions – has also moved away from a restrictive posture that previously hindered growth. Finally, the large negative impact of collapsing commodity prices is behind us, for the time being.

At home the Fed is moving to reduce liquidity, but the impact is gradual and, while economy-wide profits have barely grown, earnings-per-share are stronger as companies have bought back shares.

Thus, even as most acknowledge that equity valuations are, in some markets, relatively rich (or, simply said, prices are high), investors see mostly unattractive alternatives. Further, few have the courage to opt for "cash" holdings because of the yield give-up, so stocks can be viewed as the cleanest dirty shirt by some, and occasionally with enthusiasm by others (typically those with high hopes for tax reform, tax cuts or other business-supportive government action).

We view cash as just another arrow in investors' quiver – the one that happens to have negligible uncertainty and very low risk of losing money, with positive, if also low, returns. But we also feel that if prices are high, a little temperance today could go a long way in softening tomorrow's regrets.

Another quarter and another good performance, we gather?

Yes, indeed. The screens remain filled with green and, as Oliver Stone's Gordon Gekko told us, green is good (with a little word tweak!). Both in the U.S. and abroad, equity markets have done well, in some instances very well, including emerging markets, Europe and Japan. Even the UK has withstood shakier demand and many cartoonish steps by Prime Minister May's government with its Brexit process.

What's behind that robust outcome?

The most immediate answer is that earnings look OK in some places, and outright strong in others, especially outside the U.S. And, there, this growth could be sustained.

The reason we would give most weight to this is low interest rates. Although the U.S. Fed stands out with its bias toward gradually tighter monetary policy, most other central banks fall decidedly in the "loose" camp. This plentiful liquidity is true in both developed and emerging economies.

Further, we've also seen two other factors become supportive.

Fiscal policy, or the impact of net government spending, was a negative for quite some time. Recently, things have eased up, as the need for never-ending deficit reduction has been softened or outright reversed (like in the U.S.). Similarly, commodities' collapse a couple of years back trounced many companies and measurably hurt pricing power (temporarily lowering inflation) and profit margins for important sectors of the economy. But commodity prices have rebounded somewhat from much lower levels. This helps energy- and materials-sector firms that simultaneously had sharply cut back their costs, and lower commodity prices now support many other industries.

That seems to be a powerful combination. Isn't it also true that other asset classes aren't exactly offering abundant opportunities?

It's very true, and works in several ways.

Low interest rates help stocks beyond the support they lend to earnings growth. Low rates also present investors with a simple trade-off – they can buy bonds at unappealingly low yields, or buy stocks which could offer the hope of higher total returns. And, further, when interest rates are low, they help the math for stock valuations. Stock prices are really the value today of a stream of future earnings (or cash flows). One has to discount that future stream at some interest rate to calculate its present value. The lower the interest rate, the higher the present value for earnings, holding everything else constant. We often describe this in terms of the "P/E" or Price/Earnings ratio.

So buying stocks can be something of a default decision?

At times, yes. Witness the stock market's imperviousness to a broad range of "tremors", from multiple hurricanes to ballistic missile launches and hydrogen bomb detonations in North Korea, nationalistic political shifts and steps toward independence by secessionist "tribes" (e.g., Kurdistan, Catalunya, Scotland, even the UK itself) that risk the fragmentation of nations or unions, and, effectively, legislative paralysis in Washington (and elsewhere).

So, to generate any kind of return, investors can opt for, say, very low-yielding bonds; 100-year bonds from borrowers that defaulted several times in recent decades (e.g., Argentina); or buying stocks, though expensive (as they are in some markets, by most standards) and in a setting of higher leverage, since they're viewed as the cleanest dirty shirt in the basket in a setting where investors feel they must stay invested.

What do you mean "…must stay invested?" Why that pressure?

Hmmm, what a terrific question.

Well, history shows that, with perfect hindsight, sometimes one should just go fishing, get out of "risk assets" (like stocks, or high-yield bonds) and put all of one's chips on "cash" (e.g., money market funds or Treasury bills). But it's exceedingly difficult to time the exact moment, and it turns out it's a very difficult step for investors, so this works less well in the real world.

Though high-quality cash is a perfectly reasonable alternative asset class – one with high certainty, low risk, and positive, if low returns – there are many factors that lead investors to give it a wide berth, often just when they should award it the most consideration. This arises both from self-imposed standards as well as, sometimes, client pressure.

We agree that very low positive returns are hard to accept in an environment where many assets have produced strong past outcomes. But we try to look forward and move gradually and deliberately since we're wired to be disciplined and patient. We also feel that, when offered expensive assets, that a little temperance can go a long way in avoiding hangovers. And, as it turns out, this approach is consistent with the findings of the latest winner of the Nobel Prize in economics – that people particularly hate to lose something that they already have!

Fixed Income Portfolios

Quantitative Tightening In An Era Of Moderate Inflation

Executive Summary

The Fed is progressing deliberately through the early stages of quantitative tightening, with four interest rate increases already in place and additional rate hikes and balance-sheet reduction in the cards. Headline and core inflation figures continue to be muted, causing bond yields to stay below their end-2016 levels. We believe inflation is being underpriced by the bond markets, and continue to favor shorter maturities in our strategies as one mechanism to preserve capital in a rising-rate environment.

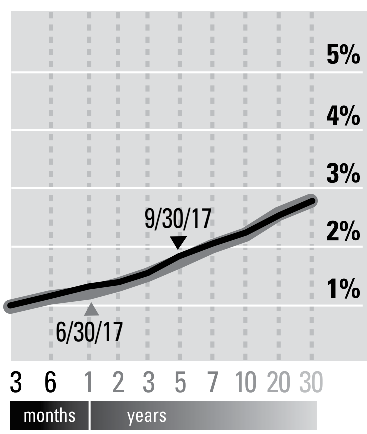
As Janet Yellen's current term as Fed chair winds down, can you share your thoughts on inflation and the Fed's future course of action?

Recent Fed discourse has suggested that we may yet see a rate increase this December. However, the Fed continues to keep a wary eye on inflation, which has been quite low this year. In fact, the Fed's preferred measure of inflation, the Core PCE Deflator, has dropped recently and is now running at only 1.25%. Any rate hike by the Fed could eventually add downward pressure on inflation. And wages have grown more gradually in this cycle than would have been suggested by the steadily-declining unemployment rate; this is one of the reasons why inflation continues to stay below Fed expectations.

Whether this low inflation environment – albeit with upward pressure – will give the Fed pause remains to be seen, but the theme of gradual tapering is expected to continue. Recall, too, that raising rates is only one tool in the Fed's utility belt as it engages in quantitative tightening; the gradual reduction of its balance sheet, which grew substantially in the years following the Global Financial Crisis, is yet another mechanism available to the Fed to normalize interest rates and tighten market conditions. We expect that the Fed will continue to act deliberately and in a data-dependent fashion, always fully telegraphing its intentions, as it steers the economy toward a higher-rate environment.

Treasury Yield Curve

Yield to maturity of current bills, notes and bonds.



How have interest rates fared in the context of this inflation picture?

The two-year treasury is currently yielding 1.54%, the highest it's been in close to a decade. That this short-term yield is this high means that the bond markets believe the Fed will continue to gradually raise rates in the coming months and years. The 10-year U.S. treasury is yielding 2.31% today, lower than the 2.44% with which it started 2017. Interestingly, the decade-long high for the 10-year treasury is nearly 4.50%! The lower longer-term treasury yield suggests that the bond markets don't perceive inflation to be a serious concern in the near term; we, however, believe that there is upside pressure on inflation in these tight labor markets.

How is your portfolio positioned to handle these contradictory macro- and market conditions?

Our approach to the markets is as disciplined as ever. We are fond of saying that we will go where the data takes us. As medium-term investors with a strong mandate to protect client capital through risk management and asset-class diversification, we have positioned our portfolio durations to be shorter than those of corresponding benchmarks. We believe this will serve us well in today's environment of gradually rising rates and upside inflation risks.

Want To Learn More?

If you'd like to take a deeper dive into Hamilton Capital's proprietary research or better understand our top-down, forward-looking investment process, join our Investment Team for one of our upcoming market briefings:

November 8
Lunch, The Refectory

December 7
Lunch, The Refectory

January 18
Lunch, Scioto Country Club

Space is limited, so contact Laura Hamilton at lah@hamiltoncapital.com or (614) 545-4013 to RSVP.

In Other Words

"We don't have to be smarter than the rest. We have to be more disciplined than the rest."

— Warren Buffett, Investor

"It's waiting that helps you as an investor, and a lot of people just can't stand to wait. If you didn't get the deferred-gratification gene, you've got to work very hard to overcome that."

— Charlie Munger, Investor

We Welcome Your Referrals

Our passion is to help you and others like you achieve lifelong financial independence and security. If those are goals your friends, colleagues and family members share, we'd be honored to earn the right to work with them as well. So please don't keep us a secret. We value and appreciate your referrals.

Economic Outlook

(Continued)

As our millennials might put it, ☺, LOLOL and HaHa!

Every ledger has two sides, and you've heard us before describe our search for the unbiased truth. So the answer would be…no.

For example, some of the supportive indicators we mentioned earlier often are meaningfully revised from their first-published early estimates, many times turn on a dime, and often are strong just before recessions. Also, some are sentiment or diffusion indicators that are better at telling us how many people are feeling good or bad, but don't necessarily shed light on how good or bad they feel.

More meaningfully, on the not-quite-as-positive side, there are also a few nuggets that, even if they point the other way, we think are very cool, intellectually.

The consumer is one such area, and the consumer matters because it represents nearly 70% of the economy. Signs have emerged suggesting that there is a gradual easing in this area. They include jobs, measures of credit stress, even actual spending levels. The harshest is perhaps auto sales. Before a sharp pick-up in September that can be very closely associated with the Harvey and Irma hurricanes (which destroyed over 500,000 vehicles, many of which will be replaced quickly with insurance dollars), auto sales were falling quite rapidly and still inventories remained engorged in spite of increased sales incentives, leading to production cutbacks.

The other arena is housing, which, although small in size, can swing up and down materially and impact overall economic growth out of proportion to its weight.

In both cases we're talking about a gradual moderation of growth rather than an outright contraction. But contractions start with a slowing in positive growth rates, so this merits our scrutiny.

So, taking the whole ledger into account, what's "… the rest of the story?"

Net-net, we choose to worry more about the risk of a continuing gradual slowdown than the "risk" of an acceleration, at least in the U.S. (as is our bias when managing funds that back our clients' dreams).

And what tips the balance in this "leaning" toward some caution, if that's what you're saying?

That's a very fair way to put it, and we are reaching this posture in the context of two major factors.

The first is the fact that the Fed, our central bank, unlike monetary authorities in most other places, has also been gradually leaning toward a more cautious stance for some time, retains a bias toward additional increases in interest rates, and just recently announced its plans to start reversing Quantitative Easing (or QE) and reducing its balance sheet. This will move it further on a continuum toward a snugger, and eventual "tight", monetary policy, which should draw liquidity from the economy.

The other key factor relates to our new administration and Congress.

As we mentioned before, we've sorted the various promises and statements of intent from the Trump camp and the Republican party during the elections into five key areas of possible action. We continue to feel that this framework remains an excellent tool by which to measure shifts to public policy. To date, even with a 2018 budget that merely represents step one toward possible tax cuts and is unlikely to result in any real "reform", Washington hasn't really moved the needle in most of the five areas we identified.

Except for one.

On the "Open Borders" measure, which captures trade and other crucial flows, we have seen some action and signals aplenty. A few months back, the administration triggered a new agreement on sugar prices, which effectively increased the government's involvement in the economy, further increasing the price of sugar within the U.S. to an even greater mandated premium to world sugar prices. Good for producers, not so much for consumers or those who feel, in principle, that the "swamp" should not be in the business of telling the market what prices to pay. More recently, the U.S. announced duties of 299% on Canadian jet aircraft (which Canada and Ireland/UK are not happy about), blocked appointments to the WTO's appellate body and has taken hard-nosed positions in current NAFTA negotiations, among others.

Whether you politically agree or disagree with this direction, from an economic and financial markets point of view, these steps and underlying philosophy raise the risk of higher prices, higher interest rates and lower profit margins across the economy overall.

Hence, we're aiming our "worry radar" in this direction. But please don't misunderstand our use of the term worry, because we spend the bulk of our time trying to find risks to our base case to fret over, just so we're not surprised on the downside.

HAMILTON
CAPITAL MANAGEMENT
Future In Sight™

5025 Arlington Centre Blvd., Suite 300
Columbus, Ohio 43220

614/273-1000 • 614/273-1001 (fax)
888/833-5951 (toll free)

hamiltoncapital.com

For Your Information

Hours & Holidays: Hamilton Capital Management is open Monday through Friday, 8:00 a.m. to 5:00 p.m., except New York Stock Exchange (NYSE) holidays. Upcoming holidays include: Thanksgiving Day, November 23; Day After Thanksgiving, November 24 (1:00 p.m. close); Christmas Day, December 25; New Year's Day, January 1; Martin Luther King, Jr. Day, January 15.

Change In Your Financial Circumstances: If you face changes that could affect your financial circumstances, please call us so that we can discuss any appropriate adjustments to your portfolio.

Form ADV: If you would like to receive a copy of our current Form ADV, Part 2A and 2B, please contact us.