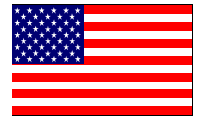




Hamilton-Bates

Update

June 5, 2008



P.O. BOX 270 Newtown Square, PA 19073 877.768.4247 www.hbir.com

Recap

The seesaw battle between the stock and energy markets has been in full force since early May, with the price of oil largely dictating the direction of stocks. Higher oil prices have prompted investors to dump stocks in recent trading sessions, while dips in the price of crude have sparked mini-rallies in stocks. Even so, overall volume has been very light, an indication that investors are still wary of placing large bets in the current market environment. The rally begun at the March lows has now rallied to the levels we were looking for (and mentioned over and over again since then), but has stalled around the key 200-day moving averages on the indexes. This is typical whether it is for a pause in a bull market, or a reversal in a bear market. Which of the two outcomes is currently unfolding in front of us isn't clear—as there are clear positives and negatives facing us.

Economy, Earnings, and Interest Rates

On the positive side, the Commerce Department reported data showing that the U.S. economy grew at a slightly faster pace during the first three months of the year than economists initially thought. Gross domestic product grew at an annual rate of 0.9 percent in the first quarter, a figure that was revised upward from a preliminary reading of 0.6 percent taken about a month ago. Overall corporate profits—a broader gauge than the more closely-watched earnings of the S&P 500 companies—fell 2.5 percent on a year-over-year basis. The Commerce Department also released the PCE, the Federal Reserve's preferred yardstick for inflation: the price index for personal consumption expenditures. It grew at an annualized rate of 3.5 percent in the first quarter, while the core rate, which strips out food and energy costs, was up 2.1 percent. This puts the core rate near the

central bank's target zone for annual inflation growth (1-2%). While in the past, the Fed has used the core PCE when making its interest rate decisions on the theory that food and energy prices are too volatile to function as reliable indicators of consumer prices, in its recent policy decision the Fed acknowledged the persistent high cost of food and energy—a sign that it is at least aware of the strain on consumers' budgets and rising inflation concerns. Interest rates have been relatively stable, but have recently shown signs of moving up and out of their tight range of recent months. This leaves the bond market in a tight spot—showing little value if the economy is on the road to recovery or if inflation becomes a problem.

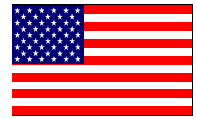
The high cost of energy is also putting pressure on earnings. Dow Chemical said yesterday that it will raise prices by as much as 20 percent across the board in response to raw materials costs rising 42% in the 1Q. In the announcement, the CEO laid much of the blame for the current state of the energy markets on the failure of the U.S. government to develop a sound energy policy. Also in response to higher energy prices, a number of airlines have begun grounding/removing planes from service in order to bring costs into line. Energy prices will continue to be a challenge for companies with oil above \$100 a barrel. Americans are driving less in response to record-high gasoline prices, but the major oil exporters are also exporting less oil than they used to. In part this is due to rising consumption in traditional oil exporting nations like Saudi Arabia, and lowered output from state run oil companies (Venezuela-Mexico) that have been poorly run and maintained. It will likely take a demand drop from Asia/India, where consumption is subsidized by governments, to eventually cause the current bubble to pop.



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Market Outlook

As mentioned in the Recap, the market has now rallied up into our target area and has twice been push back from the key 200 day average.

Whether this is a brief pause before another leg higher or whether the rally has exhausted the move is now a question. The next week is a critical period in which it will likely be determined if the trend turns down or not.

On the positive side of the ledger is the S&P has held above its 50-day average, and a move back above 1400 would negate any 'false breakout' pattern. As long as the S&P holds above the recent lows (around 1375) the trend remains bullish. The NASDAQ 100 and Midcap 400 indexes look quite strong, and both remain above their 200-day averages—a very bullish sign. The Technology sector is clearly leading, which shows an appetite for taking risk, another healthy sign for the market.

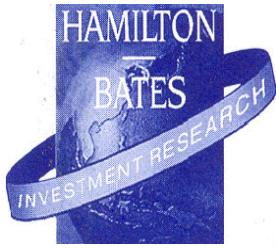
On the bearish side, so far the move up since the March low has conformed within the historic parameters of a counter trend up in a bear campaign. The move down from the October high was 20% and is the normal percentage decline for the first leg down in a bear trend. The move up since March (for the DJIA and S&P) has been a 'struggling' trend up with less than ideal breadth and volume readings, as well as a financial sector that not only has failed to rally, but has just this week hit new 52 week lows.

This leaves us at a critical juncture. If this is not a resumption of the prior bear trend and the uptrend is going to remain intact, then we should see the market find support (in the 1375 area on the S&P 500), and the bull trend would resume taking all the major averages above their 200-day averages in resuming the uptrend.

If the S&P can move back above 1406-1410, the bullish case is likely in force. Since the rising price of oil was being blamed for the fall in stocks it will be very interesting to see what stocks do if oil declines, and or the rising trend in energy is broken.

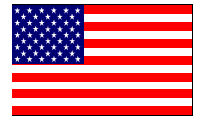
As you can see this is a very important rally, maybe one of the most important during the year. The strength in indexes like the RUSSELL 2000, NASDAQ 100, and MIDCAP 400 coupled with the strength in tech are battling with the drag that the dreadfully weak financial sector is putting on the S&P 500 and DJIA— as well as the negative connotations that a weak financial sector has for the overall market and economy.

With techs rallying and financials declining we are left with a bifurcated market. One of these sectors is 'correct' and the financials will bounce with the market or techs and the averages will come down to financials. With one of our key sectors rallying and the other declining, we are left right in the middle. We reduced 'aggressive' long positions above 1420, but overall holdings remain most definitely 'long' of stocks. It remains prudent to be so as long as the bullish market trends remain intact. We'll let the market tell the story, and right now we're not sure how it'll end, especially with such diverging plotlines (strong techs vs weak financials). Our gut tells us to worry about the weakness in the financials more than anything else but we'll defer to our objective trading rules. Key support for the S&P 500 is 1370-1375 on the cash index. Given the weakness in financials, staying 'long' below this area makes little sense if the market breaks down. A move above 1406-1410 signals a likely test of the recent high of 1440.



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Market Charts and Technical Indicators

S&P Trying to Negate Bearish 'Pop & Drop' Pattern

The S&P 500 (bottom panel of top chart) vacillated around 1400 in mid-April, prior to pushing well above it into May sending the S&P to an eventual peak around 1440. The up trend then faltered at resistance around the 200-day average, amid the skyrocketing price of oil above \$130 a barrel. Such a sharp downside reaction upon hitting the 200-day average is not what we wanted to see. The drop below 1400, and indeed below 1375, sets the stage for a potential 'breakout fake-out' and a resumption of the bear trend. **Critical support between 1360 and the 50-day average (red line) needs to hold to support the bullish case. It has so far, and the S&P is once again trying to push above 1400.** Things look a bit better for the NASDAQ, as investors have flocked to large-cap tech. The NASDAQ (top panel top chart) reacted much better as it neared its 200-day average, and is now pushing above that key level. A clearly positive sign. Tech is clearly a sector to overweight, and whether or not its strength (and the positives it suggests for the economy) can ultimately overcome the weakness in financials is likely to determine the course of the market for the rest of the year.

Finance and Bank Sectors Hit New Low

Banking (top panel bottom chart) is an important part of the economy, and one of the largest sectors in the S&P 500. The market's bounce into June, especially the strength in technology, created hopes that the worst is over. We have noted more than a few times the weakness in financials, as well as their under performance during the market's rebound. This week the BKB Bank Sector Index broke to new 2008 lows! This is concerning, even if we are happy to see this weakness countered by strength in tech (top chart). If troubles in the financials are not largely past, it tells us a lot about the future of the economy. A rebound from the lows by this sector could help a larger rebound in the broad market, but we cannot shake the fact that poor action in this group is a concern.

