Hamilton-Bates

Market Update

January 7, 2014

January 6, 1838– Samuel Morse demonstrated telegraph, ushering in electronic communication.

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2013 is gone, 2014 is here, and we are all struggling to remember to write 2014 instead of 2013 on checks and correspondence. We've been bitten by the changeover more than once already. By March we should all get it straight. As for 2013, we did not see such strong stock market gains coming given the headwinds the market faced at the beginning of the year. We went through a tax hike, a sequestration that cut GDP, the fiscal cliff, and the risk of default on our debt. There was also possible war in the Middle East (Syria) and then a government shutdown. Finally the Fed also began its 'QE Taper' in December, a few months earlier than we expected. One would think after all that, the stock market would not have been so kind. However, the market really never flagged, and never even saw a full-blown correction of 10% or more. The worst declines were a couple of 5% dips in the year's second half. Bonds on the other hand did NOT fare so well. Interest rates rose, and bonds registered their worst year since 1994. While 2013 was pretty much a smooth ride for stocks there are bound to be some surprises in 2014; <u>history suggests there will greater volatility this year than last</u>. We'll take the 2013 gains and be sure to protect them in 2014.

Presidential Cycle

2014 is the second year of the Four-Year Presidential Cycle. According to the Stock Traders Almanac, since 1934, the *average* decline within the second year of the cycle has been 21%. But the declines tended to be worse when there was no correction in the first year of the cycle, which is what we saw in 2013. With this history, and with investor sentiment at quite a bullish extreme as a result of the strong 2013 gains; 2014 will likely prove to be a year to be on guard and not complacent. The 'good' news is that there has also been a significant rally from the low that is made in the second year of the cycle into the high of the following year, in which the average gain was 50%. Given historical patterns along with the Fed's tapering process, 2014 will likely be a year that flexibility and active allocations prove beneficial for investors.

January Barometer and January Effect

Over the next few weeks there will be much written and said about the January Barometer and January Effect indicators. The *January Effect* is where small caps tend to lead the market between mid-December into January of each year. The *January Barometer* is correct two-thirds of the time and it says that whichever way January goes, so goes the market for the rest of the year. There is another add-on that says that the way the first five days trade are the way that January will go, and thus the year. January 2013 was a very positive month that led to the big gains for the year. The first day of the year for 2014 saw the worst decline in weeks. Given that the last down first week and month of January was 2008 (and we know how that ended), the January Effect will likely be widely discussed over the next few weeks. The first full week of trading will finish this Wednesday, so we'll see what happens over the next two trading sessions in order to see what the January Barometer is forecasting for 2014. The S&P 500 ended 2013 at 1848.

Yellen Confirmed

Janet Yellen has been confirmed as the new Fed Chair, the first woman ever to lead the Fed, and she will replace Bernanke on 2/1/14. The Senate vote was 56-26 with 18 senators who did not vote. Both republicans and democrats are supportive of Yellen and her Keynesian monetary policies that urge for easy money (and debt) to get the economy moving. The problem has been that since 2011 (when earnings and GDP really slowed) all that has happened is a deeper debt hole for the US without providing any appreciable improvement in the economy. One could easily argue that Fed policies have only made the rich richer and taken interest earnings from savers and pensioners. Since senators are part of the 1% they voted in favor of continuing these policies. QE may have had a place in 2008-2009 to stem a potential meltdown but since 2011 it has done little for the economy and job creation. The sooner the markets get rid of Central Bank distortion the better.

The Fed Begins to Taper But is Still Supportive

The Federal Reserve announced at its December meeting that it will provide $75 billion of quantitative easing (QE) in January, a $10 billion dollar reduction.

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It will then provide diminishing amounts of additional stimulus for months thereafter until the tapering is complete sometime this year. If the Fed continues to taper at the same pace it will provide an additional $65 billion of stimulus in February, $55 billion in March, etc…with an end sometime early Fall.

After stumbling a few times in late 2013 on the 'mere talk' of a taper, the equity markets apparently changed their view over tapering concerns. On the positive side the Fed will still provide $75 billion of QE in January, and significant amounts monthly thereafter even though the last GDP growth was at 4.1% in the third quarter. That is double the 2% GDP rate in 2012 when QE3 was started. That is a good deal of liquidity going into the economy for several more months, and most likely continuing to go into paper assets instead of loans and capital expenditures. The stock market's positive reaction to the tapering news was also helped by Chairman Bernanke's assurances that even though it will slowly reduce the degree of QE stimulus in 2014, it will continue to hold interest rates extremely low, even longer than it previously indicated, probably well into 2015.

We were proven wrong in expecting the Fed to delay tapering until its March meeting, as well as the market's positive response to the news. We'd have thought the market would decline on a taper. However, the announcement and the market's reaction does not change our longer-term forecast for increased volatility in 2014. The combination of favorable seasonality and Fed support will keep the market positive into Q1, possibly until March or April if things go well. But the risk of a strong correction is now higher than at any time since 2012.

Economy, Earnings, and Interest Rates

Since 2008 the world's central banks have been trying to spur demand and boost prices in response to the Great Recession of 2008-09. In terms of stock market gains the results are great. The S&P 500 has more than doubled off its lows as Fed asset purchases and rate policy have caused a boom in financial assets. As for the 'real' economy the results are mixed. There were definite gains in 2009, 2010 and part of 2011 as earnings recovered from the deep economic slump and companies hired workers. Not quite at the rate or wages of past recoveries, but still we saw gains.

But since late 2011 we have seen a slowdown in earnings, and most definitely a slowing in sales/ revenues. While we continue to see signs of modest growth, that growth hasn't morphed into the kind of self-sustaining growth cycle the Fed envisioned, and certainly hasn't been worth the $100's of billions of dollars created to fund it.

The real issue remains one of uncertainty. Companies are not creating capital expenditures; and are not hiring and expanding. Instead of adding more people or machinery, companies have tried to cut costs and increase productivity however they can. Companies in the U.S. are already finding ways to expand without hiring more workers. Everyone it seems is hunkering down. Consumers may still be buying cars with zero down and 0% financing, but credit cards have been put away and real wages have been mired in the weakest period of growth in at least five decades. We keep repeating this point because it is important. Median wages have fallen over the past 5 years even as asset markets sky-rocketed. Since most consumers depend more on their wages than financial assets to drive spending, the Fed's attempt at boosting asset markets to foster the 'wealth affect' to boost the economy haven't been as successful as planned.

2014 will likely be the year of the wake-up call that will put the Fed's theories to the test. Investors have in the past ignored weak earnings with an eye to improvement 'in the future'. The Fed is tapering, the future is now. Unless earnings show signs of dramatic improvement in Q1 along with positive visibility, the stock market is very likely to have trouble maintaining the bull trend beyond the seasonally strong first part of the year.

The economic data showed Q3 GDP growth revised upward to a strong 4.1% annual rate, the fastest in nearly two years. With the Fed having announced its

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strategy to taper, good news may actually be viewed as good news, rather than a threat to QE it has been. But Q4 data hasn't been as good, and other recent data could put the Fed back in the pickle of how fast to taper. First it was the latest Manufacturing ISM posting its first drop since September, and then it was the Services ISM that recorded its second miss to expectations (of 54.5) in a row. More concerning in the Services ISM report (remember services are the bulk of the economy now) was in the New Orders component which went down from 56.4 to 49.4. Below 50 is back to contraction territory. This was this was the first contraction in the New Orders index since July 2009 after 52 consecutive months of growth. Not quite the signs of a healthy economy.

The stock market and the economy are not one in the same right now. One continues to be boosted by Fed policy (the stock market), the other (the economy) remains constrained and hampered by poor Fiscal Policy and hiring uncertainty.

Market Outlook and Investment Strategy

The mid-December correction led to a year-end rally as expected that has lasted into January. Although that pullback alleviated the previous short-term overbought conditions, it did nothing to lessen the longer-term overbought conditions and extremes in bullish sentiment that remained for much of the latter half of 2013. 2013 was an anomaly in that there were no corrections nor 'touches' of the 200-day average, illustrative of just how persistent the rally was. We fully expect to see at least a 10% correction at some point and there will likely be a visit or two to the 200-day average. Both suggest lower prices at some point for 2014.

The near-term remains bullish for now, with a bit of a stumble the first few days of the year followed by a rebound attempt this week. We don't want to abandon the bullish trend as long as the short and intermediate-term trends remain intact. But we will be alert for signs of a trend change this year. Our forecast for 2014 may result in a surprise to investors who have become so used to the low volatility and lack of corrective activity after such an unusual 2013. Rather than another unusual one-direction year like 2013, seasonal and presidential cycle patterns (mentioned on page 1) are likely to combine with rising rates and a Fed taper to see more swings than last year. Based on the 4-year cycle pattern alone this year should see an important top in the first half of the year followed by an equally important bottom in the latter half.

In the short-term our strategy and road map remain unchanged from December. We are looking to add to equity holdings on brief bouts of January weakness, as long as the larger trend remains intact. Nearby support levels on the S&P are 1820 and then 1800; a drop beneath both would turn the short-term trend down and threaten the intermediate-term trend.

Fixed income investors that piled into bonds in 2012 got stung last year. Many are selling bonds now to pile into stocks thinking that rates and stocks will go up together this year. We are not in agreement. Unlike last year, 2014 could end up being a good year for quality bonds, but likely not until yields move a bit higher first in Q1. We'd look to be buyers of investment grade bonds into weakness from mid-quarter to quarter end if the 10-year note reaches our target area of 3.30-3.40%. At these levels even government bonds would begin to look attractive for the first time in years.

The equity market looks poised to rally in early 2014 but we do not believe the rally will be as persistent and linear as 2013 proved to be. Our anticipation is that the broad indexes are in the process of making a potentially significant top in the first half of 2014, one that could be on par with prior cycle peaks of 2000 and 2007.

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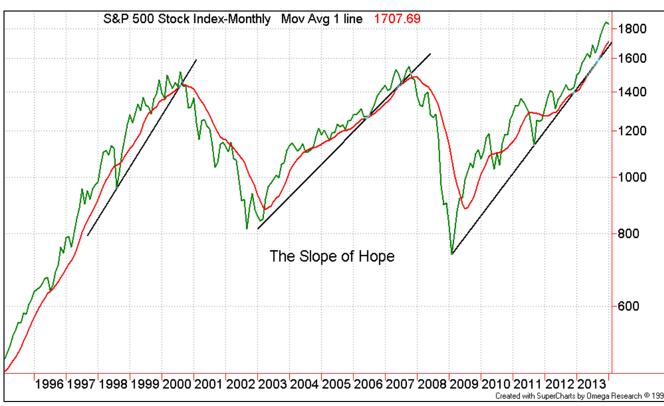
Market Charts—The S&P 500, the 10-Year Note Yield, and the Long-term S&P 500

The S&P 500 (*left*) has held within an upward sloping channel for all of 2013. As long as it does the bull is clearly intact. Since the last mid-December ***Update*** the market has indeed rallied into the New Year as expected.

As long as the S&P holds above 1810-1800 the near-term path should be for higher prices. However we are looking for a top of some significance in the first part of 2014.

2013 was anything but good for bond investors as yields move sharply higher and away from the 2012 all-time lows. The 10-Year Note Yield (*right*) is the primary driver of long-term interest rates. Since mid-2013 yields on the 10-year note have moved sharply higher. This back-up in yields has reverberated throughout the bond market and caused moderate losses for bond investors.

However, for investors we believe that 2014 could be much better. Yields could go a bit higher—to the 3.3-3.4% level, but such a move would likely set-up the best opportunity for bond purchases in over five years.



The long-term view of the S&P 500 (*left*) shows what we are calling the **'Slope of Hope'**. Since the mid-1990's there have been three bull markets space by two nasty bear markets. Each bull market rode up a trend line that was tested multiple times (**bold black lines**) and generally followed its 10-month average (red). Once these long-term trend lines were broken, the bull market (which move up on 'hope' that the economy and earnings will be better) was over. **The trend line is now around 1700, as is the 10-month average, these are key levels for long-term investors to watch.**