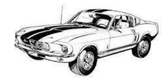

January 27, 1965– Debut of the legendary Ford Mustang Shelby GT350.

Hamilton-Bates

Market Update

January 27, 2014

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The markets happy run ended last week as global equities suffered broad declines as new data suggested Chinese growth was slowing, exacerbating a decline in emerging equity markets and currencies (primarily Argentina and Turkey) in Asia and Latin America that has been ongoing for many weeks now. The selling in emerging markets hints back to the mid-1990's, when a crash in the Thai baht unleashed the 'Asian Contagion' that sent world equity markets lower. The weakness in emerging markets and China last week came on the heels of a warning from IBM that their sales in China were disappointing and a sizable drop in China's manufacturing data. We are not making a prediction, but any continued disruption in the emerging equity and currency markets could spill over and weigh on sentiment in the developed markets like the U.S..

Earnings, Economy, and Interest Rates

Meanwhile, fourth quarter earnings reports have also not been too encouraging. Prior to the earnings season, we mentioned that negative announcements were at their most pessimistic in years. According to Thomson/Reuters, pre-season were the most negative in 20 years. This suggested a disconnect between expectations and reality that could leave the market vulnerable. A review of the week's trading confirms that possibility as the majority of the selling pressure last week came on Thursday and Friday due to pressure from General Electric and Intel after both missed earnings expectations. This on top of IBM's earlier week miss.

The Fed May have to Un-Taper

The Fed surprised us (along with many market watchers) with its December decision that the economy is strong enough to stand on its own with less stimulus (we disagreed). We thought the Fed would (and should) wait until March for more evidence to accumulate. In the month since the decision, economic reports from key areas of the economy and consumer confidence, have not been so hot. There was that terrible December Jobs Report that showed only 74,000 jobs created in December. New home starts plunged 9.8% in December, as did existing home sales. Permits for future starts fell 3.0%. Mortgage applications continued their sharp decline, ending December at the lowest level in 13 years. Auto sales slowed significantly in December in spite of the return of rebates and zero percent financing to entice buyers. Consumer sentiment fell in December to 80.4 versus the consensus forecast of an improvement to 84.0. In our view the economy hasn't been a strong as the stock market gains purport it to be, and remains vulnerable to a slowing in 2014. If the Fed ends up being forced to 'un-taper' it would be a PR disaster as it would make the Fed look like it had little idea of what it was doing.

Market Outlook and Investment Strategy

The U.S. stock market initially took the Fed's decision that the economy was strong enough to stand on its own as a positive, rallying to a new record high at the end of the year. However, so far in 2014, investors have looked beyond the QE stimulus that had been masking the realities of the market's normal trading. Given the poor earnings and economic reports since December, coupled with China and emerging market troubles, investors are now concerned. Unlike the US market, many world markets did not make higher highs in 2013, and peaked back in May 2013 when the Fed first hinted it was getting ready to taper back its stimulus.

This past week the U.S. market lost some of its confidence and momentum. The drop below 1800 on the S&P suggests we are getting the long-awaited pull-back that seemed elusive in 2013. Like many, we thought we'd have seen one well before now, but it finally seems market odds have caught up.

As long-as the S&P holds above the 1770 area, the market has a good shot of rebounding back above 1800 and keeping the bull intact. The problem comes should the S&P fail to hold the uptrend that has been in place since the late 2012 low. Should that trend break investors would benefit from a more defensive posture since it would be possible for a much more sizable decline. **The key level to watch is around 1770 on the S&P 500.** A drop below 1770 would

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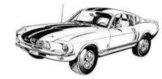

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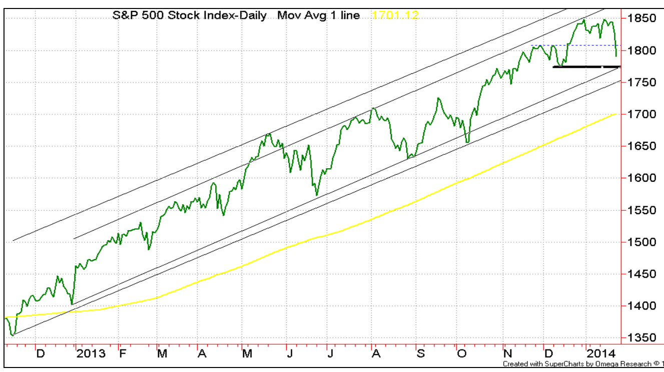
open up a move to 1680-1700, the level of the 200-day average (the yellow line in the S&P 500 chart on pg 2). The market normally touches its 200-day average at least once each year. Last year (2013) was the first year in at about 15 years that didn't see a touch of that key average, so it is very likely we'll see a move down to that level in 2014. A drop to the 200-day average which is around 1,700, would take the S&P 500 back down to its level of mid-October, wiping out the gains from year-end. That could in of itself create further selling and some panic. In a year in which we expected a significant correction, and a return to reality as the market unwinds 'QE", anything can happen. Investors sentiment indexes were peaking out at year-end 2013 at levels not seen since 2000 and 2007, as markets topped out just when investors were at their most confident.

We'd look for a test of 1770, and we would then want to see a bounce in the market get back above 1800 to put the bulls back in charge.

Charts—The S&P 500, and a Holdover Chart from the last Update—A Sobering Look at Jobs



The S&P 500 (*left*) did exactly what we warned against in the last Update, but moving to a new high two weeks ago, but quickly falling back below both nearby support levels at 1840 and 1810 (dashed line). The decline looks like it wants to test the up-trend lines dating back to the 2012 lows and the channel the S&P has been in since that time. The market is testing that area (1770) now.

A drop below 1770 would open the doors to a drop to 1700, and is a level we would not want to see fail.

We think the bottom chart is one reason why there is such a difference between what is going on with the stock market versus the 'real' economy. It comes from streetalklive.com (an excellent site) and clearly sums up the problem within the economy. The red line is the **percentage (%) of full-time employees compared to the working age population**. Since the peak in 1999 this ratio has dropped significantly, but the drop since 2007 has been staggering. Full-time job losses in the last recession were the worst in 50 years! We have gained jobs back since 2008, but sadly the gains have barely kept up with population growth! This chart shows an economy still not 'right'.