February 3, 1959- The 'day the music died'. American rock stars Buddy Holly, Ritchie Valens, and J. P. "The Big Bopper" Richardson are killed when their plane crashes in Iowa.

Hamilton-Bates
Market Update
February 3, 2014

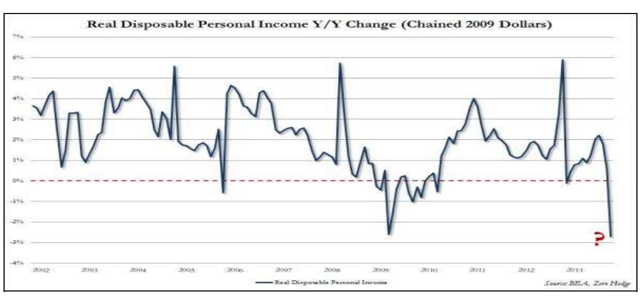
P.O. BOX 270 Newtown Square, PA 19073 877.768.4247 www.hbir.com

The Fed's tapering, economic news from China, disappointing economic data, and continued disruption among emerging market currencies conspired to send the market lower through the first four weeks of the new year. We think recent action means there is a high probability that the correction that has been put off from some time is here. Since mid-January the up days have come on lighter volume than the down days. Buyers have become reluctant while sellers have become more aggressive. The break of the 1770 support level we mentioned in the last Update triggered follow-on selling and the first signs of 'panic' in this decline. Stocks are now working off overbought conditions built up from 2013, and we will be watching for signs that the correction has run its course (or turning into something more).

Earnings, Economy, and Interest Rates

Earnings have to be considered slightly disappointing even though slightly more than 70% of companies are beating expectations. The problem is these 'beats' are on lowered estimates and forward guidance has been soft. Revenue growth—the mother's milk of a healthy economy-has been hard to come by. Earnings for the S&P are growing at roughly 7-8% but revenues are growing at less than 4%. Recent economic data has also been poor, but largely discounted due to weather.

We are not so sure. Along with the relationship of full-time employment to working age population (a chart we showed in the last Update), the following chart from Zerohedge.com also shows a dysfunctional economy, with 2013 seeing one of the worst drops in real disposable income in the last 20 years, and nearly as bad as the 'Great Recession'.



If the consumer is 70% of our economy, it doesn't take a PHD in economics to understand that when real disposable personal income drops by 2.7% from a year ago, all is not well with the economy and the consumer.

Fed Taper and the Butterfly Effect

The 'butterfly effect' is the sensitive dependency on initial conditions in chaos theory in which a small change at one place can result in large differences in another. The name of the effect, coined by Edward Lorenz, is derived from the theoretical example of a hurricane's formation being contingent on whether or not a distant butterfly had flapped its wings several weeks earlier.

We had thought the Fed moved to taper a bit too soon, and although the US market seemed unaffected by it, other markets were anticipating a taper as far back as May of 2013. The Fed's small step of an initial $10 billion reduction in QE may have seemed innocuous enough – like a butterfly flapping its wings. But the effects were felt many thousands of miles away across Asia and South America as investors anticipated the liquidity withdrawal and rushed for the exits. As a result, since last May many emerging market equity and currency markets have been battered, and we are seeing the type of drops that in the past reverberated back to the developed capital markets. In an interconnected world central bank moves have effects all across the globe. Tapering may effect world markets enough to reverberate back to the Fed and force them to 'un-taper', something they definitely don't want to do so as not to lose 'face'. Unfortunately it is looking more and more that the Fed taper was too soon.

Market Outlook and Investment Strategy

From a technical perspective, the holding of 1,770 was the hope that the bulls had for a quick end to the pull-back. The loss of that level and the severity of the ensuing decline points to a 'correction' being very likely (the market is off 7% from the peak so a correction is just another 3-4%). Short-term the market

Hamilton-Bates

Market Update

February 3, 2014

February 3, 1959- The 'day the music died'. American rock stars Buddy Holly, Ritchie Valens, and J. P. "The Big Bopper" Richardson are killed when their plane crashes in Iowa.

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

is now very oversold so a snapback rally of 2-3% could occur at any time. Given that margin debt is at a record level, any significant bearish move or a sign of break in bullish momentum will likely result in strong sell-off as these leveraged buyers are not able to withstand larger declines. Given yesterday's move we see one of three general outcomes along with their rough probabilities as we see it.

Option 1 (odds 25%). An immediate resumption of the bull-trend; the market quickly reverses early 2014 negativity and resumes the bull trend. <u>We would need to see the S&P 500 recover 1770 and then 1800 quickly</u>.

Option 2 (odds 50%) The market sees a 'normal' correction. The drop below 1770 points to an eventual test of 1700 on the S&P, just 3% lower. The market rallies from that level. Near-term bounces until we hit that level, but eventually 1700 is tested and holds.

Option 3 (odds 25%) The S&P falls below 1700, suggesting an even larger correction.

We saw an attempt at a bounce last week that failed near 1800 on the S&P 500 (<u>we sold positions last week on that rally</u>). Given the odds and what we see right now, we favor option 2 above. **But a move below 1700 would see us move to hedge or prepare for lower prices.**

Charts—The S&P 500 : Key Short and Long-term Levels to Watch

Near-Term S&P 500 (Left)
The S&P paused briefly last week around support in the area of 1770 (bold horizontal line), but the rally fizzled and once broken we saw aggressive selling come to market like (Tuesday of this week's 300+ point DJIA decline). The move this week suggests that the market will eventually test the 200-day average now around 1700, which is also an area of long-term support mentioned below. We expect the first good tradable rally to come from around the 200-day average marked by an X in the chart.

1700 is a Key Level for the Big Picture (right)
The past 18 years have been marked by 3 bull markets split by two 50% bear market declines. A key warning that something more than a normal correction was unfolding came when the S&P broke a multi-year trend-line (3 solid lines) and fell below its 10-month average (in red). These things happened early in 2000 and 2008 warning of a potentially larger decline. Currently the trend-line and 10-month ma coincide with the 1700 area. **A drop below 1700 would be a major warning.**