Hamilton-Bates
Market Update

February 27, 2014

February 27, 1827— A group of masked and costumed students dance through the streets of New Orleans, marking the beginning of the city's famous Mardi Gras celebrations. The students, inspired by their experiences studying in Paris, donned masks and jester costumes and staged their own Fat Tuesday festivities.

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Once again the stock market has given little ground to bears. After sliding 6% in six of the eight trading days into early February over emerging market currency and growth concerns, the S&P 500 has since rebounded nearly 6% over the past 3 weeks. While emerging market currency concerns haven't abated totally, investors have been keen on US stocks due to a dovish take on new Fed Chair Janet Yellen's house testimony.

Earnings, Economics, and More Yellen

Economic data from December and January came in decidedly weaker than expected, but many economists have dismissed the weakness as largely weather-related. The weather was indeed bad with more storms than usual, but we are not sure we agree entirely with the idea that the weakness was entirely due to the weather. The market certainly has so far, but we'll soon find out the truth though. Spring has to arrive eventually.

We have mentioned a number of times that sooner or later earnings will have to improve. Last year the market's outsized gains came largely through an expansion of the P/E ratio, which expanded 20.1% as earnings only increased 8.1%. Sales gains were even weaker. As for earnings, so far 90% of the S&P 500 companies have reported fourth quarter earnings. 66.3% have beaten estimates, 12.4% were in line, and 21.3% missed. The misses are slightly above prior quarters' levels. Earnings growth is about 6% with sales growth just slightly higher. The bottom line is that without aggregate earnings and sales improvements it will be tough sledding for stocks to appreciate substantially from current levels even with low interest rates.

Market Outlook and Investment Strategy

Talk about whipsaw market moves. The only thing that matched the markets swift 6% drop between Jan. 15 and Feb. 3 over 8 trading days was the 6% recovery over the ensuing 8 trading days. The quick drop prompted hedge funds to push short sales to the highest level since 2012 and investors withdrew funds from ETF's at the highest level in more than a year. Once this selling was exhausted the market quickly recovered the lost ground. In fact, so quick was the recovery that with the S&P now back at its prior high, it has erased its loss six weeks faster than the average recovery from declines of 5 percent or more since the bull market began in 2009 (according to data compiled by Bloomberg).

Equity markets continue to rally in response to favorable comments from new Fed Chair Janet Yellen, and her likelihood to continue favorable QE policies. This remains the key driver for bulls—easy money. The quick recovery of the early year losses indicates that the bull market is still alive. Once again this market defies odds and convention and avoids a full-fledged correction. As long as the S&P 500 holds above 1800 the bulls are back in control.

Now What

On a longer-term basis the markets remain very extended, overly bullish, and excessively valued. There hasn't been a 10% drop since May of 2012—a span of almost 2 years. However, it is also important to remember that markets can remain irrational longer than most would expect, lulling investors into an extreme state of false security. Historically mid-term election years have a nasty tendency of early peaks and summer swoons, so we'll be on the lookout for a continuation of that trend. Should the recent economic soft-patch worsen in coming months it could put a damper on earnings and cap market upside.

A move above 1850 on the S&P could trigger a Spring rally toward 2000 on the S&P and 17000 on the DJIA. Perhaps it occurs even if economic data weakens with the hope and belief that the Fed will halt the taper or even reverse course. The quick rebound and resilience in stocks was impressive, and portfolios have gained with the market's recovery. In the end price action is the final arbiter, and the market has once again dodged a bullet. We'll continue to take market gains as they come.

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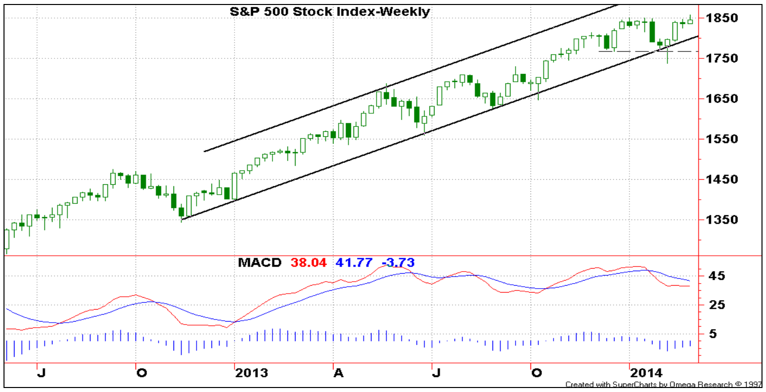
What We are Seeing in the Charts—The S&P 500 : Key Levels and Sectors to Watch

Near-Term S&P 500 (Top)

Everyone is watching the prior highs around S&P 1850 for a bullish 'breakout'. Given the intense focus on this level we need to expect some false signals, as the market tends to follow the road of maximum frustration for investors. If the S&P breaks and holds above 1850 we could see a move to the 1900's pretty quickly. Sideways action within the range of 1850 down to 1820 or even 1800 would still keep uptrend intact.

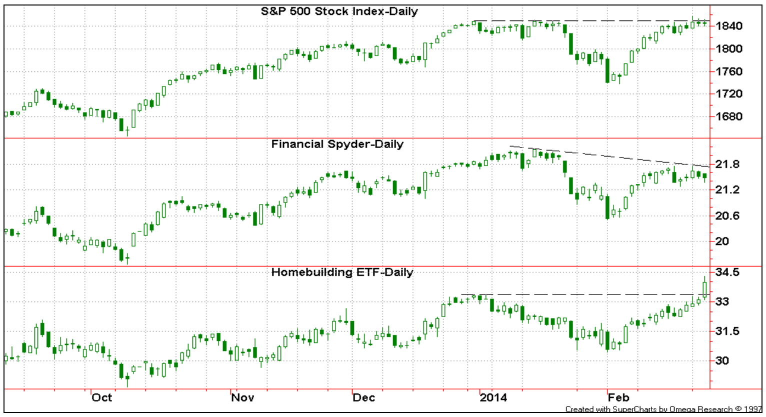
Unless the S&P falls below 1800, which is the level of the lower trend-line in the top S&P chart, the bulls have regained control.



Key Sectors to Watch (Middle)

The S&P 500 has regained its prior highs now around 1850 (top panel of middle chart), but the important Financial Sector (middle panel of middle chart) has not—it is lagging. For the upside to continue Financials need to catch-up. We will be watching this sector closely in coming weeks. On the positive side is the Homebuilders ETF (bottom panel in middle chart), which just moved to a new high. This could help alleviate concerns that the real estate sector of the economy is stalling.

Financials and Homebuilders are key sectors to watch for signs of both economic and market health.



Key Level for the Bull Mark (Bottom)

Since the mid-1990's there have been 3 bull markets punctuated with 2 severe bear markets. A key warning that something more than a 'normal correction' was unfolding came when the S&P finally broke a multi-year trend-line (3 solid lines) as well as falling below its 10-month average (in red). This happened early in 2000 and 2008 warning of a looming decline.

Currently, a drop below 1730 would be a major warning for long-term investors or buy-hold investors thinking of making an adjustment. A drop below 1730 puts the bull market in doubt.