Hamilton-Bates

Market Update

March 28, 2014

March 28, 1979 - Nuclear accident at 3-Mile Island in PA in which there was a partial meltdown. Worst nuclear disaster until Chernobyl, and then of course Fukushima. Remember Fukushima? We hardly hear any follow ups about that anymore.

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The penultimate trading session and week of the 1st Quarter looks to be ending on a positive note, with the market rebounding as tensions in Ukraine ebb slightly. After early quarter gains followed by a mid-quarter drop and finally an end of quarter bounce- we'd love to be able to say that all's well that end's well—but we can't just yet.

The situation in Ukraine looks to be tense but stable, with it seemingly unlikely that the situation could escalate into a war immediately. Russia looks to have won the round, sanctions or no sanctions from the West. They secured access to their warm water port—a critical goal for them. Suring up access to Sevastopol in the Crimea was as important to them as New Orleans is to the US. Its that big a deal.

While all eyes are on Ukraine we are actually more concerned with China—as it is currently struggling with a severe liquidity crunch in its shadow banking system that is threatening to be a become a major problem for even the developing markets. One concern is that China's growth rate is really slowing, as is their demand for raw materials—this is triggering backlash all through the supply chain of producers and heavy equipment makers. Even China's real estate make has shown signs of weakness as sellers have started dropping prices to get access to cash given the cash troubles. China has also been the source of growth for the world economy, if they hiccup it will become even more important for the recent economic gains in the US to hold on. The stresses in China have so far been limited to its own equity market and the nether regions of the credit market—distressed debt. But we need to stay on top of it as any spread further through the credit markets say to our own high-yield bonds would imply the liquidity crunch was becoming increasingly global.

Earnings, Economics, and A Jobs Report

Earnings turned out not so bad, and recent economic data has been slightly better. On the positive side this means the economy might just be getting better little by little. Possibly this coincides with the Affordable Care Act getting pushed off for awhile. Businesses may feel better and get back to some capital expenditures. As we mentioned in the St. Patrick's Day Update it will be important for earnings growth to continue given the massive expansion in P/E last year. We need to see forecasts increase also because equities can't continue to rely on multiple expansion for price appreciation. Without earnings growth it will be tough for equities to appreciate substantially even with low interest rates. On the negative side the decent economic numbers and resilience of the stock market will keep the fed on track with its taper, removing QE liquidity from the capital markets. Eventually this will produce an 'ouch' moment, its just a matter of when.

Market Outlook and Investment Strategy

The S&P is up about 1% on the year, not bad with what has been thrown at this market. We have a few concerns, the greatest of which is the situation in China which could really spread later this year if their shadow banking troubles continue. **For the most part though our market continues to hang tough and as long as the DJIA holds above 16100 and the S&P holds above 1835 the bull trend remains intact**.

Moves between 16,100 and 16,600 on the DJIA and 1840 and 1880 on the S&P 500 have to be considered range-bound behavior. We'll be watching for a push above or below these ranges for a sign the market was making a sustained move higher or lower.

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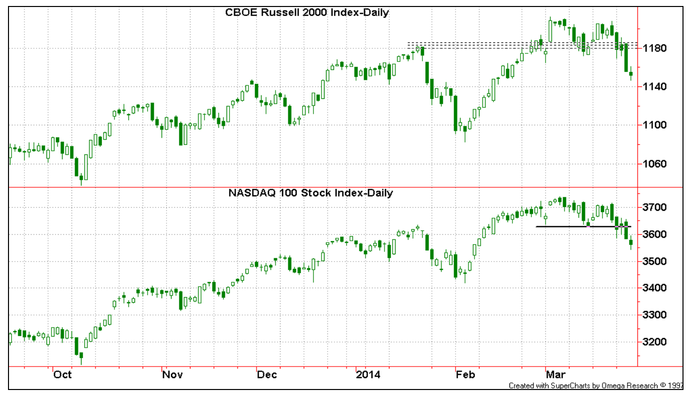
What We are Seeing in the Charts—Key Indexes and a Look at Biotech

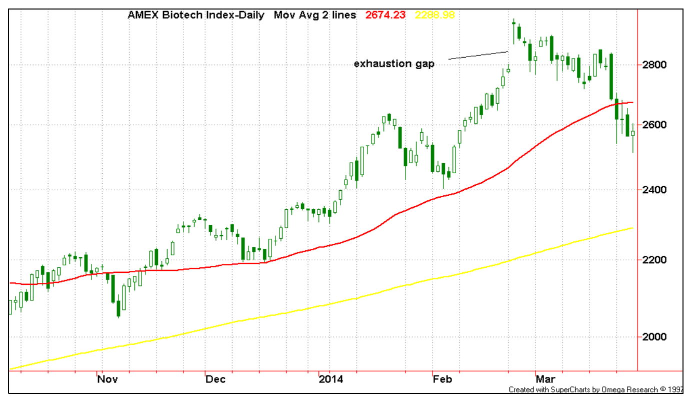
Near-Term NASDAQ and Russell
The DJIA and S&P have held up well during recent volatility, but the higher beta indexes (at right) have been much weaker. This could be a warning the correction isn't over. These prior leadership indexes are now pulling back. Both the NASDAQ and Russell 2000 could dip another 3-4% to lower support.

We are focusing on blue-chip stocks and funds right now, avoiding the OTC and Russell 2000.



Biotech Sector Gets Hit (middle)
The biotech sector had been on fire over the past year, and had been sitting on a 20% gain in 1Q until recent selling took more than half of it back. The decline in this high-beta sector along with the weakness in the NASDAQ and Russell 2000 suggest a clear risk-off phase unfolding. Biotech's could drop another 3-5% before finding support.

No rebound in biotech on Friday, so this sector remains weak.



Long-Term S&P 500 (bottom)
No change to the long-term outlook as the S&P has stayed above intermediate support around 1840, and well above the long-term trouble line at 1750.

A correction could drop all the way to 1750 on the S&P, a 6% decline, and still not change the long-term outlook.

A drop below 1750 on the S&P would be a warning move for all investors to pay attention to.