Hamilton-Bates
Market Update

April 18, 2014

April 18, 1906 - At 5:13 a.m., an earthquake estimated at close to 8.0 on the Richter scale strikes San Francisco, California, killing hundreds of people as it topples numerous buildings. The quake was caused by a slip of the San Andreas Fault over a segment about 275 miles long, and was felt from Oregon to Los Angeles.

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First Quarter

The global economy ran into headwinds in the first quarter, with the US being troubled by inclement weather, and the emerging markets roiled by brewing banking troubles in China. The FED continued to save the day by providing a generally benign backdrop for asset markets. However, divergences between what is going in in the real economy versus the financial markets continued to expand, as do global geopolitical risks from events in Ukraine. These things have increased the likelihood of higher market volatility ahead. Most asset categories had positive returns for the quarter, despite a rocky start, with fixed income leading the way. Equities in the U.S. and other developed economies posted modest gains following large gains in 2013.

Economy, Earnings and Interest Rates

The global economy continues to grow at a slow pace led by developed economies. The growing banking crisis in China is threatening to become a larger problem as the year moves along. China's economy is slowing rapidly as their shadow banking system, which had been built on loans backed by commodities, has seized up. Commodities like steel, coal and copper have collapsed in price—partly due to a slowing economy, and partly due to forced sales from China. China's Central Bank has realized they cannot bail everyone out, and is likely to support only the largest banks and government owned entities. There is still more pain to come in China which could lead to weaker growth and earnings globally later in the year. Europe has rebounded somewhat, but the situation in Ukraine could stall any rebound hopes if a civil war breaks out.

As for the Federal Reserve, the long-expected tapering of quantitative easing contributed to slowing global liquidity growth, but other central banks in Japan and Europe remain inclined toward additional easing. 'Abenomics' has proven to be a failure in Japan, and a looming tax hike and a current account deficit are potential sources of economic slowing. The Japanese Central Bank is likely to remain very accommodative and should continue to weaken the Yen. The European Central Bank just this week said it would enact QE programs if needed, but has so far not done so.

It is clear that Central Banks around the world will do whatever it takes in order to 'foster growth', so we'd expect to see more QE whenever and wherever asset markets weaken. Even in the US, which is seeing the Fed 'taper', a drop in the asset markets of 10% or more is likely to get the Fed to halt the taper if not reverse course. Our market's big rebound this week came on the heels of poor economic data worldwide—— and hopes that bad data would bring on more central bank support. Bad economic news is once again good news for Wall St apparently.

Earnings have been slightly better than expected this quarter, but companies still struggle to grow sales and have managed to bear their numbers with 'cost cutting'. As a result of the large gains over the past year, price-to-earnings (P/E) ratios have risen significantly, and the market will have trouble making headway without real earnings growth developing. Inclement weather across much of the U.S. has been accused of dampening economic activity, but so far the Spring rebound hasn't been so bouncy. Real Estate has been sluggish and the homebuilders sector is down 8% from its peak. With the Fed unwinding QE and the aforementioned credit crisis in China, there could be a continuation of disappointing economic and earnings data. Utility prices are also going to be a factor for consumers as high

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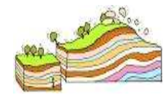

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energy prices create headwinds. For now consumer sentiment has somehow held up, but job growth has been less than desired. All-in-all economic conditions can be described as 'blah'.

Market Outlook and Investment Strategy

The global economic backdrop remains slightly positive, led by the U.S. and developed Europe. However, risks to the outlooks for Japan and China have increased, and conflict in Ukraine would certainly hurt European financial markets and growth prospects. There are clear signs that despite the best efforts from the world Central Banks, volatility in global asset markets is on the rise.

There has been a clear sea-change in attitude for the market in the past few weeks. The blue-chip S&P 500 and DJIA have turned into safe-havens as investors rotate into dividend paying stocks and away from high beta. The DJIA and S&P could very well attempt new highs, masking the weakness in the other averages, but the long-term outlook for the bull market will hinge on the NASDAQ and Russell 2000. After falling over the last month, with a drop of about 4%, market found support this week as the DJIA held 16000, the S&P held 1815, and the much weaker NASDAQ and Russell 2000 bounced from key technical support at their 200-day averages, but had drops of 7 and 10% respectively.

A rotation into dividend paying stocks and renewed hopes of central bank support could see the blue-chips take out their recent highs. A move above 1873 for the S&P 500 would end the trend of lower highs and lower lows and open the door for a run to 1900 and even higher. Until this happens though attention should be paid to the NASDAQ and Russell 2000, which could be forming sizable topping patterns. Should these indexes rally weakly or worse fall below their 200-day averages, it would signal the potential for an even larger decline. It is very normal for the blue-chips to make highs after the broader averages peak as a bull market runs out. This could be what we are seeing now. The NASDAQ and Russell 2000 had been market leaders but they fell harder and have also rebounded much less than would be expected after such sizable drops. Not alot of bounce in their bungee so to speak. Unless the NASDAQ and Russell 2000 pick up steam, any new high in the other major averages will likely be short lived.

We cut back some exposure in our balanced portfolios earlier this month as the weakness in the Russell 2000 and NASDAQ unfolded and hinted at further drops. In our balanced portfolios we remain focused on the stronger blue-chip areas of the S&P 500 and DJIA. We also run more aggressive tactical portfolios, and for those we bought the Russell 2000 this week as it fell 10% from its high and tested its 200-day average. These portfolios are shorter-term in nature and this trade is more for a bounce than a long-term buy.

Despite the market's rebound this week, it is not at all clear that the high beta stocks that led the market last year are only having a simple correction. We could be on the cusp of a market turning from bull to bear. Dividend-paying plays along with energy stocks are now the apparent leaders, but even that news isn't all good. Rising oil and gas prices are not helping the US economy as they act like a tax, and rising Utility stocks suggest rising utility costs. We look for a rebound that could see new highs for the DJIA and S&P, but not necessarily a rising market for all. Time to pay close attention.

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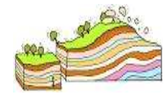

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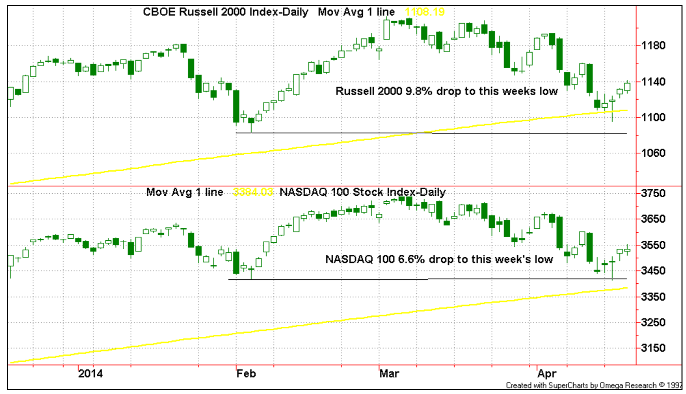
What We are Seeing in the Charts—Key Indexes and Sectors - High Beta Takes a Hit

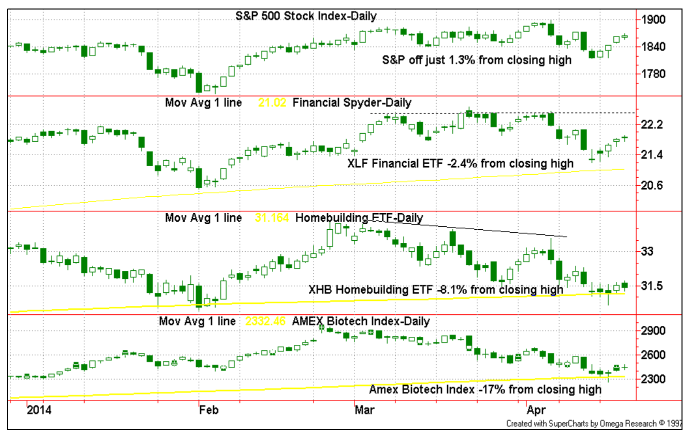
Near-Term NASDAQ and Russell

The DJIA and S&P have held up well during recent volatility, but the higher beta indexes (at right) have been much weaker. Just as we noted in the last Update ***this was a warnings the correction wasn't over***. The Russell and NASDAQ (former leaders) have led on the decline. Money rotating into blue-chips have held the S&P and DJIA up much better. With the NASDAQ and Russell both bouncing off their 200-day averages and oversold—a bounce would be expected. We bought Small-caps on the day of the low this past week expecting such a bounce in our tactical accounts. **For longer-term investors we remain focused on blue-chips.**



High-Beta Sectors Also Get Hit (middle)

We mentioned the big hit in biotech last time, but other former leading sectors like financials and homebuilders have also been weak. The S&P 500 is just 1.3% from its closing high, but financials are down -2.4%, homebuilders 8.1% and biotech 17%. Homebuilders and Biotech from some support from their 200-day average (like the NASDAQ and Russell 2000), so a bounce would be expected, but the weakness in these groups suggests the clear potential for a market transitioning from uptrending to sideways or declining.



Long-Term S&P 500 (bottom)

A lot of volatility in the short-term, but still no change to the long-term outlook as the S&P has stayed above the very important 1775-1780 level that would open the door for a potential decline down to as low as 1500.

A correction could drop all the way to 1775 and still not change the long-term outlook, so its too early to say the bull market is over. **A drop below 1775 on the S&P would be a warning move for all investors to pay attention and consider defensive measures.**