# Hamilton-Bates
# Market Update
*May 5, 2014*

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Encouraging news on the job front wasn't enough to lift the stock market at the end of last week as traders and investors continue to remain nervous over the situation in Ukraine. The jobs report also failed to reverse the negative affects of an anemic Q1 GDP report showing growth of just 0.10%.

**Earnings, Interest Rates, and the Economy**

This past week the Fed cut its QE program back by another $10 billion per month to $45 billion, split between Treasuries and Mortgage bonds. The Fed believes growth has picked up although Q1 was abnormally and temporarily affected by weather. The stock market didn't react to the news and has so far held up well in the face of QE reductions.

So far 377 of the S&P 500 have reported first quarter earnings. 72% have beaten estimates, 9% were in line, and 19% missed. This is ahead of last quarter which saw 68% beat estimates, 11% in line, and 21% miss. While aggregate reported earnings are coming in better than expected with more beats than last quarter, gains continue to come through cost savings and share buy-backs, as revenue growth continues to languish. If this doesn't change equities will have to rely on multiple expansion for price appreciation, which, as we have discussed for some time, will be difficult with P/E ratios not far from their recent multi-year highs. This could be part of the reason for the stock market's hesitation of late. So far the market has held up because selling has been muted, likely because alternatives in a low interest rate environment are few. The first move for investors seems to be into dividend paying stocks. But if stocks can't make any headway investors may at a point grow impatient and decide they would rather wait things out from the sidelines or other fixed income investments. We need to see earnings and forecasts increase because with P/E ratios still near multi-year highs equities can't continue to rely on multiple expansion for price appreciation. Stocks remain at an inflection point as we see if the remaining technical negatives can be erased and if earnings forecasts for earnings improve. Longer-term we remain bullish but we could change that opinion at any time should the S&P violate our long-term support target around 1800 (see chart section).

**Market Outlook and Investment Strategy**

The market was up last week but only slightly as GDP disappointment and unrest in the Ukraine put new pressure on the market. The NASDAQ retreated from its 50 day average as Amazon fell almost 10% after merely matching most analysts' forecasts. They did signal a loss for the ongoing quarter. Ford also missed on higher costs and Visa slid 5% after slower sales growth and a warning that Russian sanctions were prompting a competitive payment processing system. The situation in Ukraine is having more of an affect on companies then many investors thought. The market has so far shrugged it off in terms of the blue-chips but for how long? The building tension with Russia creates uncertainty that investors hate. But there is no way to plan for external market events except by limiting risk and to focus on domestically centered companies. That generally means less speculative stocks with lower appreciation potential. That is exactly the market rotation we are seeing now. There is also renewed interest in fixed income.

The bottom line is that its bearish when the market cannot rise on good news such as what we got from the Job's Report on Friday. If it cannot rise on such news, what will it do on bad news? We're told the weakness owed to the escalating violence in the Ukraine. Americans are very tired of wars 12,000 miles from home and

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other than a lot of talk and some sanctions, there's little the Administration can do to hurt Russia, assuming that Russia is actually to blame for most of the fighting in Eastern Ukraine and now Odessa.

A decline back toward the recent lows seems likely. With the averages having failed to break out above their highs last week we will likely see some selling this week as stocks search for support. We also have a switch to bearish seasonally from May to October.

The US equity market continues to undergo a violent rotation as tech, high beta, and small caps struggle as dividend payers move up. During the multi-month period in which the overall index has remained range-bound a number of key sectors have broken out, including energy and utilities, while others have threatened to breakdown like consumer discretionary and internet.

Breadth remains positive and the AD Line confirms the recent highs. But buying has been on weak volume and not enough traditional growth sectors are leading in a normal way to ignite a new rally. The indictors have us positive but so far we don't see a new bull market with uninterrupted gains this year. A new pullback should follow a market peak in the 1st half of the year.

So far 2014 seems like the opposite of 2013, with fixed income and defensive sectors leading and last year's winners lagging. These rotations make some sense given the uncertainty but so far there has been little confirmation from the economic data to show a slowdown. Perhaps it is coming. There is an abundance of confidence in the Fed's ability to control the market or limit downside. If that belief is ever shaken the market could be in for trouble. Given that the low interest rate environment favors equities, we would certainly allow for the possibility of a violent rebound in some of the more beaten down portions of the market which would see the Dow and S&P 500 hit new highs. We also suspect some of the strength in defensive names has now become momentum driven, and doubt that a sector like Utilities could keep up with the overall market in the event that the SPX were to break out.

With the major averages still above long-term support it is too early to make any calls that the end of the bull market is upon us. However with the bull run now over 5 years old, we must pay attention as indicators shift from 'green' to 'yellow' and potentially to 'red'. The market won't go up forever and a correction greater than 10% or possibly even a bear market is likely in the market's not too distant future. A move below 1800 on the S&P 500 would be something to pay attention to, as it would begin to break the uptrend in place since 2009.

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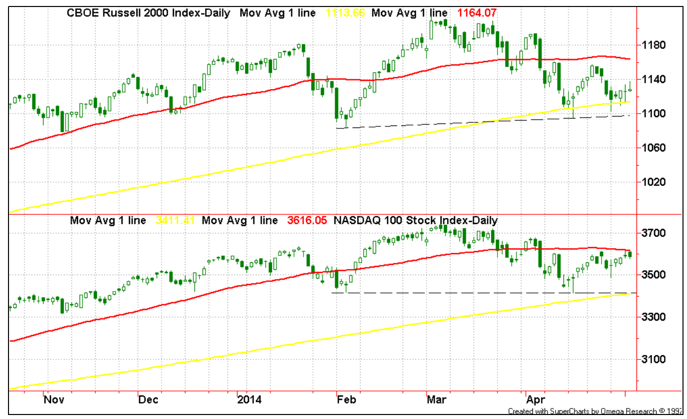
## What We are Seeing in the Charts—Blue-Chips Hold While NASDAQ & Russell Fold

**Near-Term NASDAQ and Russell 2000 (top)**

Unlike the Dow and S&P, which have held up well, the NASDAQ and Russell 2000 remain weak. Investors have gotten nervous of late over Ukraine and other poor economy data from China, but rather than exit stocks altogether money has rotated away from high beta into high dividends. Both the NASDAQ and Russell bounced from their 200-day averages (yellow lines) but unless both surpass their 50-day averages (red lines) the near-term outlook remains bearish. <u>We remain focused on blue-chips.</u>




**S&P 500 (Middle)**

The S&P remains near its best levels as money rotating into defensive sectors buoys the index. Prices are still confined to a consolidation pattern, and it remains to been seen whether the index will be able to clear its all time high around 1900 and build enough upside momentum to break clear of a several month long price pattern. <u>We now mark first support at the 1850 and key support at 1815 the recent April low</u>.


**Long-Term S&P 500 (bottom)**

Still no change to the long-term outlook as the S&P has stayed above the very important 1790-1800 level that would open the door for a potential decline down to as low as 1500. A correction could drop all the way to around 1800 and still not change the long-term outlook, so its too early to say the bull market is over. <u>A drop below 1790 on the S&P would be a warning move for all investors to pay attention and consider defensive measures.</u>