Hamilton-Bates

Market Update

May 19, 2014

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May 20, 1873 - Levi Straus and Jacob Davis receive patent for blue jeans and an American Icon is born.

The frustrating market we have been in so far in 2014 continues. Most major indexes traded lower on the week except the DJIA which mananged a small gain. The downside leader once again was the Russell 2000 (small caps), down 2.05% on the week and 5.00% for 2014. We like to see small caps leading to the upside, not the downside, because it reflects the willingness of investors to take risk, and is also a reflection of liquidity in the market.

So far the market hasn't done anything 'wrong', but the lagging aspect of the small-caps and NASDAQ are troubling. Should the disparity between what the blue-chips and the aforementioned indexes continue much further—it would suggest greater downside weakness for the market. The key levels for us on the Russell and NASDAQ are their May lows. Should they be broken we could see a much more aggressive decline develop.

Economics, Earnings, and Interest Rates

The 1Q GDP number showed minimal growth of just 0.1%, just a hair above an outright contraction in the economy. However this data was largely dismissed as weather-related by the Federal Reserve and most Wall St. economists. One thing is for sure, if the data doesn't show a significant bump in coming months there is something definitely wrong with the economy. The early year expectations of 3-4% growth for the economy now look incredibly optimistic, as we are seeing much lower growth, somewhat lower unemployment, and slightly lower inflation than forecasted. At the next meeting in June we expect to se plenty of dovish revisions in the FOMC forecasts and outlook as the Fed tries to talk the market into a comfort zone. The Fed continues to cut back on QE and state that their policy is 'data dependent'. We take this as 'stock market dependent'. If stocks go down they will say and ultimately do what they can to prop up prices. If the market goes up they will continue to cut QE. So far there seems to be significant faith in the Fed's ability to control and facilitate the financial markets. Should that faith ever get tested that will be a period of real risk for investors.

Market Outlook and Investment Strategy

Over the past three months the market has been in a trading range of about 5% and gone essentially nowhere. Beneath the surface though we have a tale of two markets. The large caps and dividend payers of the DJIA and S&P eked out a marginal new all-time closing as money flows into these areas, but the NASDAQ and Russell 2000 are down 7-8% from recent highs as money moved out. In fact both of these high beta indexes hover just above important support levels that are probably key to market direction. If the Russell 2000 and NASDAQ hold their lows and bounce, we'll probably see new highs in the blue-chips. The key is that if the market is still in a bullish configuration the Russell and NASDAQ should begin to assert upside leadership once again. If the Russell 2000 and NASDAQ roll over, then the risk of a more sloppy period of broad selling across the market would increase. The levels at which concern over the divergence would warrant caution are the April-May lows, which now converge with these indexes 200 day average. More on this in the chart section on the next page.

We remain invested with a focus on blue-chips and dividend paying stocks. Value is leading growth right now as investors are showing less appetite for risk. This is ok as along as the weakness in the secondary indexes remains contained—any further weakness would likely shift us to a more defensive posture.

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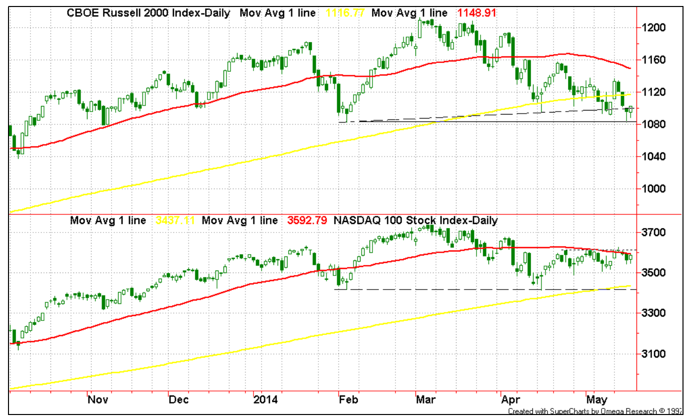
Charts—NASDAQ and Russell Struggle as Blue-Chips Hit Resistance

Near-Term NASDAQ and Russell 2000 (top)
Unlike the Dow and S&P, which have bounced and are once again near their highs, the NASDAQ and Russell 2000 remain weak. So far neither the Russell or NASDAQ has been able to but above their April-May peaks, which would be a very bullish sign. Rather than leave stocks investors have rotated to the blue-chips instead, which is why those averages (DJIA and S&P) are holding up. Both the NASDAQ and Russell bounced from their 200-day averages (yellow lines), and we would not wish to see those levels broken. Key support for the Russell 2000 is 1080, and 3400 for the NASDAQ Composite. **Much broader selling is likely if these levels are broken.**



S&P 500 (Middle)
The S&P remains near its best levels but the rally has stalled in 2014 as the S&P bumps up against the top of its 5 year channel from the 2009 lows. You can see by the red arrows that prior bumps against the top of the channel saw minor to significant corrections. Should prices break 1800 we could see a dip down to the bottom of the channel now near 1600. **We now mark first support at 1860 and key support at 1800**.

Long-Term S&P 500 (bottom)
Still no change to the long-term outlook as the S&P has stayed above the uptrend line from 2009. The level to watch is now 1800, a level that if lost would open the door for a potential decline down to as low as 1500-1600. A correction could bounce off of 1800 and still not change the long-term outlook, so its too early to say the bull market is over. **A drop below 1800 on the S&P would be a warning move for all investors to pay attention and consider defensive measures**.