Hamilton-Bates
Market Update

June 2, 2014

June 6, 1944—Allied forces cross the English Channel and land on the beaches of Normandy, France, beginning the liberation of Western Europe from Nazi control during World War II.

P.O. BOX 270 Newtown Square, PA 19073 877.768.4247 www.hbir.com

Stocks rose nicely last week with the S&P 500 reaching another high, and the major averages adding about 1%. Traders and investors shrugged off a negative revision of GDP growth for Q1, along with slightly weaker than expected housing data. Focus instead was on positive reports on consumer spending and the labor market, along with ongoing merger activity. Traders are now looking ahead to anticipated corporate expansion during the remainder of this year as they hopefully react to better consumer spending.

Economics, Earnings, and Interest Rates

Government policies rather than a robust economy have been the market's driver over the past year. Even as the Fed tapers its QE program, its remaining liquidity additions coupled with suppressed interest rates have been enough to push money into stocks and prevent so much as a 10% correction since 2011. Companies have been able to grow profits through efficiencies but revenues have not kept up. The time has now come for sales to grow, but this could perversely limit hiring as companies strive to boost revenues while limiting expenses. that may also impact hiring. US Personal Spending rose to a 4%+ year over year gain in April, much better than expected. Personal Spending has accelerated slightly in recent months, as one would expect given a gradual improvement in employment over this period. But this spending has come at the expense of savings, which dropped to a new low. If consumers don't see income gains soon (which have so far lagged spending) we could see a drop-off in economic activity later this summer as consumers become tapped out.

Longest Stretches Without a 10% Correction

The market has done well over the past 6 years, recouping the 2008 losses and moving into all-time high territory. But this should not lull investors into a sense of complacency as the stock market is very overdue for a correction (decline of 10% or more) as we have seen a very long run without a 10% decline. The last 10%+ correction was a 17% drop from April to October 2011, more than 30 months ago. Since 1914 there have been 8 other times when the DJI rose longer than 30 months without a 10% correction. Looking at these 8 times the rally lasted just another month or two in 6 cases. Only during the 1990's tech bubble and into the 2000 top did we see much longer moves of 50 and 80 months. But both of those cases saw pretty severe declines thereafter. We would expect a correction sometime in 2014. If we don't see one then we'd look for an even bigger 'payback' decline in 2015. For now the market hasn't done anything 'wrong' but its not the time to 'buy and hold'.

Market Outlook and Investment Strategy

The market looks as though it wants to resolve the multi-month range with a push higher. The blue-chip averages have edged to a series of minor highs but haven't picking up momentum. On the other hand the small-caps continue to lag as does the NASDAQ (which did perk up last week). With the blue-chips strong and small-caps weak the tech heavy NASDAQ could be the deciding vote. A move up this week on top of last week's gains would suggest the tech sector will be a leadership sector—a good sign.

The small-cap Russell 2000 index has avoided a breakdown by rallying off of its 200-day average, but hasn't moved to a new high. Should small-caps start to pick-up steam we could see an enthusiastic summer rally. What is important is that the Russell 2000 avoids an actual breakdown, which could then spread across the market. The recent rebound is another important improvement for the overall environment.

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2014 was 'supposed to be' the year yields rose as investors rotated from bonds into stocks, but what we have seen is entirely different. Investors haven't given up on bonds, which in fact have rebounded this year from last years sub-par showing. The rotation we have seen has been out of high-beta stocks and small-caps into blue-chip stocks—ostensibly in search of yield—dividend yield. This has led to an unusual situation where blue-chips have diverged from small-caps and bond yields—undoing a trend that had been ongoing to a few years. We cover this a bit more in the chart section on page 3.

The fact that fixed income and equity markets are telling such different stories (bond yields falling suggests a slow-down, while S&P rising suggests growth) means that the economic message from one of these areas is wrong. How this divergence resolves itself over the Summer is the key question for the financial markets. Given that weaker credits like high-yield bonds have held up well, we do not yet see an economic basis for another collapse in the economy, but neither have we seen anything close to a normal economic growth cycle. What we have seen is a tremendous build-up of global liquidity and the promise from forward guidance of the Central Banks to keep monetary policy very loose. This has driven investors to seek yield wherever they can find it—ie dividend paying stocks and REITs.

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 decline would increase. Should they regain leadership we could see some real upside fireworks in June and July.

The market will reveal the direction it will take over the next few months. After a sharp rally into early June the market is due for a break, which will be a test as to whether the current break-out is for real. So far the uptrend is still intact, and unless we see some serious selling any pullback is likely to be just that—and lead to higher prices later this summer.

We remain invested with a focus on blue-chips and dividend paying stocks. As along as the weakness in the secondary indexes remains contained, we'd look for higher market levels. Any further weakness below the May lows would likely shift us to a more defensive posture and potentially change the long-term outlook.

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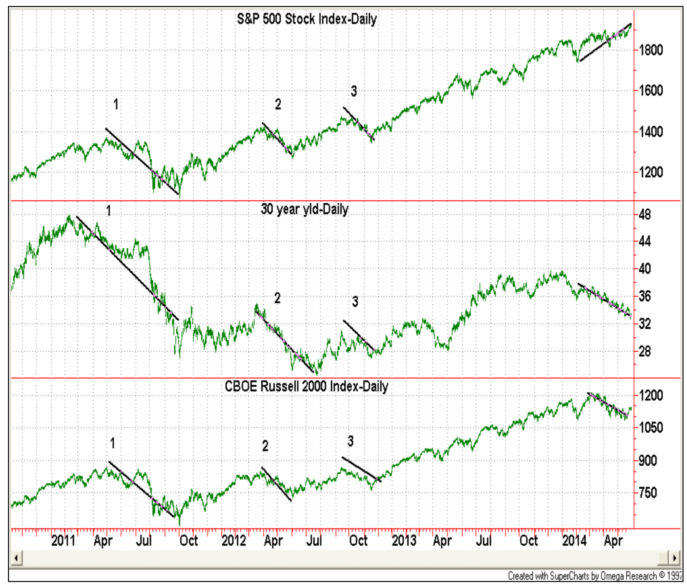
Charts—NASDAQ and Russell Struggle as Blue-Chips Hit Resistance

S&P 500 Marching to Its Own Drummer (top)
One aspect of the rally that has thrown many investors this year is the apparent disconnect between the blue-chip stocks, small-caps, and bond yields. Over the past few years these three have traded in synch, rising and falling together. When bond yields and small caps fell so did the blue-chips (See noted areas 1, 2, & 3 in chart). 2014 however has been different. The S&P has moved higher as bond yields and small caps fall. Weakness in small-caps and yields **could** be a sign the economy is really weak, **or** it could just be a reflection of a rotation from small-caps into dividend paying stocks **because** the Fed has held down rates and looks to do so for some time. The resolution of this divergence should be interesting.



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**.