Hamilton-Bates

Market Update

July 11, 2014

July 11, 1804 Two Founding Fathers Duel. In a duel held in Weehawken, New Jersey, Vice President Aaron Burr fatally shoots his long-time antagonist Alexander Hamilton. Hamilton, the chief architect of America's political economy, died the following day.

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After six weeks of rally, the financial markets suffered a hangover this week after a long Holiday Weekend. Increased tension in the middle-east was part of the blame, so were concerns about upcoming earnings season, but a good deal of it belonged to news of renewed banking trouble in Europe—and in specifically Portugal. Rumors were flying all week as bank stocks in Europe fell, but news hit late Wednesday night that Banco Espiritu Santo was going to miss a debt payment—shocking financial stocks in Europe and our market was hit as well. The sharp decline blunted a rebound attempt mid-week, and started off Thursday's session down over 1%. Gradually however, stocks managed to claw back to finish just marginally lower as dip buyers came in.

Economics, Earnings, and Interest Rates

The FMOC released its minutes this week, and the notes were largely as expected—no shockers. Expectations (by the Fed) are for a solid earnings season and they expressed confidence in a rebound for the economic growth in the second half of 2014 (we are not as optimistic). The Fed will maintain their rate strategy and timetable for QE, wrapping up in October. With QE ending it will now be up to earnings to carry the load.

We need to see a good earnings season due to the run-up in P/E ratios in 2013. First quarter earnings had 70.4% of stocks beating analyst estimates, and a disappointing earnings season could be a catalyst to bring sellers off the sidelines. In addition, the spike in crude oil may dampen earnings and outlooks for many companies for the second half. Valuation, based on spreads between equity and bond yields, remains at levels where stocks are attractive versus bonds, but only on a relative basis. Bond yields have been suppressed by the Fed, making stocks look better. So the next few weeks are important ones for stocks, and come during a normally quiet period (summer doldrums). We need to see earnings and forecasts increase because equities can't rely on further PE expansion for price appreciation. In 2013 the S&P 500 gained 30.11%, with 2/3 of the gains through PE expansion rather than earnings growth.. The market is now pretty stretched in terms of PE, and without earnings growth it will be tough for equities to appreciate substantially from here, even with low interest rates. The earnings season starts slowly and builds in intensity. Companies now must deliver higher earnings and increased revenues to satisfy the delayed expectations of the market, and weather can no longer be an excuse.

Market Outlook and Investment Strategy

The market ended the July 4th week at a high, as positive jobs data helped to lift stocks. The impending long weekend and early Thursday close meant volume fell sharply, contributing to the session strength but the internals were not that great. Expectations are high for the new quarterly results so any failures may be met by quick selling pressure. On Monday of this week the new quarter began on a cautious note as markets pulled back. Small stock weakness was clear with the Russell 2000 down twice as much as most major averages. Volume did increase sharply on the drop so this is a sign of institutions trimming positions. We don't yet know if a new broad market retreat is underway, the market is trying to end the week with a rebound, but should weakness persist much more, but some increased defensive action would certainly be prudent.

Given the concerns over China's economy and the latest Europe banking crisis, the US economy is now in crunch time. The US was supposed to take the lead for growth prospects in 2104 and now it looks like it really must in the second half for things to turn out well. If the US can't become the world's growth engine the fledgling recovery could be in trouble.

We remain invested in stocks and corporate bonds, while avoiding government debt. The uptrend could <u>continue</u> into 2015, but its not a given with the end of QE and PE's elevated. It will be important for investors to have a nimble and flexible strategy once the Fed-induced rally comes to its eventual end. We believe there could be a top of some significance in late Summer.

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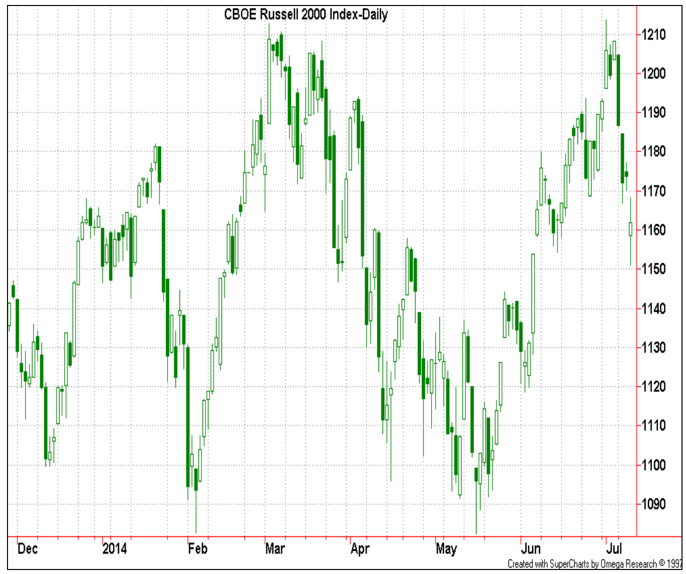
Charts—Small-Caps Lag, Long-Term Trend Still Bullish

Blue-Chips Gain for 2014—Small Caps Don't

While the DJIA and S&P have solid gains for the year, small-caps have lagged badly. In fact the Russell 2000 (top chart at right) is currently negative for the year-to-date. This concerns us since the Russell 2000 generally leads bull trends. When it starts to lag it generally reflects a drying up of liquidity, along with less risk appetite by investors. Also concerning is that the Russell 2000 is a domestic based index, so it generally reflects what investors believe is happening in the US economy. Investors may be coming to believe that growth will not pick up in the latter part of the year.



Long-Term S&P 500

Still no change to the long-term outlook as the S&P has stayed above the uptrend line from 2009 that we call the 'Slope of Hope' since it seems that for much of the rally everyone hopes solid growth is around the next corner. <u>The level to watch is now 1860-1865, a level that if lost would open the door for a potential decline down to as low as 1500-1600</u>. A correction could bounce off of this area and still not change the long-term outlook. A drop below 1950 would signal the onset of at least a short-term correction but not necessarily the end of the bull market.

A drop below 1860 on the S&P would be a warning move for all investors to pay attention and consider defensive measures.