HAMILTON BATES INVESTMENT RESEARCH

Hamilton-Bates
Market Update

June 30, 2014

June 30, 1936—Gone with the Wind is published. Margaret Mitchell's book became one of the best-selling novels of all time and was the basis for a blockbuster 1939 movie.

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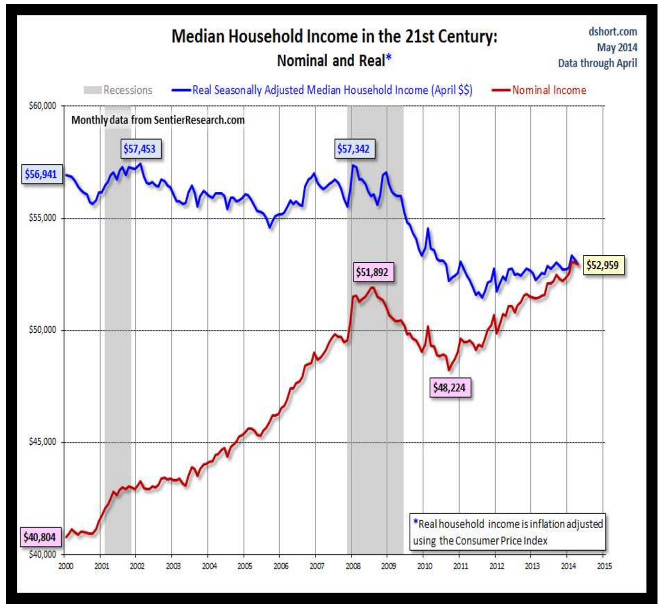
Stocks barely budged last week as movement, volume, and volatility continued to contract. Much of the trading activity was limited to just a 10-point range in the S&P 500, a range of about 0.50%, or virtually nothing in historical context. For the quarter and year-to-date stocks and bonds have both posted modest to moderate gains, confounding experts who expected rising interest rates in 2014 to stall the stock market advance.

In fact the markets have so far shrugged off many external negatives like events in Ukraine, Iraq, as well as rising oil prices. Even poorer economic data (such as a -2.9% 1Q GDP!) and earnings haven't moved the market needle. Perhaps it is the summer doldrums come early, but more likely we are seeing the affects of the Central Banks' QE and zero interest rate policy.

Why the Economy Stinks in One Chart

Today, most major developing countries are struggling. In Europe for example, recent GDP data shows growth of just +0.8%. First quarter GDP data for the US showed a **decline** of 2.9%, much worse than expected and one of the 20 worst quarters this century. It was also only the second of 20 similar quarterly declines in GDP that have occurred outside of a recession. We continue to see data that suggest the economy is weaker than believed.

Despite massive amounts of stimulus, global growth remains stagnant. The reason for the lacklustre rebound is due to businesses and individuals slowly withdrawing their money from the economy, not investing in capital equipment expansion, and hiring, but rather favoring stock buybacks and mergers to create the illusion of earnings growth. Earnings growth peaked in 2012 and has declined since. The reason for that, and much of what ails the economy is in the following chart. The Blue Line is Real or Inflation adjusted median income, the Red Line is nominal or non-inflation adjusted income. The Blue line is



the 'real story' as to why the Fed is so eager to keep stock prices rising, and why it continues to pin its hopes on confidence games and the wealth affect in the real estate and financial markets.

What the above chart shows is that income gains have not kept up - real income peaked in 2000 and has been falling since.

As the excellent chart from Doug Short at dshort.com shows, the typical U.S. household was struggling before the Great Recession of 2008. Real median household income (blue line) spent most of the first nine years of the 21st century struggling slightly below its purchasing power peak in 2000. Real income (adjusted for inflation) hit an interim peak in early 2008, far below the nominal and very much illusionary peak just recently. When inflation is taken into account, the real recovery from the trough has been minor. At this point, real household incomes are in worse

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shape than they were four years ago when the recession ended. The Fed may say that inflation is not a problem, but that is not true. Perhaps inflation isn't as bad as it was in the 1970's and 80's, but it is still a persistent problem. Part of the blame could be on companies getting rid of jobs, and the economy's well-documented loss of what are called breadwinner jobs. Part of the problem could be that the types of jobs created since 2009 are just not as good as those lost during the last recession.

But the bottom line is that households and companies live in a world where you can only spend what you make. If you spend more than what you make, you need to borrow to make up the difference. Eventually, you will have reached your borrowing limit and then you have to start repaying your debt, or if you cannot repay – you default on your loans. When the housing bubble went bust we got the Great Recession of 2008, as consumers had to retrench when the home equity ATM shut-down. Looking at the chart and seeing that median income was stagnant showed just how import consumer debt through housing has become. Households used debt to fund purchases for much of the 2000's. Debt fueled booms eventually go bust. When it did the Fed spurred by the political leadership took the very short-term approach of substituting one form of debt for another. As consumers pulled back the government and the Fed loaded up. Funded by a seemingly perpetual access to debt, governments around the world have turned to debt to prop up their economies and ailing banks. Months have turned to years, and we have continued to see and deficits and borrowing pushing the theories of money to their limits. Europe is close to having negative interest rate—where they charge you to put your money in a bank! The world's Central Banks are inclined to keep the monetary party going – no one wants to take the pain of a recession anymore. This is the reason for 0% interest rates, money printing, bank bailouts and the ultimate robbing earnings on savings from the poor to pay for the illusion of health that rising stock market's provide. This has and can go on for some time, and we could see even more upside market fireworks as stocks truly become the only game in town as interest rate suppression forces assets into stocks in search of growth.

They say a picture is worth a thousand words, and if so the chart of median income is one in our opinion that explains clearly why the Fed is so intent on keeping rates at zero percent despite being several years into a so-called recovery. And it also explains why the economy continues to feel so soft despite the stock market's rise and the proclamations that everything is fine by CNBC and the leadership in Washington (and the Fed).

However, unless and until real income rises, the economy will continue to feel sluggish, the Fed will remain tied to its desperate and misguided attempt to boost the economy through the wealth affect, and the middle-class will continue to shrink.

Market Outlook and Investment Strategy

How does the above apply to investment strategy? Frankly it doesn't—not yet. More important than

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the news is how the market reacts to it—and right now the market is not moving up due to growing earnings or an economic recovery. The market is rising because of the actions of the Fed and other central banks. Given the underlying trends in market momentum and breadth, this uptrend is likely to remain for some time. <u>The concern and true risk will come when the market no longer responds bullishly to easy money</u>. And that time will come. When it does we will likely see a decline much greater than anything since 2008.

As we enter the second half of the year some sort of pullback would be the healthiest course for the market, and a break below 1,925 should lead to a deeper pullback towards 1900, our short-term support target. A summer correction would be a welcome opportunity to buy into year-end rally, which could stretch well into 2015 and lead to some sort of blow-off culmination of the central bank induced bull market.

Bull markets die or correct because of a retraction in liquidity, and despite the reduction of QE there is still no shortage of liquidity—the Fed has made the financial market the only game in town. With the advance-decline line confirming the recent highs, we are not look for THE top just yet.

We remain invested in stocks and corporate bonds, while avoiding government debt. The uptrend could continue into 2015, but it will be monumentally important for investors to have a nimble and flexible strategy once the Fed-induced rally comes to its eventual end.

Charts—Short-Term Correction Possible but Bull Trend Intact

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. The level to watch is now 1835-1840, 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 this area and still not change the long-term outlook. A drop below 1930 would signal the onset of at least a short-term correction but not necessarily the end of the bull market.

A drop below 1835 on the S&P would be a warning move for all investors to pay attention and consider defensive measures.