Hamilton-Bates

Market Update

July 23, 2014

July 26, 1775—The U.S. postal system is established by the Second Continental Congress, with Benjamin Franklin as its first postmaster general.

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After a strong start to July, the market seemed on the edge of a sizzling summer rally. But it wasn't to be as the market made a peak on July 3rd and has been trading sideways ever since. The major averages finally and only slightly surpassed the July 3rd high this week. Its been a volatile few weeks where geopolitical events fought earnings reports for the attention of investors. Neither have been able to push the market more than a few percentage points one way or another, or out of its trading range.

Earnings, Economics, and Interest Rates

Earnings season is starting to heat up, and we do need to see a good set of reports due to the run-up in P/E ratios in 2013. We also need to see growing revenues and forecasts to move higher. First quarter earnings had 70% of stocks beating analyst estimates. So far we have seen 74 companies report—with 75% of them beating on earnings and 2/3 on revenue. Not bad, but not enough to move the aggregate earnings needle. We need the trend to continue. A disappointing earnings season could be a catalyst to bring sellers, not just profit takers, off the sidelines.

Economic data has done ok, but news on this front will taper off for the rest of month. The Fed remains supportive and likely to continue their taper—but unlikely to raise interest rates any time soon.

Valuations, based on spreads between equity and bond yields, remains at levels where stocks are attractive versus bonds, but neither asset class can be called 'cheap' or 'inexpensive' in terms of valuation. . With P/E ratios around multi-year highs, equities can't rely on multiple expansion for price appreciation.

Market Outlook

The market continued its streak of higher highs in early July, but has not had the smoothest time since then as it has been hit by a number of negative news events which have proven to be setbacks, but only just temporary. The market has had to dips in July, but each time buyers have stepped up. There is something to be said about the market's resilience. It doesn't seem this bull will go down without a fight. As long as 1950 holds on the S&P 500, the near-term trend remains 'up' and a run at the round number figure of 2000 seems likely. The concerns we have about the market from a technical perspective come largely from the Russell 2000 Small Cap Index, which still sports an ugly chart. The Russell 2000 made a peak back in March, briefly tested it in late June, but has since had a drop of 5% from that level, leaving it as the only major index negative for the year. The drop took the Russell to its 200-day average, a logical level to see a rebound which did occur. Last week the Russell even dropped below its 200-day moving average briefly before closing above it the next day. This two day pattern, along with and accompanying volume reversal seen on the blue-chip averages, are signals of near-term bullishness. Our focus will remain on the Russell 2000, as we don't like to see weakness in small and midcaps as it shows a reluctance to assume risk on the part of investors. It also creates negative breadth divergences, which *so far* have been overcome, but which at some point can trigger a larger decline. Declines in small-caps and divergent action between those indexes and the blue-chips are often the first warning signs of a major market turn.

With the 3rd quarter now two weeks old, corporate earnings are starting to dominate equity market performance and have thus far been generally supportive. The major S&P and NASDAQ indexes are within spitting distance of key round numbers of 2,000 and 4,000 respectively. These levels are not insurmountable, but we do believe that we may see some hesitation. Ultimately we think it will take good news on the earnings front to propel the large-cap indexes up through them convincingly. We believe earnings forecasts will determine whether we witness a broad breakout by the indexes or a narrower advance that merely takes certain issues and sectors higher. The latter scenario would be much more risky and suggest more corrective action will ultimately be seen. It is also possible that earnings disappoint, since the vast majority of companies are yet to report, but given that the bulk of economic data pointed to a rebound in activity last quarter, this seems unlikely. Especially since the majority of negative pre-announcements,

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known as ‘confessions’, are over. With the market once again testing but so far unable to surpass the early July high, there is a chance stocks continue to consolidate until investors see what second quarter earnings and forecasts look like.

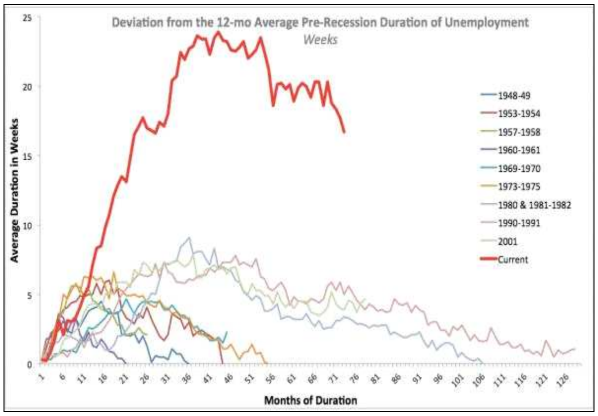
The bull trend remains intact, with the market not even threatening the key long-term level of 1860 during any of its recent pullbacks. Even short-term corrections are limited, with the bears unable to muster any energy.

Given the Federal Reserve’s government sponsored liquidity, zero interest rates, and the belief that there is no alternative than stocks, the market continues upward in much greater magnitude than the economy justifies. This has been going on for year’s, and eventually the other side of this monetary largess will be seen.

Charts—Scary Unemployment Duration, but Long-Term Trend Still Bullish

Duration of Unemployment

All we hear day after day is that the recovery is here or just around the corner. Amid all the media discussions of the 'recovery' in America and the President's employment track record, nowhere is this chart (from *true economics.com)* discussed. It shows the duration of unemployment compared to all post WWII recessions. All you need to grasp is that the bold red line is the current ‘recovery’, and it is a major outlier. In this chart ’higher’ is not better. Nearly 80 months from the last recession average unemployment duration is still over 15 weeks—and that’s with all those long-term unemployed that have run out off benefits taken out. This doesn’t mean that stocks cant run higher, it means that this bull market is not running on good fundamentals—just monetary caffeine. When it runs out the market will be in trouble.



Long-Term S&P 500

Still no change to the long-term trend as the S&P has stayed above the uptrend line from 2009. <u>The level to watch is now 1865-1870, 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. In the near-term, 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**.