Hamilton-Bates

Market Update

August 6, 2014

August 6, 1945—At 8:16 a.m. Japanese time, an American B-29 bomber, the *Enola Gay*, drops the world's first atom bomb, over the city of Hiroshima. After a second bomb was dropped on Nagasaki, Japan surrendered six days later. Let us hope such weapons are never used again.

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The financial markets broke out of their summer doldrums this past week, as stocks reeled from a combination of negative headlines that for the most part had been the same headlines they had been ignoring all Summer. More important than the news itself is the markets reaction to news—which was a definite negative. Certainly this is a change in market character that demands attention. In other words, the market may be on the cusp of its first real correction since 2011. It is possible the market has entered the transition phase to a top. The indexes lost 2% last week, and are on track to drop a similar amount this week. Our initial take of the market's action of the past week suggests that, while the decline from April's low has been reversed, longer term trends still remain intact.

Earnings, Economics, and Interest Rates

Earnings season is now three-quarters over, with much of the earnings headlines shoved in the background by events in Ukraine, Argentina, and Gaza. While earnings started off in the quarter in fairly decent fashion, the trend has been steadily declining so that currently the beat/miss rate is slightly worse than Q1. Forward guidance has been very mixed, with genuine concerns that Europe's economy could roll over once again . Those concerns appear to have been somewhat correct, as Italy's GDP was negative for the second quarter in a row (a recession), and numbers from Germany's industrial production just printed a negative trend with prior downward revisions. Germany's economy, the growth engine for Europe, seems to be bearing the brunt of the Ukraine crisis. France, Spain, and Portugal remain basket cases. We needed to see continued good earnings and forward guidance since P/E ratios are not far from multi-year highs, but so far the market has come short. Over the past week investors have indeed moved to the sidelines as absent great earnings investors are paying more attention to the effects of events in Europe.

The Cost of Stability

Even after the recent market pullback stock markets around the world are largely at or near all-time nominal highs, just as global interest rates hover near historic lows. In the wake of the 2008-2009 crisis the Fed 'saved the world' with a flood of newly-printed money and zero percent interest rates. This was designed to stave off financial Armageddon and stimulate the economy.

Armageddon was avoided in 2009, the world's financial markets exploded to new highs, but the world's economy didn't quite keep up. Growth rates in the developed world (U.S., Europe and Japan) have been significantly sub-par for the 5-1/2 years following the financial crisis. Businesses have been reluctant to invest and hire. The consumer is still squeezed as student loans replaced mortgages as the 'debt anchor' around their necks. With incomes not keeping pace with inflation, consumer spending has lagged, and choppy. The consumer (other than the 1%) finally appears tapped out. And then there significant suppressive forces from poor policy, including taxes and increased regulation (except for Wall St of course).

Enabling this poor policy has been the Central Banks, including all the major players from the U.S., U.K., Europe and Japan. Central banks have jumped on the path of holding rates at zero percent and printing money in order to stimulate the economy. With central banks buying the debt, yields have converged at remarkably low rates. In Greece (for goodness sake), long-term government debt is trading with a yield just north of 5%. In France, 10-year bonds are trading at a yield of 1.67%. Many European 5-year bonds yield less than treasuries! With zero rates on tap, money has moved down the risk spectrum in the credit markets and naturally into stocks—pushing the world indexes ever higher.

Are these financial asset prices the result of sustainable economic growth and healthy employment trends? Sadly the answer is no. Current financial market conditions are the result of policymakers engaging in groupthink believing that more debt can solve a debt problem. By reducing interest rates to zero and having central banks purchase most of the debt issued by their respective governments, the

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central banks think that economic activity can be supported and enhanced. We are 5-1/2 years into this global experiment, the kind that has never been tried in its current breadth and scope at any other time in history. The fact is the entire developed world is growing at a sluggish pace, if at all. Employment trends in job quality and wages have been stagnant or non-existent. Jobs have come back but they are not the same type of jobs lost during the last recession. So called breadwinner jobs have not come back.

Over 5 years into a recover the Fed is still enacting emergency monetary policy—that alone should raise some alarms. Like the frog who will sit in a pot of water that is gradually raised to a boil, investors and professionals alike seem to have become numbed to the fact that healthy economies don't require emergency triage measures 5 years down the line. Rather than admit any failure; governments, media, academics, politicians, and central bankers refuse to state the obvious conclusion that their policies have failed and need to be revised. Instead, they all state that in the absence of their current policies, things would be much worse. To which we respond—if the economy is truly healthy it wouldn't.

Investors need to be aware that the apparent stability of the world financial system in the wake of the 2008 crisis is both superficial and temporary. The Central Banks suppression of volatility at all costs is an ultimate trap, seeming to work until it doesn't—and when it doesn't the train comes off the tracks. We are not in the longest period in 50 years without a 10% correction. Markets don't go up forever, cycles have not been repealed—but they have been delayed. Investors are 'seeking yield' now in assets of lower quality and higher risk, with more and more leverage. Zero percent yields have suppressed interest rates to levels that do not compensate investors for some of the risks they are taking. At the moment, the long-term trend remains intact, and investors engaging in this yield searching do not see any clouds on the horizon.. But rather than a healthy recovery built on consumer demand and true economic expansion, the current 'recovery' has been largely monetary steroids since 2012. In essence the financial world has learned nothing from the last bubble bursting in 2008, and at some point is set to repeat the disaster once again. Perhaps not as severe, but still a 'normal' 20-30% drop given the recent suppression of volatility would feel like the end of the world to the Fed and policymakers, and possibly many investors. We will do our best to be prepared, aware, and properly positioned.

Market Outlook

The market's downward action late last week triggered some short-term sell signals in our technical models, resulting in some sales of aggressive positions at that time. More core holdings were kept, and no changes to were made to most bond holdings. We are seeing deterioration in the high-yield sector, so we are becoming cautious in that area as well.

One thing that struck us was the severe nature of the selling right off the top of the market. Last Thursday's 300 point decline in the DJIA saw NYSE declining stocks exceeded winners by almost 12:1 with up/ down volume ratio was bearish by about 8:1. With volume also increasing on the day, such negative momentum clearly showed a move by institutions to become more defensive. Such strong initial moves off the market's peak (which itself had been showing signs of being ragged) suggests more downside—and indeed that is what we have seen so far this week.

Presently our outlook suggests that this correction should test support around 1900 on the S&P 500. **This is the level of a prior breakout and an area of significant technical support**. Thus, we will look to the 1880-1900 area as reasonably important support in the days ahead. A decisive break of that area would indicate that a more serious decline is developing. In the meantime, our outlook suggests that there is still a very good chance of yet another run (one the current correction is over) toward the prior highs to come. Should that rally fail—then the outlook would decidedly turn negative. This bull hasn't wanted to go down easy, but given the maturity of the long term trend, we will keep this warning in mind Long-term

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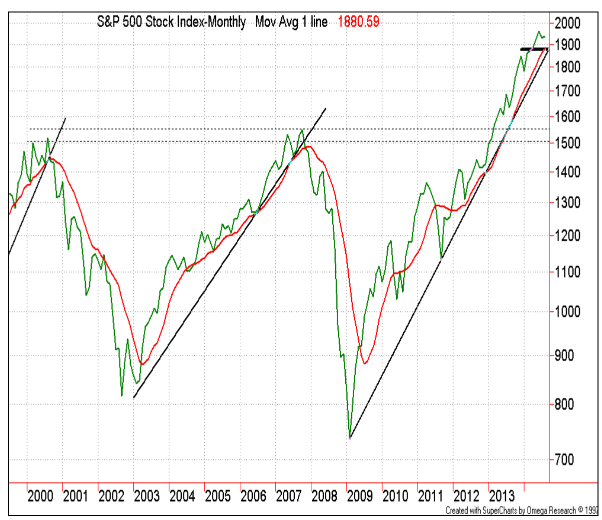
investors who have been riding the market higher should pay close attention to the 1880 level on the S&P 500. A drop below that level would suggest that the longer-term trend was in transition. See chart section below for more on this.

Charts—Short-Term Correction, Long-Term Trend Still Intact (But on Notice)

Near-term S&P 500 (Top)
Last week's action clearly started a near-term correction for the markets, one that has been overdue. Once support at 1950-1970 was breached the S&P quickly fell toward stronger support around 1900. There have been s few oversold bounce attempts but they have so far been unable to gather much steam. We could see a dead-cat bounce up toward 1950-1960, but it really feels like this market wants to drop lower to test the **key** support between 1880-1900. As long as this level holds the long-term trend will remain up, and the bulls have hope of quickly reversing this downside action. A breach of 1880 on the S&P would be very negative (see below).



Long-Term S&P 500 (bottom)
Still no change to the long-term trend as the S&P has stayed above the uptrend line from 2009. The current drop is but a little squiggle to the top right. <u>The level to watch is now 1880, 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 bull trend. However, a drop below 1880 on the S&P would be the first drop below the trend-line <u>and</u> the 10-month average for the S&P 500 since 2009. It would be a warning move for all investors to pay attention and consider defensive measures** as the long-term uptrend from 2009 could be topping out.