Hamilton-Bates Market Update

August 21, 2014

August 21, 1959 - The US receives its crowning star when President Dwight D. Eisenhower signs a proclamation admitting Hawaii into the Union as the 50th state. The new flag became official July 4, 1960.

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

So much for a correction, as the market rebounded over the past two weeks putting to bed any thoughts of a true 'correction' setting in. The major averages are now once again challenging their highs. Given the market's near imperviousness to negative news and a renewal of money-flow the rally looks to have legs.

Its Been a Long Time

The market is now well past the 1,000-day mark since the last 10% correction; making the current stretch the fifth-longest since 1928 (credit Bespoke Investment Group). This run just surpassed the 1,127-day run without a 10% drop from July 1984 to August 1987. Now that came just prior to the Crash of 87', but we are not making comparisons to that time though—as other measures such as market breadth are much more favorable now.

Its true that you can have even too much of a good thing, and while its tough to be too negative on a market that has done nothing but go up—history suggests that whenever this run is done, the ensuing correction gets larger as the duration since the last correction increases.

No one can tell exactly when this bull run will be over, or just how far it will go. It is seeming ever more likely that we have a serial bubble-blowing central bank that just wants to stoke asset prices higher. All we can do is try to capture as much upside as possible while respecting signs of both short and long-term tops. Odds are, whenever this QE fed , Zero-Interest Rate greased, Stock buy-back funded rally is through, the correction we will see will be greater than 10%.

Earnings, Economics, and Circular Logic

Its getting to the point of not really knowing how to take the economic data at this point since it remains lumpy—coming in better and worse than expected in alternating fashion. Furthermore, the market doesn't seem to respond to the data in consistent fashion. Sometimes it rallies on bad news and falls on good news. Does the market want better growth to feed earnings, or does it prefer lower rates? If the economy gets better will rising interest rates hurt the stock market. So getting a read on what the market wants the economy to do is getting to be a pretty tough call.

What we have been pretty clear about is our belief that the economy just isn't that good, no matter the headline GDP and 'job creation' numbers thrown out there. Given the way the data is adjusted and massaged, the further you look into the numbers, the less healthy this 'recovery' looks.

I guess the bottom line comes from the actions of the Fed itself. On the one hand, the Fed insists the economy is expanding and all is well. If this is true, then why more than five years into a recovery, has the Fed not allowed interest rates to normalize. Why haven't rates been allowed to rise to whatever the market of borrowers and lenders sets as fair in the current climate.

If the economy is too weak to handle higher rates, then it means the economy is weaker than the Fed would have us believe. So is the economy better or worse? These are contradictory stances, but the Fed would have us believe both conditions are true. The both 'alive and well' and 'sick as a dog' at the same time. This makes no sense of course, and it our mind the truth is that the economy is not doing well and this recovery continues to be the weakest on record. But what then continues to boost stock prices? The answer is stock buy-backs, which have become extremely popular by corporations.

The Power of Stock Buy-Backs

The latest numbers show that between 2007 and Q1 2014, in aggregate, Households, Hedge Funds, Private Pensions, Governments, Mutual Funds and even ETF's were <u>net sellers</u> of stocks to the tune of $687B. If everyone is selling how could the market be going up? Because it was every category but one, and an important one. Businesses have more than made up for this selling, and were net buyers to the tune of $3.16 trillion of their own stocks though share repurchases- nearly 5 times greater than the selling categories combined.

Hamilton-Bates
Market Update
August 21, 2014

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

August 21, 1959 - The US receives its crowning star when President Dwight D. Eisenhower signs a proclamation admitting Hawaii into the Union as the 50th state. The new flag became official July 4, 1960.

The key question of course is 'why' and it comes down to both Fed policy and the economy. First, fed policy has pushed rates to historic lows, so <u>companies can buy-back stock using proceeds from super low rate bond sales</u>. The near insatiable demand for yield allows companies to finance bonds at rates that would be nearly unthinkable in any other time. And given an economy that is stagnant, companies are making a decision to boost stock prices and earnings through buy-backs (Each share bought boosts earnings since there are fewer outstanding shares). In a tough economy, buying back stock to boost earnings may seem like an easier and surer method than expansion and capital expenditures, since it does not require the most costly expense of all—hiring employees. Remember too that boosted stock prices mean bigger bonuses for executives– the rich get richer.

CAT a Case Study in Buybacks

Take a look at Caterpillar (CAT) for example to see those process at work. Back in 2008 Caterpillar underwent a series of 19 consecutive declines in Global dealer retail sales, declines, finally emerging from its unprecedented funk in May of 2010. But now, as of July 2014 CAT just set another record. Beginning in December 2012 CAT has now posted a new record of 20 consecutive global dealer retail sales declines, after a -9% Y/Y print for the month of July. For Caterpillar, the Great Recovery is now worse than the Great Recession. And how has the stock done?

Thanks to buy-backs the stock price of CAT is just shy of its all time high. Rather than investing in growing its business, or R&D, the company has ddirected the bulk of its cash-flow to buy-backs. In Q1 2014 CAT had a capital expenditure budget of $454 million, a 50% drop from 2013; but spent $2.1 on buying back its stock. In fact CAT is not alone. Blue-chip companies across the board have decided that in an uncertain economy buy-backs seem like a sure thing. Companies don't care of where the stock is trading in order to buy it back—they don't care. The higher the stocks rise, the more companies buy back. They get the earnings boost and boost the stock price at the same time. For them it's a win-win, and the bonus boost is gravy. If companies can continue to finance buybacks with cheap bond rates, they will. As long as the bond market continues rally companies will continue selling bonds to buy back stock, and they will continue to overwhelm all those who sell stocks for whatever reason. Zero interest rate policy has created a nearly overwhelming demand for yield from pension funds, insurance companies, and other large bond buyers, all of which are desperate for yield.

Does this mean mean that there can't be corrections—ones that last longer and three days and 5-7%. Of course not. But as long as the underpinnings of the corporate bond market remain intact, the chances that te bull market remains intact are pretty high. Given the massive shift of flows into buybacks, we will continue to focus our eyes on the credit markets for signs that the buy-back boom is coming to an end. At that point the market will have a tough road to hoe.

So, if you wonder why and how stocks keep going up despite flat revenue growth, higher PEs, and a punk economy, there is your answer. With interest rates so low buybacks will likely continue until rates normalize and the 'cost' in terms of bond interest payments becomes to expensive to continue.

Market Outlook

The market bent but did not break. It rebounded from where it had to with sufficient momentum and breadth so that the long-term trend remains intact. As long as interest rates are near zero, allowing easy money and buy-backs to flow into stocks, the market seems likely to continue to surprise on the upside–just as it has for much of this bull run.

With bond yields recently declining it could push another round of PE expansion. In other words, stock prices will rise without any increase in earnings just because interest rates are declining more than expected. We will continue to watch the markets very closely, especially the credit markets—since it now seems likely to us that the credit market is the funding source for stocks. A slip in the credit market is likely to be the cause for a stock fall.

Hamilton-Bates

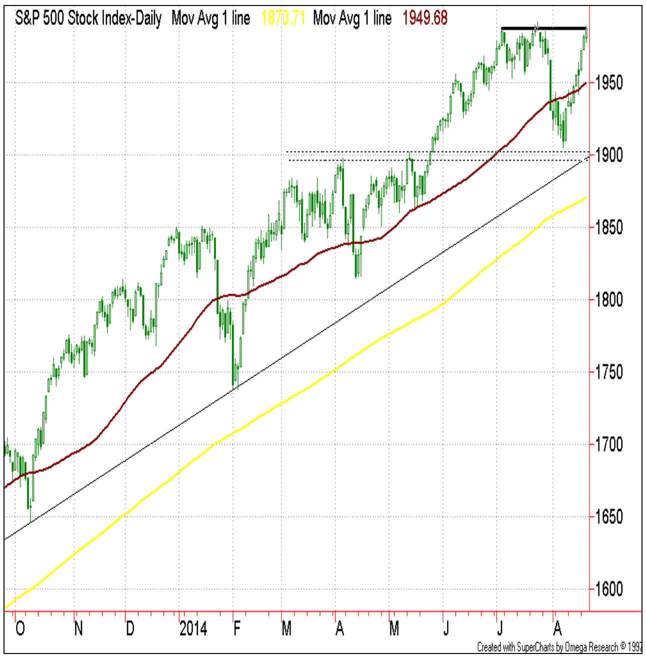
Market Update

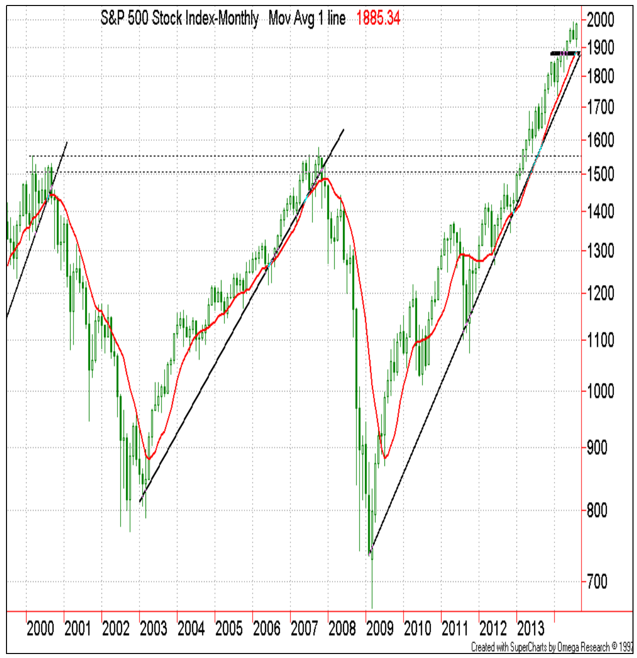
August 21, 2014

August 21, 1959 - The US receives its crowning star when President Dwight D. Eisenhower signs a proclamation admitting Hawaii into the Union as the 50th state. The new flag became official July 4, 1960.

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

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





Near-term S&P 500 (Above Left)

After a brief pullback that just barely tested 1900 and never threatened key levels around 1860—the S&P is right back at resistance levels. The NASDAQ just broke out above its corresponding tops, so its likely the S&P will follow. A move above 1990 would likely see a follow on rally well into the 2000's for the S&P. The fact that no pullback can get traction is sending a message that "agenda" is to drive the indices to new highs. Don't fight the Fed.

Only a drop below the recent low around 1900 would turn the near-term trend to cautious. The bulls hold serve once again.

Long-Term S&P 500 (Above Right)

Still no change to the long-term trend as the S&P has stayed above the uptrend line from 2009. The recent dip touched the key average but didn't break it. The level to watch remains the recent lows around 1900 and down to 1880. If 1880 is broken it would open the door for a potential decline down to as low as 1500-1600. A correction could bounce off the 1880-1900 level just as it did recently and still not change the bull trend.

A drop below 1880 on the S&P would be the first drop below the trend-line and the 10-month average for the S&P 500 since 2009 and would be a warning for all investors.