Hamilton-Bates
Market Update

October 28, 2014

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The market rebounded as expected in the last Update, and stocks have continued that rally as we head into month-end and the upcoming Elections. So far this rally has been due to a combination of oversold conditions, some positive economic data, some decent earnings reports, and relief regarding Ebola. This week we'll get an FMOC meeting on Wednesday, with possible news on the wrapping up of QE. There is also the first estimate of Q3 GDP on Thursday. The FOMC meeting is the wild card. Originally the Fed was expected to complete the taper by removing the final $15 billion per month of the QE3 program. However, given recent turmoil and the fact that the Central Banks immediately started jawboning the market up as it neared a 10% decline leaves speculation they may keep QE around a while longer.

We are against keeping QE as at this point there is little proof it has done anything to help the real economy, and in fact keeping QE3 around sends a signal that the Fed has growing concerns about the US economy. That would likely have some very negative effects for stock prices. At this point interest rates should be allowed to normalize and the Fed should step back from the financial markets—even if it means a 10-15% correction as the market adjusts. Given their near immediate chatter of possibly more QE as the market fell last week makes it seem that the Central Banks are willing to do so.

Economics, Earnings, and Interest Rates

So far 207 of the S&P 500 have reported third quarter earnings. 70.5% beat estimates, 11.6% were in line, and 17.9% missed. Last quarter after 217 had reported 70.5% beat, 12.0% were in line, and 17.5% missed. So we are about where things were last quarter—and not the collapse some feared. But even though earnings season is unfolding nicely for current quarter results, forward looking projections for 2015 have been coming down. The end result has been a very choppy reaction to earnings season as the market rallies on one key report then slides on a weak one. Ultimately, to provide the positive visibility investors are looking for, we need to see this trend reversed and projections to start rising again.

When Even Good Earnings Don't Help

An even worse sign for the economy and workers is that even with good earnings companies are not hiring and expanding. Look at Amgen for example. It is a great company in a great sector, and it delivered solid third-quarter earnings with EPS at $2.30 vs. an expected $2.11. It is also raising its full-year guidance. Sounds like good news—and the stock is up in trading. But not so good for workers or the broader economy as the company is not only not hiring, it is increasing the number of planned job cuts to 15% of the workforce. Of course it is also expanding its stock buyback plan something we have covered a number of times in past Updates. A good company in a good sector with good earnings is cutting workers but buying back more stock. This is not a recipe for sustained economic growth and is a sign of the perverse set of incentives created by the Fed's zero interest rate policy. With essentially free money it is cheaper to take on debt to buyback stock than higher workers and expand.

Market Outlook

In the last Update we said that the market was oversold and sentiment was overly pessimistic, and that we ultimately expected this to be a correction with another rally to follow. So far that has been the case as the market bottomed just a few days after that last Update. We had hoped there would be more base-building around that

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low, but that possibility got tossed out quickly as comments about the possibility of continuing or renewing QE should the market falter any further re-affirmed to investors that the Fed would be there to support stocks. Some decent news on other fronts and the fact that we haven't had a rash of further Ebola cases combined to push major indexes quickly back through important resistance levels on strong volume and market breadth.

In the wake of such a quick rebound and with a "v" shaped recovery stocks are once again short-term overbought and the recent extreme pessimism has been replaced by optimism. It would not surprise us to see some corrective activity this week or early next to digest those gains. We are not yet halfway through earnings season, so more good earnings reports can certainly keep this rally going, and we are also about to enter a period of very strong seasonality, as November is the start of the best three and six-month periods of the year for equities. Ultimately we think the market will test or surpass the 2014 highs. Investors will have their eyes on the FOMC Wednesday, as everyone wonders about the end of QE3. The next major drama will be from the election on November 4th. All in all though we have seen a big improvement in the technical condition of the equities market, including many new buy signals and the short and long-term trends have been re-affirmed.

Investment Strategy

The rapid nature of the decline with the worst selling occurring over just a few sessions, coupled with the v-shaped rebound have made the market very tricky over the past few weeks as many investors and managers have been whipsawed in both directions. Fortunately we had an increased cash position ahead of the worst of the decline, and managed to allocate funds at or near recent lows before the market recovered. We would have preferred more basing action in order to put even more cash to work at favorable pricing; but current allocations have allowed portfolios to recover along with the market. Most portfolios are matching or beating their benchmarks in what has been a very tricky year.

Key support has been established for the S&P once again at 1900, and then at the retest of the April low around 1820. As long as the 1900 level holds we'll continue to put cash to work on weakness.

Given the action we've seen, the odds suggest the move to 1820 was the low for the decline, although this would still keep the S&P from experiencing a 'true 10% correction' (the loss being just under 9.9%). The drop was significantly worse for small-caps (more like 15%), and the degree of damage suffered by the average US listed security was quite high.

We look for an eventual move to new highs during the upcoming period of seasonal strength, and it would likely take some shocking type of news to break last week's support level. By and large corporate earnings have been strong enough in the current earnings season to generally confirmed the strength of domestic US economic data, even though outlooks have been cloudy or muted for 2015. It seems the financial market has once again dodged a bullet, and we would expect seasonal strength to allow the market to retest its 2014 highs. We'll monitor such a move for signs of distribution or waning strength.

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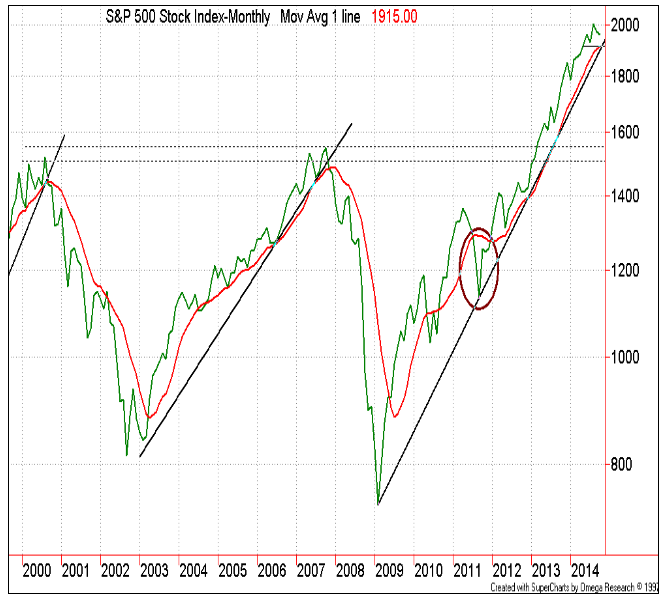
Charts—S&P 500 Passes Tests to Short and Long-Term Trends



S&P 500 (Top Left)

In the last Update we stated that we thought the market was very near a short to intermediate term low, and that was indeed the case. However the market did dip briefly and somewhat violently below the expected support around 1900. This move caught many investors the wrong way, and a selling panic ensued. But rather than initiate a larger decline, the selling served to wash the market out and set the stage for a rebound. The recovery has been another "v" shaped move, without much of the base building we'd prefer to see. The bulls should be heartened by the fact the index was able to retake the ground above the 200-day average (yellow line around 1900), although now short-term overbought some corrective action is likely. As long as the S&P holds above 1900 the near-term trend once again favors the bulls.

Long-Term S&P 500 Chart (Top Right)

The bull trend up from the 2009 lows remains intact, but was tested severely as at its worst levels the recent decline saw the S&P well below the key trend-line and 10-month moving average. But once again the market recovered at the 11th hour to prevent a breakdown of the major trend.

The key average and trend-line to watch are now around 1915, and as long as the S&P remains above that level the long-term trend remains intact.