Hamilton-Bates
Market Update
November 12, 2014

November 11, 1918: At the 11th hour on the 11th day of the 11th month of 1918, the Great War (WWI) ends.

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The stock market continues its rebound from the mid-October lows, and after a slight pause ahead of the elections, the rally has continued. As expected the midterm elections resulted in Republicans taking control of the Senate and extending their majority in the House of Representatives. In the short-term the stock market rallied on the news, but we wonder how much lasting affect the win will have. Lacking a supermajority in either house, and with a President determined to go his own way, significant policy change appears unlikely.

Economics, Earnings, and Interest Rates

Third quarter earnings season is nearly complete and any positive benefits are likely behind us. Overall it was just another 'ok' quarter. Revenues remain challenged and forward visibility remains cloudy as 2015 earnings expectations have started to come down. The latest raft of economic data show that the economy continues to muddle along in the 2-3% range, one of the lowest growth rates since WWII this long into an economic expansion. The latest PMI data from Markit confirmed the slowing growth rate in October, as both its services and manufacturing indexes fell to multi-month lows.

Distortion of Fed Policy

The reality is that the economy remains sluggish and breadwinner job creation is troubled. Wages have declined after inflation for the past few years. Job creation remains sub-par in terms of quality—even if quantity has improved. The loss of hundreds of thousands of breadwinner jobs during the last recession continues to hang over the economy. No amount of new waiter and bartender jobs can make up for the loss of these 'core' jobs.

The financial markets remain elevated but this is largely the work of the Fed and other Central Banks. Cheap money, zero interest rates, and inflation of asset values have made things appear healthy—but more and more Americans are noticing the disconnect between Wall St. and Main St. Perhaps that realization was the momentum behind the GOP gains on election night. QE has done nothing for the economy at large—other than boost Wall St. bonuses and NYC real estate. Yet, the Fed and the Administration continue to perpetuate the myth that making the cost of money zero for big-banks and Wall St firms has had a positive effect on the population at large. If anything the policy has had several negative unintended consequences.

Central-bank stimulus has relieved pressure on governments to revamp their economies, punished savers, inflated asset bubbles and left financial markets overly reliant on liquidity and prone to volatility when it reverses. Just look at what happened in October– when the market declined as QE wrapped up—only to rebound when the Fed talked up a 'pause' or even a 'renewal' of QE should the market drop sharply.

But this isn't new news. Over the last decade in particular, Fed intervention distorted the relationship between the financial markets and the underlying economy. Corporations have increasingly resorted to a host of tools to maintain their stock prices in the face of weak economic growth. Share buy-backs has allowed profitability to surge, even with weak revenue growth. Companies have also cut workers and decreased capital expenditures. Hardly the stuff of healthy growth.

It wasn't always this way. From 1960 through 1980, the economy was growing faster than asset

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prices as the U.S. was the manufacturing powerhouse of the post-WWII period. However, beginning in the early 1980's the economy begin to shift from a production and manufacturing based society to a service based economy with finance at the core. As interest rates and inflation began a 30-year decline, the demand for credit rose to offset a rising cost of living that outpaced both economic and wage growth. Between 1982 and 2000 the price of the market caught up with, and eventually surpassed, real economic growth.

In the decade since 2000, asset prices have continued to rebound from any weakness and push higher thanks to floods of liquidity from mortgage equity extractions, easy credit terms and recently direct injections from the Federal Reserve. The Fed became the market's backstop. Since 2000, the price of the market has far outpaced the growth of the real economy.

The Reality is QE Doesn't Help the Economy

QE and low rate policy boosts asset prices—that is pretty much self-evident. But eventually the unwind will be tricky and likely involve a decline in asset prices—the piper will have to be paid. As for the real economy—that is another matter. The magic mix of QE and zero interest rate policy has been tried and shown not to help the real economy. Japan, a highly developed economy and #3 in the world, has been using these tools since 2006. So far the Japanese Central Bank's balance sheet has tripled and rates held at zero for years—<u>yet their GDP has shown no net gain</u>.

Market Outlook

The very strong rally since the October 15th low broke multiple resistance levels and created many technical buy signals, sending stocks quickly higher and into 'overbought' levels. Selling has so far remained absent, and stocks remain overbought. But buyers appear to be tiring and those caught short have likely covered. Earnings season has been positive, but it is coming to an end, so that catalyst will be gone. Therefore, a pullback or consolidation can occur at any time. We don't think any pullback will be deep. The strong breadth statistics during the rally off the October low point to further strength in the future, and we are now squarely in the period of strong year-end seasonality.

Thanks to the jawboning of the Fed the financial market has once again dodged a bullet. The market has now made new recovery highs even earlier than we expected. We look for seasonal strength to allow the market to make even greater gains into early 2015. <u>With QE wrapping up the market will become increasingly vulnerable as we head into 2015, and another correction is likely in the early part of the new year</u>. For now though its clear the bulls continue to hold the upper hand, and the recent dip was just that, a sharp but temporary blip.

Investment Strategy

To the extent that clients are invested we are pleased with the market's rebound–however we do lament the v-shaped nature of both the decline and the subsequent rebound. We had been looking for a decline of the 10% magnitude and got it (9.99% from high to low), but the speed of the rebound prevented even greater asset purchases at these lower prices.

Key support has been established for the S&P once again at 1950-1960 on the S&P 500, and then at the retest of the April low around 1820. As long as the S&P holds above 1950 we'll continue to put cash to work on weakness.

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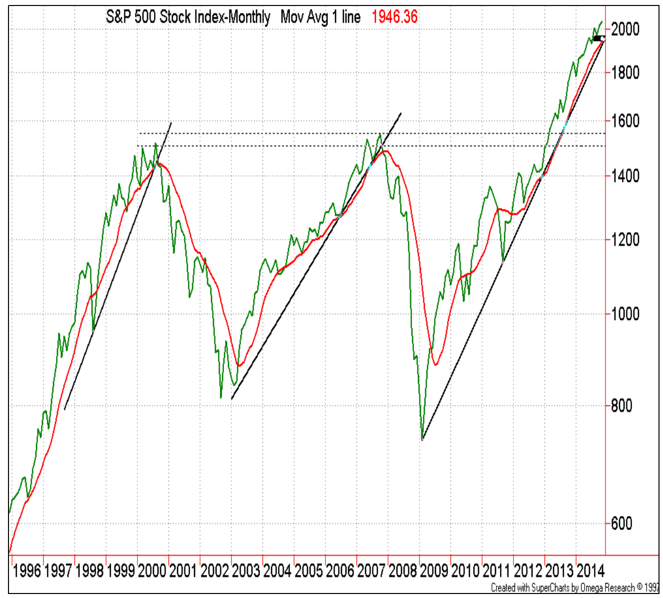
Charts—Trends Remain Bullish



S&P 500 (Top Left)
The S&P 500 has become increasing volatility as QE wraps up—note the widening range pattern noted by the dotted lines since July that sort of looks like a megaphone. This increased volatility is likely here to stay, and we'd expect a short-term pullback as the market nears the upper trend-line boundary. The current pattern looks much like one seen in 1996—which saw a short-term pullback followed by even further gains.

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 as the latest decline took the S&P well below the trend-line and moving average. But the market recovered quickly and no lasting damage was done.

The key average and trend-line to watch are now around 1950, and as long as the S&P remains above that level the long-term trend remains intact.