Hamilton-Bates

Market Update

December 9, 2014

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

The stock market continues its historic rebound from the mid-October lows, and there hasn't been much in the way of change to write about—so we have written a bit less during the Holiday season. This week we have seen some fireworks, as the uptrend has seen a bit of a hitch as the precipitous drop in oil has finally been revealed to have a pretty seedy underbelly. Seen initially as a boon to consumers and the economy, the sharp drop is now being seen as a potential bust. The drop in oil has been severe enough that it now threatens slowdowns, shutdowns, capital expenditure cuts, job cuts, and potential bond defaults in an industry that had been THE engine of growth across the country due to the shale oil boom.

The Drop in Oil Prices

For a time the drop in oil prices brought relief at the pumps and the wallets for US consumers. But oil's precipitous price drop is beginning to reverberate in ways that are not so good for the economy. And its not just oil, in fact all of the base metal commodities such as copper, iron, and nickel, all of which are used in the 'real' economy where things are made; have had precipitous drops on the back of slack demand and economic slowdown in China, Asia, and Europe.

The decline in oil and the other commodities suggests global growth is just not that robust. A good deal of the price drop reflects increased supply—but demand for oil is not keeping up with supply gains. That suggests global economic growth and demand is not anywhere near 'escape velocity' or self-sustaining growth.

Worse yet, the oil price drop now threatens an industry that had been at the forefront of 'good job' creation right here in the U.S.—what are known as 'breadwinner jobs'. Presently the energy sector accounts for nearly 1/3 of business capital expenditure budgets—on equipment, drilling, new hiring—money that feeds the economy through the multiplier effect. Already energy companies are cutting back 2015 expenditures some 20% - enough to possibly cut 0.50% to 0.75% from GDP growth. Oil prices have slid from about $107 a barrel in June to about $64 a barrel today. From what we have found, the $60 level is the breaking point for many companies, should prices go below that level for any length of time. So while a decline in oil may help the consumer wallet a bit, it may hurt the overall economy even more through lost business, lost jobs, and potential financial defaults should it continue much further. Too much of a good thing it seems can be a bad thing.

Economics, Earnings, and Interest Rates

The US economy is growing moderately. That's pretty much certain — but it's not growing as fast as the government data would suggest. The Commerce Department recently put 3Q growth at a 3.5% annual rate — a pretty solid number on its face. But digging a little into the massaged data suggests that number is too high. Our exports declined in the third quarter and construction spending was weak. So that 3.5 percent initial estimate will probably be revised down to a 2.5-2.9 percent just on that adjustment. Once you figure in the ramifications of the oil price cut you could see another 0.50% cut. Now you are looking at an economy that moves from 3.5% growth to 2.2%-2.5%, just a continuation of the 'muddle through' economy. Even that low number is boosted by the artificially low inflation rate used in the calculations. <u>If we use any reasonable measure of true inflation, US real GDP growth all but disappears</u>. A roughly flat economy with little growth is about how things have 'felt' to most consumers and job seekers, and differs significantly from the robust sounding 3%+

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expectations and data points provided by the statistical managers down in Washington, D.C.

The Economy and the Stock Market are not the Same Thing

The continued divergence between what is happening in the real economy (Main Street) vs. what is happening in the financial markets (Wall St.) is amazing.

Simply put, in the wake of the economic crisis in 2008 the central banks have decided that forcing asset prices higher will somehow result in good economic outcomes. Somehow they believe higher asset prices will make everyone feel better and that spending will continue on as before. Of course this is fallacy but while the Fed's monetary policy can't fix the economy—it most certainly can boost asset prices. For all intents and purposes the central banks have become asset bubble blowers by making investors reach for yield.

Most of the bond yields around the globe are for the most part absurdly low, due to QE buying and zero interest rate policies by all the central banks (The Fed, the ECB, and the BOJ are all on board). Meanwhile, this easy money policy results in an ever increasing search for yield and investors gravitate to the equity markets for growth with fixed income yields so low. Coupled with stock buybacks which have now reached historic levels, a reach for yield has kited the financial markets higher and the averages are now at nose-bleed valuations only bested by the tech bubble of late 1999.

It is important to recognize that there is an underlying disconnect between the fundamentals of the economy and what the financial markets are doing. These divergences can last and lull investors into a false sense of complacency, only to see severe and sharp losses mount quickly when the cycle eventually and invariably turns. What matter did the last few months of gains of 1999 matter when the cycle turned in 2000? Eventually the divergences between the economy and the financial markets, which in our view took hold in 2013, will be rectified. <u>Eventually there will be a time to get off the Fed induced party train, and no one rings a bell at the top. It will be our job to invest appropriately and prudently during this advance, capturing gains as they come, but be prepared for the eventual return of the business cycle –which the Fed cannot repeal no matter how hard it tries</u>.

Market Outlook

The rebound from the October lows has been historically strong, and the momentum is likely to persist through a rally into the first half of 2015. Short-term pullbacks aside, a significant top is not likely until we are past the seasonally strong next few months.

Investment Strategy

We are pleased with the market's rebound but perhaps like many we wish the market took a little more time at the October bottom. We did some additional buying on the dip this week, and will continue to do so should further opportunity show itself. The fixed income markets have shown a little wear, and have given back some of the gains from earlier in the year. We cut back on high-yield bonds several weeks ago, as this sector started to buckle under the weight of what has become the oil price slide. We'd add to certain bond sectors on additional weakness, as these declines open up opportunity.

For important price levels and support targets please see chart section on page 3.

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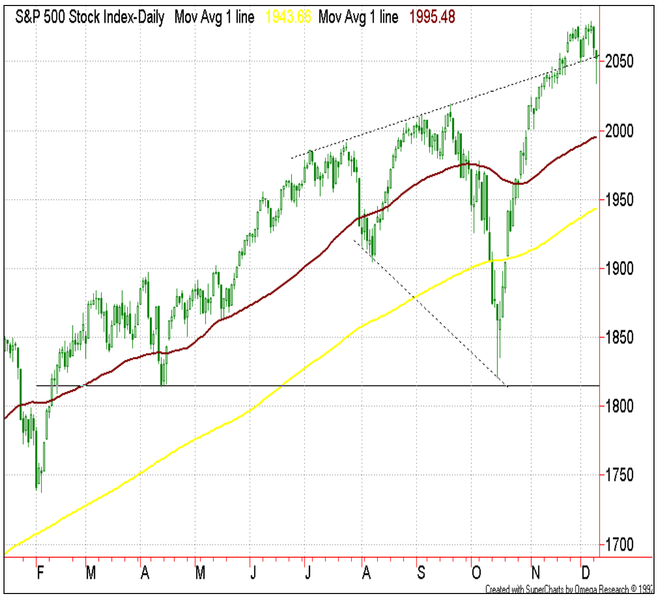
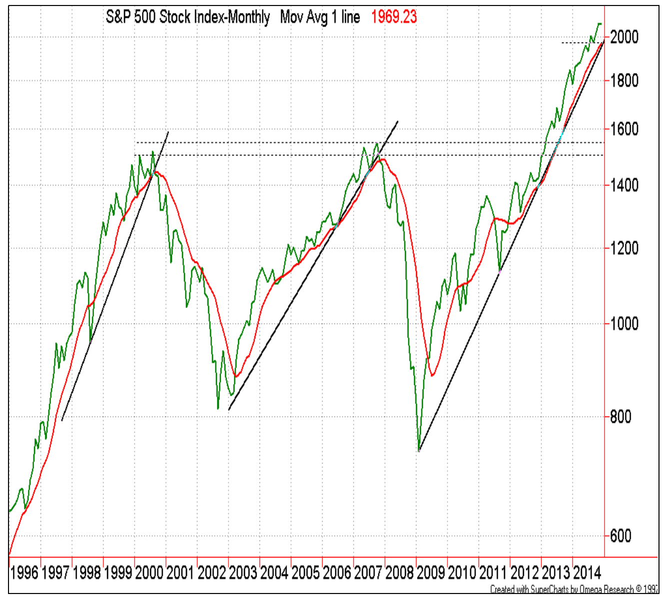
Charts—Trends Remain Bullish





S&P 500 (Top Left)

The S&P 500 has swung in an increasingly wide range as QE has ended. We have referenced before the pattern noted by the dotted lines since July that sort of looks like a megaphone. This increased volatility is likely here to stay even though we expect gains into early 2015. Declines like this week, even down a bit toward 2000 are possible but wouldn't change the intermediate trend.

The current pattern looks much like one seen in 1996—which saw a short-term pullback followed by even further gains. We are seeing a pullback this week as the decline in oil reaches the main stream news cycle. We'd expect to see a bounce in oil which is now deeply oversold, and this could couple with a recovery in the stock market to even higher highs into early 2015.

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

The bull trend up from the 2009 lows remains intact, as it has been fervently supported by the Fed. We saw a brief test this past October, but some Fed jawboning and further easing from the ECB, BOJ, and China turned the market right around.

The key market average and trend-line to watch are now around 1970 on the S&P 500 Index. As long as the S&P remains above that level the long-term trend remains intact.