Hamilton-Bates

Market Update

January 15, 2014

January 15, 1919– Prohibition of Alcohol consumption in the US begins, ushering in the era of the 'speak-easy'.

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

It was a bumpy ride for stocks during the first full week of the New Year, as the market declined in the year's first five trading days for the first time since 2008. But the market has since recovered so the early year drop wasn't a real disaster. Currently, the market remains in a very bullish uptrend and there is little evidence at the moment that the current run is done. We have concerns for 2014 based on historical patterns (were covered in the last Update), and further concerns over the full-time employment situation, but in terms of 'evidence' the market still favours the bull vase.

Earnings, Economy, and Interest Rates

We continue to observe economic data that paints the picture of an economy that is just above levels that have historically delineated expansions from recessions. We get fits and starts, but nothing that looks like a true self-sustaining growth cycle. In the past it was a muddle-through economy-it now looks like its going to be a struggle-through economy. Just as the full-time employment data mentioned below and in the chart sections shows, this recovery has seen a far longer period of hesitation than in prior economic cycles. We simply haven't observed any meaningful acceleration. One concern we have is that the slight pickup in economic activity over the last several months may quickly dissipate as the impact of higher bond yields, taxes, and costs associated with the onset of the Affordable Care Act reduces disposable income of workers already struggling.

The Lack of Breadwinner Jobs

Despite all of the discussions and debates in regards to the recent Non-farm Payroll Reports and its sister report ADP's Payroll situation report, the heart of the matter remains a loss in the last Recession and lack of creation in the current 'recovery' of breadwinner jobs. We have covered the topic of 'breadwinner' jobs and how devastating the last few years have been, and the chart on page 2 fits nicely with that. But rather than just high-paying jobs it covers all full-time jobs relative to the working age population. Full-time employment is what ultimately drives economic growth, pays wages that (at least with Mom and Dad working) will support household formation, and fuels higher levels of taxes. <u>If the economy was truly beginning to recover, we should be witnessing an increasing number of full-time employees</u>. That has not been the case, as this measure has moved in laboured fashion since 2008. It is only slightly better than the lows witnessed during the financial crisis. Not quite the same picture as a 100% rally for the stock market averages is it.

The stock market and the economy can and do diverge, but eventually they come together. It is these 'divergent' periods that trip investors up, as they chase the market but get 'bit' when the market snaps back to the economy as it always does. If employment doesn't improve, and in turn boost corporate revenues and earnings, the stock market will eventually hit troubled waters no matter what the Fed does.

The Good News Is...

Businesses have slashed labour costs to the bone, we are now reaching a point where businesses simply cannot cut further. This means that if you have a full-time job and are relatively competent, you are likely to keep it. But if you do not have a job, you are going to have a tough time finding one. The stubborn average length of unemployment which is now near an all-time high of 30+ weeks is testament to that.

Earnings Season Once Again

Its that time again, when companies issue earnings for last quarter and outlooks for the year ahead. So far 24 of the S&P 500 have reported earnings. 50.0% have beaten estimates, 12% were in line, and 38% missed. That is running a bit high in terms of misses, as last quarter only 20% of the S&P 500 missed. Its time for the economy to deliver. The Fed is tapering now, we need to see revenue growth, and an increase in positive projections. The rally in 2013 was fueled with Fed QE and P/E expansion. With trailing P/E's now at multi-year highs we are not likely to see further multiple expansion for price appreciation.

Market Outlook and Investment Strategy

In the short-term stocks are rebounding from an early

Hamilton-Bates
Market Update
January 15, 2014

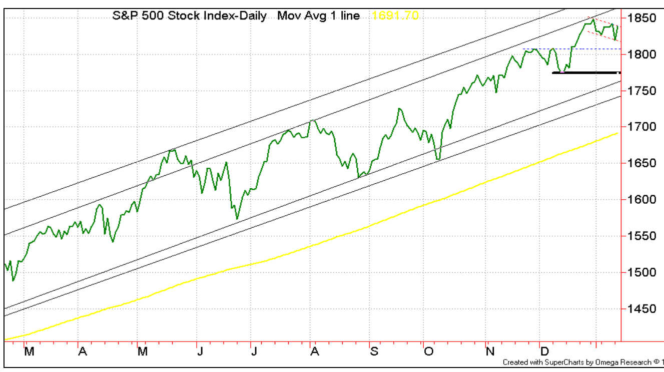
January 15, 1919–
Prohibition of Alcohol consumption in the US begins, ushering in the era of the 'speak-easy'.

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

year pause, just ahead of earnings season. With the up-trend intact we remain bullish for the first quarter. Hopefully some positive news from corporate America will provide a healthy catalyst for stocks and the economy. With an intact bullish trend we remain invested in equities, and in the fixed income area we continue to favor high-yield bonds. Unlike 2013, 2014 has started out well for fixed income of all types, a trend which we expect to continue as the year unfolds. If we get a positive earnings news, coupled with an intact bullish trend in stocks—we could see a robust advance in the early part of the year.

Levels to watch on the S&P 500 are **1840**, **1810**, and **1775**. This week's rally above the end of year peak at 1848 suggests a resumption of the advance—as long as this breakout isn't quickly reversed. A drop below 1840 would turn the short-term outlook bearish, while a drop below 1775 would suggest a more significant top is at hand. 10-year bond yields dropped from 3.00% to the mid-2.80's, and could drop as low as 2.50%. This should help bond investors recoup some of last year's losses. High-Yield bonds remain the strongest sector for bonds, but would be vulnerable to any economic weakness.

Market Charts—The S&P 500, and a Sobering Look at Employment



The S&P 500 (*left*) pulled back a bit to begin the year, but bounced off initial support levels to keep the uptrend intact. The early 2014 dip provided a few more levels to watch for keys to market direction. The dip created a short-term channel of lower highs and lower lows (dashed red lines), that resolved with the market moving **up** and out of it this week. As long as this trend doesn't quickly reverse below 1840, the breakout suggests a move to 1870+ on the S&P. Support levels come in at 1840, 1810 (dashed blue line), and 1775 (**bold black** line).

The chart at right comes from streetalklive.com (an excellent site) and clearly sums up the trouble within our economy and labor situation. It looks at the **percentage (%) of full-time employees compared to the working age population**. Since the peak in 1999 this ratio has dropped significantly, but the drop since 2007 has been staggering. Full-time job losses in the 2008-2009 recession were the worst in 50 years! More concerning is that the ratio hasn't move up much 5 years into a 'recovery'. What we have now is an economy creating lots of less than full-time jobs. The economy won't get healthy with the employment situation like it is—every prior recovery showed a clear uptrend in full-time jobs.