Hamilton-Bates

Market Update

February 25, 2015

February 25, 1964—22-year-old Cassius Clay shocks the world by beating heavyweight boxing champ Sonny Liston. Clay predicted victory, boasting that he would "float like a butterfly, and sting like a bee". He would go on to even more fame under a name taken a few years later… Muhammad Ali.

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It has been a very interesting few weeks as what started off in January as a consolidation has ultimately turned higher in another upside run. While stocks have gained, investment grade bonds struggled and erased all their recent gains as stocks forced their way up and out of a trading range with upside breakouts.

The source of the stock gains comes from yet another 'kick the can down the road' plan for Greece, and a cease fire in Ukraine that seems anything but. Economic data has been mixed at best, but this rally has been led by economically sensitive groups. We thought the consolidation would resolve itself with a run to new highs and it has, now we'll see just how much steam the bull has left in it.

Economy, Earnings, & Interest Rates

While economies in Europe and Japan teeter into and out of recession, the U.S. economy has shown somewhat of a measure of strength at least on a relative basis. Many look for a growth acceleration as 2015 unfolds, including the Federal Reserve and the White House. Despite their belief in growth acceleration, Fed chairwoman Yellen stated that rate hikes are still not likely until June or July but more likely the second half of the year if at all. We don't think we'll see any, with one 'symbolic' move a small possibility. Recent strength in the small-caps and economically sensitive sectors suggests we could be wrong, and that maybe the economy will gain some traction later in the year. At the same time, much that we see still reflects growth-retarding influences (like job losses in the formerly leading energy sector) that have kept this recovery substandard, and weakness in commodities like copper and lumber that don't point to robust growth. Growth is likely to continue—especially since the Fed continues to pour on the special monetary sauce (in terms of zero interest rates), but the data we see suggests more muddle through than the acceleration commonly expected at the moment.

Don't forget that the quantitative easing (ECB QE 1.0) recently announced by the ECB will begin in March, and it is a sure bet that some of that liquidity will make its way into world's equities markets. With rates pegged at zero here, and negative in many parts of Europe, relative valuations continue to favor stocks over bonds, but bonds remain supported due to massive Central Bank purchases around the world. In the end the Central Banks remain the markets.

The market has surged higher the past two years thanks to the Central Banks and P/E expansion, as earnings have hardly budged. We have been noting our concerns over aggregate earnings and future projections for some time now. But zero interest rates keep kicking any market correction down the road. This problem at this time is that P/E ratios are breaking out to multi-year highs and are at levels only seen at prior market peaks in 2000 and 2007. A lot of the cause can be attributed to the energy sector, and a recovery in oil could help, but we still need to see the aggregate numbers move up. That isn't likely with GDP growth of 2-2.5%. Right now we are seeing aggregate S&P earnings growth in the low single digits with sales/revenue growth about the same, but half of the gains are just Apple! Other than cell-phones and gadgets, there just isn't much that seems to be booming in our economy right now.

Case Study in Politics—A Greek Tragedy

The financial markets avoided trouble when the political war of words between the Germans and the "radical" Greek government was avoided with another temporary bridge loan.

What is especially interesting is that we felt there was a real chance that Greece went off the Euro and back to the Drachma, given the massive public discontent and the recent election that put Syriza in power precisely on a platform of no more austerity. It seems that politicians around world are ultimately afraid of and beholden to the financial markets above all else. Namely, the fear that the stock markets and banks will crater upon even a hint that anything other than more free money and debt is a possibility.

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Greece isn't likely to be able to pay the debt taken on the past two years in any timely fashion, an amount equal to its GDP. Its economy is a shambles with unemployment over 25%. Tax revenues are withering, and there is little hope of recovery with the amount of debt it carries. But even the 'renegade' Syriza party blinked when bluffs were called. When even a fire breathing leftist government compliantly straps on the yoke you wonder if the people's will can ever be heard anywhere. So the Syriza government now has many angry MP's and an angry populace, and is still wearing the massive debt imposed on them by the Eurozone and IMF in order to bailout the German, French and Italian banks. At least for another few months.

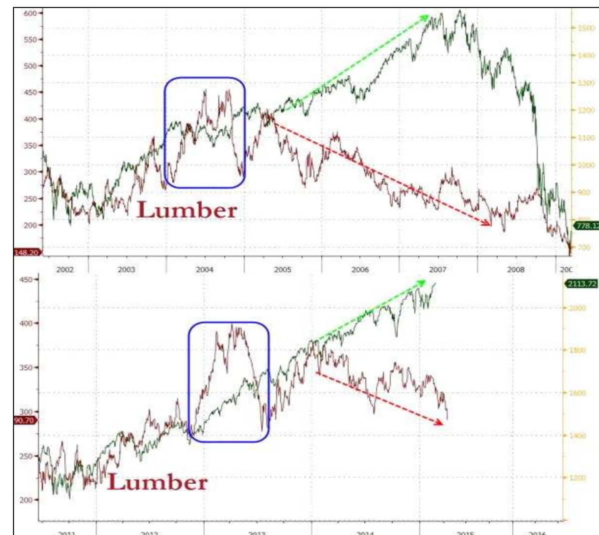
Another Important Commodity Suggest Caution on the Economy

The economic data has been mixed, but still strong enough (at least on the labor front) to suggest growth, but we continue to see caution signs in commodity prices that have in the past had a strong correlation with economic activity.

We have covered copper before, which remains in a multi-year downtrend, and of course oil has come down sharply as well. Demand, as much as supply, is the reason for the drop in oil—and that suggests something less than robust economic growth.

Another commodity that has a good record is lumber prices, which reflect on the housing market and the overall economy. In fact lumber is highly correlated with GDP. And like copper and oil, lumber suggests concerns over the economy later in 2015 and into 2016. The chart on the next page from www.zerohedge.com shows lumber prices and the S&P in the run-up to the 2008 peak and now. You can see that in the run-up to the 2008 peak lumber diverged for some time, as it is now, but eventually the market fell as the economic weakness reflected by lumber eventually came to pass in the housing market.

Like the divergence in from copper and oil, the weakness in lumber doesn't preclude the continuation of the bull market for some time yet, especially with interest rates so low—this can delay any reconing for some time. But the lumber chart is a reminder that eventually economic realities will play out, and could result in a negative surprise later in 2015 or 2016.



The chart above shows the divergence between lumber and the S&P in 2008 and now. This divergence can continue for some time, but caution remains warranted as it seems to us just another sign that the economy isn't as strong as the government's seasonally adjusted data purports.

Market and Investment Outlook

We remain invested in equities with an emphasis on the US, and in the fixed income area an emphasis on corporate bonds. High-yield bonds have come back strong on the delay in rate hikes here, and as oil's stabilization in the $50 area put off defaults in the energy sector for now.

The recent consolidation has resulted in another upside run as we expected, with confirmation by market breadth. With QE from the European Central Bank due in March, we look for further highs for the first half of 2015. Central Bank support keeps the bull market on track for now, and until proven otherwise.

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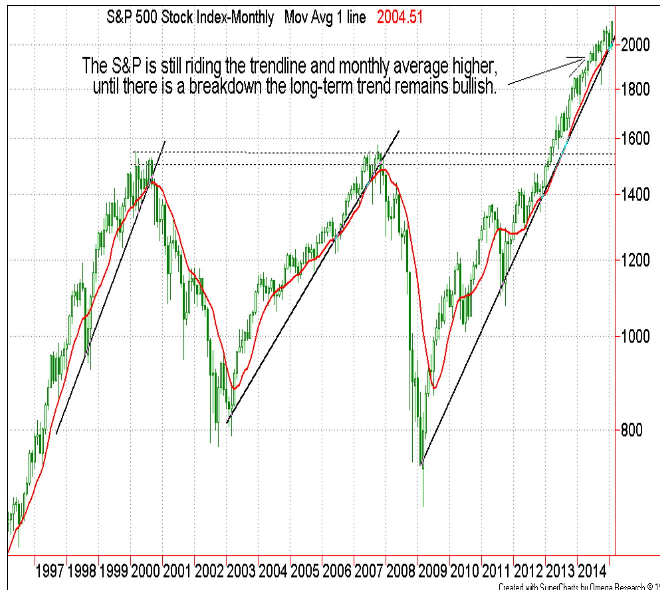
Charts—Market Diverges From Economic Tells; Volatility Up But Trends Still Bullish



S&P 500 Long-Term (Above Left)
The S&P 500 resolved its short-term consolidation with an upside breakout, as we thought it would. The recent consolidation and push higher have the S&P 500 holding above the long-term trend line (**bold black line**) and key monthly moving average (red line).

The rally to this new high has not been parabolic, but has been confirmed by the other major averages and market breadth. **We now mark key support for the bull market at 2000 on the S&P 500. Despite the concerns over the economy the market keeps moving higher thanks to the Central Banks. It would take a break of this level to cast doubt on the bull market**.

Small-Caps Breaking Out (Above Right)
Finally the Small-Cap Russell 2000 looks to have completed an eleven month consolidation (marked by bowl-shaped black line) with the index clearing the top end of its range. The odds that the multi-week churn within the US market has been resolved to the upside have been meaningfully increased by this confirmation of the trend from small-caps along with breakouts in the other major averages.

Given likely headwinds on multinationals from a strong dollar, the strength in domestic oriented small-caps suggest the bull market still has some legs.

Disclosures:
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