Hamilton-Bates
Market Update
March 20, 2015

March 19, 2003—Operation Iraqi Freedom begins**.** The United States, along with coalition forces primarily from the United Kingdom, initiates war on Iraq. Hostilities began about 90 minutes after the U.S.-imposed deadline for Saddam Hussein to leave Iraq or face war passed.

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This week was dominated by the 2-day FMOC meeting and the immense trepidation the market had that a rate hike could be imminent. The result has to be considered unambiguously bullish; as the Fed removed the word 'patient' from its statement but stated that it would not be 'impatient' by moving too soon. The FMOC also downgraded its economic assessment and raised the bar as to what would cause it to tighten. This was greeted by a furious rally by all markets that were open and was seen as a dovish move by the Fed. The major averages have so far managed a gain of about 1% on the week.

Economy, Earnings, & Interest Rates

The economic data of late has come in very weak, and the latest GDP-Now Model put out by the Atlanta Federal Reserve Bank puts current quarter GDP growth at just 0.3% , down sharply from the 2-3% expectations at the start of the year. Empire manufacturing missed rather badly coming in at 6.9 versus 8.8 expected.

Other than the last Jobs Report, the data have been bleak. Industrial Production and Capacity Utilization missed consensus, and last month's 0.2% gain was revised to a negative 0.3%. The NAHB housing index missed as well with a decline of 17% year over year in February, but much of that drop at least was blamed on the poor weather over much of the country.

Illustrating the divergence between stocks and fundamentals is a chart (top of next column) from www.zerohedge.com which plots the S&P 500 vs. Earnings expectations and US Macro Economic data. Its clear from the chart that earnings and economic data have trended downward since mid-2014, while the stock market continues higher.

This situation keeps the Fed stuck where it is. They gave had to walk back their rosy growth projections for the economy in 2015, but the stock market continues higher. No doubt they would like to raise rates at least to 1% to get off this extraordinary zero bound in rates, and to give themselves some room for the next downturn.

It seems likely that they (the FMOC) understand that QE and Zirp (zero interest rates) haven't done anything for the economy, other than stimulate an asset bubble in bonds and stocks. But having created yet another asset bubble, the Fed is in fear of pricking that bubble, so it is likely they will stand pat on rates for some time. As much as they would like to have some room to cut rates when the next downturn comes, which it will at some point, their bigger fear is a downturn caused by their actions at a point when they have few levers to pull to help things rebound. Being caught between a rock and a hard place, it is likely the Fed will remain 'patient' on interest rate hikes, even if they removed it from their statement.

Market and Investment Outlook

Stocks rallied and the dollar dropped back from its parabolic rally in the wake of the dovish FMOC statement, as the real economic data casts doubts on the Fed's raising rates anytime soon.

The Fed is now a prisoner in a prison of its own making. We have now had nearly three decades of Central Bank intervention in financial markets, with successive rate cuts undertaken to 'save the economy' serving only to foster the notion of a 'Fed Put' - that the Fed will always be there to backstop the financial markets. The latest round of Central Bank action has resulted in what will be 80 months of zero % money market rates and a massive monetization of debt. It has been so long now that is seems 'normal' for interest rates to be at zero six years into a supposed recovery.

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Six years of ZIRP (zero interest rate policy) and QE have created a widening disconnect between the real main street economy and Wall St., something we have covered over and over again. We believe the chart on the previous page is another example that clearly illustrates that. It is pretty clear now that the Fed's attempts at monetary stimulus have been ineffective, as the added liquidity doesn't get into the economy and essentially stays within the confines of Wall Street; in order to fund bond issuance and to facilitate stock buybacks. These buybacks have been the major source of stimulus for the market's move higher over the past few years—pushing stocks up time and again despite growing concerns over the economy and earnings.

There is no monetary policy benefit from ZIRP and QE to the real economy because households have little ability for increased debt, and businesses see greater value in debt refinancing and stock buybacks in a general environment of economic uncertainty than perusing capital expenditures with uncertain returns. Stock buybacks have proven a sure thing—so far.

Since the Fed began tapering we have been expecting the market to have a nasty spill at some point. As we have noted many times, the market is where it is because of money printing by the Fed (and other central banks) which has led to the flood of buybacks. That is what has been powering the market and given Wall St. talking heads a hope for a bullish result for the economy, even as sustainable growth always seems just around the corner but we never get there.

Even more dangerous for investors has been the duration of the current bull, and its relative calmness given the Central Banks actions. With rates at zero percent many investors who would otherwise been in CD's or other conservative investments—have moved into riskier areas in order to chase returns or yield.

This only leaves them oblivious and exposed to the growing risks that the Fed has sown, and the eventual turbulent period that is likely to come to pass at some point once the Fed moves to normalize rates or its actions are no longer deemed effective by the market.

Just because a big break has not happened along the way doesn't mean that it won't. All bull markets come to an end at some point. Timing the exact ending of a market that has been juiced by easy money is impossible. What we can do is monitor the markets for signs and react accordingly.

While our Fed has ended its QE program, the European Central Bank and the Japanese Central Banks are continuing theirs– if not expanding them. This source of funds has no doubt help keep markets moving higher. With interest rates at zero the buyback flow should remain strong as companies continue to issue low interest debt to a yield starved market in order to buy back stock. Should stock buybacks drop off it would be a definite warning sign. A decline in buybacks is something that could turn a correction into a bear market.

Fundamentals are not supportive of stocks at current levels, unless we see a near immediate turn up in economic data and earnings outlooks. Something we don't believe is likely with oil so low and the former job generating energy sector in trouble. The current market is purely a momentum affair– but the momentum is likely to remain strong with interest rates so low (and absent some sort of dislocation in the credit markets). As shown in the charts on the next page the bull trend remains intact, despite recent scares. We remain invested in equities with an emphasis on the US, and with an eye on small-caps given their recent leadership performance. In the fixed income area will still prefer corporate bonds over government issues. High-yield bonds have come back strong on the delay in rate hikes here, although their continues to be some pressure in the sector from energy firm debt.

Once again the pullback has resulted in an upside move, this time with small-caps leading. With rate hikes on hold, it's a bull until proven otherwise.

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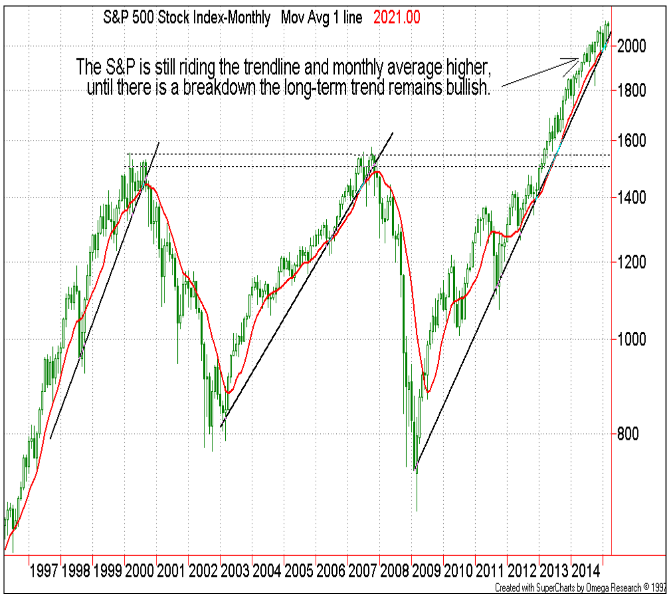
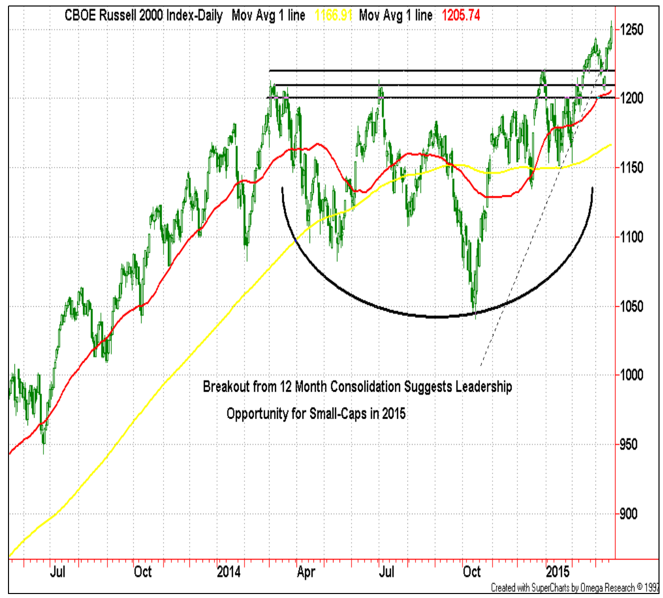
Charts—Long-Term Trend Still Intact; Small-Caps Breakout in 2015





S&P 500 Long-Term (Above Left)
The S&P 500 is 500 points above the prior 2000 and 2008 peaks, and hasn't shown signs of slowing yet. As long as the S&P 500 holds above its long-term trend line (**bold black line**) and key monthly moving average (red line) the bull market remains.

We now mark key support for the bull market at 2000-2020 on the S&P 500. Despite many concerns, including the rising dollar's negative effects on earnings, the market keeps moving higher thanks to the Central Banks.

Small-Caps Breaking Out (Above Right)
After a poor 2014 Small-caps look to be finally getting some love in 2015. The nearly year long consolidation that ranged between 1050 and 1200 gave the small-caps a chance to regroup. The breakout that has occurred this year should lead to further gains for the Russell 2000, and is a positive sign for risk assets in general.

The Russell 2000 broke above resistance, re-tested that level successfully this past week before moving higher once again. So far this is text-book bullish action. As long as the Russell remains above 1200 the bullish breakout remains in force.