Hamilton-Bates
Market Update

April 7, 2015

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April 7, 1776—Navy Captain John Barry, commander of the American warship Lexington belonging to the fledgling American Navy, makes the first naval capture of a British vessel when he takes command of the British warship HMS Edward off the coast of Virginia.

The past week has seen the market rally in April after struggling for much of the month of March. Leading sectors like healthcare and biotech have pulled back, while the previously lagging energy sector has begun to show signs of strength.

The stock market is essentially flat over the past several months, with dollar strength beginning to take the starch out of earnings growth. There could be some further near-term risk as the consolidation runs its course, but we don't see evidence for a major top just yet.

Economy, Earnings, & Interest Rates

US economic data has been pretty weak of late, something we have written about frequently in these Updates. The latest March jobs report joined that trend. The March NFP report from Friday saw payrolls rose 126,000, missing the 245,000 consensus by a nearly 50%. Adding to the weakness were downward revisions for February (revised down to 264,000 from 295,000), and January (revised down to 201,000 from 239,000). The only positive was a slight beat on average hourly earnings, which rose 0.3 month-over-month, beating the 0.2 expected.

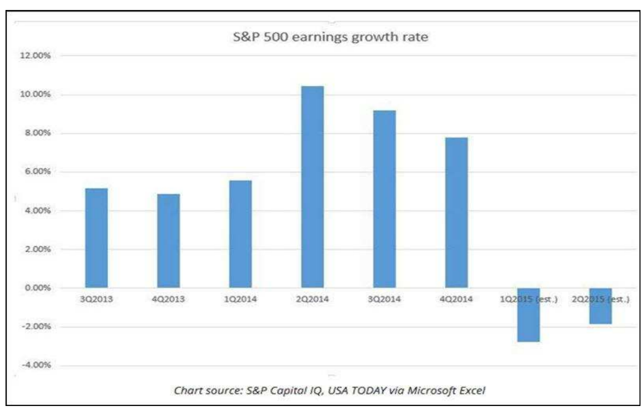
The jobs data had been a notable holdout among the US macro data that has been trending downward. With it's weakness investors could begin pushing back rate hike expectations as the Fed has indicated it is very dependent upon employment numbers. Just this week JP Morgan has pushed out its forecast for a 25 bps rate hike out to September from June.

Our view is the Fed won't hike rates because of economic conditions. However, even if it does because of outside pressures to get off of zero , such a hike will actually propel T-bonds upward in price as it will just drive up the dollar and weaken the economy even more.

US bonds also remain among the highest yielding in the world, keeping the dollar strong. When the next meaningful market correction or plunge occurs, there will be a mad rush into U.S. Treasuries as a safe haven. Interest rates are not likely to rise in the US for some time, the economic data just does not support it.

GDP projections have taken a hit along with the data. At one point last Fall the expectation was that the economy would grow 3.5% to 4.5% GDP growth this year. We didn't think so then and felt that the 'real economy' wasn't nearly as strong as the market was suggesting. Currently 1Q GDP is projected to be dead flat 0.0%, down from 2.5% growth as recently as February. The first half of 2015 could see a potential threat of a recession that could end up being just narrowly avoided. Weakness in the energy sector is largely to blame for the latest slowdown, which has caused a sharp drop in capital expenditures in this important sector. The recent rebound in oil from the low 40's to the low 50's could give the economy a chance for a rebound, and avoid a prolonged slump.

Corporate profits were expected to rise about 15% this year, according to Wall Street forecasts made last September. The most recent forecasts are for declines of 3% to 5% in the first quarter. That's a big swing. However, the stock market continues to flirt with new highs. See the earnings chart below.



The chart shows the trend of S&P earnings growth, which has recently declined to the point of a point of a threat of an 'earnings recession' - back to back quarters of earnings declines.

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The market could be facing the longest stretch of profit declines since the 2008-2009 financial crisis, according to data compiled by Bloomberg. As shown in the previous chart, earnings are forecast to shrink 5.8% in the first quarter of this year and fall 4.2% and 1% over the next two. Naturally the energy sector is responsible for the drop, with an average decline expected of 65% in earnings. Ex-energy earnings would likely rise slightly. That could be something investors focus on in order to continue the rally.

Market and Investment Outlook

Our beliefs of the past 18 months with regard to the economy weakening have generally come to pass, as have our concerns over a slowdown in earnings. But so far this has not yet had an impact on stock prices, which have continued to push higher.

In the long-run stock prices and earnings will move together, and eventually they will. We will need to see earnings rebound or stock prices will eventually fall to meet earnings. The problem is that the intervention of the world's Central Banks through zero interest rate policy and quantitative easing (QE) have interfered with normally price discovery and distorted both the credit and equity markets.

Things Central Bankers Say Once They Leave Office

Former president of the Dallas Federal Reserve
"The market has become hyper overpriced." March 2015

Former British Central Bank head Gordon Brown
"QE hasn't helped the economy." June 2014

Former Fed Chairman Alan Greenspan
"Gold is going measurably higher." Oct 2014

Eventually this will have to be undone, and with it the massive 'carry-trade' along with its leverage. The carry trade is the practice of borrowing money in a low yielding currency (yen) to buy assets in a higher yielding currency to profit from the spread or 'carry'. This works in an environment of falling rates, but when it comes undone, things unravel quickly and messily. Think back to the 1998 currency crisis. In such situations stocks end up getting sold because the high PE levels are no longer justified, and the drop causes a rush to meet or beat margin calls which further exacerbates the weakness.

Most astute money managers and investors seem to recognize the risks in the market, and that it is getting overpriced. Some seem to believe the market is OK right up until the Fed hikes interest rates. But the market doesn't work that way and will largely act in ways contrary to popular expectation. **What if the Fed isn't able to raise rates because it is a slowing economy that is the threat? Waiting for signs of a rate hike then in order to get defensive won't help**.

We are focusing on signs of weakness from the market itself, and we are paying close attention to the health and nature of the current trend. Right now signs point to a continued move higher. As we see signs that the trend is weakening or threatening a break—we will assume a more defensive posture. At the present time we see signs of a short-term pullback within an intact bullish up-trend.

We remain invested in equities with an emphasis on the US given the strength of a dollar, and with an eye on small-caps given their recent leadership. In the bond market we favor prefer corporate bonds over government issues. High-yield bonds have recovered their recent weakness but we are still watching this sector closely. Usually weakness in the high-yield market precedes weakness in stocks.

The market has recovered some of March's weakness, and small-caps continue to lead. With rate hikes seemingly on hold dip buyers have come back into the market. A push above the February highs could spark a spirited Spring rally but earnings news due out over the next few weeks is likely to dominate market action. **The bullish trend remains intact.**

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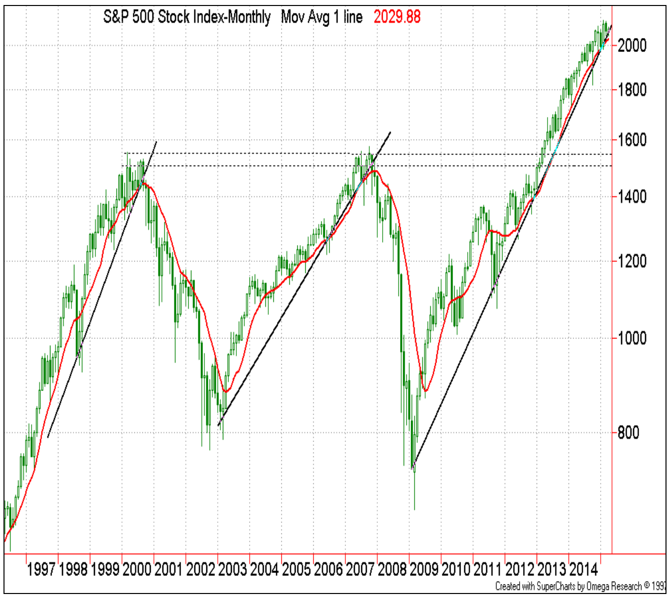
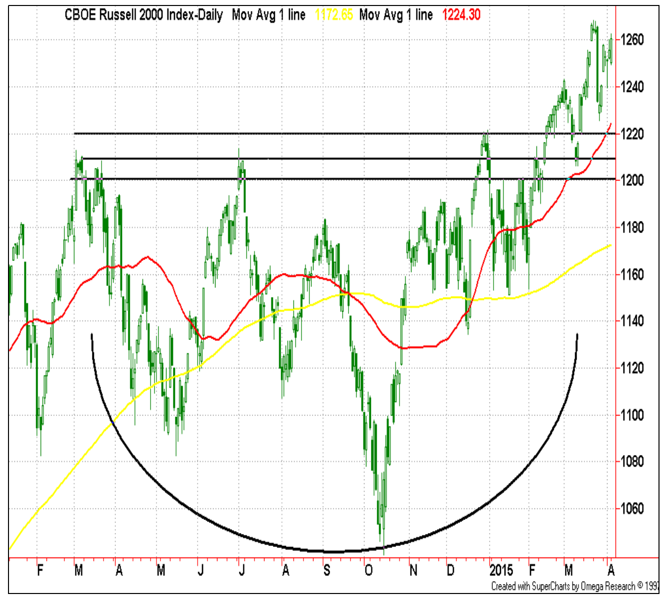
Charts—Long-Term Trend Still Intact; Small-Caps Breakout in 2015





S&P 500 Long-Term (Above Left)

The bull market remains intact as there has not been a 20% decline nor has the S&P closed below its 12 month moving average since 2011. The S&P also remains above the trend-line up from the 2009 lows.

In 2000, and again in 2008, the S&P broke long-standing trend-lines and fell below its 12-month average very early in those developing bear markets, so it is important to keep these levels in mind to potentially avoid the bulk of the next 'bear market' whenever it arrives.

2020-2030 is an important area for the S&P 500, a break below that level—and more importantly a month-end close below that level, would be a negative signal and a warning for investors that the long-term could be changing.

Small-Caps Leading the Way (Above Right)

The small-cap story remains favorable, as the Russell 2000 completed a year-long consolidation with a bullish breakout in early 2015.

With the dollar's surge hurting overseas profits from the large-caps, the domestic centric small-caps have begun to emerge.

As long as the Russell remains above 1200 and preferably 1220, the breakout and upside trend remains in force and suggests small-caps as a leadership group for 2015.