



# Hamilton-Bates Market Update *April 29, 2015*

**April 29, 2004**—The National World War II Memorial opens in Washington D.C. The memorial was a long overdue tribute to the 16 million Americans that served during the war, and the 400,000 that died. It is amazing to think it took that long. Bob Dole, wounded veteran, and Tom Hanks were two big supporters.

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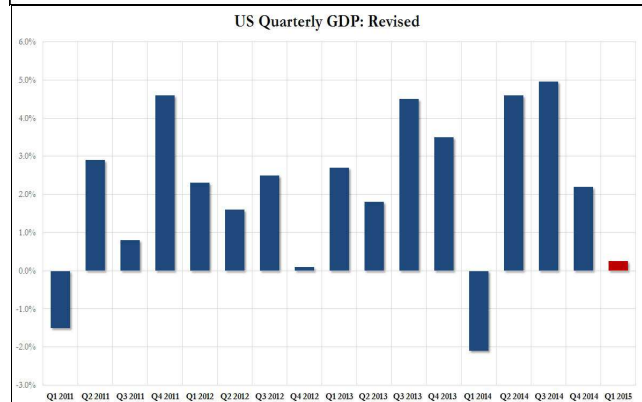
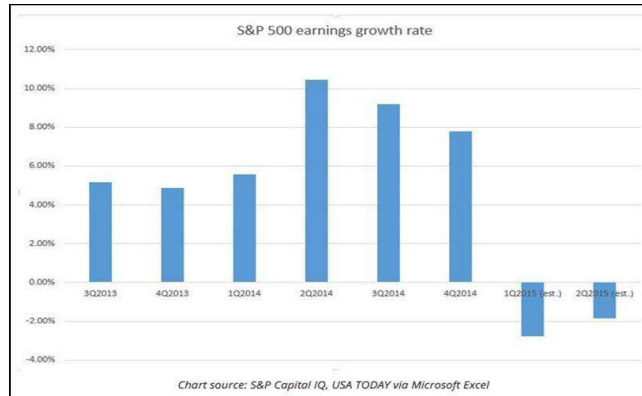
The stock market added to its gains with an advance in April, with the NASDAQ Composite finally eclipsing its all-time peak made back in 2000 at the height of the tech bubble. The blue-chip indexes have joined the move, as both the S&P500 and DJIA have made highs this month. All major averages have posted modest gains so far in 2015, with the small-cap Russell 2000 leading the way. The DJIA, S&P, and NASDAQ have gains of 1.5-2.0%, while the Russell is up 4.5% so far. The world's equity markets have been able to dodge any all threats, with dip-buyers in search of yield preventing any decline from turning into anything approaching a correction. We still believe there is some upside left to this rally, but the going is likely to be much more measured the next few months.

### Economy, Earnings, & Interest Rates

Although we have expectations for further gains, that certainly doesn't mean there aren't any concerns. In fact a couple fundamental divergences have developed over the past several months that must be resolved positively if the bull market is to continue. Both are issues we have brought up before, but the data are now clearly coming into focus and the market finally seems to be paying some attention.

The first of which was earnings, which have just not kept pace over the past few years, meaning that as the market has risen P/E's have expanded—significantly. As a result, on a trailing P/E basis the market is overvalued and at a valuation peak similar to those seen at prior market highs. Even worse, earnings have begun to weaken. As of last Friday, 200 companies have reported Q1 2015 earnings and there is an aggregate decline of 2.8%. That is the largest decline in earnings since Q3 2009 and well below the expectations of 10% plus gains just 2 quarters ago.

The reason for the slowdown in earnings was revealed just this morning, as 1Q revised GDP went from 2% down to just 0.20% in Q1, meaning the economy has come nearly to a halt. Q1 GDP was far worse than almost everyone had expected, and tumbled well below the Wall Street consensus of a print above



The two charts above clearly show that some sort of downturn occurred after a peak in the 2Q of 2014, as earnings growth (top chart) has dropped off to expectations of negative Q1 and Q2 earnings growth in 2015, threatening an earnings recession. GDP (bottom chart) did peak in 2014 but held up well for awhile, but the Q1 reading shows an economy on the edge of contraction.

1.0%. The slowdown in the economy that had been showing up in a declining earnings growth trend has finally revealed itself. The GDP data is quite a shock to some that have believed the narrative that the economy was on the upswing. Clearly it is not. And this time it can't be blamed on the weather.

The plunge in economic growth was broad based and showed a drop in both personal consumption growth which was cut by more than 50% from last quarter, and capital expenditures. Clearly the drop in oil and



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resulting contraction in activity in the energy sector have flowed through to the economy. Sometimes a drop in oil isn't such a great thing for the economy. Bottom line; this was the lowest GDP number since 2009!

It seems pretty clear that the surge in the dollar in 2014, coupled with the drop in oil, served to weaken corporate profits much more than expected. The drop in oil did not see a corresponding surge in economic activity as many economists expected. This confirms our belief that the Fed will not hike rates in 2015, and if in fact they do it will only make the economy slow further. Today's GDP data tells us the Fed is on hold for rate hikes for the next few months at least. **This opinion was in fact confirmed by the FMOC statement released this afternoon in which the Fed expresses a concern over "the slowdown in economic activity since the last meeting".**

The only good news in the GDP release was that it could have been much worse. There was a huge inventory build, the largest since 2010, which boosted GDP by nearly 3%. Absent this huge growth in inventory and we could have seen a sizable drop in GDP. Q1 GDP would have been -2.5%. That would have been a shock indeed.

Before we get too negative, there is a way to put a viable glass half-full spin on both the economic growth dip and decline in earnings that we have seen, that leaves room for a rebound and possibly more. The key to the earnings and economic weakness has been the strength in the dollar, which has killed overseas earnings, and assisted in the collapse of oil prices—further gutting the energy sector and capital expenditures.

But the dollar may have peaked for the time being, as it has been weak for about six weeks, allowing oil to rebound and preventing a major disaster in energy earnings and bonds. There haven't been any major credit defaults as feared, and the sector has been

helped by consolidation talks. If the dollar has peaked, helped by a Fed now on hold for rate hikes, and we see a drop, it would boost lowered earnings expectations and help oil to rebound. If this happens and we both an earnings recession and outright economic decline could be avoided.

## **Market and Investment Outlook**

Structurally the bull trend remains intact. The concerns mentioned previously have slowed the markets advance, but as of yet there hasn't been a break of key levels or a decline in the number of stocks making new highs or a rise in the number of stocks making new lows. We haven't seen any signs yet 'under the hood' that suggests the health of the market has weakened enough to suggest an imminent bear. A pullback yes, maybe even 5%. But the market can change quickly and nothing is guaranteed, that is why we will let the market's action guide us.

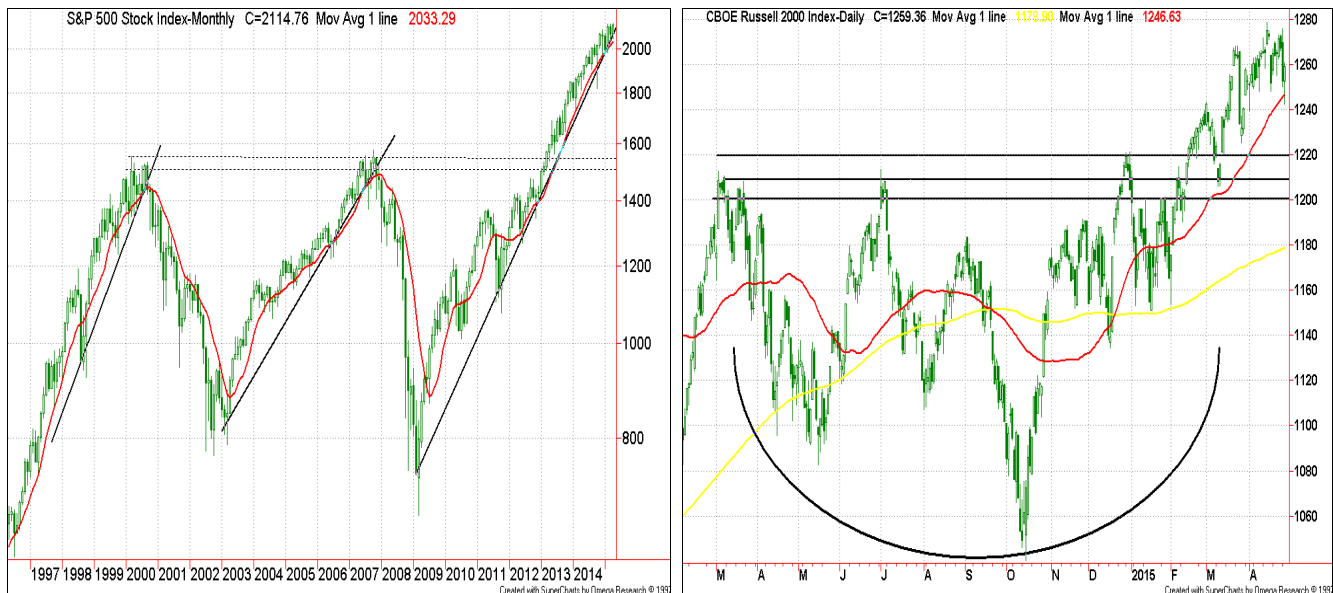
The general attitude is that is no reason to be bearish on the stock market right now. After all, with Central Banks supporting asset prices there seems little reason to worry according to many. In fact most believe they can wait until a hike in rates to get defensive. That works unless economic weakness is the problem. The central banks of the world are all pursuing the same policies; create trillions of dollars of artificial money which propels the asset markets, boosting demand through the wealth effect. We are finally seeing that monetary policy has little effect on the real economy. Given the weakness in earnings and subsequent overvaluation for stocks, we remain justifiably concerned that a market correction is coming. We still like bonds and prefer investment grade corporate bonds at the moment. Economic weakness favors bonds, as does a Fed on hold from rate hikes. We maintain long exposure to stocks along with our bond holdings as our trend models remain positive. We can't deny having some concern that the long-running rally stalls or ends in 2015. We will be watching key technical levels (more in chart section) for signs of weakness unfolding.



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## Charts—Long-Term Trend Still Intact; Small-Caps Leading the Way in 2015



### S&P 500 Long-Term (Above Left)

The bull market remains intact but you can see from the chart above the trend is quite a bit extended. Its nearly been a vertical trend since 2012 and the S&P 500 is well above its prior peaks in 2007 and 2000. Normally there would have been some hesitation at that level or a brief revisit, but there was neither in 2013. This suggests that the next 'bear market' is likely to drop to that level for a re-visit whenever that occurs— that would be a drop of 25%!

**For now, as long as the S&P remains above its long-term trend-line and 10-month moving average now in the area of 2030-2050; the long-term trend remains intact. A drop below 2075 (now around 2100) would be the first sign 2030-2050 support could be tested.**

### Small-Caps Leading the Way (Above Right)

After a poor 2014 which saw the Russell 2000 remain flat, small caps have shown some life in early 2015. After completing a near year long consolidation (choppy trading area above curve) the Russell broke up and out of its range in March. This strength in small-caps is a bullish sign as it suggests willingness to take risk. The market usually makes a top with small-caps lagging not leading.

**As long as the breakout holds (as long as the Russell stays above 1200) it suggests good things for small-caps in 2015.**

#### Disclosures:

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