May 19, 1935—T.E. Lawrence, known to the world as **Lawrence of Arabia**, dies. As a young officer he convinced his superiors to aid the Arabian rebellion, and was sent to join the Arabian army as a liaison officer. He proved a gifted strategist and under his guidance, the Arab forces ultimately captured the city of Aqaba near the Sinai. He was also an author and archaeological scholar.

Hamilton-Bates

Market Update

May 19, 2015

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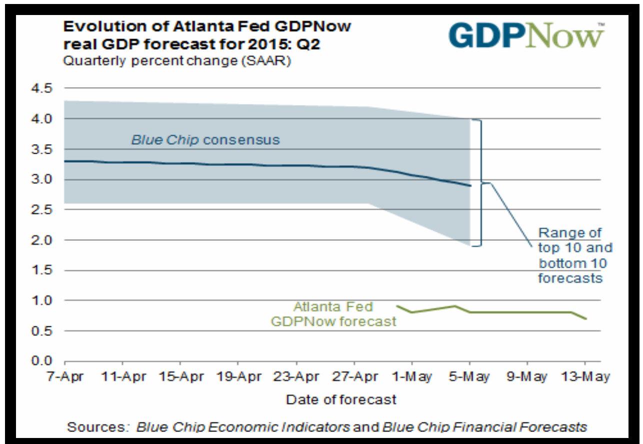
Stocks continued their move higher early this week with a pre-holiday rally. On Monday with the S&P 500 Index finally closed above 2120 another new high along with the DJIA. The week before Memorial Day is often characterized by a lazy, upward-drifting stock market on low volume. That's how this week started off and it appears the pattern could continue ahead of the holiday. Add to the mix a market which has spent the last several weeks chopping back and forth in a trading range and the potential exists for a surprise rally if the market can maintain the upward momentum from Monday. Gains could further be fueled by short covering. Bearish sentiment increased among retail investors over the last few weeks and this could provide the fuel to propel a breakout.

Economy, Earnings, & Interest Rates

The U.S. economy continues to show softness. Industrial production had its fifth consecutive monthly decline in April, falling 0.3%. The University of Michigan Consumer Sentiment Index declined to 88.6 from 95.9 in April, the lowest since October 2014 and the biggest miss of expectations on record. Retail sales showed virtually no growth. Excluding auto and gas, they rose 0.2%. So much for the boost from lower oil prices as they didn't help then and energy prices (especially gasoline) are heading higher again.

You can love it or hate it, but either way Wal-Mart is a bellwether for retail and the consumer. Their earnings miss this week was just another sign the economy is sputtering. Revenue declined $2 billion to $114.8 billion, missing expectations of a jump to $116.2 billion. EPS also missed at $1.03, vs. $1.05 expected. Wal-Mart's results show just how tough things are for the average consumer. If it is not luxury or consumer staples, its moving slowly.

With Q1 GDP showing tepid 0.2% growth (that could end up being revised to a decline in the Q1 Final), the outlook for Q2 is already starting to come down toward the Atlanta Fed's GDPNow model shown in the chart above right. Wall Street's consensus crowd of over-optimists have only just started to cut Q2 GDP growth expectations. The Fed Model has proven to be extremely accurate and the low readings for Q2 and drags total 2015 growth well below trend.



The GDP Model put out by the Atlanta Fed nailed the Q1 GDP number, and once again it is projecting lower than expected growth for Q2. The model forecast is in green 0.7%, while the Blue-Chip consensus of Wall St forecasts is in blue, and still remains quite high at just under 3%. Wall St's estimates for Q2 have just started to come down.

With below trend growth and weak economic data you would expect bond yields to remain tame, but in this upside down market Government Bond yields in the U.S. have risen from 1.85% in April on the 10yr to just above 2.3% last week. That is the equivalent to a 50bp Fed rate hike, and will no doubt exert some pressure on the economy in coming months should rates remain above 2.3% or even head higher. We would love to see the end of Zero Interest Rate policy but we are not sure the economy could handle it. We expect no more than a token hike in 2015 if at all.

More Signs of the Divergence Between Wall St and Main St.

Even though economic data has come down sharply, it has had little effect on financial markets that have come to count on central bank intervention and easy money. For some time now Wall St. see bad news as good news for the financial markets.

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Consider the two charts above and below from www.zerohedge.com, which show the diverging markets and economies in the US and Europe. The S&P 500 above (in green) continues to rise, while US economic data (US Macro in red), continues to fall.

When US Macro data and stocks started to crumble after QE3 ended last year, the Fed rushed out Jim Bullard in October to suggest that QE4 was possible if things deteriorated. The notion of QE4ever turned stocks up, but didn't help the economy.

So now Europe is heading down the same path with stocks and data weakening (above chart), so Mario Draghi goes to the Fed's playbook and talks about more QE in order to stimulate growth. Growth in the stock markets perhaps, but not likely for the economy.

Market and Investment Outlook

With new highs on four of the major indexes this week it seems as though the market is finally breaking out, and that is positive over the next few months. However, the budding range breakout must hold beyond just a day or two to instill confidence for the weeks ahead.

We are a bit surprised that stocks did not head lower on the weak economic and earnings data of the past few weeks, along with rising bond yields. Perhaps the muted decline is a belief that the problems are only temporary (West Coast port shutdown, the strength of the dollar), and that the economy will pick up. Likely more cause lies with the faith in the central banks' willingness and ability to levitate risk assets. The lack of good options investors have outside of stocks and corporate bonds (and REITS) likely helps also. Neither of the traditional 'risk off' assets (cash or Government bonds) has much appeal right now, although U.S Treasuries are starting to enter the attractive range given their 50bp rise in yield over the past few weeks

We remain invested with a focus on stocks over bonds and corporate bonds and high-yield over Treasuries. Fundamental concerns grow but structurally the bull trend remains intact. The concerns over the rise in bond yields could stall the rally, but we expect yields to moderate. As of yet there hasn't been a break of key technical levels, nor have we seen a decline in the number of stocks making new highs or a rise in the number of stocks making new lows. The financial sector broke out to a new high this week, historically a good sign for stocks.

No change to our outlook. We expect the market to push higher into the summer months, with the potential for a peak in July or August. We are watching SPX has support at 2120, 2080-2090, then 2050-2060. We don't want to see a break of that lowest level which would be a blow for the bull case. A move above 2125 that holds could finally be the trigger for a rally toward 2200.

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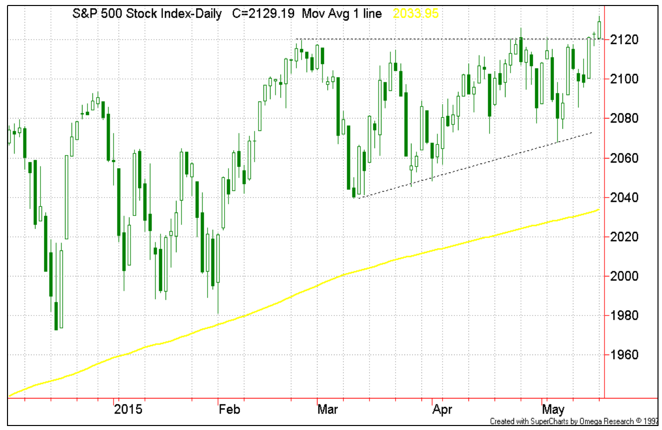
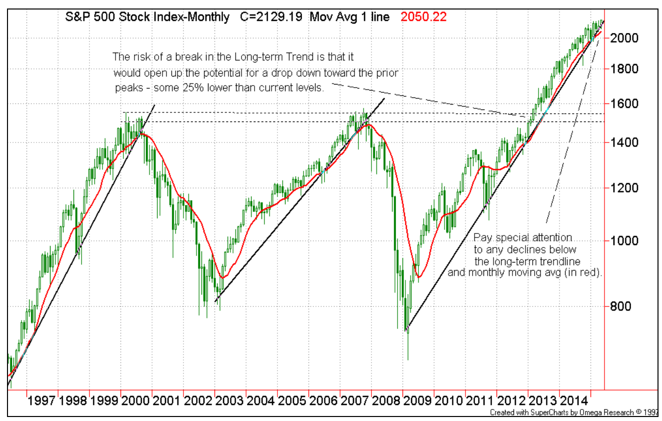
Charts—Short-Term Breakout or Fake-out?; Long-Term Trend Intact; Dow Theory Trouble



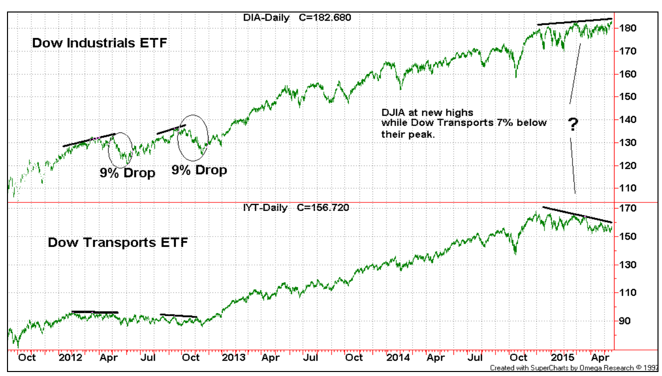
Near-Term S&P 500 Outlook (Above Right)

After rebuffing as many as 5 attempts since February the S&P 500 finally closed above 2120 this week. The flat-top and rising bottoms pattern (bounded by the dotted lines) looks very much like a classic bullish wedge. This pattern suggests higher prices if the S&P 500 is truly pushing above the upper boundary, and we could see short sellers spooked into covering. This could stoke a continued rally toward 2160-2200. **A drop back into the range is possible given the choppiness we have seen; a drop below 2100 negates the short-term breakout.**



S&P 500 Long-Term (Middle)

The bull market remains intact but the market is hovering higher just above key support levels. The long-term trend is very over-extended, and the next serious break whenever that occurs could see the S&P drop back to the prior highs of 2000 and 2007, a 25% move. **As long as the S&P remains above its long-term trend-line and 10-month moving average (now in the area of 2050-2060), the bull market remains intact.**



Dow Theory Warning? (Bottom)

Proposed by Charles Dow his theory put forth that strong trends in the Dow Industrials were confirmed by the Transports. When they diverged it was a warning the trend wasn't healthy. Right now the theory is flashing a warning. Transports have lagged since late 2014 while the DJIA has managed a new high. The last two occasions where we saw marked divergence between the two averages happened in 2012, and each saw a 9% decline eventually unfold. We don't want to see the transports break their recent lows, it would not be bullish.