Hamilton-Bates

Market Update

February 13, 2012

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The Politicians Fiddle While Athens Burns

The market's five week wining streak ended last week as concerns over a Greek bailout grew. But the market looks set to open this week higher as the Greek parliament passed the austerity measures required by the ECB, the IMF, and Germany in order to get the second Greek bailout done. The financial markets may be cheering but its safe to say the Greek population is less than pleased. There has been mass rioting across the country with banks and buildings burning, conflicts with riot police, and an outright revolt doesn't seem far away. I can't imagine even the Greek politicians who passed the latest measure even believes the promises will be kept. Given the shambles of their economy and the severe recession that their debt and ensuing bailout measures have caused, how much worse could an actual default be? A Greek default is coming at some point, it is just a matter of when. When it comes, the trouble likely won't be the Greek default itself, but what happens to the financial markets when Ireland, Portugal, and possibly Spain see a Greek default and want to renegotiate their debt as well?

Earnings, Economics, Interest Rates, & Europe

Even with the troubles in Europe our economic data has been slightly better than expected, showing modest growth. Even the employment situation has been showing improvement. Earnings, on the other hand, have been lackluster to say the least. According to First Call, so far a little over 350 of the S&P 500 have reported fourth quarter numbers, and of these 64% have surpassed estimates, 10% have been in line, and 26% have disappointed. These results would be a drop of 5% in the 'beats' and a rise of 5% in the 'misses' compared to the prior quarter. Given the less than stellar results, it is even more impressive that stocks have managed the gains they have this year. While it has been the supportive actions of the central banks to pump up the financial markets that has dominated so far, eventually earnings will have to improve if the rally is to last into 2013. For now valuations based on spreads between equity and bond yields remain at levels where stocks should be very attractive versus bonds, but bond yields still reflect the artificial attempts by the central banks to hold rates low. Based on data from First Call, current S&P 500 current earnings for the S&P are over \$96, and the 2012 number is near \$105, for growth of 9.8%. A reasonable 13 P/E based on these expectations to an S&P 500 of 1368, while modest P/E expansion equates to 1473. For P/E expansion to occur earnings will have to get better than what we have seen so far, and some sort of favorable resolution in Europe has to come about. That doesn't seem to be close at hand as of yet. Europe might get worse before it gets better.

Market Outlook

The major averages have rallied since the October lows, and especially so since mid-December. This has largely, if not entirely, been due to the actions of the Fed and the ECB, both of which have undertaken programs of quantitative easing—which have at least temporarily been very supportive for stocks. The trend has certainly 'been our friend', and we'll continue to hold bullish positions as long as the favorable trends hold up. But it is important not to get too bullish and get caught should stocks suffer a reversal or severe correction. The market is now due for a consolidation of the rally we have seen since mid-December. Corrections can come <u>through price</u>, (by having them drop), or <u>through time</u>, with the market going through a period of sideways trading. As of now we lean toward the latter. We could see the S&P move up to the 1350-1370 area in the near-term, but much more than that without an intervening correction/ consolidation seems unlikely.

The major averages have rallied through resistance, and the intermediate trend remains bullish. We are seeing some potential negatives pop-up, such as the fact that the Dow Industrial Average is at a new high while the Dow Transport Average is not. Should it last this divergence could be a potential sign of weakening in the economy. **However, as long as the S&P holds above 1300, and the NASDAQ 100 holds above 2400, the long-term trend remains bullish.**

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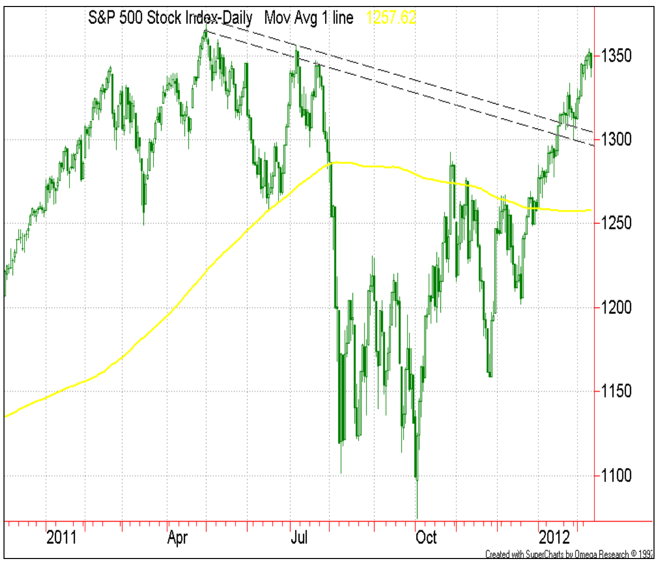
Key Charts

S&P 500



The S&P was rebuffed last week as it neared the levels seen at the 2011 highs, but the bullish breakout above the downward sloping trend lines back to those peaks remains intact. As long as 1300-1310 holds, a continued move up is allowed even if the market pauses here to catch its break so to speak. We could see the S&P challenge the 2011 highs around 1370 a bit more fully over the next week or two.

NASDAQ 100

The NADSAQ 100 continues to lead the major averages, and is well above its 2011 highs. Leadership in the growth oriented NASDAQ 100 is generally a positive, and this strength fits with the other technical signs we see that suggest more upside for stocks. The structure of the NASDAQ's pattern is such that it projects for a rally to 2700-2800, or a potential gain of 7-8% from current levels. Such gains are not likely without some corrective activity prior to the achievement of that move.