Hamilton-Bates

Market Update

February 22, 2012

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New and Improved Grecian Formula

Now that the latest Greek 'Bailout' seems to be in the books (pending Germany's final approval), the market's reaction seems to have been to 'sell on the news'. The European averages have now given back several days worth of gains and the Greek market is near a one-month low, suggesting the latest bailout was priced into the market well ahead of its announcement. As for our market, the signs for a short-term market top have been building for a few weeks now, but over the past week the number of warning signs have jumped a bit suggesting that a consolidation is needed (more on this in the outlook section). In terms of market news this week is light, but next week we'll have the latest QE program announcement from the ECB, with the size of its purchases yet unknown. We'll also get U.S. employment data next Friday. A third payroll gain of 200k+ would certainly help the case for economic improvement.

Earnings, Economics, Interest Rates, & Europe

Earnings season on the surface seems ok. So far 64% have surpassed estimates, 10.0% have been in line, and 26% have disappointed. The problem is that these earnings 'beats' are bottom-line heavy. Top-Line revenue has not been nearly as strong, with less than 49% of companies beating revenue estimates. **This is a bit of a concern because bottom-line earnings can be 'gamed' using one-off charges, but its much more difficult to fudge revenue**. Weak revenue numbers could be hinting at earnings weakness in the quarters ahead. Valuations based on spreads between equity and bond yields still remain at levels where stocks should be very attractive versus bonds, but the recent rally in stocks has certainly reduced the markets attractiveness in this regard, especially since yields on bonds reflect stress in the European financial system and the efforts by the Fed to hold rates down. If rates rise greater than the gains in earnings, it could put pressure on P/E ratios, meaning lower prices for stocks. In addition, we are now watching as the price of oil and gasoline are threatening to break up and out of their recent ranges; with both moving sharply higher in recent weeks. Rising energy prices could serve as a 'double whammy', pressuring earnings in the form of higher input costs, and as a 'tax' pressuring consumer spending. A continued move higher above $115 bbl for oil and $4 gal for gasoline would not be a positive for equities (other than the energy sector) in spite of those who believe it is a sign of a strengthening economy.

Market Outlook

The major averages have rallied 24% since the October lows, with a good chunk of those gains coming in the last 2 1/2 months. The market is now overbought from the perspective of momentum, time, and sentiment. These conditions, coupled with some near-term technical deterioration (see chart section next page), suggests that there is increasing risks for a consolidation. Nonetheless, the prospects seem reasonably good for still higher recovery highs thereafter, even allowing for an intervening corrective pause. **However, as long as the S&P holds above 1300, and the NASDAQ 100 holds above 2400, the long-term trend remains bullish.** The first sign of a correction would be a drop below 1350 on the S&P and 2550 on the NASDAQ 100. We'd look to add to holdings on dips toward but holding above 1300 on the S&P.

The Federal Reserve and the ECB

Despite some improvement in the US economy and in US Employment situation, the latest rally has been largely, if not entirely, been due to the actions of the Federal Reserve and the ECB, both of which have undertaken sizable 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 recognize signs of risk when the begin to grow, as we are seeing now. The market is now due for a consolidation of the rally we have seen since mid-December, but as long the key levels on the averages mentioned above hold, and the next ECB QE announcement doesn't hugely disappoint, even more upside could be coming courtesy of the Central Banks.

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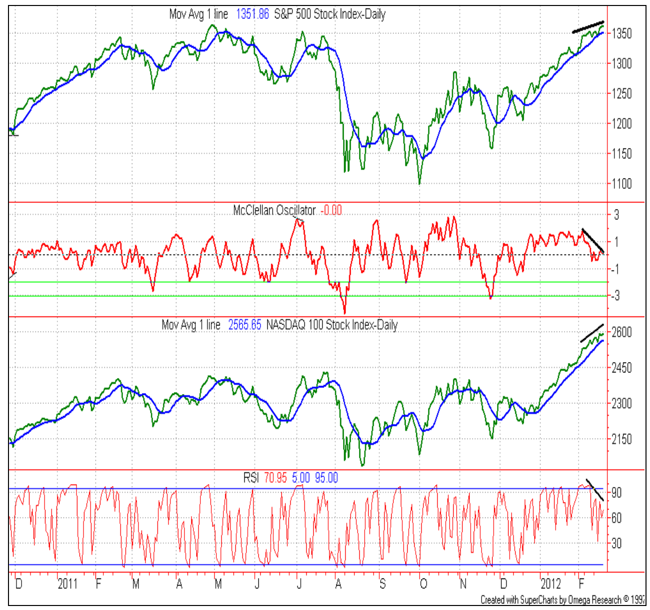
Key Charts

Market Indexes Hold Breakouts but… **...Concerns Cropping Up**



In the top left chart it is easy to see that the S&P 500 and the NASDAQ 100 have broken above their respective resistance levels, shown by the horizontal red dashed lines for both, along with the falling trend lines shown in black dashes for the S&P 500. For the NASDAQ 100, the 2400 level becomes the key area to watch. As long as it holds the bigger picture trend is positive. The respective level for the S&P 500 is 1300, which also represents the area of the rising trend line up from the recent October lows. A drop to those levels but not below them would mean that we could see a drop of 5% an still not invalidate the longer-term bullish outlook.

The top right chart shows some of the short-term deterioration in the market's technical conditions, often an early warning that a consolidation is near. This deterioration comes in the form of negative divergences, which is when a market or stock is making a higher price high that is not confirmed by internal market measures or indicators. The chart above right shows the S&P 500 in green in the top panel, along with the McClellan Oscillator in the panel just below it. Marked on the chart is the recent rise in the S&P without a corresponding rise in the McClellan Indicator. The lower panels show the NASDAQ 100 in green and a measure of its short-term price momentum (RSI) just below it, also showing negative non-confirmation of the recent highs. The divergences certainly don't work all the time, and the market could continue to rally and sweep the divergences away, but given the magnitude of the gains in 2012-we believe a 3-4% pullback is near.