Hamilton-Bates

Market Update

October 13, 2014

Oct 13, 1792: White House cornerstone laid. In 1800, John Adams became the first president to reside in it, and it soon became known as the "White House" because its white-gray Virginia freestone contrasted with the red brick of nearby buildings.

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The page has turned to the Fourth Quarter for stocks and it has not been a good start. Stocks got clobbered last week as major indexes recorded their third losing week in a row as fears regarding the global economy, the Middle East, and Ebola dominated the headlines. The bluest of blue-chips held up the best, as the DJIA were down slightly less than 3% on the week, and now flat for 2014. The Russell 2000 took it harder as small–caps continue to under-perform. The Russell lost 4.6% on the week, is down -13% from its peak, and is now down -9.45% for 2014. The S&P 500 lost about 3% on the week and is managing to hold onto a 1.1% 2014 gain. and The least damage was in the Dow Jones Industrials, down 2.74% and now slightly down for 2014, followed by the NYSE Composite, down 3.01%. The biggest loser was the former year-to-date leader Dow Jones Transports, plunging 6.94%.

Economics, Earnings, and Interest Rates

We have just entered third quarter earnings season which could remove the lack of visibility which has been responsible for a good deal of the recent weakness for equities. If there is a catalyst that could get something going positively for stocks it could be earnings. Earnings can't be any worse than the headline news lately can it? At this point, it is very possible that traders and investors have priced-in so many negatives into the guidance that we might surprise on the upside. A positive earnings season and good guidance is needed to bring buyers back off the sidelines. How the market reacts to earnings could tell us much about whether we are just seeing a correction or the start of something more. Even though the market has been down, there has been some good news. US GDP estimates have been bumped higher for Q3 and Q4 to +3.2% for Q3 and +3% for Q4). There has also been and increase in payroll gains—much to our surprise. A final positive has been a sharp decline in energy prices—with oil falling 20% from its peak giving consumers a break on their heating and driving costs. Drops in energy prices are like tax cuts for the economy. How and whether investors focus on the positives mentioned above or whether concerns deepen will guide the markets path in Q4.

Ebola

The real wildcard is not European or China economic weakness, it's Ebola. As Donald Rumsfeld once said— “it’s the unknown unknowns you have to worry about”. And there are a lot of unknowns about Ebola, as there isn’t even agreement on how it spreads. We have just read that the Center for Disease Research believes it can be spread through the air—contradicting the CDC and what Washington has told us. That makes sense given so many healthcare workers seemingly protected in HAZMAT suits have been contracting the virus. If it spreads through the air they need full respirators not just masks to keep the virus out. Given the sequence of “Ebola isn’t likely here—and its not likely to spread through airline travel—trust in the government to protect the public and deal with the problem is slipping daily, especially with the latest news on the virus possibly spreading through the air not just physical contact. With so many unknowns It is impossible to model this (Ebola) and the potential impact on the global economy and stocks. The Center for Disease Control said it is concerned there could be other infections in the coming days, especially following the infection of a healthcare worker who treated the man who died from Ebola in Dallas. Even though there are only two diagnosed cases in the U.S., there is a very high sensitivity to it. Airline stocks down hard, and have lost 17% over the past few weeks. The transportation sector has gone from one of

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the strongest to one of the weakest sectors. Should there be any more than just 1 or 2 isolated cases here it could really dent the economy.

Market Outlook

In the last Update at the end of September we said that in the short-term it would not be surprising to see a pullback given a deterioration in market breadth and the lagging action of key areas like small-caps. At that time the market wasn't declining but rather chopping around and going nowhere. Since then we have seen the sharpest decline of 2014, and are indeed getting the correction that has been overdue for some time. With the exception of a sharp but brief bounce in the wake of dovish FOMC minutes, stocks have been sold-off nearly relentlessly for the past several trading sessions.

The result of this selling has been a failure to hold short-term support levels, and a lack of bounce given oversold conditions. The market has now reached the general area where we should see the market stabilize and develop a rally. **If we do not see strength in stocks over the coming week that would be a warning regarding the equities market. A market that does not respond to oversold conditions with a bounce is once that can be dangerous**. In the short-term stocks remain oversold, sentiment is very pessimistic, and the correction should be nearing its end.

From a technical perspective the short-term trend is certainly down, but the long-term trend remains bullish. The upcoming week is likely going to decide whether the bull retains its horns or loses them. The S&P 500 is right at its 200-day moving average, an important long-term support level that it hasn't touched since November 2012. That is a long way to go without probing that vital area of support. Yet it tells you just how strong the QE-fed market has been.

Technically speaking we should see a bounce soon given oversold conditions. How long that lasts depends on how investors view the fundamentals. With the market at support and now deeply oversold the stage is set for stocks to bounce. We will be measuring any rally that does occur in order to ascertain its sustainability. We will also be watching to see if investors sell into any rally that develops.

Investment Strategy

If this is just another correction for the market—albeit the deepest of 2014, then it should be nearly over and stocks should be getting ready to bounce. If so this would be just another opportunity to buy the dip—which we did as we bought modestly for some portfolios at the end of last week. We had built up one of our larger cash positions of the year due to some selling two weeks ago (which proved timely).

My gut currently tells me that the bull market is still in place for now, since we haven't seen many of the normal signs that a long-term top was in place just yet. It may take another week or two to shake things out and put a trading low in place, so expect more volatility around the S&P 1900 level until the balance of good versus bad news is weighed out. Ultimately though we don't listen to m gut, as the market determines the trend. Should conditions not show improvement, even more defensive measures may be needed.

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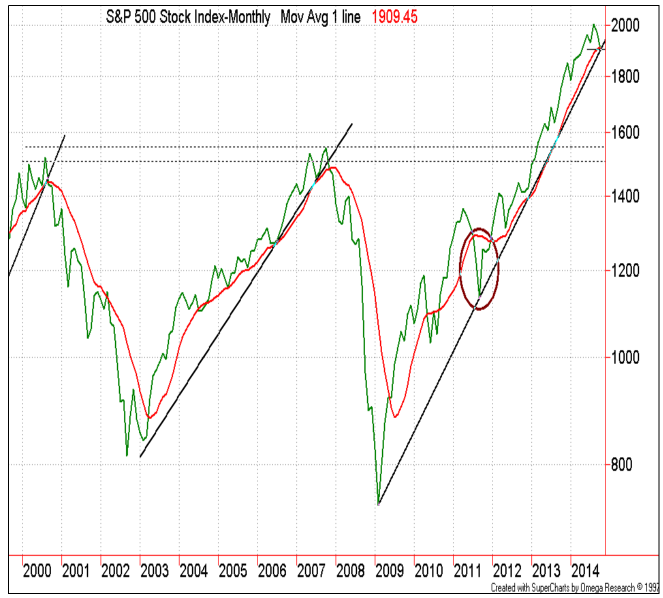
Charts—Short-Term Correction Tests Long-Term Trend



S&P 500 (Top Left)
The market has now corrected down to the 1900 level, a key area which should see buying interest develop. This level is the old breakout level from early summer, and is also the level of the July low and the much-watched 200-day moving average (in yellow). A drop much below 1900 would be a significant negative given the number of coincident support agents here, and would suggest risk in the longer-term trend.

Long-Term S&P 500 Chart (Top Right)
The bull trend up from the 2009 lows remains intact but the market is now testing that trend. Should the S&P 500 fall below 1900 and remain there for longer than a day or two—the warning for a change in the long-term trend would be given. A drop below 1900 would take the S&P below its long-term trend-line from the 2009 lows, and below its 10-month average—something it did only briefly in 2011. That was during an 18% drop at the end of QE.

Should the rising trend-line from the 2009 low and 10-month average be broken, it would be prudent for investors to consider defensive measures for their portfolios, whether that be increased cash or hedging.