AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

October 7, 2012
Volume 2 - Issue 8

Inside This Issue

"A recession will not hit the US in 2013."

Perspectives

The stock market is a forward-looking system, but rarely views the risks through unobstructed views. Unreasonable fear hinders common sense too often. Economists tell investors to beware of the bubble in China bursting and the pending surge in inflation for the US. Both of these risks will have a hard time existing in the same fear story. If China's economy weakens and demand drops, commodity prices will fall. This will lead to lower input costs and potentially a deflationary environment. Such a set-up gives the Fed an open door for more quantitative easing. If China has a "soft-landing", demand will not drop enough to hurt the US economy and the US recovery can continue.

Investors are also lectured on the dangers of US dollar weakening at the same time as announcing the imminent the fall of the euro. The dollar has shown strength in every instance of European Union weakness. With each tick higher in the dollar versus the euro, commodities prices have fallen. As commodity prices fall (including oil), input prices drop for US goods and companies' profits improve. A collapse of the euro will be no more than a short-term fear induced sell-off in stocks. The lack of a lasting effect comes from the shift in the US to a service based economy. The US derives only 13% of its GDP from exports. With much of the European Union in or near recession already, a reduced benefit from exports is factored into current stock prices. Further weakness will be felt, but not enough to turn the US economy back into a recession, while the Fed and other world central banks flood the markets with stimulus.

Bond prices are high, indicating fear of a stock sell off. At the same time, the VIX, often referred to as the fear index, is below historic averages, indicating a major correction is unlikely in the near-term. Investors have good reason to be wary of further gains after such a strong past 12 months, but stock valuations have just recently reached historic averages. This will dampen the chances of a surge in stock prices from current levels and also reduces the risk of a bear market. Bear markets do not tend to start until extremes have been pushed in P/E ratios. Earnings season starts in a few days. Investors will learn if earnings estimates were accurate and will get an update on forecasts for 2013. If current 2013 estimates prove accurate or improve, the market indexes will have a clear path higher. If estimates decline, stocks will have an excuse to sell-off as traders take profits to lock in 2012 gains.

A recession will not hit the US in 2013. Even with slow job growth, trouble in the Middle East, worries in Europe and a slowing Chinese economy, the future for US stocks' earnings is strong. The housing market is improving as seen in increasing home prices and new homes being built. As this momentum builds, employment will improve. With a better jobs picture, GDP and earnings will improve. The Fed's easy money policy (also known as QE3) will continue to stimulate the economy and create favorable loan conditions for homebuyers and large businesses that are expanding. Oil prices are dropping as some of the risk premium fades. This will lead to lower gas prices, which frees up more discretionary spending for consumers and reduces companies' input costs.

The presidential election is just weeks away. Republicans claim a Romney victory will help the market by avoiding the expiration of the Bush tax cuts and the expense of health care reform. Democrats counter that an Obama reelection will prevent major spending cuts at a time when the economy needs stimulus. History has shown that the uncertainty of the election process usually plays a larger role in the markets than which party takes control. Once the election results are in, investors can remove a piece of ambiguity and stocks tend to move higher as the risk premium recedes.

The fiscal cliff is weighing heavier on investor sentiment more than who the next Commander in Chief will be. The typical move higher for stocks after the election will be muted without a resolution or extension of the fiscal cliff deadline. After the fiscal cliff is resolved or pushed further down the calendar, the stock market will resume its momentum higher and whoever is elected will get credit for a regular economic cycle playing itself out to the upside.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average TR	10/5/2012	13.74	27.83	15.42	2.18
NASDAQ Composite PR	10/5/2012	20.38	27.46	14.89	2.44
Russell 2000 TR	10/5/2012	14.99	29.95	14.07	1.37
S&P 500	10/5/2012	18.16	30.58	14.36	0.93
S&P MidCap 400	10/5/2012	14.64	27.76	15.38	3.32
Global Stock Indexes					
Developed World (Ex-US)	10/4/2012	12.57	22.46	5.71	-3.96
Emerging Markets	10/4/2012	10.62	16.71	5.20	-0.70
Bond Indexes					
Core Bond	10/4/2012	4.17	5.07	6.05	6.72
Intermediate Core Bond	10/4/2012	4.13	5.18	5.85	6.81
Long-Term Core Bond	10/4/2012	7.66	8.87	11.07	10.25
Short-Term Core Bond	10/4/2012	1.63	2.02	2.52	3.79

Market Movers

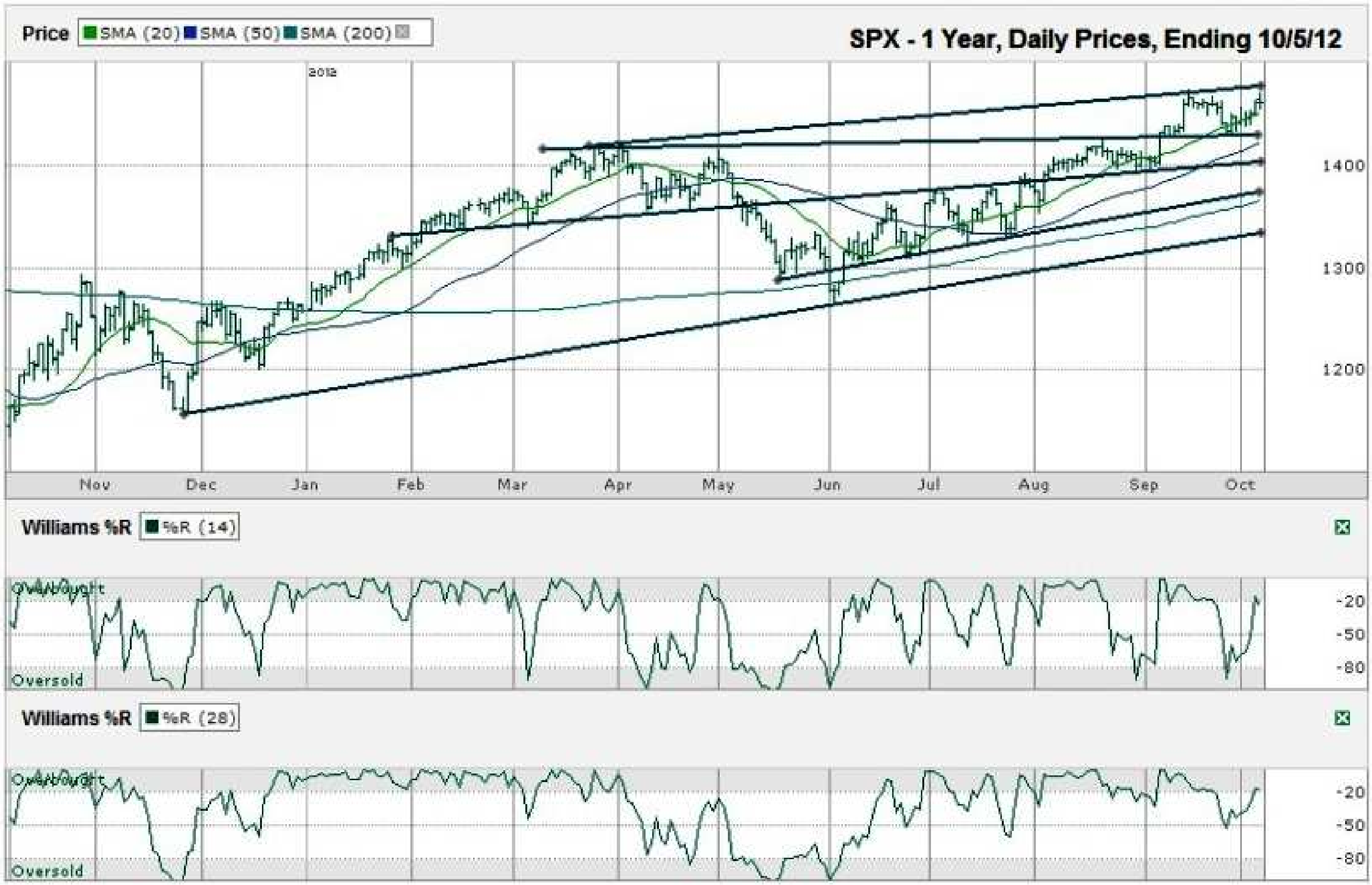
- Near the end of July, European Central Bank President Mario Draghi stated that officials are "ready to do whatever it takes to preserve the euro." The comments sparked a rally in both European and US stock markets. One week later, Mr. Draghi surprised the markets with a failure to deliver detailed plans to fix the ongoing crisis. Stocks returned nearly half of the gains they had made over the prior week.
- By the end of August, news reports from Europe indicated the International Monetary Fund sees a "major challenge" in implementing measures for Greece as planned. In addition, the Slovak Prime Minister, Robert Fico, suggested there is a 50% chance of a euro area break-up. Theses combined comments rattled the markets and triggered a drop followed by a move sideways for a week.
- At the end of the first week of September, Mr. Draghi was back in the headlines and confirmed reports of a European Central Bank plan to buy bonds with maturities shorter than three years. The announcement sent stocks higher and US treasuries lower.
- One week later, the Federal Reserve announced its plans for a third round of quantitative easing. The plan was bigger than the Street expected and stocks rallied. As part of QE3, the Fed will buy $40 billion of agency mortgage-backed securities each month. It's also keeping in place “Operation Twist”, which consists of swapping short-dated securities for longer-term securities and reinvesting the proceeds of maturing securities. The Fed also extended its commitment to keep interest rates exceptionally low at least through mid-2015. The Fed said it's acting "to support a stronger economic recovery" and expects the new program to put downward pressure on longer-term interest rates, support mortgage markets and help make financial conditions more accommodative.
- The move higher for stocks lasted less than a week. Within days of the Fed’s announcement, EU concerns proved to be the catalyst for a change in direction and pushed stocks below pre-QE3 levels over the following two weeks.
- By the beginning of October, stocks resumed their higher trajectory on positive domestic indicators, but now face technical resistance at 2012 highs (see chart on page 4).

Fundamentals & Indicators

- The September unemployment rate fell below 8.0% for the first time since January 2009 to 7.8%. This came with a nonfarm payrolls number that fell slightly below estimates to 114,000, but included large revisions to the prior two months totaling 86,000 more jobs than previously reported. The nonfarm payrolls number has fluctuated over the past quarter while maintaining a trend of slow growth.
- Adding to the bullish headline number, the average workweek moved up to 34.5 from 34.4 and hourly earnings increased by 0.3% while forecasts were calling for a 0.2% increase.
- Personal income increased in August by 0.1%, which was below the expected increase of 0.2%. Personal spending increased by 0.5%, which is in-line with expectations. Core personal consumption expenditures were higher by 0.1%, which also met forecasts.
- Bears point to the U-6 number that stayed at 14.7% in September. This count includes part-time workers who are still looking for full-time work. While down 1.7 percentage points, seasonally adjusted, from a year earlier, it stayed flat month over month.
- The September Challenger Job Cuts report showed a 70.8% year-over-year decrease in job cuts.
- New home sales in August were close to two-year highs and new home prices reached their highest levels in more than five years. These two readings indicate a housing recovery has begun.
- Housing starts hit an annualized rate of 750,000 units in August, below expectations of 770,000. In addition, July figures were revised downward to an annual rate of 733,000 housing starts. These figures dampened the case for a fast housing recovery.
- August building permits fell to a seasonally adjusted annual rate of 803,000. Although this is below the July reading of 811,000, it is up more than 24% over the August 2011 reading.
- The Housing Market Index for August came in at 37, up from July.
- According to the Case-Shiller 20-city Home Price Index released in September, all 20 cities and both Composites recorded positive monthly changes for the third consecutive month.
- Durable goods orders decreased by 13.2% in August. This was worse than the 5.0% decrease that had been anticipated. This comes after positive readings in June and July of 1.6% and 4.1% respectfully.
- The third estimate of second quarter GDP surprised the Street when it showed growth of only 1.3%, much worse than the forecast of 1.7%. 2012 GDP is now predicted to grow 1.7% to 2.0%, which is lower than the previous forecast for growth of 1.9% and 2.4%.
- The Federal Reserve raised its GDP outlook for 2013 and 2014 to 2.5% - 3.0% from the previous estimate of 2.2% - 2.8%
- June Factory Orders decreased 0.5%, which disappointed investors who were looking for a 0.6% increase.
- Retail sales beat expectations in recent months and rose by 0.6% in July and 0.9% in August.
- Overall producer prices rose again in August by 1.7%, partly because of the recent rise in energy costs. The Core Producer Prices Index (prices for goods excluding foods and energy) rose by 0.2% in August. This is a slower pace than the 0.4% increase in July and matches May and June reports. Inflation remains relatively tame, partly due to weak job growth.
- Consumer prices increased by 0.6% in August, which was in-line with the forecast for a 0.6% gain. Core prices increased by 0.1%, which was slightly short of the 0.2% increase anticipated by economists
- The Philadelphia Fed Survey rose to -1.9 for September. This is an improvement over the August reading of -7.1 and the July reading of -12.9. While still negative, the trend is on a clear path higher.
- The September Chicago PMI of 49.7 surprised to the downside for the second month in a row. Economists were looking for a reading of 52.9 following August's reading of 53.0 that came in short of expectations of 53.8. A reading below 50.0 implies contraction and raised red flags for the reliability of the recovery.
- After the disappointing Chicago PMI report scared investors, July Factory Orders showed an increase of 2.8%, which was better than the consensus of a 2.0% increase and improved prospects for the US economy.
- Momentum continued to build with the September Manufacturing ISM Index. It came in at 51.5, above the 49.7 consensus, and up from August's 49.6 report.
- Construction spending declined in each of the past two months and caused the markets to pause their advance.
- The Empire Manufacturing Survey for September disappointed with a reading of -10.4, which is below August's reading of -5.9. Early predictions indicated the Survey would rise to -3.0.

Please see Index Fundamentals & Indicators on page 5

Index Chart & Analysis



This S&P 500 ($SPX) chart shows the past year of daily prices after the index finished the week at 1,460.93 on Friday, October 5, 2012. Market trends are often foreshadowed in part by their moving averages. As stocks trade above their moving averages they tend to move higher. When momentum shifts and prices begin to fall, stocks fall below these moving averages. The longer a trend maintains the same trajectory, the more of its shorter-term moving averages move above its longer-term moving averages. Buy signals can be seen when a shorter moving average moves above a longer moving average and vice-versa. The same holds true for most indexes.

Traders can see momentum shifts has occurred when the 20 and 50 day moving averages (dma) crossover on this SPX chart. The exact bottoms and tops of each cycle are not foreshadowed, but the majority of the trends are signaled early, allowing traders to capture most of the swings. The 20 dma moved above the 50 dma on this chart in early July. The index tested the 50 dma at the end of July, but has not been close to it again since then. While every move below the 20 dma should be watched, it is the crossover that matters for these long trends. Like every technical indicator, it is prone to giving false readings occasionally. That is where the art of reading a chart factors in.

Following trend lines is one of the arts a technical trader needs to understand. In this chart, the SPX is closer to its trend line of higher highs than it is to its trend line of higher lows. That gives more room to the downside for the index to move if it is to continue through its current channel. In addition, resistance is often seen at horizontal levels of previous highs. The S&P 500 is facing resistance around 1,475, close to the intraday high from September. A break above this resistance would normally bring in more buyers quickly, but the trend line of higher highs is close enough to slow the flood of buy orders. These will be key lines to watch in the coming weeks.

Another seemingly easy indicator to read is the Williams %R indicator, but the variables that factor into a trade signal are not as simple. A move below the overbought (-20) and oversold (-80) is usually a signal for a trade.

Experienced traders have learned to wait for two to three confirmation days to reduce the number of false readings from this indicator. The art using this tool comes from choosing the correct time period that works well for each stock or index. Also, every move above and below these levels cannot be viewed in a vacuum. In this chart, the 28 day period did not break below the overbought period enough in August to signal a sell order even though the 14 day period did. Recently, the 14 day period broke support again and the 28 day period came with it, but reversed quickly. This was enough of an action to cause doubt in the strength of the bull market from current levels.

Active traders could consider using options to hedge their long positions or entering trailing stops to protect themselves from outsized losses. If the market does correct soon, it could fall all of the way back down to its 200 dma, which is close to a trend line of higher lows, near 1,365. That would be more than a 7% correction from the recent intraday high.

Continued from Fundamentals and Indicators from page 3

- The ISM Services index improved in each of the past three months from 52.6 in July, 53.7 in August and 55.1 in September. Not only do these readings show expansion in the large services sector, but also they indicate the momentum is building.
- August factory orders showed a decrease of 5.2%, which was better than the consensus of a 6.0% decrease.
- PMI readings from Germany, France, Italy and Spain all beat expectations, but remained below 50, which indicates contraction, although not as severe as feared.
- Data in the United Kingdom was less positive as the British PMI was reported at 48.4, below the anticipated reading of 49.3.
- The Eurozone unemployment rate was revised up to 11.4%, a record-high.
- Chinese Manufacturing PMI improved to 49.8 and Chinese HSBC Final Manufacturing PMI rose up to 47.9. These numbers help the case for a "soft landing" for the Chinese economy.

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