AF CAPITAL MANAGEMENT
Registered Investment Advisor

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INSIDE THIS ISSUE

"…another seven months of gains before this bull market peaks"

Perspectives

Since the 1920s, bull markets have averaged less than 30 months from trough to peak, about three times longer than the average of bear markets. The current bull market started 45 months ago. Does that mean the bulls' turn is coming to an end soon? Not necessarily, but it should raise a cautionary flag. Since 1940, the average bull market has lasted more than 52 months. Investors could have at least another seven months of gains before this bull market peaks.

Being an average means that some bull cycles last longer. These extended cycles tend to come after more severe declines. The bear market that preceded the current bull market was one of the worst in US history and the S&P 500 has not reached the peaks (not including dividends) reached in March 2000 and October 2007. Just as the 2007 market top inched above the 2000 zenith, investors can expect the current bull market to exceed previous turning points.

In addition, markets tend to top out with exuberance and higher than average P/E ratios. Fear has stayed a solid part of this entire bull market while stock prices "climbed the wall of worry". Those who were bold enough to take a calculated risk have prospered. Others missed doubling their money in less than four years. The recent P/E ratio for the S&P 500 is 16.80 using trailing earnings, close to historic averages and far below most market cycle tipping points. Using forward-looking earnings estimates, the P/E ratio for the S&P 500 drops to 13.68. If these estimates are accurate and the P/E ratio contracts down to 15.0 (not typical at the end of a bull market), the index should hit 1,560 by the end of 2013. This would equal an annual gain, including dividends, of more than 12% again.

Economic risks remain from the debate over the debt ceiling and delayed spending cuts. A drop in government spending will cause a reduction in corporate earnings when spending cuts come to fruition, which in turn would create a higher P/E ratio, not from higher prices (the numerator), but from smaller earnings (the denominator). If earnings do not fall, the size of this market multiple will expand as confidence builds. 1,560 could be on the low side of where the S&P 500 could reach.

Even with spending cuts likely, the housing market in the US has turned the corner and will add to the US Gross Domestic Product in 2013. The employment picture is improving at the same time. As housing prices and the overall employment outlook gains momentum, consumer confidence will brighten and the private sector's demand for goods and services will help balance out the reduction in government spending.

Still, bears fear that the stock market cannot withstand any spending cuts and darker days are unavoidable for equities. If investors look for proof of that theory in countries where austerity has been much more severe, they will find it does not hold much credibility. Spain has much higher unemployment and severe debt problems, yet its stock market only lost 3.6% in 2012. Greece continues with draconian spending cuts and its stock market only lost 3.5%. Even Portugal, another of the "PIIGS" countries at the root of the European Union troubles, only lost 0.5%. This shows that spending cuts are not guaranteed to ruin a country's economics.

China has been one of the biggest market risks for more than a year, but that is changing too. They are embarking on another stimulus program and are pushing for growth again. Based on recent economic data, the program is working. Demand, at least in the near-term, is improving again.

Lastly, the popping of an economic bubble of some sort is often present at market tops. The only bubble easily identifiable in today's market is in bonds. Bond yields have reached all time lows (meaning prices are high). As bonds fall out of favor, investors will sell and move the cash to equities. This asset allocation transfer could be what sends stocks to unreasonable valuations and that's when investors should take profits and exit the market.

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	1/4/2013	2.56	11.19	11.25	3.87
NASDAQ Composite PR	1/4/2013	2.72	17.12	10.35	4.37
Russell 2000 TR	1/4/2013	3.51	19.40	12.67	5.53
S&P 500	1/4/2013	2.84	17.43	11.32	3.04
S&P MidCap 400	1/4/2013	3.50	21.12	14.33	6.90
Global Stock Indexes					
MSCI Emerging Markets	1/4/2013	2.15	14.97	2.38	-2.52
MSCI World, Excluding US	1/4/2013	1.83	16.19	3.61	-2.69
Bond Indexes					
Core Bond	1/3/2013	-0.40	4.24	6.08	5.94
Intermediate Core Bond	1/3/2013	-0.17	4.14	5.78	6.05
Long-Term Core Bond	1/3/2013	-1.28	7.83	11.54	9.19
Short-Term Core Bond	1/3/2013	-0.02	1.77	2.48	3.20

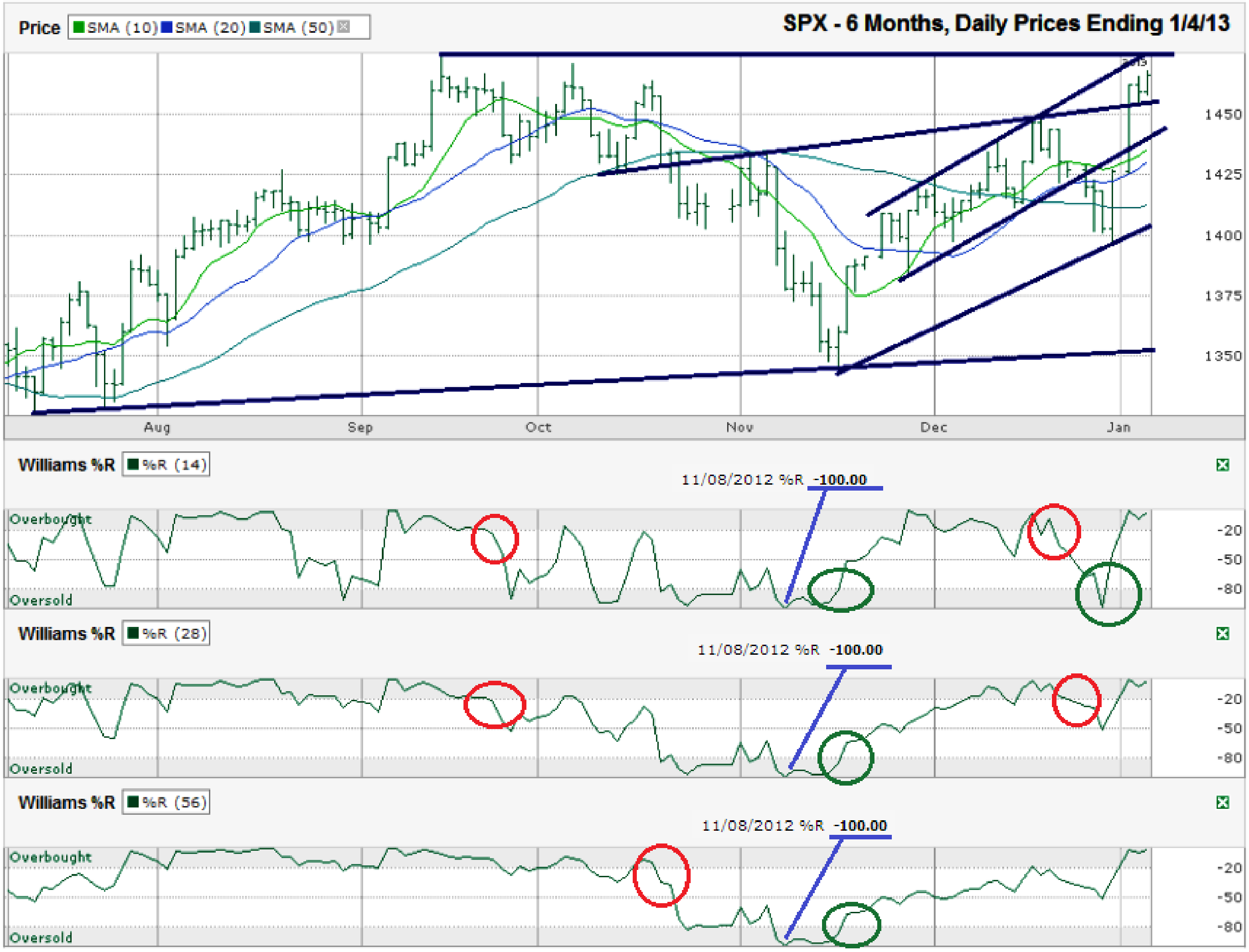
Market Movers

- The US presidential election and the fiscal cliff have dominated the market direction for the past few months as rumors about the outcome of each event caused knee-jerk reactions in stock prices.
- Hurricane Sandy's impact caused the US stock markets to close for two days. The effect of the super storm appeared in multiple earnings reports and economic indicators as the explanation for disappointing results. However, many indicators (see page 3) continue to show growth, even with the economic drag from the natural disaster that caused the most densely populated part of the country to come to a standstill.
- Stocks fell sharply after Barack Obama was reelected to a second term as president. On the same day, European Central Bank President Mario Draghi added to the selling pressure when he said the European debt crisis is hurting the German economy. Germany has been the strongest member of the EU and the hint that its economy is weakening was more than stocks could handle.
- By mid-December, China's HSBC Flash Manufacturing PMI came in better than expected at 50.9, showing expansion. Chinese stocks had their biggest one-day gain in more than three years on the news. Many investors feared China was slowing too much and it would put a drag on the world economy. This single piece of news removed that fear, for now.
- On the same day as the positive China data hit the wires, France and Germany issued disappointing Manufacturing PMI readings. The full Eurozone Manufacturing PMI hit 46.3, indicating contraction in manufacturing throughout the region. However, Eurozone Services components beat expectations.
- The resolution of part of the fiscal cliff (some of the issues were only delayed two months) sent stocks soaring as rumors surfaced of an agreement on the last day of trading in December.
- Adding to the bullish outlook in 2013, the UK's PMI came in at 51.4, beating forecasts by more than 2 points and moving the indicator from contraction to expansion.

Fundamentals & Indicators

- Overall producer prices started the fourth quarter increasing more than expected, but eased over the next two months for a net quarterly change of +0.1. Core producer prices slipped 0.1% over the same period.
- Retail sales rose September through November 1.3%. Excluding autos, retail sales rose by 1.1%.
- The Empire Manufacturing Survey remained in negative territory in each of its last three reports, but improved in November to -6.2 from its September reading of -10.4
- Consumer prices increased at a rate of 0.6% for August and September, a much higher rate than usual. October consumer prices increased by only 0.1%, followed by a decrease in November consumer prices by 0.3%. If prices rise too fast, the Fed will have a harder time maintaining its "easy money" stance.
- Momentum is building in the housing sector. Reports on housing starts averaged in the high 800,000s over the past three months, well above previous readings in the mid-700,000s
- The Case-Shiller 20-city Home Price Index highlighted the improving housing sector with increases of 2.0%, 3.0% and 4.3% from August through October.
- September building permits improved to a three-month high of 899,000 for November after reports of 890k and 868k the prior two months.
- Existing home sales steadily improved from September through November with annualized rates of 4.75 million, 4.79 million and 5.04 million units respectfully.
- New home sales fluctuated from 389,000 down to 361,000 in September and then back up to 377,000 in November.
- Pending home sales were up 9.8 percent in the 12 months through November. After three months of gains, pending home sales were at a two and a half year high.
- After two months of disappointments with readings of +5.7 and -10.7 missing expectations, the Philadelphia Fed Survey rose to +8.1 for December, beating the consensus of -1.3.
- Durable goods orders continued the story of an improving economy. After finishing August with a -13.1 reading, September durable goods increased by 9.9%, followed by a flat October and an increase of 0.7% in November. Each of the last three months beat the anticipated numbers.
- The Chicago PMI stumbled with a reading of 49.9 in October, which showed contraction. However, November and December both showed expansion again at 50.4 and 51.6 respectfully.
- The ISM Manufacturing Index indicated a small expansion from October through December with numbers coming in at 51.7, 49.5 and 50.7.
- Construction spending eased off from rises of 0.6% and 1.4% in September and October to a decrease of 0.3% in November.
- The services sector continues to show stronger growth than manufacturing. The ISM Services Index showed solid expansion of 54.2, 54.7 and 56.1 for October through December. As the US has moved to more of a service based economy from a manufacturing based economy, these positive numbers are very bullish.
- The third estimate of third quarter Gross Domestic Product (GDP) showed growth of 3.1%, which was better than the 2.7% economists expected and well above the original estimate of 2.0%.
- Factory orders increased 4.8% and 0.8% September and October, but were unchanged in November.
- December employment data came in close to forecasts, with nonfarm payrolls at 155k for December and an upwardly revised November count to 161k from 146k. The unemployment rate was unchanged from last month's upwardly revised 7.8%.
- Hourly earnings beat expectations of 0.2% to rise by 0.3% in December. This is seen as a positive indicator since employers tend to pay employees more as a step to delay hiring more workers. The data indicate a healthy employment outlook as demand for employees pushes wages higher. This was confirmed by the average workweek, which was reported at 34.5, up from 34.4 in November. The next step after increasing pay and the number of hours is increasing payrolls. This data was foreshadowed by a steady increase in personal income in each of the past three reports.
- Weekly unemployment claims have maintained their trend below the key 400,000 mark which keeps the opportunity available for a further reduction in the overall unemployment rate.

Index Chart & Analysis



This S&P 500 ($SPX) chart shows the past six months of daily prices after the index finished the week at 1,466.47 on Friday, January 4, 2013. The past week lived up to the hype built around a possible resolution to the fiscal cliff and surged higher. In the prior week, the S&P 500 index fell below its recent trend line of higher lows and also below multiple moving averages. In addition, the Williams %R indicator fell below the overbought area. These are typical technical indicators that cause technicians to sell, but a good investor understands charts should not be viewed in a vacuum. The deadline for the fiscal cliff was weighing on sentiment and while removing some risk and hedging was a wise set-up going into the final days, shorting the market would have been far too risky due to the upside risk.

By the time stock futures first printed on January 2nd, all investors could see the "risk-on" trade was back. The moving averages were no longer going to be weighted down by sinking prices and the large cap index was clearly moving back into its previous trading channel. That was the easy trade. The question is where will stocks go from here?

As this chart shows, the beginning and end of large trends are marked by shifts in the Williams %R indicator. This indicator does not foreshadow trend changes, it highlights when they have begun. The most recent indications show the bull market is still in play. While the shortest two periods below shows a signal change last week, the longest period has stayed bullish for nearly two months already. The rally is likely to continue until all three fall below overbought again. In rare occasions, Williams %R does foreshadow directional shifts. Note the extreme low in all three periods on November 8th. This tends to predict a bottom is due within two to four days. The SPX took six more days this time, but traders would've done well to start buying in on the fourth day.

For a precursor to a signal from Williams %R, traders watch the moving averages and trend lines. Resistance could surface at the recent market top from September, close to 1,475. A breakthrough above 1,475 could mean another 5% higher in a very short time. If this resistance holds, traders need to consider what the downside risks are. This resistance is close to lining up with the shortest trend line of higher highs. Resistance here does not mean the rally is over; it's simply a reasonable level for a consolidation after such hefty gains.

Any downside will first be limited around 1,455 at the trend line that cuts through the middle since October. It has worked as both support and resistance on multiple occasions, as recently as Thursday. If it breaks, each trend line of higher lows could offer support, from 1,450 and 1,410 down to 1,352. If the first of these three trend lines breaks support, the moving averages will have to fail before the next one comes back into play. If the SPX falls below 1,400 before the end of February, stocks will not be likely to withstand the second technical break in as many months. 1,350 will be the next target as shorter moving averages fall below the longer ones. By that point, value investors will begin to resurface and traders will eagerly accept downside risk again as the SPX becomes too cheap relative to the upside risk.

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