AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

July 7, 2013
Volume 3 - Issue 3

Inside This Issue

1 Perspectives
2 Summary of Indexes
3 Market Movers
4 Fundamentals & Indicators
5 Index Chart & Analysis

"Neither Bernanke nor his successor will be reckless."

Perspectives

Both stocks and bonds have lost ground over the past two months. Bonds started their descent due to rumors that the Federal Reserve would begin to taper their $85 million monthly bond purchases. Stocks followed through on fears of what this tapering would do to stock prices. The easiest asset for traders to dump, outside of bonds, was high yielding dividend stocks. When bond prices fall, interest rates rise in an inverse relationship. As low risk treasury yields rise, the spread between stock yields and treasury yields remains somewhat stable. This correlation means as yields increase on treasuries, stocks that pay a large dividend have to move lower in price to improve their dividend yields. As dividend paying stocks fall in price, they tend to drag other stocks with them in a sympathy trade. This correlation only lasts for so long and then the value investors enter the picture and begin to pick up stocks that have become too cheap to ignore for the long-term.

This rebalancing moved quickly during June and the reset point already hit. One trigger for the bounce came from Bernanke's reiteration that he did not intend to taper until economic conditions were better and would remain vigilant in coming months. This was less reassuring to investors than it might usually be due to the Fed Chairman's expected departure at the end of the year. Since Bernanke's successor is unknown, it leaves investors cautious. Neither Bernanke nor his successor will be reckless. He clearly stated tapering will be data dependent and investors have no reason to expect any other action. In fact, many traders think the impact of the Fed's quantitative easing (QE) policy has been less effective with each new cycle. If this is the case, its withdrawal should have little impact for the markets. Some speculate that the withdrawal of QE could help stocks as the artificial support system is removed and stock prices become data dependent and not Fed dependent.

To the dismay of many risk averse investors, bonds continue to be a risky asset class. The price of the 20-year Treasury ETF, TLT, has dropped 14% from its high in May. This loss in value outweighs the past few years of yield in two months. If prices continue to revert toward the norm, much steeper losses could be in store. Investors have to look elsewhere if bonds are not a safe haven. Gold has lost more than bonds over the past few months and the slide has not shown signs of stopping. Inflation worries have subsided in some models and that makes the yellow metal less attractive since it has no yield and little to no industrial application. This leaves stocks as the next best asset class.

The goal for a trader is not to predict where the market will be in 20 years. Most investors and traders agree with the expectation that stocks will move higher over longer periods. The trick is to figure out if it will hit the next leg up before the next leg down. Timing these cycles is what creates "Alpha" or index beating returns. Traders who seek alpha attempt to predict each cycle investors will follow and stay in front of it. As investors rotate from bonds to stocks, prices will be pushed higher. This is part of the P/E multiple expansion that occurs in every bull market's second half. The current bull market has pulled the P/E ratio for trailing 12 months from 15.20 a year ago to 18.41 at the end of June. Based on expected earnings growth, this P/E ratio can stay flat while stock prices rise.

In the famous investing book, A Random Walk Down Wall Street, Burton Malkiel suggests stocks are accurately priced at all times based on available public information. The theory seems to have a 5% margin of error in either direction as emotion plays its role in the short-term even more so lately with the increased use of programmed trading systems that force quicker market moves and panic traders on a more frequent schedule. The recent dip in stock prices caused a 7.5% drop from the intraday high to the intraday low. Many investors were waiting for a 5% correction, but the selling continued longer due to the time span between such mini-corrections. Now that the market has reset, investors can expect higher prices over the next 12 months. The caveats of weaker than expected corporate earnings and a shock out of China could still play their role in damaging stocks' prospects, but based on currently known information, the bulls do not have a lot to be worried about yet.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	7/5/2013	16.99	20.53	19.19	9.09
NASDAQ Composite	7/5/2013	15.23	16.91	18.48	9.15
Russell 2000	7/5/2013	19.18	24.79	20.49	10.16
S&P 500	7/5/2013	15.68	22.04	19.40	7.64
S&P MidCap 400	7/5/2013	17.10	25.58	20.84	10.26
Global Stock Indexes					
MSCI Emerging Markets	7/5/2013	-13.04	-3.94	0.16	-2.29
MSCI World, Excluding US	7/5/2013	3.51	16.89	9.85	-0.07
Bond Indexes					
Core Bond	7/4/2013	-2.28	-0.70	3.66	5.40
Intermediate Core Bond	7/4/2013	-1.86	-0.41	3.46	5.55
Long-Term Core Bond	7/4/2013	-5.97	-3.22	6.65	8.22
Short-Term Core Bond	7/4/2013	-0.14	0.70	1.62	2.83

Market Movers

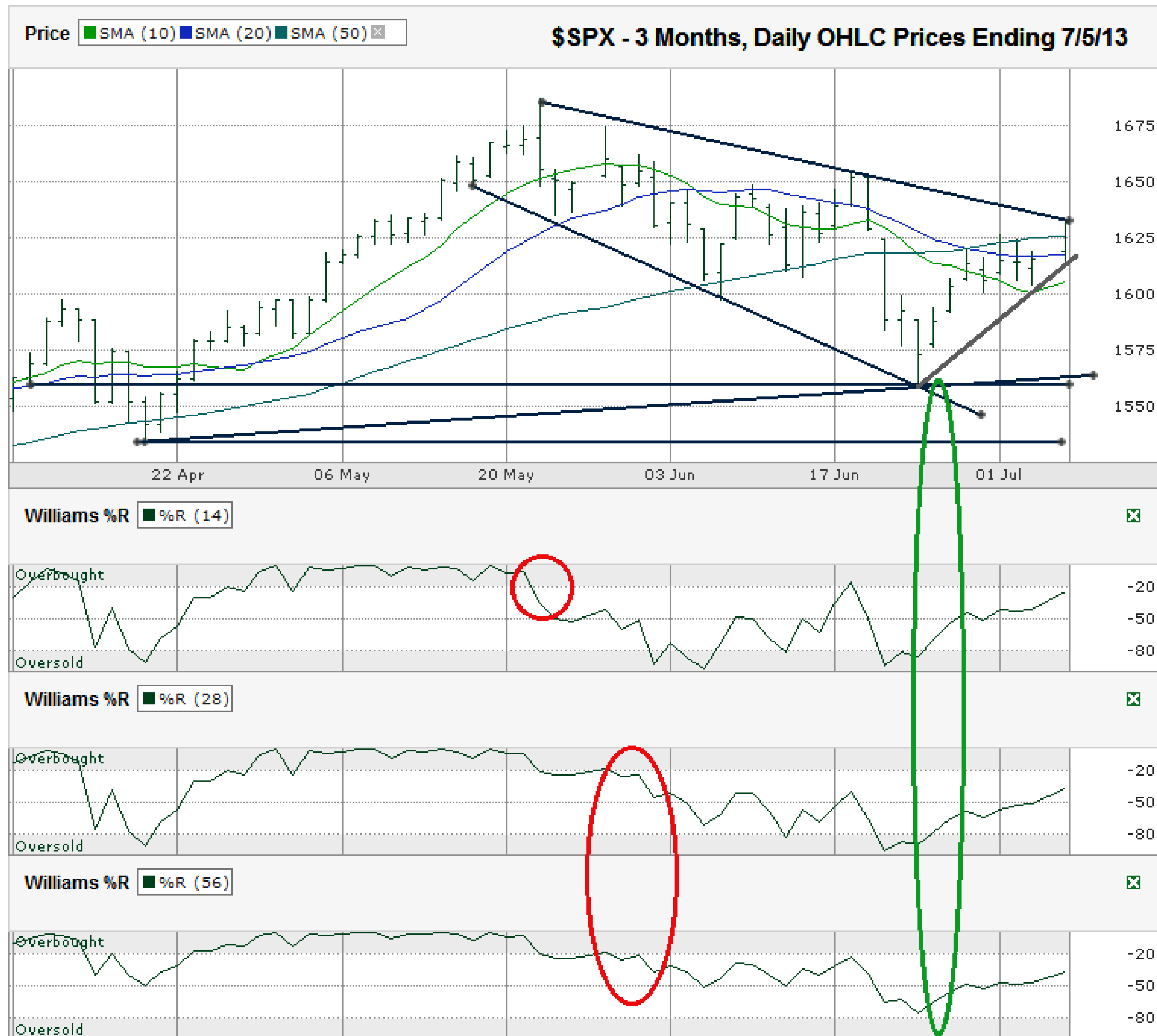
- In April, China reported their GDP rose 7.7% for the first quarter year-over-year. This is down from the 7.9% rate seen in the fourth quarter and caused a sell-off in commodity prices.
- In May, Federal Reserve Chairman, Ben Bernanke, spoke before Congress and hinted that a tapering of the Fed's quantitative easing could start sooner than later. This statement put further pressure on bond prices as it appeared their support system was about to be withdrawn.
- The following day, China announced its HSBC Flash Manufacturing PMI at 49.6 compared to 50.4 the previous month. This was the first reading showing contraction in seven months and added to the bearish sentiment in the market. The belief that the "Chinese bubble" will pop this year has many investors reducing stock and bond exposure out of fear of how it could affect the US economy.
- In June, Bernanke issued a statement reaffirming his plans to reduce the Fed's bond purchasing program if the economy continued to show improvement. Traders ignored the portion of his statement that said the Fed would be ready to react if the economy did not continue to improve and both stocks and bonds sold off further to give stocks their first 5+% correction of 2013.
- Unrest in Egypt weighed on stocks briefly as uncertainty always hampers the bulls. Oil has been the beneficiary of the uncertainty with WTI crude moving above $100 for the first time in 2013.

Fundamentals & Indicators

- The Producer Prices Index (PPI) declined in March by 0.6% and in April by 0.7%, but gained ground in May by 0.5%. Core producer prices were steadier with three straight months of moderate gains equaling 0.2%, 0.1% and 0.1% respectfully. This shows inflation does not have to be a major concern for the Fed yet.
- The Consumer Prices Index (CPI) confirmed low rates of inflation as reports came through at +0.2%, -0.4% and +.01% for March, April and May. Core CPI has risen 1.7% year over year and is running below the Fed's target level.
- Retail sales followed the same path as the CPI and PPI numbers with a slump in March by 0.5% and then gain in April and May of 0.1% and 0.6%
- The Empire Manufacturing Survey had a slight dip of -1.43 after a positive 3.1 in April. June surprised higher with a strong reading of 7.8.
- The Philadelphia Fed mirrored the Empire survey and reported manufacturing activities disappointed in April and May with readings of +1.3 and -5.2 and then rallied more than expected in June with a reading of +12.5 to end the quarter on a positive note.
- Housing starts had a strong start over the previous three reports with 1,021,000 in March. The pace slowed to 853,000 in April and, although below expectations, increased again to an annualized rate of 914,000 for May.
- Building permits held back the sector with a disappointing 890,000 reading in March, but beat expectations in April and May with 1,005,000 and 974,000 respectfully.
- Existing home sales also disappointed in March with a downward revision announced for February numbers and a lower 4,920,000 for March. April's miss was smaller, but still lower than expected at 4,970,000. May helped revive the sector with a strong beat of the consensus at 5,180,000
- Pending home sales saw a surge in May of 6.7% in sales after more moderate March and April readings of 1.5% and 0.3% respectfully.
- New home sales showed steady gains for the past three reports with March coming in at 451,000, April at 466,000 and May at 476,000. A strong housing sector is crucial for the economic recovery to continue in the US. Sales and prices show strength is building. Due to lower inventory levels, there is a supply for only 4.1 months at the current sales rates. Typically, homebuilders target a 6-month supply. This leaves a lot of upside for construction and pricing power.
- The Case-Schiller 20-city home price index beat expectations for the past three months. February came in at a 9.3% increase followed by +10.9% in March and +12.1% in April.
- Durable goods orders dropped by 5.7% in March, but improved by 3.6% in April and 3.6% in May.
- The Chicago Purchasing Managers Index bounced between positive and negative over the previous three months. April PMI surprised traders with a reading of 49.0, showing contraction. May recovered beyond forecasts to 58.7 and June settled back to a more moderate reading of 51.6.
- The ISM Manufacturing Index was more even with a reading in April of 50.7, 49.0 in May and 50.9 in June. The three-month average shows a sector that is struggling to expand.
- Construction spending reversed a slide of 1.7% in March to gain 0.4% in April and 0.5% in May.
- The ISM Services index showed continued strength and expansion. The April report at 53.1 was followed by 53.7 in May and 52.2 in June.
- The third estimate of first quarter Gross Domestic Product (GDP) showed only 1.8% growth. This estimate was much lower than the original expectations of a 2.8% gain. While much better than the fourth quarter's gain of 0.4%, fears are growing among investors that the effects of the sequester could cause lower numbers in the quarters to come.
- Factory orders slipped in March with a 4.0% decline, but showed strength in April with a 1.0% increase and in May with a 2.1% increase.
- The unemployment rate moved as low as 7.5% in April, but moved back up to 7.6% in May and June. This tick higher looks like a negative on the surface, but the rise came from more job seekers entering the market, which is a positive indicator. Bears will point to the U6 number that moved from a low of 13.8 in May to a four-month high of 14.3 in June. U6 tracks unemployed and those who are working part-time, but who want to work full-time.
- Nonfarm payrolls help to brighten the employment picture with June's count moving up to 195,000 in addition to a positive 70,000 adjustment to April and May's original numbers.

Please see Index Fundamentals & Indicators on page 5

Index Chart & Analysis



The chart above shows the daily prices for the past three months on the S&P 500 index ($SPX) after the index closed at 1,631.89 on Friday, July 5, 2013. The S&P 500 fell 7.5% from its recent intraday high to its intraday low. This hit the midpoint of the most popular calls for a correction of 5% and 10% and was enough to bring the bulls back into the market. The SPX had not corrected as much as 5% all year until the move lower began on May 22nd. A typical year has at least four 5% corrections and the longer span without such a reset is one of the reasons it overshot this time.

The move lower was foreshadowed by the break in the Williams %R indicator. The 14-day indicator showed a break below overbought, which shows short-term sentiment has changed. This was the first red flag, but can be a false positive in a bull market. It wasn't until May 31st when the 28 and 56-day indicators moved lower that the confirmation was in place and the chartists knew to get out of the way because the bears were taking over.
By June 5th, the 10-day moving average (dma) moved below the 20-dma and issued a second major warning to anyone still overly bullish. Soon after these two bearish signals jumped out of the chart, the 50-dma held support, which gave hope to the bulls. The reversal didn't last and once the 50-dma broke support, selling was the easy

choice for traders. It only took a few days for the large cap index to find support again at its trend line of lower lows and a previous horizontal line of support at 1,560. Bullish signals started showing up the following day. The Williams %R indicator showed a reversal in sentiment as it moved out of the oversold area on both the 14 and 28-day indicators. The 56-day indicator didn't make it to the fully oversold area and this remains a reason to be cautious. Based on the Williams %R's 56-day indicator, the selling didn't complete its cycle and traders could be in store for another quick move lower again within the next couple of months.

The 20 and 50-dma acted as resistance after a few days of unchallenged market conditions. On Friday, the S&P 500 closed above its 50-dma for the first time since it peaked on June 18th (its only close above the moving average in June). The week's closing high was at the new resistance level marked by a trend line of lower highs.

The coming week will be very telling for which direction the market will move next. If the 50-dma holds support, without crossing back and forth intraday, the bulls will clearly be in charge again and new all time highs could be on the horizon. Traders should watch for the 10-dma to overtake the 20-dma again for a true confirmation that the next leg of the bull market is in play. If the trend line of lower highs maintains resistance, the 50-dma will not hold support and the market could quickly follow a course to retest its June 24th intraday low or even its April 18th low, 5% below Friday's close.

Continued from Fundamentals and Indicators from page 3

- Hourly earnings rose 0.4% in another surprisingly bullish piece of data. A rise in hourly earnings shows continued pressure to get more out of each worker before hiring additional employees. As trends continue to push rates higher, employers eventually hire more workers to avoid greater overtime costs and the overall employment number improves.

AF Capital Management, LLC
6935 Hunters Knoll NE
Sandy Springs, GA 30328

404-395-2752
alex@afcapitalmanagement.com

Twitter: @AlexRFoster
Facebook: AF Capital Management

Need help deciding when to buy and sell? Subscribe to AF Capital Management's Market Timing Service.
Need help rolling over a 401(k) plan to an IRA, call or email Alex Foster for a no cost review of what you need.

If you are not on our distribution list yet, you can Join our Newsletter for free at any time.

DISCLAIMER: AF CAPITAL MANAGEMENT, LLC IS A REGISTERED INVESTMENT ADVISER. NO MATERIAL HEREIN CONSTITUTES INVESTMENT ADVICE NOR IS IT ANY OFFER OR RECOMMENDATION TO BUY OR SELL ANY SECURITY. THE PURPOSE IS LIMITED TO THE DISSEMINATION OF GENERAL INFORMATION REGARDING THE ECONOMY AND MAJOR INDEXES. NO PART OF THIS NEWSLETTER SHOULD BE CONSTRUED AS PERSONAL FINANCIAL ADVICE.

OTHER ARTICLES, LINKS, AND INFORMATION PRESENTED WITHIN THIS NEWSLETTER ARE OBTAINED FROM SOURCES BELIEVED TO BE RELIABLE, BUT THEY ARE FOR INFORMATIONAL PURPOSES ONLY AND AF CAPITAL MANAGEMENT DOES NOT GUARANTEE THEIR TIMELINESS OR ACCURACY. CLIENTS SHOULD CONSULT THEIR ADVISOR WITH REGARD TO ANY QUESTIONS THEY MAY HAVE. NOTHING WITHIN THIS NEWSLETTER SHOULD IMPLY THAT PAST RESULTS ARE AN INDICATION OF FUTURE PERFORMANCE.