AF CAPITAL MANAGEMENT
Registered Investment Advisor

# The Investors' Newsletter

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### Inside This Issue



***"The current bull market turned five years old in March…"***

## Perspectives

"Bad investors think of ways to make money. Good investors think of ways to not lose money." This is the advice Steven Sears, Options Editor at Barron's, gave in his 2012 book, The Indomitable Investor. It's a simple theory, but a hard one for many investors to put into practice. Investors who cling to buy-and-hold strategies fail to realize that even the wise old sages (think Warren Buffet, Peter Lynch, etc.) sell their investments when they believe they have earned a reasonable amount from the stocks they buy. No historically successful investor has found riches through buying and selling anything from his entire portfolio.

The fact that economic cycles occur is not up for debate, but many investors hold onto their stocks as if it is. The length of each cycle is constantly debated and should be since nobody knows exactly when each cycle will begin and end. Five years has been deemed a typical market cycle, but some are shorter and some are longer based on a variety of factors. Bad investors will try to stay bullish until the end of the bull market and then will be afraid to sell as stocks start to decline. Good investors recognize the cycle will end eventually and by the time a bull market turns five they begin to alter their allocations to less risky investments.

The current bull market turned five years old in March and reached an all-time high as recently as Friday morning. Conventional wisdom says that investors should buy and hold through the hard times and selling when the market is making new highs will cause the seller to miss out on even more gains. Conventional investors tend to trail average market index returns over multiple years, but they continue to follow this process with each market cycle.

The broader stock market indexes such as the Dow Jones Industrials and the S&P 500 could have another 20-30% of upside in them before another bear market starts. The current P/E ratio for the S&P 500 is 17.69 based on the past 12 months of trailing earnings. Using estimates of the earnings that are forecast for the next 12 months, the P/E ratio for the large cap index is only 15.57. If the earnings forecasts prove to be correct and the S&P 500 pushes its P/E ratio up to 19 before it tops out, the S&P 500 could reach as high as 2,300, 22% above Friday's intraday high.

Investors can easily be mesmerized by such lofty goals and hopes. Good investors recognize that the next bear market could cost investors 25-30%, if it is only an average bear market decline. A 25% decline from a peak of 2,300 would take the S&P 500 to a level close to 1,725, roughly 9% below Friday's intraday high. Knowing that the prices for stocks could be lower in a year or two than they are today, does not mean investors should sell everything right now. Instead, investors should consider taking some profits when good opportunities present themselves and slowly begin shifting riskier assets into more moderate or conservative investments. Good investors have already started this cyclical adjustment, as can be seen in the move away from growth towards value stocks. High flyers like AMZN, NFLX, and TSLA have all been hit in the move away from risk this year.

Now is not the time to get overly aggressive in buying or selling, but instead it is the point in the cycle to start paring risk and looking for ways not to lose money in the next decline. No investor, good or bad, knows when the markets will hit their peaks and start a new prolonged selling trend. Investors who maintain exposure to stocks will benefit from continued gains if the bulls prolonged control lasts. This late into a bull market, the allocation does not need to be as heavily weighted towards risky assets as it should have been in the first three to five years since the bears ended their last reign. Stocks will fall again. Good investors who plan for that impending day while stocks are still close to their highs will be glad they thought of ways to not lose money.

# Summary of Indexes

*Courtesy of Morningstar.com*

| Name | As of Date | YTD | 1-Year | 3-Year | 5-Year |
|---|---|---|---|---|---|
| **US Stock Indexes** | | | | | |
| DJ Industrial Average | 4/4/2014 | -0.39 | 15.12 | 12.70 | 18.54 |
| NASDAQ Composite | 4/4/2014 | -1.17 | 27.99 | 13.96 | 20.54 |
| Russell 2000 | 4/4/2014 | -0.56 | 26.24 | 12.29 | 22.02 |
| S&P 500 | 4/4/2014 | 1.44 | 22.10 | 14.31 | 19.75 |
| S&P MidCap 400 | 4/4/2014 | 2.19 | 23.24 | 12.75 | 22.92 |
| **Global Stock Indexes** | | | | | |
| MSCI Emerging Markets | 4/4/2014 | -0.06 | -1.48 | -5.65 | 10.18 |
| MSCI World, Excluding US | 4/4/2014 | 1.65 | 18.80 | 6.21 | 14.58 |
| **Bond Indexes** | | | | | |
| Core Bond | 4/4/2014 | 1.97 | -0.38 | 3.96 | 4.69 |
| Intermediate Core Bond | 4/4/2014 | 1.71 | 0.01 | 3.77 | 4.38 |
| Long-Term Core Bond | 4/4/2014 | 5.00 | -2.57 | 7.55 | 8.33 |
| Short-Term Core Bond | 4/4/2014 | 0.36 | 0.59 | 1.56 | 2.48 |

# Market Movers

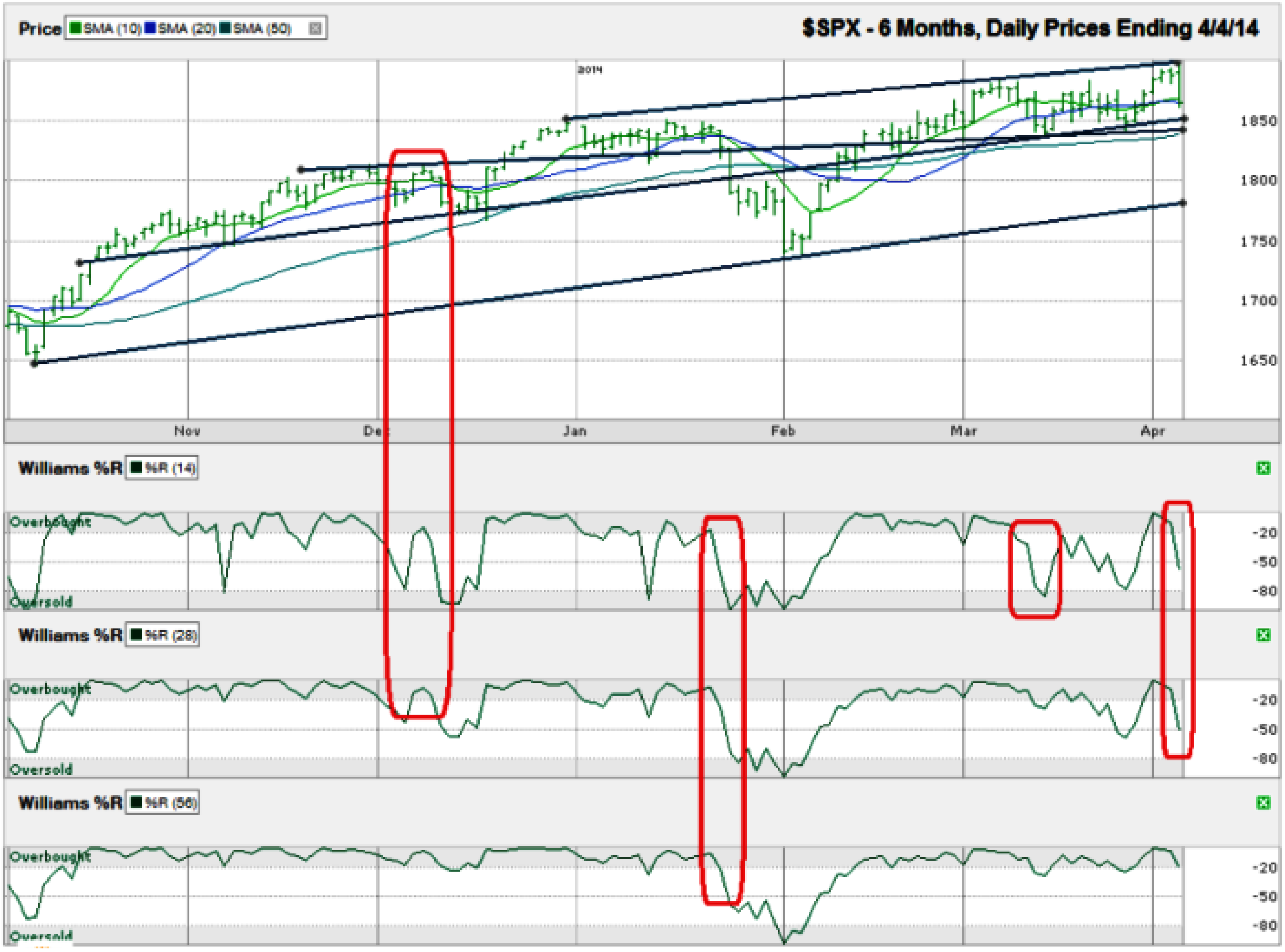
- On January 23, China's HSBC Manufacturing PMI slipped into contraction (49.6 versus 50.6 expected, 50.5 prior). The fear over a slowing China helped send the S&P 500 more than 100 points lower (5%+) over the following week and a half of trading.
- The last leg of the selling spree came on February 11, after China's Manufacturing PMI (50.5) fell to a six-month low while the Non-Manufacturing reading (53.4) registered an 11-month low. The large drop in US stock prices following the China PMI data seemed to satiate the bears and allowed the bulls to reenter the market after a couple of days of sideways movement.
- By February 11, stocks were already headed higher when word got out that the House of Representatives would pass an unconditional bill to raise the debt ceiling. With another obstacle out of the way, the bulls took over and pushed the S&P 500 to a series of all-time highs over the following few weeks.

# Fundamentals & Indicators

- The Empire Manufacturing Survey indicated conditions continued to improve for New York manufacturers over the past quarter. January began with a strong reading of 12.5 followed by positive, but less strong February and March readings of 4.5 and 5.6
- Retail sales faltered in December and January with declines of 0.3% and 0.6%, but improved in February by 0.3% after much of the cold weather excuses subsided.
- Producer prices index (PPI) showed that pricing pressures remain weak as the past three months have been close to flat with readings of +.01%, +.02% and -.01%.
- Similar to the PPI, the Consumer Price Index (CPI) remained soft with readings of 0.2%, 0.1%, and 0.1% from December through February. Economists expect this low inflationary pressure trend to continue until workers see better wage growth.
- The Philadelphia Fed Survey slumped in February to -6.3 after a positive 9.4 in January, but then rebounded in March with a report of 9.0.
- Housing starts remain higher than reports from the same period in the prior year, but have come off of their highs seen in November and December. After remaining above 1 million in December at 1,024k, January and February came in at 909k and 907k.

- Existing home sales also slowed in the three months from December through February with readings of 4.87 million, 4.62 million and 4.6 million respectfully. On a positive note, existing home prices have increased 9.1% year-over-year.
- New home sales fluctuated slightly over the past three reports with readings of 441k, 455k, and 440k for December through February. Sales remain slightly above the 12-month average, while new home prices fell 1.2% year-over-year in February for the first year-over-year decline since June 2012.
- Pending home sales receded 8.7% in December, recovered only 0.2% in January before slipping again by 0.8%
- The Case-Shiller 20-city Home Price Index for November showed an increase of 13.7%, followed by increases in December and January of 13.4% and 13.2% respectfully.
- The durable goods orders report gave investors reason to worry in December when it fell 4.3% when a 2.1% increase was expected. January's slide slowed with a decline of 1.0%. February showed the recovery isn't over yet as orders rose 2.2%, while a 1.0% gain was the consensus.
- The ISM Manufacturing Index remained in expansion in each of the past three readings. January was slower at 51.3, but February and March increased the pace at 53.2 and 53.7 respectfully.
- The ISM Services index also continued to show strength in each of the past three months. January was the strongest of the three months at 54.0. February slipped to 51.6 and March regained momentum at 53.1.
- Construction spending reports have shown a relatively sluggish environment recently. December increased 1.4% month-over-month, but January declined 0.2% and February only increased 0.1% month-over-month. Some economists point to recent extreme weather conditions as an excuse, but not everyone believes weather had a true impact.
- The advance fourth quarter Gross Domestic Product (GDP) indicated growth of 3.2%, which helped market sentiment, but the second estimate was revised down to 2.4%. The third estimate improved to 2.6%. While a positive GDP shows a growing economy, many investors worry the pace is not fast enough to produce better earnings for corporations.
- Factory orders fell 2.0% in December and 1.0% in January, but were able to increase in February by 1.6%.
- After a horrible December employment report (84k after revisions), the first quarter of 2014 has moved in a more positive direction. January's initial report improved to 113k new jobs added as economists blamed bad weather as a limiting factor for hiring. February improved again, up to 175k in the initial report. When the Labor Department released March figures on Friday, the two previous months both had positive revisions. January data moved up to 144k and February improved to 197k. The initial March reading came in at 192k to show the trend has steadied to a reasonable, but not great level.
- The official unemployment rate remained at 6.7% after dipping to 6.6% in January. The U-6 unemployment rate that includes all persons seeking full-time work, but working part-time for economic reasons remained below 2013 levels at 12.7%. In February, the U-6 rate hit 12.6, its lowest level since November 2008.
- Bulls were pleased to see the labor force participation rate climb to 63.2% by March from 35-year lows in December at 62.8%.
- Other signs of higher labor demand were seen in the average workweek that increased from 34.3 in December to 34.5 in March and average hourly earnings that grew by 0.2% in January and 0.4% in February. March earnings remained flat, breaking the streak of increases.

# Index Chart & Analysis




The chart above shows the daily prices for the past six months on the S&P 500 index (SPX) after the index closed at 1,865.09 on Friday, April 4, 2014. The S&P 500 began Friday morning by hitting an all-time high in the first few minutes of trading. After a couple of failed attempts, the bears finally took control and pushed stocks lower in a steady decline until the final 75 minutes of the day when the bulls and bears called a truce for the day. Panicky traders were able to take the large-cap index to its trend line of higher highs and then back down, close to its trend line of higher lows. This trading range has defined most of the past six months of movement outside of a few weeks that bottomed in early February.

Traders will be watching to see if the trend line of higher lows provides support at the beginning of the week. If not, the SPX could slip to its lower trend line of higher lows last touched more than two months ago. A retreat to this trend line would only be a 6% correction, but could be all that's needed to clear out some nervous investors. If the trend line of higher lows does not stop the slide, the S&P 500 could retest the October 2013 low, just below 1,650. This much of a sell-off would surpass the (some say overdue) technical definition of a market correction (10%) and allow the bulls to take over again after losing 13%.

Until stocks break out above the trend line of higher highs, the path of least resistance is lower. Friday's sell-off sent the SPX below its 10 and 20-day simple moving averages (sma) where the index has spent much of the past few weeks. Two weeks ago, the 10-sma fell below the 20-sma. This inversion is considered a bearish technical indicator, but it failed to foreshadow a lasting sell-off on the first try. Traders will keep a sharp eye on these moving averages over the coming week because the signal rarely gives two false indications within a month. The second crossover has a high probability of foreshadowing a bigger correction, if it happens.

The Williams %R indicator doesn't help the bulls' hopes either. The 14 and 28-day indicators both fell below the overbought range on Friday. After the previous three occurrences when this happened, stocks moved lower in the following days. To forecast a more meaningful decline, the 56-day indicator needs to follow suit and have two confirmation days, as it did in late January when the market corrected 6%.

The 50-sma has to break support before any bear attack becomes substantial. Coincidentally, the 50-sma is converging with a trend line that acted as resistance in late 2013 and support in multiple instances for the year-to-date. If the S&P 500 falls below these lines (close to 1,850), expect the high frequency traders' algorithms to kick into high gear as mass selling hits stocks. Any steep decline might be short-lived unless economic conditions suddenly worsen or a macroeconomic factor surprises traders.

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