AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

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INSIDE THIS ISSUE

"…corporate profits have a catalyst to continue to grow…"

Perspectives

Investors manage decisions by discounting risks of the "known unknowns", what they know they do not know. The catalyst that will trigger the next bear market falls into the category of "unknown unknowns" or surprise events and data. The majority of incoming data show little reason to abandon stocks yet. Many investors see the current market as fully valued on a P/E ratio basis, but that does not mean the bull market is due to end in the near-term.

The past two major bull markets running from March 2003 to October 2007 and October 1990 to October 1997 ran much longer than the current rally without a 10% correction. However, both of those bull markets ended with fierce bear markets. The potentially steep cliff at the end of this bear market means investors should be careful as the current cycle ages. The bull market might be entering its fourth quarter, but that can mean investors still have a lot of potential profits to gain before the reigns should be pulled in.

Based on estimates, the current forward P/E ratio is 16.25 for the S&P 500 and only 14.75 for the Dow Jones Industrial Average. Bull markets tend to stop running only when ratios reach the upper teens. Some markets hit P/E ratios in the low 20s before arriving at a tipping point. Even if corporate earnings only improve slightly, the market multiple's expansion will push stock prices higher. If the S&P 500 P/E ratio expands to 18 by the end of 2014, the broad index will be above 2,030 or more than 10% higher than it is today, without including dividends. If the Dow Jones' P/E multiple expands to 16, the index will push past 18,460 and will have gained more than 12%, not including dividends. If earnings continue to grow, these gains could be low estimates.

Investors have no guarantee that earnings will improve. A reversal in earnings growth would have the reverse effect on the market multiple. Investors would see the bears take control again as stock prices slide. Profit margins typically peak only when labor gets pricing power. As the employment picture still favors employers rather than employees, margins should still have room to grow. This simplified view favors the bulls for months to come, but the advantage employers have is shrinking with every positive employment report.

Many investors viewed Friday's employment report as an outlier and expect large revisions. This belief is based on two main ideas. First, many believe the extremely cold weather conditions across the country had a negative impact on hiring. Second, in the previous six reports where payrolls have disappointed greatly, five had large revisions in the following reports. A reversion to the mean has come to be expected and until this trend breaks, investors will remain suspicious of surprise reports.

Until revisions are issued, investors only have the data in front of them to work with. Based on the details found in the weak employment report released on Friday, employers still have a firm advantage. Wages are growing at a slower pace than inflation. The effect is higher prices for goods without as much of an increase in input costs for the companies. In other words, corporate profits continue to grow. Eventually, wages will rise at a faster pace. The bulls are looking to this change as the turning point for when consumer spending should increase and companies that have economies of scale will benefit.

In addition, oil prices have fallen sharply from the highs seen last summer. The effect has been a benefit for consumers and businesses. Consumers have lower fuel costs, which corresponds to an increase in disposable income. Many businesses benefit as lower energy costs reduce the cost to produce goods. Once again, corporate profits have a catalyst to continue to grow.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	1/10/2014	-0.77	25.04	15.18	17.00
NASDAQ Composite	1/10/2014	-0.05	33.73	15.52	21.58
Russell 2000	1/10/2014	0.09	33.91	15.31	20.99
S&P 500	1/10/2014	-0.27	27.84	15.68	18.20
S&P MidCap 400	1/10/2014	0.52	29.40	15.47	22.36
Global Stock Indexes					
MSCI Emerging Markets	1/10/2014	-3.25	-9.92	-5.13	11.17
MSCI World, Excluding US	1/10/2014	-0.40	17.41	7.78	12.01
Bond Indexes					
Core Bond	1/9/2014	0.26	-1.46	3.52	4.17
Intermediate Core Bond	1/9/2014	0.18	-0.80	3.38	4.15
Long-Term Core Bond	1/9/2014	0.84	-5.49	6.40	6.53
Short-Term Core Bond	1/9/2014	-0.05	0.45	1.48	2.36

Market Movers

Through most of the fourth quarter, the focus for both stock and bond investors was on Fed Chairman, Ben Bernanke, and what the decision on the Federal Reserve's stimulus program would be. The majority of data showed an economy that was improving, but with risks still in place. After a predominately sideways third quarter for stocks, the bull market resumed its ascending path in the fourth quarter with dozens of new all-time highs as investors started to believe the market could withstand a tapered withdrawal of stimulus.

On December 18, the Federal Open Market Committee's (FOMC) statement announced a $10 billion reduction in the size of monthly asset purchases, lowering the total size of the program to $75 billion per month. The statement noted the program would continue to be reduced through 2014 if the economy continued to improve, but could be ramped-up again if needed.

Traders' initial reaction was to sell stocks due to fear that the economy was not ready to run on its own, without government's support. The dip was short lived and savvy investors picked up all bargains they could find, pushing stock prices to new highs nearly every day, all of the way to the final day of the year.

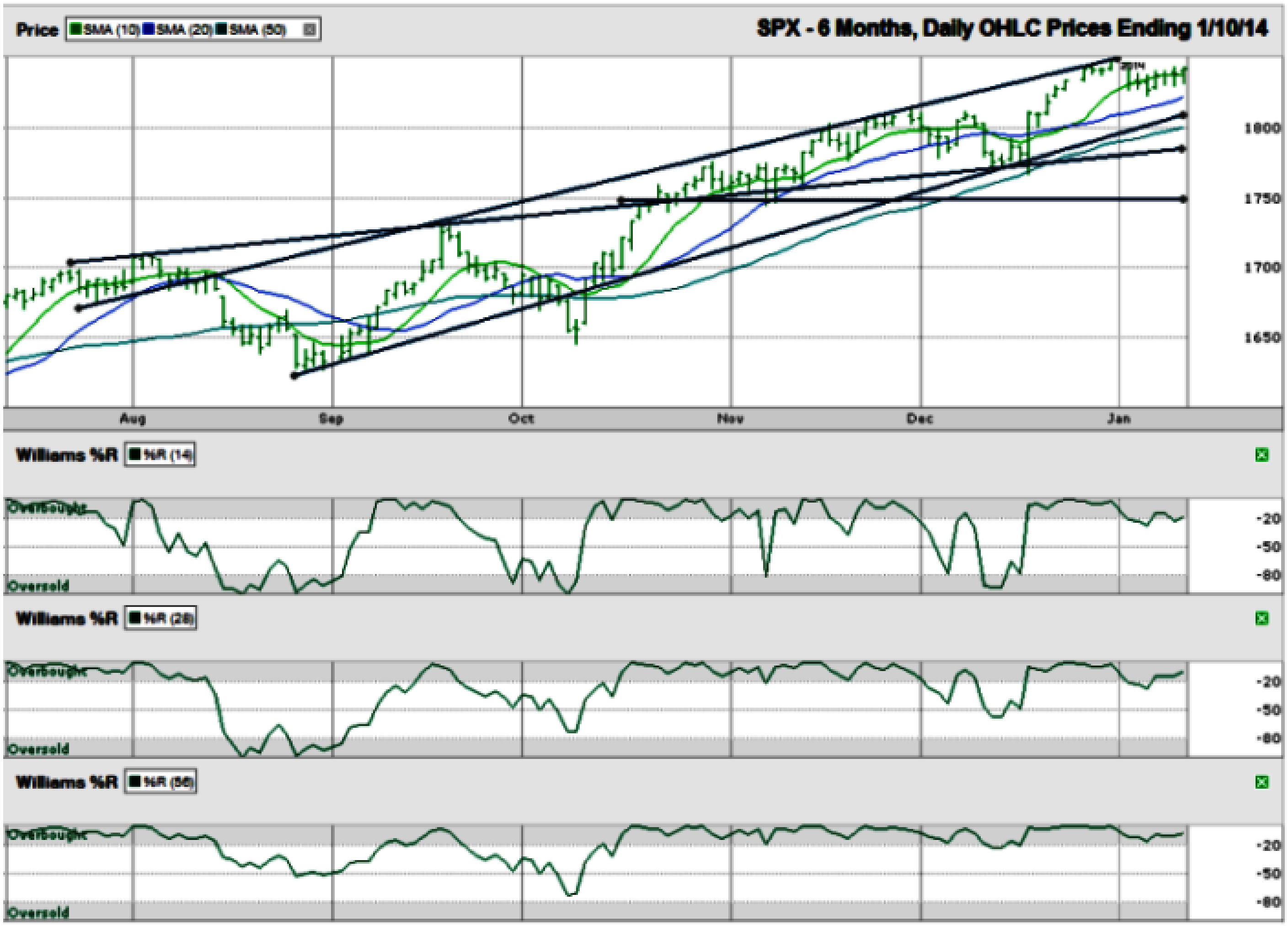
Now that the long anticipated tapering of stimulus has begun, the market is free to focus on fundamentals again. This change in focus could create a more volatile year in 2014, but as long as the economy shows improvement, every dip should be bought before it turns into the next bear market.

Fundamentals & Indicators

- The Producer Prices Index (PPI) fell in each of the past three reports, indicating inflation is under control and the Fed can continue its easy money policy. September dropped 0.1%, followed by declines of 0.2% and 0.1% in October and November. The decline in gas prices was a big factor in the lower prices.
- The Consumer Price Index (CPI) was relatively unchanged for the past quarter with readings of +0.2% and -0.1% in September and October followed by no change in November.
- After a decline in September retail sales by 0.1%, October and November showed positive signs with gains of 0.6% and 0.7% respectfully.
- The Philadelphia Fed Survey started the quarter with a strong reading of 19.8 in October, but weakened to 6.5 in November, below expectations. December improved slightly to 7.0, above expectations.
- The Empire Manufacturing Survey came in below consensus in each of the past three months. October registered a reading of 1.5, while consensus was for 4.5. November and December showed readings of -2.2 and 1.0 while economists were looking for 4.3 and 5.0.
- In December, existing home sales fell on a year-over-year basis for the first time in almost two and a half years to 4.90 million units. This deterioration came after October declined to 5.12 million from September's 5.29 million. Much of the weakness is being blamed on rising home prices and shallow inventory. Inventory will improve if prices continue to rise and owners who are currently underwater on their loans can sell for breakeven. Prices will be less of a hindrance if the employment picture continues to improve.
- Pending home sales were not as bad as existing home sales, but still disappointed. September sales fell 4.6% and October fell 1.2%, but November's reading showed a positive 0.2% gain.
- The Case-Shiller 20-city Home Price index offered one of the few bright spots in housing with three more months of increases. August rose 12.8% while September and October rose 13.2% and 13.6% respectfully. Building permit issuances increased in both September and October. Permits rose from 926,000 in August to 974,000 in September and 1.034 million in October. The Briefing.com consensus expected 932,000 building permit issuances for both September and October. The jump in October brought permits to their highest level since June 2008. Delays from the government shutdown continue to plague the residential construction data.
- Due to the government shutdown, reports on housing starts September, October, and November were delayed and released together in mid-December. The reports were slightly above consensus when averaged together. September starts came in at 873,000, October at 889,000 and November up to 1,091,000.
- New home sales fell in September to 354,000, but regained footing again in October and November with annualized rates of 444,000 and 464,000. The divergence in trends between new and existing home sales supports the idea that distressed homes are holding back the existing home market.
- Durable goods orders showed a net positive previous three months. September orders rose 4.2%, followed by a decline of 0.7% in October and an increase in November of 3.5%. Each reading beat expectations.
- Factory orders mirrored the change in durable goods orders, albeit to a lesser degree. September orders rose 1.8% while October declined 0.5% only to rise again in November by 1.8%.
- The Chicago Purchasing Managers Index (PMI) remained strong. October started the quarter with a much larger than expected report at 65.9. November and December weakened, but continued to show expansion with readings of 63.0 and 59.1. A reading above 50.0 indicates expansion.
- The ISM Manufacturing Index has shown consistently strong numbers recently. October rose to 56.4 and then November hit 57.3, the highest level in more than two and a half years. December's reading showed continued expansion with a reading of 57.0
- Construction spending started the past quarter with declining numbers at -0.3%, but improved quickly in October and November with readings of 0.8% and 1.0%.
- The ISM Services Index maintained its continued expansion, but at a decreasing pace. Reports slid from 55.4 to 53.9 and then to 53.0 from October through December.
- Estimates for third quarter Gross Domestic Product (GDP) increased with each revision. After starting with an advance estimate of 2.8%, which was above consensus, both the second and third estimates topped each previous report. The second estimate indicated growth of 3.6% and the third estimate rose to 4.1%. The robust final reading allowed investors to accept the Fed's reduction in stimulus without overreacting to the side effects.

Please see Index Fundamentals & Indicators on page 5

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 1,842.37 on Friday, January 10, 2014. The S&P 500 has been in an ascending trading channel since the end of August. The trend lines of higher highs and higher lows that define this channel have not broken support since early October. However, the index has some warning signs to watch now. Starting on the first trading day of the year, the SPX fell below its 10-day simple moving average (sma). A break in this basic technical indicator can act as a precursor to larger breakdowns in stock prices. The intraday crossing of a moving average is enough to draw attention to it, but SPX has not had a full day trading below its 10-sma yet and therefore has not had a full break yet.

The sideways movement over the first seven days of the year has given the 20-sma time to draw in closer to the 10-sma. If the index moves sideways for another week, traders could see the 10 and 20-sma break below support on the same day. The 10-sma will move lower quicker than the 20-sma and any crossover of the two moving averages will act as another bearish signal, but not until the trend line of higher lows stops supporting small dips.

The 50-sma is also closing in on the current SPX level. The 50-sma has not been as reliable of a predictor over the past six months, but did provide support in December and is worth watching again if it comes back into play soon. A retest of the 50-sma would only equal a 2.5% mini-correction, but a break below the 50-sma could trigger automated selling from computer algorithms. The result could be another 50 points to the downside where potential support is possible from the horizontal trend line used in late October and early November. A fall to 1,750 would be slightly more than a 5% drop from the all-time high set on New Year's Eve.

A 5% correction would bring the 100-sma (not shown) into play for potential support and could be enough of a consolidation to bring the bulls back into the market as bargain hunters begin picking up stocks at a discount. If not, the next area of support should be stronger at the 200-sma, which is close to 1,700 and nearly 8% below the all-time high. Unless the macro-economy is hit with a large fundamental change or a large number of key companies issue poor earnings releases, stocks should not fall more than 8-10% during a consolidation period.

The Williams %R indicator has not signaled it is time to take profits yet. While the 14 and 28-day indicators fell below the overbought range, they both recovered quickly before they had multiple confirmation days. The 56-day indicator has not fallen below its overbought range since it predicted the short-lived drop that began in September. If it stays positive, the S&P 500 could quickly return to the top of its ascending trading channel and record new all-time highs.

Continued from Fundamentals and Indicators from page 3

- Before Friday's release of the December payrolls data, the employment picture in the US had been on a strong upward trend. September figures initially showed a gain of 148,000 and later were increased to 163,000 when the October numbers showed an even stronger 200,000. November stayed strong with a gain of 203,000 jobs and was later revised to 241,000. However, the streak broke in December when the disappointing report of 74,000 hit the wire.
- On the positive side, the unemployment rate fell to 6.7%. The strong headline number was considered misleading due to the substantial drop in the participation rate that dropped to a 35 year low.
- Looking at the details within the reports does not point to a rapidly growing economy. The average workweek remained nearly flat through the previous four reports with seesawing reports of 34.5, 34.4, 34.5, and 34.4. Hourly earnings did little to change the outlook with mediocre increases of +0.1%, +0.2%, +0.2%, and +.01%.
- The most telling number is often found in the "U-6" number that includes unemployed, plus all persons marginally attached to the labor force, plus those employed part time while looking for full-time work. U-6 had fallen to 12.7% in November, but spiked to 14.4% again in December.

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