AF CAPITAL MANAGEMENT
Registered Investment Advisor

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"Inflation will be a factor to watch eventually, but is not a worry yet."

Perspectives

Institutional investors tend to have better investment performance records historically than retail (individual) investors. Part of this reason is the retail investors' method of investing on emotions and short-term personal needs. The need to factor in short-term personal factors, such as potential job losses or nearing retirement, is important. The need to keep emotions (especially fear) out of investors' decision-making process is more important when attempting to reach longer-term goals.

Too often, retail investors focus on the wrong data. For example, the fact that the current bull market has surpassed the average length of most bull markets is important to recognize for the sake of understanding typical market cycles, but the simple fact that the latest market cycle is longer than usual does not mean investors should abandon stocks yet. Understanding where the market is on a historical average basis can be important for balancing risk, but the more important factors to watch are the current economic factors.

This bull market has lasted more than 63 months already. The average of the past 11 bull markets is 58 months. This trivia is a fun fact for investors to read, but can be misleading. Some of the past 11 bull markets have been much shorter and have brought the average down. None of the past 11 bull markets came after such a severe bear market. This bull market will run longer and until the fundamental economic data changes, it will continue to move higher.

Bear markets do not start when weekly jobless claims are trending lower and monthly employment reports show non-farm payroll growth over 200,000 per month. Bear markets do not start when home prices are rising and stocks' earnings yield (5.2%) outpaces the yield on Treasuries (2.5%) by a wide margin. Military actions abroad can cause brief slumps in stocks as fear of the unknown frightens traders into taking profits early, but value investors will continue to swoop in while bargains are still available.

Bargains are becoming harder to find as stocks push higher, but any decline in stocks' prices without a decline in corporate earnings will improve stocks' prospects. Stocks are not as cheap as they have been over the past few years when viewed on a price to earnings (P/E) basis, but not by much. A year ago, the S&P 500 had a trailing P/E ratio of 18.41 and by the end of last week, the P/E ratio was up to 19.42. If earnings meet forward estimates, the P/E ratio should drop to 16.74 if stocks stay flat. The more likely scenario is that investors will push stocks higher in the hopes of continuing earnings growth and fear of missing out on further gains. The dividend yield on the S&P 500 has fallen from 2.14% a year ago to 1.89% last week. While the 10-year Treasury yield of 2.638% is higher than the S&P 500's yield, stocks have more upside potential than fixed income. An increase in interest rates will send bonds lower and will cost bondholders much more than the interest they've earned recently.

Inflation will be a factor to watch eventually, but is not a worry yet. The employment picture in the US continues to improve and any inflation that is driven by employment growth tends to be bullish for stocks. When employment growth wanes and the pace of inflation increases, stockholders will need to find the exits quickly because the end of the bull market will bring about another harsh bear market. That day just isn't here 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	7/3/2014	4.17	16.58	13.60	18.64
NASDAQ Composite	7/3/2014	7.41	30.27	16.79	20.08
Russell 2000	7/3/2014	4.51	23.49	14.48	21.05
S&P 500	7/3/2014	8.54	25.49	16.53	19.74
S&P MidCap 400	7/3/2014	8.34	25.08	14.92	22.42
Global Stock Indexes					
MSCI Emerging Markets	7/4/2014	5.95	15.22	-3.15	6.75
MSCI World, Excluding US	7/4/2014	6.49	23.19	7.55	12.15
Bond Indexes					
Core Bond	7/3/2014	3.30	3.71	3.69	4.59
Intermediate Core Bond	7/3/2014	3.17	4.00	3.42	4.47
Long-Term Core Bond	7/3/2014	7.74	6.70	7.55	8.16
Short-Term Core Bond	7/3/2014	0.64	1.35	1.29	2.10

Market Movers

- The release of the Federal Open Market Committee (a division of the Federal Reserve) minutes on April 9 from the March policy meeting revealed that policymakers are not necessarily committed to hiking the fed funds rate in the first half of 2015. Stocks moved sharply higher on the news, but faded for the remainder of the week.
- Less than a month later, on May 5, China's Services' PMI report showed a slight increase, but the Manufacturing PMI declined from 48.3 to 48.1 (below 50 indicates a contraction). The disappointment pushed stocks lower again for a few days.
- On June 5, the European Central Bank announced further easing measures, including lowering interest rates in an effort to strengthen the fragile recovering economy. Traders applauded the news and stocks have remained above the prior day's close since the announcement.
- A week later, the World Bank cut its 2014 global growth outlook to 2.8% from 3.2%, while also revising projections for several major economies, including the US and China. The announcement was one of the few negative impacts to the generally positive month of June.
- On July 2, China's Manufacturing PMI returned to expansion with a reading of 51.0 to help the bulls push stocks higher in the US.

Fundamentals & Indicators

- The Empire Manufacturing Survey started the quarter below economists' estimates with a disappointing reading of 1.3, but blew past expectations for the next two months with readings of 19.0 and 19.3, signaling much better economic conditions.
- Retail sales remain sluggish and highlight one of the causes for lower than expected GDP. March sales increased 1.1%, followed by increases of only 0.5% and 0.3% in April and May.
- Producer prices index (PPI) increased by 0.5% in March and 0.6% in April and caused investors to fear that inflation might force the Fed to raise interest rates sooner than planned. However, the May PPI reading showed a decrease of 0.2% to bring the average over the quarter to a lower level. The recent rise in gas prices could push the index higher again in the coming months.
- Consumer Price Index (CPI) have been on a steady rise with increases of 0.2%, 0.3% and 0.4% from March through May. Many economists expect this trend to slow unless income growth improves.

- The Philadelphia Fed Survey showed strength in the region with three consecutive strong readings of 16.6, 15.4 and 17.8 from April through June.
- Housing starts improved on a year-over-year basis for the prior three readings of 950,000 in March, 1.071 million in April and 1.001 million in May. Multi-family construction has improved the most while single-family homes have shown a slowing pace and could be a cause for concern if the trend continues.
- Existing home sales annualized rate for March was 4.59 million followed by 4.66 million and 4.89 million in April and May. While this is an improvement over the first couple of months of the year, the number of months' supply of houses increased from 4.9 months to 5.6 months over the same span.
- New home sales figures paint a more positive picture than the existing home sales. Total sales rose from 410,000 in March to 425,000 and 504,000 in April and May. Prior to the May report, sales had not passed 500,000 since May of 2008. In contrast to the existing home sales reports, monthly inventory of new homes has fallen from 5.6 to only 4.5 months.
- Pending home sales continue to rise as seen over the past three reports with increases of 3.4% in March, 0.5% in April and 6.1% in May.
- The Case-Shiller 20-city Home Price Index continues to show rising prices with February rising 12.9%, March up by 12.4% and April better by 10.8%.
- The durable goods orders have run in a slowing trend over the previous three reports. March rose 2.6%, but April slowed to a gain of only 0.8% and the May report produced a 0.9% decline. Much of the May decline came from the defense industry and could reverse in the near-term.
- The ISM Manufacturing Index remains in expansion (above 50) with an April reading of 54.9 followed by May and June readings of 55.4 and 55.3.
- The ISM Services index marked its 52nd consecutive month of expansion in May with a strong reading of 56.3 preceded by 53.1 and 55.2 readings in March and April respectfully.
- Construction spending reports have surprised economists who expected rapid growth after a dismal winter hampered by extreme weather conditions. Instead, March had no increase and April and May only gained 0.8% and 0.1%.
- First quarter Gross Domestic Product (GDP) estimates weakened with each revision over the past three months, starting with the advance report that showed weak growth of 0.1%, the second estimate indicated a contraction of 0.1%. Wall Street was surprised when the third estimate pointed a decline of 2.9% in the first quarter. The vast majority of economists expect a return to growth in the second quarter. Such a reversal will avoid the technical definition of a recession, two consecutive quarters of negative GDP growth.
- Factory orders followed a slowing trend recently. Orders grew by 1.5% in March and 0.8% in April, but shrank by 0.5% in May.
- The labor market continues to improve as non-farm payrolls added 304,000, 224,000 and 288,000 new jobs in the April, May and June reports respectfully.
- While the average workweek has remained unchanged for four months at 34.5 hours, average hours worked has increased in the past two months by 0.2% after reporting no change in the April report. An increase in hours worked tends to foreshadow future hiring and in its absence, economists see the increase of hourly earnings as a bullish sign of demand for employment.
- The official unemployment number fell to 6.1% and the (more inclusive) U-6 unemployment rate fell to 12.1%, more than 2% below where it was a year ago. U-6 data include the total unemployed and those employed part-time, but seeking full-time employment and is viewed as a more realistic picture of total unemployment.

Index Chart & Analysis

The chart above shows the weekly prices for the past two and a half years on the S&P 500 index ($SPX) after the index closed the week at 1,985.44 on July 3, 2014. The S&P 500 reached an all-time closing high on Thursday to finish a holiday-shortened week on the back of a positive employment report in the morning. Reaching new highs has been a regular occurrence for the large-cap index this year. For more than two years, the SPX has been in an ascending trading channel that has made investing look easy and without risk. Eventually, stocks will fall below this extended tight trading range and will catch some investors by surprise. Traders can avoid some of this surprise by watching the charts.

By the end of the first week in July, the SPX had moved back near the top of its trading channel marked by its trend line of higher highs with a little more room to move higher before facing its next technical challenge. Bulls will point out that reaching the top of the trading channel does not foreshadow an immediate sell-off. The index can trade sideways or down only a few points before finding a reason to resume its climb with more room to ascend.

Bears will wait for the smallest catalyst as a cause to push stocks lower. The cause of the reversal and how much longer the current trend lasts will determine how much lower stocks fall. Any selling in the near-term could find a support level around the 10 or 20-week moving averages and the SPX will be able to remain in its trading channel. Even the 40-week moving average (similar to the 200-day moving average) is close to the trend line of higher lows. A mini-correction to the 40-week moving average would only be a 7% drop for the S&P 500. A drop of this size should be a welcome buying opportunity, as the bulls would view it as a healthy step back after more than a few steps forward.

If the bears can push the index below the trend line and the 40-week moving average, as they did in late 2012, support could surface around 1,800, roughly 9% below Thursday's closing level. If the SPX can reach a few points higher before starting its correction (and little data says it won't), traders could see a full 10% correction before any major levels of support break. The current bull market has run well past its average length of time between 10% corrections and has many traders on edge. A quick 10% drop for the large-cap stocks that make up the S&P 500 could be viewed as a welcome reset and act as a launching pad for the index, much as the small-cap Russell 2000 index rebounded fast from its recent 10% correction.

The Williams %R indicator could be one of the first predictors of any move towards a 10% correction. The 14-day view will raise the first red flag. Traders should watch for a move below the overbought area. This drop will coincide with a fall below the 10-day moving average and bring out some automated selling from the computer algorithms. The 28-day view will act as a confirmation that momentum is shifting, but could be premature to predict a true correction has begun. The 56-day view hasn't fallen below overbought by more than two points in 2014 and those days did not have a follow-through that would indicate the bulls lost control. When the 56-day indicator shows a break below the overbought area, traders will know the bears have the reigns and should expect the year's first correction is likely in process.

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