AF CAPITAL MANAGEMENT
Registered Investment Advisor

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INSIDE THIS ISSUE

"Wall Street refers to times like this as 'Goldilocks'."

Perspectives

At the end of the trading day on October 1, after the Dow Jones had fallen 236 points (1.39%), CNBC reported this was the worst start to the fourth quarter since 2011. This is exactly the type of headline that causes naive investors to panic into selling. The statistic means that if you pick a random day out of the year, two out of the past four days with the same date have had a better return. In other words, the probability of a bad day for equities on October 1 is a coin toss and in 2014, the bulls lost the flip. This single day has no relevance on how stocks will react for the remainder of the quarter and definitely does not predict where stocks will be whenever each individual investor needs to withdraw their funds from the market in the years to come.

Investors should buy stocks on what they expect the companies will be worth in five to ten years and not worry about the daily fluctuations of a few percentage points. Stock prices are based on the expectations of future earnings. Most daily fluctuations are due to hedge funds and institutional traders updating their allocations and not because long-term fundamentals have changed. The market stalled recently because investors do not have a consensus on where the earnings will be this quarter or over the next few years. Some of this uncertainty comes from global influences, which is warranted, but only for shorter-term trading.

The independence referendum in Scotland caused many traders to worry that a non-unified Britain would disrupt banking throughout the euro zone and bleed into the US economy. Scotland voted to stay united with England and stocks throughout Europe and the US rose for a few days. Investors who sold stocks in fear of Scotland's independence missed the bounce.

Economic sanctions against Russia are starting to take their toll, not just on Russia, but also on companies in Europe that export to Russia. The worst of the economic pain could be over, but the uncertainty of where it could lead has caused European stock indexes to falter. In turn, some investors have sold European stocks in favor of bonds. As the yield on European bonds shrank, large investors had to buy US bonds in a search for better interest rates. The increased demand for US bonds pushed yields lower (bond prices move inversely to yields). The main worry only a week earlier was that bond prices were about to begin a bear market based on the belief that the Fed will raise interest rates soon. The Fed is still expected to raise rates within the next 6-12 months, but traders are already focused on another fear. Investors who exited bonds too early missed the rally in bonds.

The longer-term reality that China's growth is slowing continues to spook investors on a recurring basis, especially when there is little other news for the networks to focus on, and that concern grew when China said they were going to delay further monetary stimulus. This news mattered only until something else hit the wires, but it will return as "important" news whenever there is a lull of other data. Protests in Hong Kong may have no effect on the US economy, but the uncertainty of what it could lead to gave the bulls a reason to doubt future earnings potential for multinational companies. The chances of the unrest in Hong Kong growing into an event that disrupts the US economy is slim, but traders are easily swayed by dread.

Airline stocks sank when news of the first Ebola case diagnosed in the US hit the wires. Within a few days, value investors began to take advantage of the discount in the stocks and prices rose. Long-term investors sat through all of these panics and will be better off over time.

The US economy is not falling off a cliff and long-term investors need to learn to control the temptation to sell on any scary headline. Another bear market will hit the US markets again, but it hasn't started yet. Inflation is under control and the unemployment rate is dropping, but wage growth is stagnant and the participation rate is low. The combination of these factors allows the Fed to delay raising interest rates in the very near term.

Meanwhile, the US dollar is strengthening and has caused oil prices to drop along with the prices of other imports. Cheaper oil leads to cheaper gas, which leads to more money in the pockets of consumers, just in time for the holiday shopping season. US companies (and their stocks) benefit when consumers have more disposable income available at the most crucial time of the year for retailers. Wall Street refers to times like this as "Goldilocks". It's not too hot and not too cold. It's just right for investors.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	10/3/2014	4.42	16.07	19.91	15.34
NASDAQ Composite	10/3/2014	7.16	18.58	24.20	16.92
Russell 2000	10/3/2014	-4.13	4.51	23.64	15.28
S&P 500	10/3/2014	8.12	19.66	24.09	16.36
S&P MidCap 400	10/3/2014	2.73	10.92	24.19	17.20
Global Stock Indexes					
MSCI Emerging Markets	10/3/2014	-0.54	-0.79	5.38	2.04
MSCI World, Excluding US	10/3/2014	-3.44	1.86	12.99	6.72
Bond Indexes					
Core Bond	10/3/2014	4.48	4.14	2.51	4.15
Intermediate Core Bond	10/3/2014	4.13	3.57	2.68	4.11
Long-Term Core Bond	10/3/2014	11.09	10.42	4.11	7.35
Short-Term Core Bond	10/3/2014	0.83	0.97	1.15	1.82

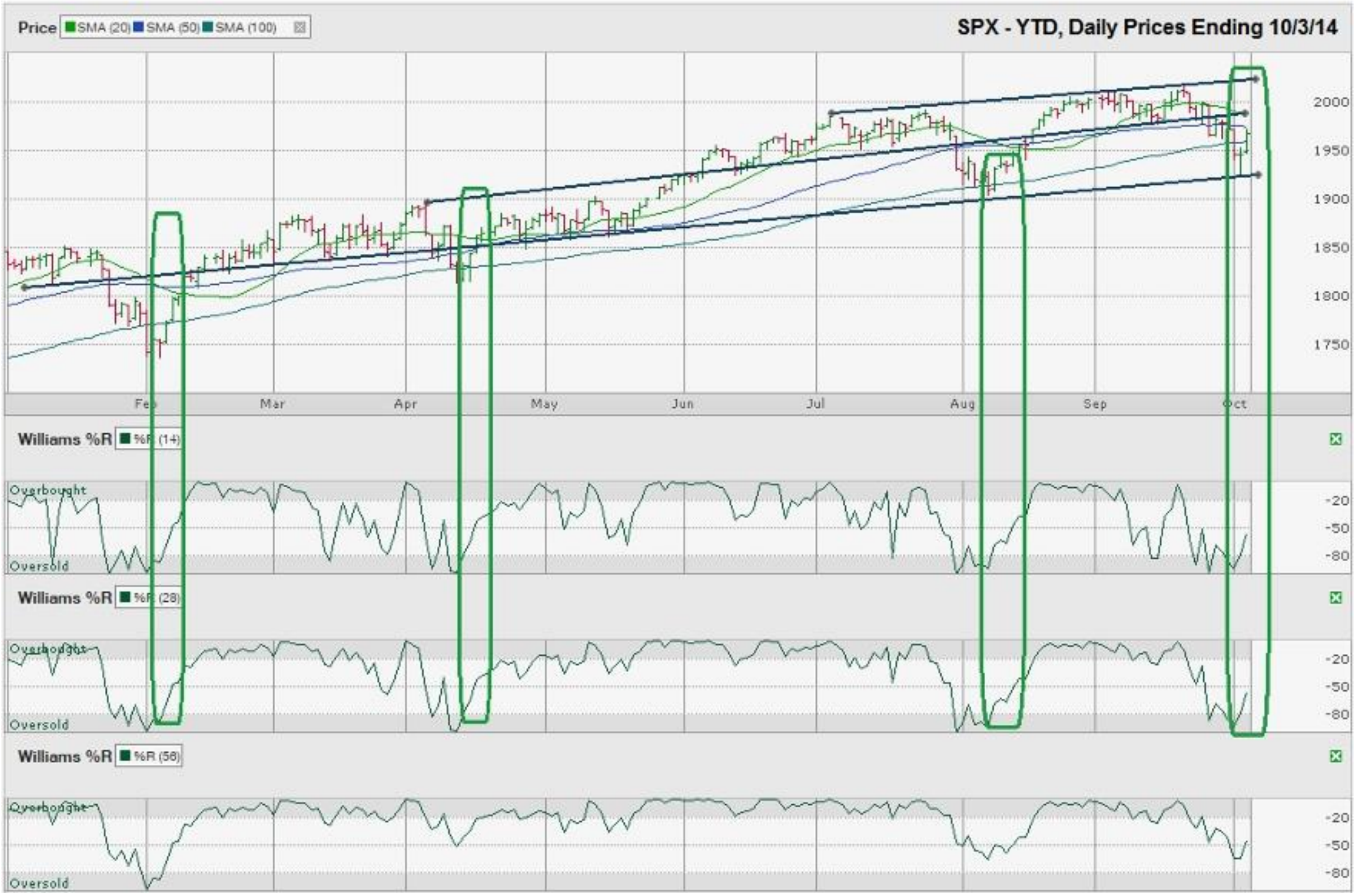
Fundamentals & Indicators

- The Empire Manufacturing Survey fluctuated greatly over the past quarter. July registered a reading of 25.6. August eased to 14.7 followed by a strong September reading of 27.5.
- Retail sales inched higher with gains in each of the past three months, starting with 0.2% in June and followed by 0.3% and 0.6% in July and August.
- The Producer prices index (PPI) readings released over the past quarter have shown slight increases ranging from +0.4% in June to only +0.1% in July and no change in August. These small price changes show that inflation is in check and the Federal Reserve does not have to rush into raising interest rates.
- The Consumer Price Index (CPI) data confirmed the PPI data and added to the case that inflation is tame. CPI rose by 0.3% and 0.1% in June and July respectfully and fell below consensus in August with a decrease of 0.2%.
- The Philadelphia Fed Survey showed strength in July with a reading of 23.9 (above zero indicates expansion) and then hit a 22-year high in August at 28 followed by an expected retracement to 22.5 in September.
- The pace of housing starts slowed from earlier in the year with June starts of only 909,000. July heated up with 1.117 million starts only to slow again in August with 956,000 starts.
- Existing home sales figures from June through August showed better conditions than the housing starts. Existing home sales reached 5.04 million in June, followed by 5.15 million and 5.05 million in

July and August.

- New home sales stayed on their ascending pace in June and July with reports of 419,000 and 427,000. The August new home sales data spiked to a six-year high with 504,000 new homes sold.
- Pending home sales have been less consistent lately with a drop of 1.3% in June, an increase of 3.3% in July and drop again in August of 1.0%.
- The Case-Shiller 20-city Home Price Index continues to move higher with three more positive reports of an increase of 9.3% in May and an increases of 8.1% in June and July.
- Total durable goods orders can be extremely volatile. June orders rose by 2.7%. July orders rose by 22.5% and then August gave most of it back with a decline of 18.4%. The trend is smoother when aircraft and defense orders are removed from the equation. The same period showed an increase of 5.4% in June, followed by a decline of 0.1% and then an increase of 0.4%.
- Fluctuations in aircraft orders affected factory orders too. After an uneventful 1.5% increase in June, factory orders rose 10.5% in July only to decline 10.1% in August.
- The ISM Manufacturing Index continues to remain in expansion territory with three more positive months of surveys. The index reported 57.1 in July followed by 59 in August and 56.6 in September.
- The ISM Services index was steadier with a trend that indicates strong expansion. July's survey rose to 58.7 followed by another rise in August to 59.6 (the strongest reading since January 2008). September eased slightly to 58.6 while it marked the 56th straight month of expansion (above 50).
- Construction spending has been inconsistent over the past few months with readings ranging from -1.6% in June to +1.2% in July and -0.8% in August.
- Estimates for the second quarter Gross Domestic Product (GDP) improved with each revision. The advance report indicated growth of 4.0%. The second estimate rose to 4.2% and the third estimate pointed to a 4.6% increase, matching the best quarterly increase since Q4 2011.
- The weekly unemployment claims' four-week moving average fell to 287,000 which signals the economy is close to full employment.
- The unemployment rate unexpectedly rose to 6.2% in July only to resume its multi-year decline in August when it fell back to 6.1%. The September report showed unemployment fell below 6.0% to 5.9% for the first time since 2008.
- Non-farm payrolls revived in September with 248,000 new jobs, on top of 69,000 in revisions for the prior two months. The upward revisions pushed July and August's count to 243,000 and 180,000 respectfully.
- The average workweek also ticked higher by 0.1 to 34.6 from 34.5 in the previous six months.
- Average hourly earnings stayed flat in July, but increased by 0.3% in August and then remained unchanged again in September.
- The U-6 unemployment rate (viewed as a more realistic picture of total unemployment) fell to 11.8% in September from 12.2 and 12.0 in July and August. The U-6 rate includes the total number of unemployed and those employed part-time, but seeking full-time employment.

Index Chart & Analysis



The chart above shows the daily prices for the year-to-date on the S&P 500 index ($SPX) after the index closed the week at 1,967.90 on October 3, 2014. The S&P 500 marked an all-time high of 2,019 on September 19. This peak coincided with its trend line of higher highs and acted as resistance to further gains. The following day, SPX fell below its 20-day moving average and technical traders seized the opportunity to sell while the bulls lost momentum. The bears were able to push the large-cap index below its 50-day moving average within three days. Four days later, the selling pressure pushed SPX below its 100-day moving average. The following day, the SPX found support from its trend line of higher lows and reversed mid-day.

Before the market opened the next day, index futures were predicting a positive open as the reigns were being handed back to the bulls after a 4.6% mini-correction. When the monthly jobs' data showed better than expected data, the bulls had more than technical indicators on their side and the S&P 500 gained more than 1.1% on the day. On the way higher, it paused at the 100-day moving average briefly, broke through it and then came back to retest it before moving another leg higher. Late in the afternoon, SPX met resistance at its intraday high from two days earlier, just a few points shy of its 50-day moving average.

Technical traders who follow the Williams %R indicator saw the weakness forming on September 22, when the 14 and 28-day indicators fell below the overbought area, a bearish signal. On September 23, the 56-day indicator broke below the overbought area and a clear momentum shift was underway. All three indicators bottomed on Wednesday, October 1 and reversed course on October 2 as the bears stepped aside.

Before the bulls can ring the victory bell, the SPX needs to break through the 50-day moving average and log two confirmation days of continued momentum on the Williams %R indicator. A follow-through on higher volume will give the rally more credibility as the index faces resistance at the middle trend line in this chart. Trading through the middle trend line will open a clear path to new highs and a retest of the upper trend line. From there, the battle starts over.

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