AF CAPITAL MANAGEMENT
Registered Investment Advisor

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Inside This Issue

"…the S&P 500 will reach 2,195 by the end of 2015."

Perspectives

2015 started with a thud and many investors began to question if the bull market was starting to roll over and die. After all, the S&P 500 had its first five-day losing streak in more than a year and by January 6, the index was down nearly 5% from its high achieved only five days earlier. TLT, The 20-year US Treasury ETF, hit an all-time high on the same day. To more perceptive investors, this rush to "safety" that caused an extremely low yield in Treasuries (yields move inversely to prices) showed that the fear of a catastrophe was too great and it might be a good time to stop selling stocks and the rush for the exits abated for two days.

The weakness in stocks that started at the end of December was reasonable after such a long run of above average annual gains. The S&P 500's 13.69% gain (including dividends) in 2014 gave the index its third consecutive year of at least 10% gains. This three-year run of consecutive 10%+ gains has happened only three other times since 1929. Small-cap and international stocks weren't able to hold onto the same momentum, which will disappoint diversified investors who open their 2014 401(k) statements in the coming weeks to see total returns closer to 6-7% in 2014 rather than 13%.

While many traders expect greater volatility in 2015, this bull market has more room to run because the growth rate has been slower than average. Factors such as GDP and employment growth have been weaker than previous recoveries and have helped to avoid broad-based bubbles across the markets.

Corrections will happen, but will not be as severe as recent bear markets because the excesses are not as prevalent, yet. Stocks are priced on what is expected to happen in the months and years ahead, not on how long it has been since the last bear market ended. Investors can reasonably expect corporate profits to continue to grow in 2015, even if at a slower pace than they might want. This consensus outlook can be seen in the market's price-to-earnings multiple (P/E ratio). As of December 31, 2014, the S&P 500's forward looking P/E ratio was 15.72. This is very close to the forward P/E ratio from a year earlier (15.22). While 2014 earnings came in a little lower than predicted, stocks were able to gain ground with very little multiple expansion. In other words, the fundamental risks to the market are still in check and the door is open to another positive year for stocks, although maybe not another year above 10%.

S&P 500 earnings for 2014 finished the year at $116.77 according to S&P Dow Jones Indices. 2015 earnings are expected to reach $131, but estimates rarely live up to their forecasts for the S&P 500. If we factor in an earnings shortfall again and use an earnings estimate of $124.45 (5% below the current $131 estimate) and the same December 31, 2014 trailing P/E ratio of 17.63, the S&P 500 will reach 2,195 (6.6% higher than its 2014 close, not including dividends) by the end of 2015. With a little multiple expansion, 2,300 is possible. The caveats are going to be how falling oil prices hurt the earnings of the big oil companies versus how the rest of the companies benefit from the lower input costs and greater demand from consumers who find more disposable income available after filling up their gas tanks.

Another risk comes from the forecast for earnings that is based on lower interest rates. If rates rise earlier than expected, stocks could fall due to the fear of a hit to earnings. The current consensus assumes interest rates will not rise until July or September. This target date gained credibility mid-week when Chicago Federal Reserve President, Charles Evans, voiced his opinion that 2016 would be a better starting point to raise rates.

Investors were skittish with each headline scare during 2014, but those who kept their eyes on the US economy (improving home prices, GDP growth and healthier employment data) knew better than to abandon their long-term plans because of a short-lived move lower. 2015 will bring another set of global scares, maybe with a revisit of some of the same characters, such as ISIS, Putin and Ebola, but until US businesses start to hurt, all setbacks should be considered part of the normal market cycle and more of a buying opportunity than a call to exit.

Just as the market took the end of the Federal Reserve's massive asset purchase program in stride, the well-telegraphed interest rate hike is unlikely to disrupt the market for more than a few days. The build-up to that unidentified date will cause more downside fluctuations than the event itself because the Fed will only raise rates if they believe the economy can handle it.

When should the Fed act? This question is debated every day among traders and economists. The Fed has a dual mandate – to help create maximum employment and keep inflation close to 2%. The employment side has improved steadily since the recession ended, which shows the low interest rates and stimulus have been working. Unlike previous recoveries, wage growth has been slow for the past five years. This is good and bad. It's good for the stock market because it has allowed the Fed to keep interest rates low, which helps corporations' profitability. The lack of wage growth is also good for the broader payroll numbers because employers are able to hire more workers without hurting their bottom lines severely. On the other hand, workers' incomes are not rising and in inflation adjusted terms, they are making less each year.

The Fed does not have to rush into raising rates as long as wage growth remains tame. Inflation will stay below target and will continue to need an easy monetary policy to promote higher prices. The rising dollar will help to push effective prices lower for products that are imported. Not only will consumers benefit from lower gasoline prices that work as an effective tax-break, nearly every company not in the energy industry will have lower input costs.

Oil prices will move up again at some point and inflation will start to surface in more places than just college tuitions. This turning point will be when the Fed has to react and pull in the reins. If the Fed waits too long, their reaction could come at the same time as the business cycle is ready to roll over. The end of this extended period of easy money and cheap oil will likely not be good for stocks if the rate of these changes is too swift. That time is not here yet, but investors need to recognize the risk before the events unfold. Ideally, the Fed will not wait until 2016 to raise interest rates, but will start in September and have a slow rate of increase that will allow corporations to ease into the change.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	1/9/2015	-0.41	10.39	15.55	13.70
NASDAQ Composite	1/9/2015	-0.68	13.18	20.68	15.21
Russell 2000	1/9/2015	-1.57	3.71	17.92	14.48
S&P 500	1/9/2015	-0.63	13.54	19.41	14.69
S&P MidCap 400	1/9/2015	-0.75	9.12	18.90	15.56
Global Stock Indexes					
MSCI Emerging Markets	1/9/2015	0.53	-0.18	1.08	-1.11
MSCI World, Excluding US	1/9/2015	-2.70	-5.71	9.58	4.14
Bond Indexes					
Core Bond	1/9/2015	0.88	6.74	3.14	4.60
Intermediate Core Bond	1/9/2015	0.63	6.04	3.04	4.40
Long-Term Core Bond	1/9/2015	2.07	16.50	6.10	8.87
Short-Term Core Bond	1/9/2015	0.30	1.39	1.19	1.78

Fundamentals & Indicators

- The Empire Manufacturing Survey began Q4 with two strong numbers in October (6.2) and November (10.2), but disappointed in December (-3.6).
- The Philadelphia Fed's Business Outlook Survey continues to show robust manufacturing expansion in the Philadelphia region. After an October report of 19.0, November rose to 40.2 and December came back closer to trend at 24.3.
- Retail sales began with a slow start in September with a reading of -0.1% (revised higher from the original reading of -0.3%). October showed improvement at +0.5% (revised up from 0.3%) and by November, consumers pushed retail sales up to +0.7%.
- The Producer prices index (PPI) has benefited from the drop in energy prices. September PPI fell 0.1% followed by an increase in October of 0.2% and then another drop in November of 0.2%
- The Consumer Price Index (CPI) followed a different path than PPI, but ended the past few months with the same result, lower prices. After ticking 0.1% higher in September, October was unchanged and November fell 0.3%. The drop in the CPI allows the Fed to keep interest rates low for a longer period to help encourage inflation towards the Fed target close to 2.5%.
- Housing starts remained slightly above the 12-month trend of 994,000 from September through November with readings of 1.028 million, 1.045 million and 1.028 million. The pace of starts could slow when interest rates begin to rise (likely in the second half of the year).
- Existing home sales rose to 5.18 million in September and then rose again to 5.26 million in October before slowing to 4.93 million in November. On a positive note, sales rose on a year-over-year basis for the past two months and November marked the 33rd straight month of year-over-year price gains.
- New home sales haven't had the same growth as existing homes for the past year. While September through November readings of 455,000, 445,000 and 438,000 have been above the 12-month average of 433,000, the overall trend has been relatively flat for the previous 12 months.
- The Case-Shiller 20-city Home Price Index improved by 5.6% in August and continued to rise in September and October by 4.9% and 4.5% respectfully. Bull markets do not tend to end while home prices are rising.
- Total durable goods orders proved to be one of the few negative reports (along with factory orders) from the past few months. September orders fell by 0.7% followed by an uptick in October of 0.3% and then another drop in November of 0.9%.
- Factory orders declined for the fourth consecutive month in November with a reading of -0.7% following readings of -0.5% in September and –0.7% in October.
- The ISM Manufacturing Index maintained its trend of continued expansion as October through December reports stayed above 50.0, with readings of 59.0, 58.7 and 55.5.
- The ISM Services index also showed continued strength. The October report of 57.1 was followed by 59.3 in November and 56.2 in December.
- Construction spending remained within the same low range as it has been for the past two years with September and October gains of 0.6% and 1.2% respectfully, but faltered in November with a 0.3% drop, mainly due to a slowdown in public construction and educational construction.
- Gross Domestic Product (GDP) estimates beat the consensus in each revision. The advance Q3 GDP estimate started at 3.5% and was revised higher in the second estimate to 3.9%. The third estimate showed an expansion of 5% and was the largest increase since Q3 2003.
- Weekly unemployment claims remain under 300,000 as the overall employment picture continues to improve.
- The unemployment rate dropped to 5.6% after two months of holding steady at 5.8%.
- Non-farm payrolls have shown steady strength for much of the past year and finished 2014 on a high note. Including revisions, October added 261,000 new jobs, November employment grew by 353,000 and December produced another 252,000 new jobs. Recessions do not begin while jobs are growing at such a positive rate.
- The average workweek figures have not echoed the growth in payrolls. The workweek has remained relatively steady with a report of 34.5 hours per week in October and 34.6 in November and December. While at a post-recession high, it seems to be leveling off.

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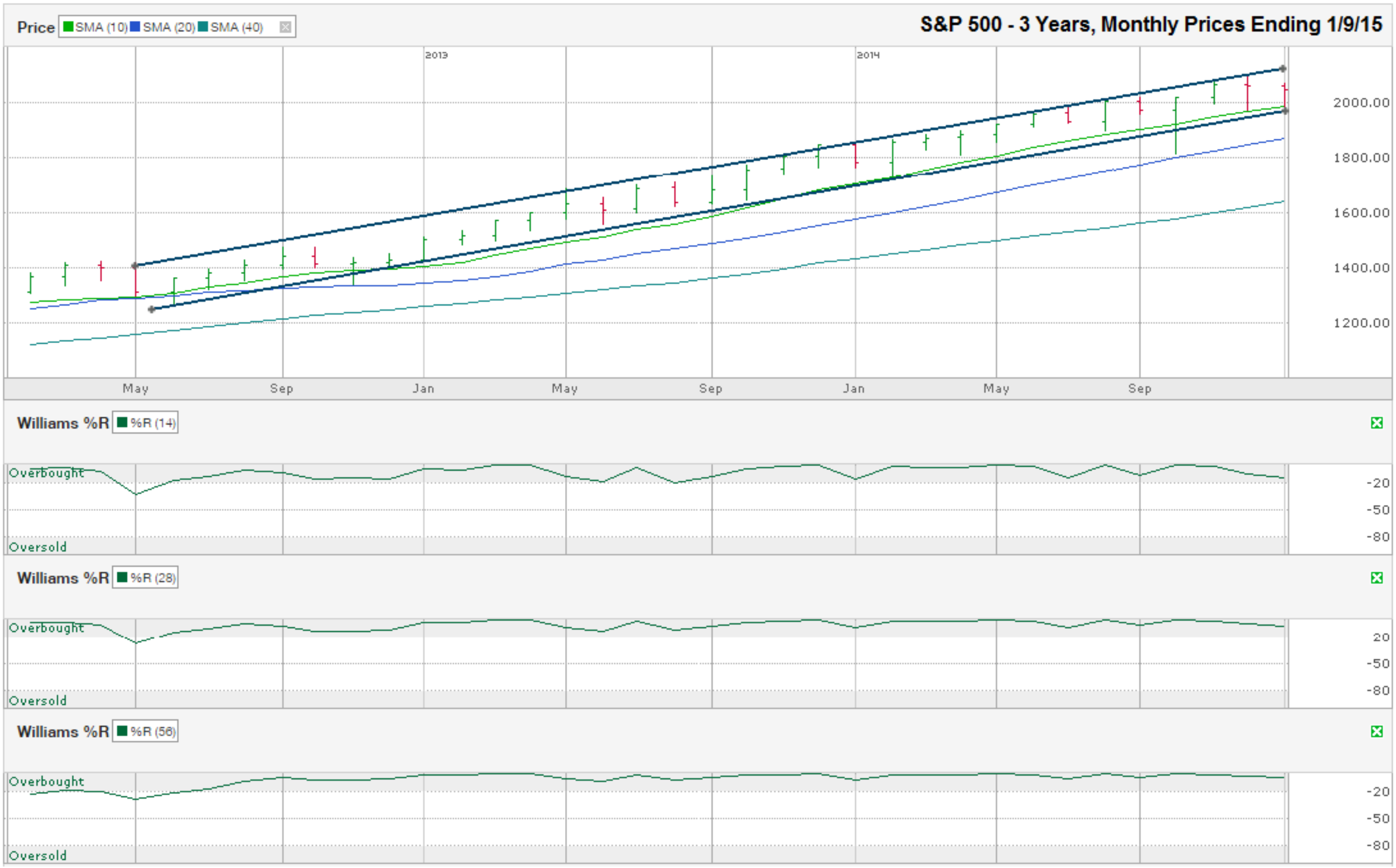
Index Chart & Analysis



The chart above shows the monthly prices for the past three years on the S&P 500 index ($SPX) after the index closed the week at 2,044.81 on January 9, 2015. When stocks hit a volatile period and fear starts to consume investors, charting a multi-year view of the major indexes is a great way to clear away some of the daily noise and put the recent price action into a more constructive view. The daily price movements of stocks shouldn't be the focus for long-term investors. Longer trends are more helpful for those who do not plan to trade in and out of the market on a regular basis. At the same time, short-term investors can find insight that can benefit their immediate needs too.

At the beginning of December, the S&P 500 ended a multi-week move higher that included very narrow intraday price swings. Since those days of 10-point swings, the SPX has had a series of 30 and 40-point swings intraday. Days with wide margins between its highs and lows can feel worse than they really are. Traders who initially fear losing money, quickly switch their fear to the risk of missing gains when the index reverses a few days later. What is more important is that the large-cap index has not left its three-year trading channel since October.

For the past three years, the SPX, with only two exceptions, has maintained a steady move higher with clearly defined trend lines of higher highs and higher lows. Even in the two months when the SPX fell below its lower trend line in the middle of the month, it finished the month close to its monthly high and resumed its trend that runs along with its 10-month moving average as added support.

On January 6, the S&P 500 found support from its trend line of higher lows and 10-month moving average. These lines are going to be the first indicators to watch to the downside to see if the bears might have their turn to take the reins again. The 10-month moving average is still ascending at 1,986.34 and the trend line of higher lows is only a few points below it. Traders won't know if any break below the 10-month moving average is the beginning of a bear market right away. While it would raise yellow flags, a break below the 20-month moving average (1869.75) would send up red flags. The SPX has remained above its 20-month moving average since June 2012 and has been solid support on both breaks below the 10-month moving average.

The S&P 500 hasn't had a true correction (defined as falling at least 10%) in more than a year. Stretches this long are rare and it has traders worried that the market is due for such a reset. If the S&P falls to its 20-month moving average before the end of February, it could register this overdue correction and bring the bulls back into a buying frenzy with a renewed optimism.

The Williams %R indicator has not had a two-month period below its overbought range in more than 3 years and has still not shown a reason for bulls to worry. This indicator does not give early warnings when viewed on a monthly breakdown, but can be very helpful trying to predict when the next full bear market has begun. Until Williams %R and the 20-day moving average alert investors to longer-term concerns, investors need not worry about the daily gyrations of a moody market. Short-term traders can work the swings between the trend lines to try to eke out an advantage, but should be careful until they've seen a successful retest of the recent lows.

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- Average hourly earnings factor in heavily to the Fed's decision of when to raise interest rates. After increases of 0.1% and 0.2% in October and November, December hourly earnings fell 0.2%. This single data point will have a big influence on Fed, and coupled with data in the coming months, could force the Fed to delay raising rates until deep into the second half of 2015.
- The U-6 unemployment rate that includes the total number of unemployed and those employed part-time, but seeking full-time employment and is viewed as a more realistic picture of total unemployment, fell to a six-year low of 11.0% in November from 11.3% in October, but ticked up to 11.1% in December.
- A drop in the labor-force participation rate to 62.7% matched a post-recession low and is back to a level reached in 1978. This reduction of people trying to find work helped push the unemployment rate lower, but economists debate the cause of the decrease. Part of it comes from baby boomers retiring and from spouses giving up work voluntarily because their spouse makes enough to support their families. The worrisome part comes from those who have giving up looking for work because they believe their efforts are futile.

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