AF CAPITAL MANAGEMENT
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INSIDE THIS ISSUE

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Perspectives

Bull markets end when recessions begin or when markets are excessively overvalued. Market corrections begin when uncertainty surrounds the economy. A market correction is defined as a decline of at least 10% from a high, typically in reference to the S&P 500 Index or Dow Jones Industrial Average. Such a shallow decline does not mean the bull has ended; it is simply taking a break while the market gains clarity. If the index falls 20%, the market is considered to be in a bear market and the bull market is technically over.

The S&P 500 has spent four of the past five days moving in and out of correction territory intraday and has found a way to move higher in the past four straight days. This resilience shows that a lot of the fear of the unknown is beginning to subside. An unnerving statement from the Federal Reserve Chair, Janet Yellen, or a disappointing employment number can startle traders for a few hours, but cooler heads are starting to prevail and value investors are entering the markets to pick up stocks while they are cheap.

This isn't to say the coast is clear for investors with a short time horizon. The market will likely remain volatile through the end of this year and into next year, especially if the Fed keeps the interest rate unchanged. Long-term investors have an opportunity right now. Stocks of companies that are growing have fallen with the rest of the market and are available at discount prices compared to what was considered reasonable just a month or two ago. Even broad indexes have fallen enough to make their valuations reasonable to buy and hold for a few years.

S&P earnings should end 2015 around $118-$120, 8-10% below the estimates from nine months ago. If earnings finish on the lower side and stocks were to end the year at current levels, the S&P 500 would have a trailing P/E ratio of 16.5. 16.5 is not indicative of an overvalued stock market, in fact it is only slightly above historical averages. 2016 earnings are forecast to be close to $125, which could still be a little generous with job growth slowing and economic trouble around the globe. Even if earnings only grow to $120 in 2016, stocks are not overvalued now and should ease higher over the next two years as clarity returns to the market. The Fed will have raised interest rates by the end of 2016 (hopefully) and China's future should be a little clearer by then. As the fog clears, the P/E ratio will be allowed to expand again, even with slow growth.

Rather than limit focus on how stock prices relate to earnings (P/E), many investors wisely compare the dividend yield of the S&P 500 to the 10-year Treasury's yield. The idea is that a long-term investor has the choice between buying stocks or bonds and should make the decision based on which investment vehicle will produce a better gain for the perceived risk. The current dividend yield for the S&P 500 is 2.04%. Ten-year Treasury notes (technically, they aren't called "bonds" unless their duration is greater than 10 years) are yielding 1.98%.

If the risk was the same, stocks have a greater potential return using yield as a guide. However, both investment choices offer different risk and reward potential outside of their yields. Stocks have more upside potential based on historic performance while not overvalued. (16.5 is not a historically high P/E ratio. Bull markets tend to peak when the index P/E surpasses 19-20.) On the other hand, bonds (and other fixed income products) are in the upper range of their historic trading range. This elevated price for bonds means they have limited upside potential and have a great deal more downside risk. The Fed will raise rates eventually and bond prices will be forced lower as yields move inversely to prices. The next few months could feel safer in bonds, but for the price of a little more volatility, long-term investors will be much happier not to have too much allocated to bonds instead of stocks.

Bear markets and market corrections have a long history of finding a bottom in October. The cycle doesn't always play out so predictably, but is worth noting as the markets approach the six-month period that has the best historical performance. As painful as the past couple of months have been for some investors, the Dow Jones is only down 5.85% for the year-to-date and has averaged more than 11% per year over the past five years. Long-term investors need remember that not every quarter can be positive and experiencing an occasional decline is healthy for the longer-term and can reduce the severity of the next bear market.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	10/2/2015	-5.85	0.45	9.57	11.55
NASDAQ Composite	10/2/2015	-0.60	6.27	14.70	14.71
Russell 2000	10/2/2015	-6.59	2.98	11.34	11.90
S&P 500	10/2/2015	-3.72	2.36	12.88	13.61
S&P MidCap 400	10/2/2015	-3.46	3.85	13.65	13.16
Global Stock Indexes					
MSCI Emerging Markets	10/2/2015	-15.92	-18.98	-7.20	-5.84
MSCI World, Excluding US	10/2/2015	-5.30	-6.57	4.80	3.65
Bond Indexes					
Core Bond	10/2/2015	1.78	3.32	1.96	3.33
Intermediate Core Bond	10/2/2015	2.62	3.96	2.34	3.50
Long-Term Core Bond	10/2/2015	-0.15	3.66	2.32	5.49
Short-Term Core Bond	10/2/2015	1.36	1.50	1.04	1.34

Fundamentals & Indicators

- The Empire Manufacturing Survey registered a reading of 3.9 in July, but fell hard in August with a reading of -14.9 and again in September with a reading of -14.7.
- The Philadelphia Fed's Business Outlook Survey softened in July to 5.7 from 15.2 in June and rebounded some in August to 8.3. September severely disappointed with a decline to -6.0 in its first decline since February 2014.
- Retail sales were unchanged in June after being revised higher in July. July retail sales increased 0.7% followed by another gain of 0.2% in August.
- The Producer prices index (PPI) increased 0.4% in June, which encouraged analysts to believe inflation was finally returning to the economy. However, July PPI increased only 0.2% and August was unchanged, which weighed into the Fed's decision to leave interest rates unchanged.
- The Consumer Price Index (CPI) followed the pattern seen in the PPI, a good start and poor finish. June rose 0.3%. July rose 0.1% and August surprised with a decline of 0.1%.
- The Case-Shiller 20-city Home Price Index continued to be a bright spot for bulls. The May report showed a 4.9% increase in home prices followed by increases of 5.0% in both June and July.
- Housing starts continued to show strong numbers in the past three reports, but began to slow as the end of the summer's reports came through. June starts rose to 1,204,000 (after revisions), close to a seven-year high and then the pace eased to 1,161,000 in July and again to 1,126,000 in August.
- Existing home sales have maintained their upward trajectory. June sales reached 5,480,000, a 6.4% year-over-year gain. July and August's pace slowed from the June report, but still gained 4.6% and 4.7% respectfully.

- New home sales is a key leading indicator of economic strength and tells a different story than some of the other indicators outside of housing. June sales slipped 6.8%, but July and August sales more than made up for the temporary dip with sales 5.4% higher in July and 5.7% higher in August. The August reading of 552,000 was the most new homes sold since February 2008 when sales were moving in the opposite direction.
- Pending home sales disappointed in each of the past three reports. June fell 1.8%, July sales rose 0.5% and August sales fell 1.4%.
- Factory Orders started with a positive report in June with an increase of 2.2%. July still showed an increase of 0.4%, but August orders fell 1.7%. The weaker August report was partly due to the strong dollar, which has slowed demand for exports, and low oil prices, which have reduced demand for drilling equipment.
- Total durable goods orders rose 4.1% in June (revised up from 3.4% initially) and rose another 1.9% in July, but declined 2.0% in August.
- The ISM Manufacturing Index has been losing steam recently with numbers that still show expansion (above 50.0), but at a slowing pace. The index's reading in July hit 52.7, but eased to 51.1 in August and 50.2 in September. Manufacturing will begin contracting if the trend continues into the fourth quarter.
- The ISM Services index produced one of the strongest three months of readings compared other major indicators. The index hit 56.0 in June and expanded to 60.3 in July and then only slipped to 59.0 in August.
- Construction spending remained positive throughout the past quarter's reports. June spending rose 0.6%, July rose 0.4% and August increased 0.7%.
- Strong Gross Domestic Product (GDP) estimates lead economists to believe the Fed would raise rates in September or soon after. The advance estimate for second quarter GDP came in at 2.3%. The second estimate surprised to the upside when it was revised to 3.7% and then the third estimate rose to 3.9%, indicating a healthy economy had finally emerged.
- Weekly unemployment claims have continued to be a bright spot in most reports. The four-week moving average dropped to 271,000 last week, which is the lowest level since 1973. Such a historically low level gave false hope for the monthly non-farm payrolls report.
- The monthly non-farm payrolls report initially indicated 215,000 new jobs were added in July on top of an upward revision of 14,000 more jobs in the previous two months. August is the most revised report of the year and didn't spook investors too much when the data showed only 173,000 new jobs were added. When the September data was released, August numbers were revised lower by 37,000 to 136,000 and September fell far below expectations with 142,000 new jobs added. The negative revision in August, in addition to the disappointing September report, caused stocks to sell off at the market's open while bond prices spiked, but stocks finished the day higher and yields retreated from their highs. The average number of jobs gained in the third quarter fell to 164,000 from 215,000 in the first six months of 2015.
- The unemployment rate remained at 5.3% in July and fell to 5.1% in August and September. September's rate might be misleading because 350,000 people reportedly dropped out of the labor-force bringing the labor-force participation rate to 62.4%, its lowest level since October 1977. Economists view a low labor-force participation rate as a bearish indicator, but part of the low rate comes from baby boomers beginning to retire.
- The U-6 unemployment rate (includes the total number of unemployed and those employed part-time, but seeking full-time employment is viewed as a more realistic picture of total unemployment) fell to 10.4% in July and marked the lowest level it has been since June 2008. The next two months improved further to 10.3% in August and 10.0% in September. The drop in the U-6 rate is one of the few positive points taken from the September jobs report.
- The average workweek beat expectations in July with a report of 34.6. The August workweek was reported at 34.6 while September disappointed with a slowdown to 34.5 hours per week. An expanding workweek tends to lead to more jobs being added in the near-term.
- Average hourly earnings showed positive signs in July and August with increases of 0.2% and 0.3% respectfully, but remained unchanged in September.

Index Chart & Analysis

The chart above shows the daily prices for the past three months on SPY, an S&P 500 Index ETF, after closing the week at $195.00 on October 2, 2015. SPY went through a long consolidation period from early February through mid-August when it did not waiver more than nine points from its high to low. No news could push the large-cap ETF below 204 or above 214, with the majority of days trading between 207 and 212. The 10, 20 and 50-day moving averages all converged during the final month of tranquility as SPY's trading range narrowed to an even tighter range. This period of complacency ended in mid-August when SPY fell in a two-day panic attack as low as 182.40 before recovering to 189.50 by the end of the day.

For some traders, the tantrum seemed over. SPY had finally had its long-overdue correction with a 14.7% drop from an intraday high of $213.78 in May. To technical traders, the recovery seemed false and merely what is referred to as a "dead cat bounce" (as in, even a dead cat will bounce if it falls hard enough). To truly reset technically, SPY needed to retrace most, if not all, of its collapse on a calmer descent.

On Monday, September 29, SPY made it as low as $186.93 before closing above its previous day's closing price. The next three days followed suit with better closes each day. The biggest challenge came on Friday after Thursday's advance was halted at its 10-day moving average and its two-week trend line of lower highs. The poor employment report on Friday morning added onto the technical resistance and it looked like the recovery might stall after only three days. After dropping 3.01 points in the first hour of trading, SPY rallied 3.1% to finish at $195.0 close to its high of the day, above the descending trend line that stopped it the day before and above its 10 and 20-day moving averages.

To give the rally credibility, the bulls need SPY to stay above $195 on Monday. Moving averages and trend lines are very important to technical traders, which makes Monday's trading range a psychological make it or break it point. The area around $195 has been important resistance and support since the correction hit SPY. Closing above $195 on Monday will show traders that the past four days of better prices is more than a short-covering rally. In addition, the Williams %R indicator moved above the oversold range on Wednesday and needs three confirmation days to make the signal more reliable. A higher close on Monday will give this momentum indicator its third confirmation day. A lower close on Monday could take the legs out from the rally and cause a retest of the August lows.

We are far from seeing an all-clear signal above $195. Another trend line of lower highs has moved below $200 and the 50-day moving average is just above $200 and falling. Both of these points of potential resistance will draw a lot of attention in the coming days if SPY's push higher continues. A move above the 50-day moving average will give the market a chance to trade up to its previous highs from the spring again. The chart will need a completely new technical assessment by the time SPY reaches the $210-214 range again.

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