AF CAPITAL MANAGEMENT
Registered Investment Advisor

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"Markets do not collapse when employment is improving at such a steady pace."

Perspectives

Fear mongering on the news channels and newspapers does not mean the stock market is actually due for a bear market. Sentiment shifted in favor of the bears to start 2016, but the reasons were more emotional reactions than analytical based. Some data was less than ideal, but long-term investors need to focus on their personal financial goals and timelines rather than what a news anchor says is important for the next few weeks.

Bears pointed to the falling labor participation rate through most of 2015 as an indicator that the falling unemployment rate was a mirage. The theory was that the percentage of people unemployed was falling due to the decline in people being counted as job seekers. While true that the drop in the participation rate accounted for some of the unemployment rate's improvement, the biggest input was (and still is) the number of net new jobs added each month. The decline in the participation rate was due to potential workers giving up hope out of frustration. This logic was worth consideration, but is no longer a factor since workers are returning to the work force and attempting to find jobs again. The reason they are returning to the workforce is because jobs are available and more people are being hired than fired. Weekly jobless claims are at 40-year lows and still trending lower. Markets do not collapse when employment is improving at such a steady pace.

The employment outlook is important for longer trends, while gains in oil prices have been the biggest driving force on a daily and weekly basis for the markets this year. The Fed's decision not to raise interest rates again fits in the middle. The latter two forces are interrelated. After raising rates in December 2015, Janet Yellen, the Fed Chair, has remained dovish (i.e. not giving too much concern to inflationary risks as they relate to interest rates) in recent public comments. The US dollar strengthened through much of 2014 on the probability that a rate hike was imminent, but that expectation waned during 2015. By the time the Fed actually raised rates in late 2015, the dollar was close to a multi-year low and then reversed on the news, weakening through the end of March.

The Fed's decision to delay further rate hikes helped trigger the dollar weakness because currencies tend to strengthen as interest rates rise. Oil is priced in US dollars and with all other inputs remaining equal, oil prices rise with a weakening dollar. It takes a smaller amount of a foreign currency to buy a barrel of oil prices in dollars, so demand for the commodity increases, which pulls prices higher. As oil prices rise, energy companies become more profitable and their stocks rise. In addition, rising oil prices decreases the risk of bond defaults for companies that became overleveraged during the oil boom. As default risks decline, financial companies' exposure to these risks decline too and their stocks rise in response.

Of course, all other inputs rarely remain equal. One of the semi-annual drags on investor sentiment is the fear of an implosion in China. Since peaking in June, China's Shanghai Composite Index fell through late January, losing nearly half of its value. This decline stopped in January and the index has begun to slowly recover since then, easing panicked investors' worries over a hard landing throughout China and other Asian markets. As China's market and economy stabilize, the demand for oil improves and energy prices rise.

While the US economy has many macro-economic factors confronting it, the bias is on the side of the bulls for now, but sudden changes in oil prices and interest rates could derail this sentiment quickly again.

Summary of Indexes

Courtesy of Morningstar.com

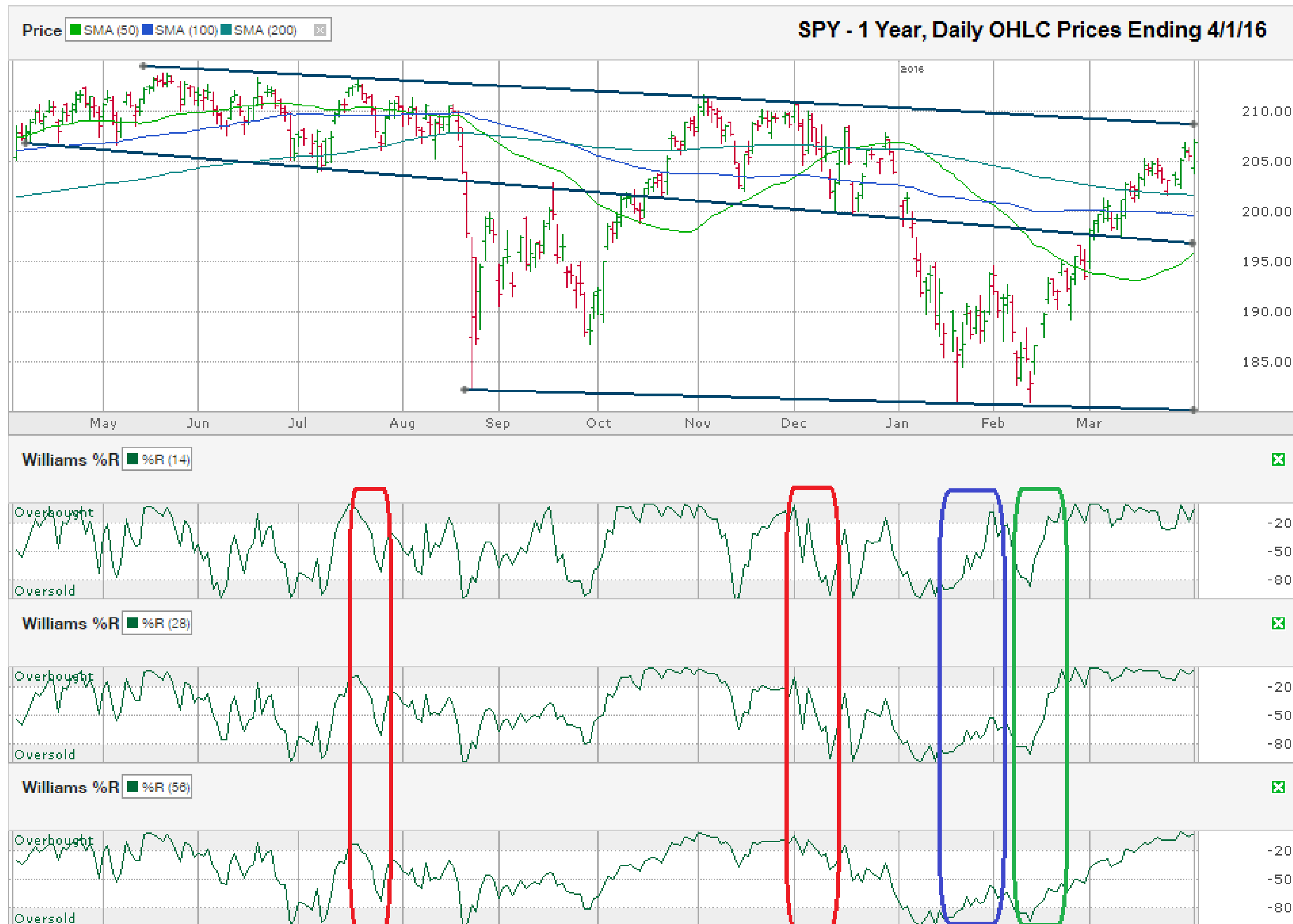
Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	4/1/2016	2.82	3.14	9.53	10.30
NASDAQ Composite	4/1/2016	-1.85	0.70	14.91	11.99
Russell 2000	4/1/2016	-1.19	-9.39	7.44	7.19
S&P 500	4/1/2016	1.99	2.82	12.22	11.61
S&P MidCap 400	4/1/2016	4.25	-2.83	9.98	9.46
Global Stock Indexes					
MSCI Emerging Markets	4/1/2016	4.04	-15.95	-7.12	-6.96
MSCI World, Excluding US	4/1/2016	-4.01	-10.51	1.12	1.10
Bond Indexes					
Core Bond	4/1/2016	3.07	2.10	2.68	4.01
Intermediate Core Bond	4/1/2016	2.61	2.89	2.87	3.96
Long-Term Core Bond	4/1/2016	6.26	1.03	4.14	7.40
Short-Term Core Bond	4/1/2016	1.23	1.23	1.12	1.49

Fundamentals & Indicators

- The Empire (NY) Manufacturing Survey hit its lowest level in January since April 2009, during the recession. The reading bottomed in January with a reading of -19.4, followed by another disappointment in February with a reading of -16.6. The March reading of +0.62 was the first positive report since July 2015 and is still subject to revisions.
- The Philadelphia Fed's Business Outlook Survey began the year with two negative reports in January and February of -3.5 and -2.8 and then surprised to the upside in March with a positive reading of +12.4, adding to the NY survey's positive momentum.
- Retail sales were initially reported lower by 0.1% in December, but had two upward revisions to pull the December count to +0.3%. January couldn't hold the trend and saw sales fall 0.4% (after an initial +0.2% reading). February sales fell 0.1%.
- The Producer prices index (PPI) declined 0.2% in December, increased 0.1% in January, and declined 0.2% again in February. The decline in energy prices has helped put downward pressure on prices, which has also allowed the Fed to delay raising interest rates.
- The Consumer Price Index (CPI) followed a similar, but more subdued, pattern as the PPI. December prices fell 0.1%, January was unchanged, and February fell 0.2%. However, when energy prices were removed, the "Core CPI" rose 0.2%, 0.3%, and 0.3% respectfully.
- ISM Manufacturing Index showed the sector contracted (below 50.0) in January and February with readings of 48.2 and 49.5 before expanding in March with a reading of 51.8. The March reading ended five months below 50.0, its longest stretch of contraction since 2009.
- The ISM Services Index continues to indicate an expanding services sector, but at a slowing pace. The past four reports have been lower than each preceding month. December fell 0.8 to 55.8, January fell 0.7 to 53.5, and February fell 0.1 to 53.4. While drawing closer to the 50.0 line that marks the difference between expansion and contraction, the monthly decline has slowed in each month. The March report will draw considerable attention when it is released later this week.
- Construction spending rose 0.6% in December and added 2.1% in January after an upward revision from 1.5% when the February data was released. However, February spending fell 0.5%, which put a damper on the January revision.
- The Case-Shiller 20-city Home Price Index continued to improve at a steady pace through the first quarter's readings with gains of 5.8% in November, 5.7% in December, and 5.7% in January.

- Housing starts consolidated some of the increases seen over the past quarter. December starts decreased 2.5%, January starts decreased 3.8%, and February starts increased 5.2%. The three-month moving average's trend remains positive and could double from the current level to reach the highs touched during the housing bubble.
- Existing home sales grew to an annualized rate of 5.45 million in December, up 7.2% year-over-year. January sales edged higher to 5.47 million, up 8.2% from the previous year while February sales fell to 5.08 million, which is still up 4.4% from February 2015.
- New home sales weakened over the past quarter's reports. Sales in December reached an annualized rate of 540,000, up nearly 50,000 from November, but down 2.1% year-over-year. January sales fell to 502,000, 4.5% below the previous year comparison. February was the bright spot with 512,000, up 2.6% year-over-year.
- Pending home sales rose 0.1% in December, declined 3.0% in January, and rose 3.5% in February.
- Factory Orders declined 0.7% in November and fell 2.9% further in December. January orders increased 1.6%, but are still down 3.3% year-over-year.
- Total durable goods orders have been inconsistent recently. December orders fell 4.6%. January orders rose 4.6% and then fell again in February by 2.8%. On a positive note, total durable goods orders are up 2.6%.
- Weekly unemployment claims fell as low as 259,000 in March and have been below 300,000 for 56 straight weeks, the longest streak since 1973.
- Total nonfarm payrolls for January were revised from 151,000 initially to 168,000. The February report added 245,000 new jobs (242,000 initially). The March data released this past Friday showed an increase of 215,000 new jobs. The three-month average is up to 209,000 from 190,000 in the first quarter of 2015.
- The unemployment rate fell to 4.9% in January after three months at 5.0% and remained at 4.9% in February. Due to the increase in the participation rate to its highest level since May 2015 (a bullish indicator), the unemployment rate rose in March to 5.0%, even with the steady increase in new jobs.
- 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) remained at 9.9% in January for the third month in a row and then dropped to 9.7% in February. The short-lived trend lower reversed in March when the U-6 rate rose to 9.8%.
- The average workweek has been one of the few bearish factors seen in the generally bullish employment reports recently. After rising 0.1 to 34.6 in January, the average workweek fell to 34.4 in both February and March, marking a 2-year low. A drop in the average hours worked each week indicates a drop in demand for employees and tends to put less pressure on wage growth, which the economy needs to help overall growth.
- Average hourly earnings rose 0.5% in January, fell 0.1% in February, and rose 0.3% in March. The minimal growth in average hourly earnings year-over-year was one of the inputs that allowed the Fed to delay raising rates at their March meeting.

Index Chart & Analysis



The chart above shows the monthly prices for the past year on SPY, an S&P 500 Index ETF, after closing the week at $206.92, on April 1, 2016. Technical indicators can be cruel sometimes. As with every stock and index prediction tool, sometimes they give false positives. If they didn't, everyone would use them and nobody would fall prey to a bear market. The occurrence of these false positives is the primary reason technical investors need to use more than one indicator. Three of my favorite technical indicators to use together are trend lines, moving averages, and Williams %R.

The Williams %R indicator, sometimes simply called %R, was early in its forecast for doom before the August 2015 correction. The steep decline hit stocks the following month before % R had a chance to reset for another red flag. The same indicator accurately predicted the return to the downside in December 2015, but gave a false positive for a lasting rebound in January 2016. The beauty of %R is that when it does give a false positive, the next signal tends to be very reliable, but not completely infallible. In mid-February, %R signaled another bullish turn and vigilant investors were rewarded. Since that day a month and a half ago, stocks have risen on a relatively steady basis and Williams %R hasn't indicated the rally is near an end yet, but the chart shows another reason for caution.

The trend line of lower highs that began nearly 11 months ago, and marked the top of each rally since then, is within a few points of where SPY ended on Friday. A trend line this long shouldn't be relied on to predict an exact turning point, but should be watched for a close range of where resistance to further strength might be met. The range to watch for SPY in the coming days and weeks is around $208-209, depending on how soon SPY takes its next step higher.

SPY is facing a high hurdle if it follows the typical path of an index after such a long and stable rally. In most instances when an index has had a run like SPY has, it hits resistance on its first contact with a long trend line. This resistance causes the index to pull back some and then retest the trend line after a short pause. The second test is more important. If resistance to higher prices continues, the index will be pushed back a few percent (if not more) most of the time. If the index breaks through the trend line on this second contact, it often comes back to test the same line as support before advancing quickly again.

The longest trend line in this chart shows a line that has been both support and resistance. It worked as great support until August 2015 and when it broke, SPY bottomed two days later. SPY recovered, but hit resistance on this same line and fell again. After multiple days of providing further resistance, the trend line broke and SPY pushed to multi-month highs, until it hit resistance at the same trend line of lower highs mentioned above. The same pattern repeated in December and January to the downside before SPY broke through to the upside in March.

If SPY meets lasting resistance at the upper trend line, the likely reversal point for support could come from the 200-day moving average. The 200-day moving average is one of the most widely used technical indicators to help investors determine if bulls or bears are in charge. If SPY remains above the 200-day moving average, it has a much better chance of finally moving above the descending trend line of lower highs. If it falls below its 200-day moving average, the 100-day moving average and then the long trend line mentioned above, currently close to $196 (and its 50-day moving average), could provide support. If none of these potential areas of support hold, SPY could correct to the lowest trend line since August 2015, currently around $180.

Other trend lines and moving averages are available on a shorter scale and could all come into play, but the multi-month trends tend to follow the longer duration indicators. Investors who are more concerned with the next few months versus the next few days should concentrate on the bigger picture and not fret over daily headlines meant to draw in viewers more than educate investors.

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