AF CAPITAL MANAGEMENT
Registered Investment Advisor

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Perspectives

Hurricanes Harvey, Irma, and Maria were major personal and economic impacts in the third quarter. Many of the economic reports beginning on the next page were skewed and will be revised as people return to work. The net effect will be more positive for the economy than some investors might realize. Thousands of cars, trucks, homes, and businesses will have to be repaired, if not completely replaced. These repairs and replacements will be labor intensive and will create new jobs for those who have the skills. The increase in jobs will lead to higher wages and a rise in inflation too, which will give the Fed more room to raise interest rates again in December and possibly two or three more times in 2018.

The Fed has an inflation target of 2%, but the US has not been above 2% sustainably in five years. This has led to the conclusion that the Fed will not raise interest rates in the near term. That was the consensus near the end of the summer and then Gross Domestic Product (GDP) estimates for the second quarter began to move higher, hitting 3.1% in the third estimate released in late September. This growth was before hurricane season slammed the US. The Fed says it plans to raise rates in December, as they've indicated all year, but traders are starting to believe them recently. For now, the Fed predicts three rate increases in 2018, but many investors doubt they'll be able to keep that pace without spooking the markets. Interest rates are still well below historical norms and need to move higher, but not so fast as to disrupt an economy that has pushed a stock bull market into its second longest run in US history.

When a stock market moves higher with very few dips and corrections along the way, investors begin wondering what they've been missing. We question what could go wrong this time. Some investors sell for the sake of selling before the next calamity hits. These investors could be lucky and get the timing right, but those who reacted out of fear for the past few years have missed out on massive gains in stock prices. We've experienced a tech bubble and a housing bubble in the past two decades and know there will be more overvalued industries that become unsustainable and then deflate faster than most investors can sell.

Far too many investors don't realize we've already been through rolling corrections in various sectors. Small cap stocks fell 24% from their peak in June 2015 to their trough in February 2016. Long-dated Treasuries, as measured through the 20-year Treasury ETF, TLT, fell nearly 19% from their peak in July 2016 to their trough in March 2017. Large-cap European stocks fell nearly 30% from May 2015 to June 2016. Small caps and European stocks are above their previous highs this week. Treasuries are off their lows, but have a rough road ahead as interest rates begin to rise.

One of the potential bubbles being hyped is the shift from managed mutual funds into lower cost passive exchange traded funds (ETFs). Investors shouldn't fear an ETF correction. The call to be afraid of the growing assets in ETFs is more for selling newspapers and getting internet clicks than protecting investors. The story goes that with such a large portion of assets in ETFs, passive investors could be prone to panic on a sell off. While this change in sentiment could happen, it is unlikely to be any different than investors who flee managed mutual funds and individual stocks in a recession. If panic selling does come to fruition, the selloff will create a buying opportunity in stocks that have been oversold when the herd changed direction. Investors would be better served to keep some cash available in short-term bonds or cash rather than avoid all passive ETFs completely. When, not if, a large correction hits the stock market, investors will have money available to buy at cheaper prices. If the correction takes years to materialize, these investors who remained mostly invested will have sizeable gains to show for their patience and foresight.

Summary of Indexes

Courtesy of Morningstar.com

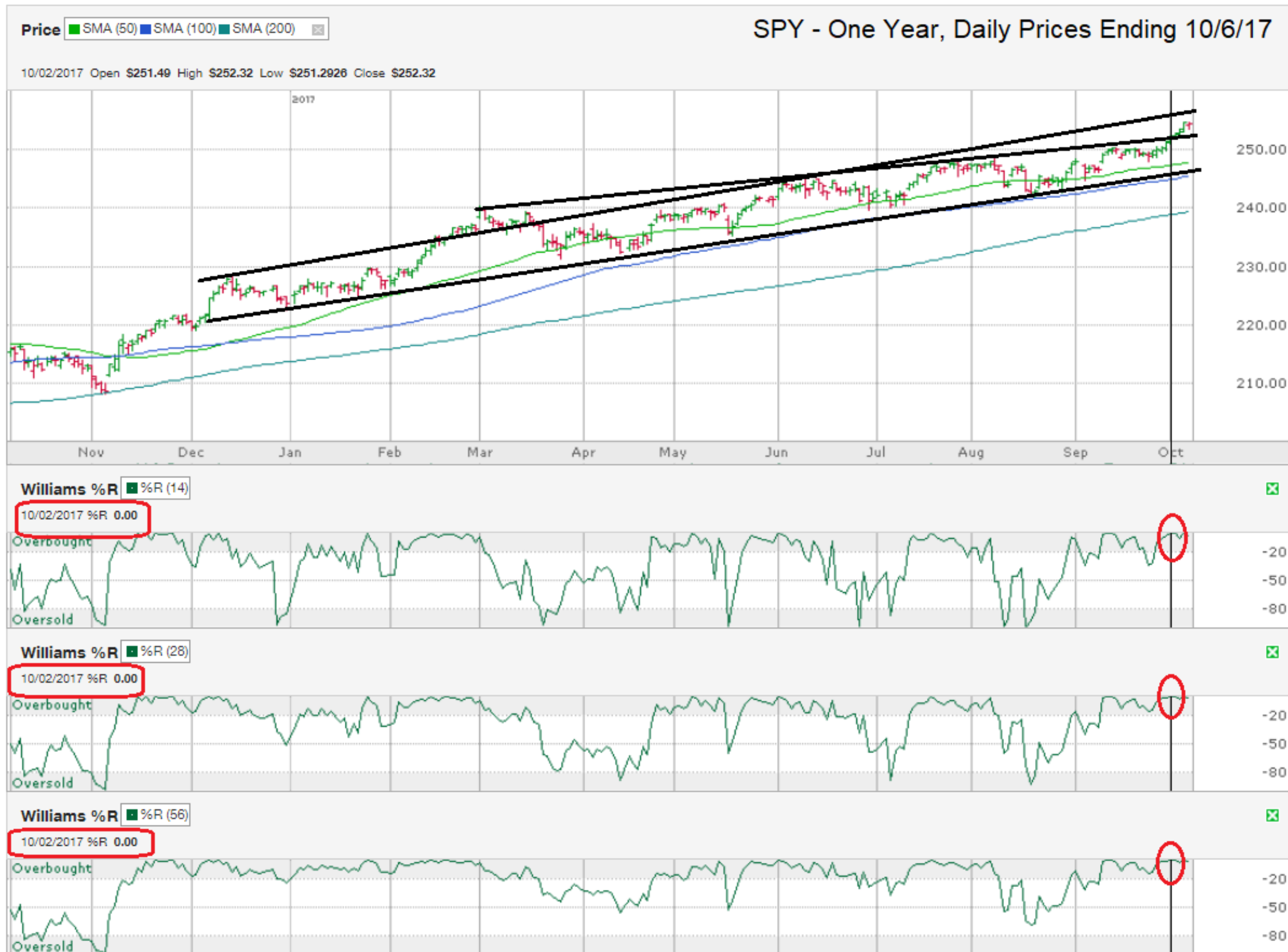
Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	10/6/2017	17.42	27.78	13.08	13.64
NASDAQ Composite	10/6/2017	22.42	24.18	13.94	16.01
Russell 2000	10/6/2017	12.40	22.83	12.90	13.94
S&P 500	10/6/2017	15.67	20.43	11.40	14.17
S&P MidCap 400	10/6/2017	10.79	19.61	11.93	14.54
Global Stock Indexes					
MSCI Emerging Markets	10/6/2017	27.93	20.29	2.97	1.80
MSCI World, Excluding US	10/6/2017	19.13	19.25	5.27	7.33
Bond Indexes					
Core Bond	10/6/2017	3.11	0.50	2.70	2.23
Intermediate Core Bond	10/6/2017	2.56	0.52	2.66	2.27
Long-Term Core Bond	10/6/2017	6.11	0.06	4.32	3.57
Short-Term Core Bond	10/6/2017	1.35	0.86	1.24	1.08

Fundamentals & Indicators

- The Empire Manufacturing Survey was one of the least consistent reports of the past quarter. July's reading of 9.8 (below 0.0 indicates contraction) was followed by +25.2 in August and +24.4 in September.
- The Philadelphia Fed's Business Outlook Survey (the dividing line between expansion and contraction is 0.0) was much steadier. July's survey showed a reading of 19.5, while August and September hit 18.9 and 23.8 respectively.
- Retail sales have shown a slowing trend for consumer spending. June sales declined 0.1%, but increased 0.3% in July (thanks to Amazon's Prime Day) before declining 0.2% in August.
- Producer prices index (PPI) does not show effects from the hurricanes that hit the US during the past quarter, but economists expect producer prices to react more in the coming months as the lag pulls through the economy. On a year-over-year basis, producer prices rose 2.4% through the end of July, while readings from the past quarter show that pace might be slowing. June prices rose 0.1%. July prices fell 0.1% and August prices rose 0.2%.
- A tame Consumer Price Index (CPI) has given the Fed the ability to keep rates close to historically low levels for much longer than many investors expected. This trend continued in June with a flat reading (0.0%) and in July with a slight increase of 0.1%. In August, CPI rose 0.4%, (1.9% year-over-year). If the August increase is the beginning of a new trend, the Fed will have more room to raise rates sooner than Wall Street has been predicting.
- The Case-Shiller 20-city Home Price Index showed continue increases in the year-over-year readings. Prices rose 5.7% in May, 5.6% in June, and 5.8% in July.
- The last three reports on housing starts stayed within the relatively narrow range of the past two years. The peak from the past six months hit in June with 1,217,000 housing starts and slowed in July and August to 1,119,000 and 1,118,000 respectively. Supply pressure and the impact from recent hurricanes will affect the counts for months to come.
- Existing home sales have declined in each of the past three months. June sales dropped 110,000 to 5.51 million, while July sales fell 70,000 to 5.44 million and August sales fell 90,000 to 5.35 million. These numbers can be misleading, because the cause of the decline is due more to the low inventory (not a lot of people moving from their homes) and high prices (up 5.6% year-over-year through August) than from a declining economy or increasing unemployment rate. One realtor I spoke to noted she's seen potential clients who want to sell, but can't find affordable/comparable homes to buy.

- New home sales have seen a similar, but less severe decline. After increasing 8,000 to 614,000 in June, new home sales dropped 34,000 to 580,000 in July and declined another 20,000 to 560,000 in August. Part of the decline is due to the impact from hurricanes, but sales also declined 2.7% in the western US, where the hurricanes had no influence. Year-over-year prices are up only 0.4% through August, but buyers have still held back.
- Pending home sales did not help to change the trend's forecast for the next couple of months. After increasing 1.3% in June, pending home sales declined 0.8% in July and 2.6% in August. Not all pending sales close as scheduled, which could mean September sales could show another decline when the reports are issued in a few weeks.
- Factory orders increased 3.2% in June, declined 3.3% in July, and increased 1.2% in August. Factory orders are up slightly year-over-year, but the trend has slowed, making this report an interesting one to watch in the next two months to see if orders can regain their previous momentum.
- Durable goods orders are up slightly year-over-year also and have been more erratic over the past quarter. June orders rose 6.4%. July orders declined 6.8%. August orders rose 1.7% to finish with a net gain over the previous three reports.
- The ISM Manufacturing Index has been steady and strong recently. The index came in at 56.3 (above 50.0 indicates expansion) in July and rose to 58.8 in August before hitting its highest level in over three years in September with a reading of 60.8. Such strength in manufacturing gives the Fed more room to raise rates again this year.
- The ISM Services Index hit a multi-month low in July at 53.9 (above 50.0 indicates expansion) and recovered to 55.3 in August and rose to 59.8 in September, echoing the bullish theme scene in the manufacturing index.
- Construction spending has been a weaker spot of the economy. June spending declined 0.8% and July declined 1.2%, but August increased 0.5%.
- Gross Domestic Product (GDP) estimates for the second quarter improved in each of the past three estimates. The advance estimate showed 2.6% growth, while the second estimate rose to 3.0% and the third estimate indicated an expansion of 3.1%.
- Weekly unemployment claims remained below 300,000 for the 135th straight week, even with the brief spike to 298,000 after three major hurricanes hit US soil. The trend lower resumed after Hurricane Maria ended.
- Total nonfarm payrolls rose 138,000 in July and 169,000 in August, but declined by 33,000 in September due to the effects of the hurricanes. On top of the first decline in payrolls since 2010, the July and August numbers were revised lower by net 38,000. The numbers above include the revisions made in August and September. July's count was originally 209,000 and August was originally 156,000. September's total will be revised also because a large portion of the survey was conducted while businesses were closed during and post-hurricanes.
- The unemployment rate declined to 4.3% in July, but rose to 4.4% in August before falling to a 16-year low of 4.2% in September. The labor force participation rate has risen 0.6 percentage point over the past twelve months. Such a small change in the number of potential workers participating in the labor force gives more credibility to the unemployment rate being an accurate reflection of employment.
- The U-6 unemployment rate, which 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 steady at 8.6% in July and August and then dropped to 8.3% in September.
- The average workweek continued at an even 34.4 hours from July through September.
- Average hourly earnings increased 0.3% in July, 0.2% in August, and 0.5% in September. Like much of the employment data, the hurricanes skewed the September totals. Some of the increase seen in September comes from the reduction in lower income hourly employees who didn't work temporarily. Higher income salaried employees were not affected in the same way. Even discounting the hurricane effects, the demand for labor is growing and putting pricing pressure on wages.

Index Chart & Analysis



The chart above shows the daily prices for the past year on SPY, the SPDR ETF that tracks the S&P 500 Index, after closing the week at $254.37, on October 6, 2017. SPY has had an incredibly boring and strong 12 months, recording one of the lowest periods of volatility in the history of the S&P 500. Two technical indicators are predicting the large cap ETF is due to take a breather. Before I sound too much like an alarmist, a "breather" is much different than calling for the beginning of a bear market or even a full 10% correction. While SPY could fall into a correction or worse, it's too early to tell and the fundamentals don't appear to be ready to trigger a bear market.

The first technical indicator is more subjective than the second one. I drew the trend lines of higher highs and higher lows in black lines on this chart. The lower trend line has provided support to every dip since December without one exception. For now, we don't have a reason to believe that trend will end soon. However, SPY is getting closer to the longer trend line of higher highs and if history repeats, it should find resistance and move lower again to test the lower trend line. The shorter trend line of higher highs acted as resistance to further gains from March until this past Tuesday. This shorter line could become a new line of support as the S&P 500 continues higher in its narrow trading range. This theory would hold more water if it were not for the Williams %R indicator.

On Monday, October 2, the Williams %R, a non-subjective technical indicator, reached the 0.00 overbought level (circled in red on the chart) in its 14, 28, and 56-day views. This extreme overbought condition is an extremely rare and hasn't happened since January 25, a few days before SPY paused its run higher and retested the trend line of higher lows. After such an extreme reading on all three periods, an index (or stock) typically retreats two to three

days later. The retreat for SPY should've hit on Thursday to match historic patterns, but didn't have a negative day until Friday when it declined only 0.11%.

Since no technical indicator is 100% accurate, SPY could fail to drop, but probability and history are on the side of the technical indicators. If the lower trend line of higher highs and the 100-day moving average, which hasn't broken support since November 2016, provide support again, SPY shouldn't fall further than 245.00, or 3.6% below Thursday's high. A 3.6% decline happens multiple times throughout most years (as does a 10% decline), but has only happened one other time in 2017. In a year without volatility, a 3.6% decline could be all SPY needs to recharge before pushing into new highs again.

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