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Perspectives

From the day before the US election through March 1, the stock market looked unstoppable. In what was soon called the "Trump trade" (since it coincided with his victory), investors binged on the idea that every promise would come to fruition and we would have no side effects as the Republican controlled White House and congress lowered the cost of healthcare, lowered taxes, and increased infrastructure spending.

By March, reality set in and investors started to realize that Washington is still Washington and nothing is going to happen overnight. Changes are sure to come, but when and in what size is being second guessed now. The question of when these changes trickle into the economy is starting to worry investors as the Fed has made it clear the time for steady interest rate hikes has begun. In

addition, the idea that tax cuts will energize stocks is fading because the effective tax rate (top line rate minus deductions) is already relatively low and is not expected to change as deductions will be eliminated when the top line rate is reduced.

What began as nearly four months of unquestioned hope for growth has turned into a search for why stocks should move higher from their currently inflated valuations. Stock valuations do not predict where prices will move in the near-term, but are good indicators for the next three to five years. In other words, stocks do not have an on/off switch at a specific P/E ratio, but, the upside becomes very limited without follow through on expected growth. Stocks are not at outlandish valuations today and may not have to fall much to reset again. However, the catalyst for the next 10% higher for stock prices has become evasive.

As investors rethink their bullish outlooks, many are starting to wonder what the downside catalyst could be rather than what could take stocks even higher. As the summer draws closer, the seemingly annual summer disruption from the European Union starts to weigh on investors' minds. Nothing could happen this summer to disrupt the bulls' party or fallout from France's upcoming election could spook investors briefly (see Brexit). The fear of the debt problems in some of the Mediterranean countries is due to surface again too as it seems to have become a cyclical process that won't be resolved until it breaks one day. These issues could skip this summer while immigration issues and the likelihood for continued terrorism dominate the headlines.

Whether one of these known risks causes a correction or if an unforeseen event surfaces, 2017, like most years, will have a retreat in stock prices of at least 10% at some point. Barron's reported "The value of our stock market has reached 207% of our GDP - surpassing the credit bubble high near 181% and the tech bubble peak of 202%." Such stats do not predict an immediate drop in prices, but add to the theory that stock prices are getting stretched and a correction would be good for the longer-term health of the bull market.

The above caveats are not a call for a new bear market. Instead, they are intended to remind us that stock prices ebb and flow and tend to have a reversion to the mean after overshooting in either direction. To reach the mean, stocks need to either push lower or trade sideways for an extended period before pressing much higher. Just as it's hard to pinpoint the catalyst for higher prices, the fundamentals of the economy are stable and do not paint a case for the end of the bull market. This point of the market cycle is meant for vigilance, not greed. Investors don't need to fear a short-lived dip, but only if the fundamentals remain strong.

Summary of Indexes

Courtesy of Morningstar.com

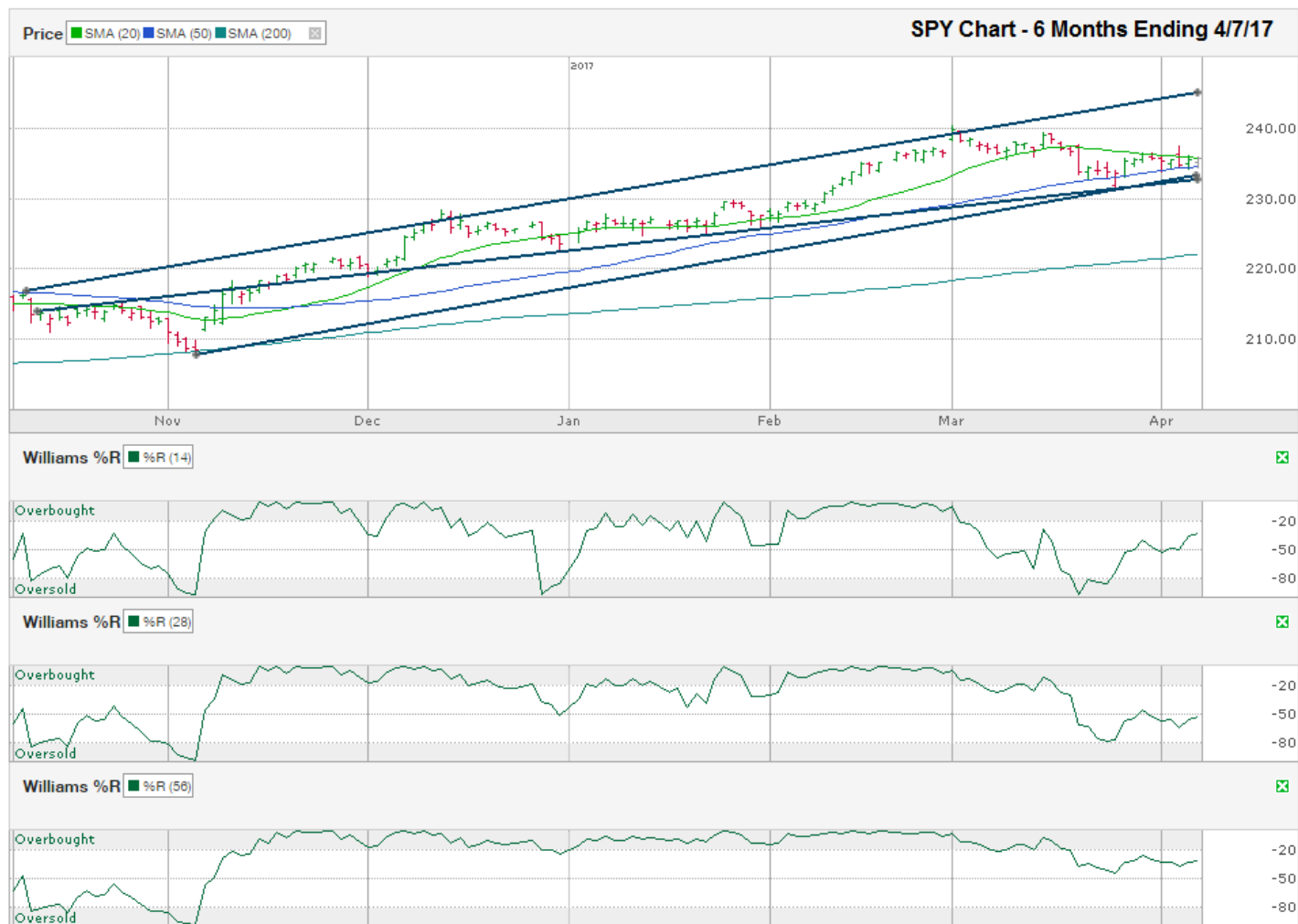
Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	4/7/2017	5.21	20.84	11.09	12.40
NASDAQ Composite	4/7/2017	9.19	21.23	12.94	13.79
Russell 2000	4/7/2017	0.91	26.69	7.82	12.33
S&P 500	4/7/2017	5.81	17.84	10.81	13.40
S&P MidCap 400	4/7/2017	3.15	22.26	10.00	13.37
Global Stock Indexes					
MSCI Emerging Markets	4/7/2017	11.52	18.82	-1.43	-1.49
MSCI World, Excluding US	4/7/2017	6.20	14.33	0.15	5.87
Bond Indexes					
Core Bond	4/7/2017	0.97	0.08	2.81	2.42
Intermediate Core Bond	4/7/2017	0.83	0.18	2.87	2.44
Long-Term Core Bond	4/7/2017	1.76	-0.59	4.78	4.07
Short-Term Core Bond	4/7/2017	0.51	0.55	1.13	1.10

Fundamentals & Indicators

- The Empire Manufacturing Survey eased to 6.5 in January before rebounding to 18.7 in February and 16.4 in March.
- The Philadelphia Fed's Business Outlook Survey rose 3.9 points to 23.6 in January and rose again to 43.3 in February before slowing some in March with a reading of 32.8, still far above the 0.0 mark dividing expansion and contraction.
- Retail sales continue to grow, but at a slowing pace. December retail sales grew 1.0%, followed by 0.6% in January and 0.1% in February.
- Producer prices index (PPI) rose 0.2% in December, 0.6% in January, and 0.3% in February marking the fourth straight month of increases, indicating inflation is beginning to enter the economy. On a year-over-year basis, PPI is up 2.2%, which is the largest 12-month gain since March 2012 and helped support the Fed's decision to raise interest rates again.
- The Consumer Price Index (CPI) followed a similar pattern as the PPI with increases of 0.3% in December, 0.6% in January, and 0.1% in February. On a year-over-year basis, total CPI is up 2.7%.
- The Case-Shiller 20-city Home Price Index continues its steady climb higher over the past quarter's reports. November showed a price increase of 5.2%, while December and January improved by 5.5% and 5.7% respectively.
- Housing starts remained in their upward trend since bottoming in the recession. Housing starts increased by more than 100,000 in December to 1,279,000, slipped to 1,246,000 in January, and rose to 1,281,000 in February. Strength in the housing sector is key to a strong economy and with numbers close to 10-year highs, the chances of a recession near-term are low.
- Existing home sales were relatively flat over the past quarter's readings. December sales reached 5,510,000. January sales improved to 5,690,000 before slipping slightly to 5,480,000 in February. Limited supply and increasing prices have held back bigger increases in sales.
- New home sales dropped by 43,000 to 530,000 in December, but increased to 558,000 in January and to 592,000 in February. Demand for lower-priced homes have outpaced higher-priced homes as mortgage rates rise and more expensive homes become less affordable.
- Pending home sales increased 1.6% in December, decreased 2.8% in January, and increased 5.5% in February. While only a predictor of sales to come, the strong February reading helps the overall bullish outlook for the economy.

- Factory orders maintained a steady pace of gains in each of the past three reports. December orders grew 1.3%, followed by 1.5% in January and 1.0% in February.
- Durable goods orders averaged a slight gain over the past three months. After declining 0.9% in December, the three-month average returned to the positive side with gains of 2.4% and 1.8% in January and February respectively.
- The ISM Manufacturing Index indicated healthy expansion in recent reports. January's 56.0 reading (above 50.0 indicates expansion) was followed by March's 57.7 reading that reached the highest point since August 2014. March eased back some to 57.2, as was to be expected after such a strong February.
- The ISM Services Index reached its 87th straight month of growth by the March reading after three more positive reports in the first quarter. January showed a reading of 56.5, while February hit 57.6 and March came in at 55.2. The services sector is a larger part of the US economy than is the manufacturing sector, which is why it is a key indicator to watch.
- Construction spending showed weakness in December and January with declines of 0.2% and 0.4% respectively before rebounding 0.8% in February with growth in both the private and public sectors.
- After finishing the third quarter with 3.5% growth, the Gross Domestic Product (GDP) estimates for the fourth quarter began at 1.9% in both the advance reading and the second reading before being pushed up to 2.1% in the third reading. 2.1% is lower than most of Washington and Wall Street would like to see, but some investors prefer the slow and steady growth over fast growing bubbles that do not last as long.
- Weekly unemployment claims stayed below 300,000 for the 109th straight week, helping the four-week moving average reach its lowest level since June 2000.
- Total nonfarm payrolls kicked off the year with a strong reading of 216,000 (227,000 before being revised lower) and remained steady at 219,000 in February before dropping sharply in March down to 98,000.
- The unemployment rate continued to fall through the first quarter. January's rate was 4.8% and dropped to 4.7% in February and 4.5% in March. The labor force participation rate remained low, only ticking 0.1% higher to 63.0% from January to March. Depressed participation affects the unemployment rate as the denominator in the equation skews the rate lower.
- 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 and improved steadily in the past three readings. January hit 9.4% and dropped to 9.2% and 8.9% in February and March respectively.
- The average workweek began the year at 34.4, but slipped to 34.3 in February (after revisions) and March. An expanding workweek shows greater demand for labor. The reverse is more bearish than the overall unemployment rate indicates and is worth watching in future months.
- Average hourly earnings painted an opposite picture from the workweek data. January hourly earnings rose 0.1% followed by increases of 0.2% in February and March. An increase in earnings indicates stronger labor demand and is bullish.

Index Chart & Analysis



The chart above shows the daily prices for the past six months on SPY, the SPDR ETF that tracks the S&P 500 Index, after closing the week at \$235.20, on April 7, 2017. The S&P 500 has edged lower since peaking at the beginning of March, but the chart shows it hasn't rolled over yet. The two trend lines that mark SPY's higher lows converged at the intraday low on March 27, but both still maintain support from further lows. The longest trend line drawn below marks the trend of higher lows. The area between these sets of lines is called the trading channel and projects where SPY is likely to trade, until it breaks outside of either barrier.

Other technical indicators can help predict future movement too. The moving averages indicate directional patterns that help to highlight changes in sentiment. An index that falls below its moving average tends to fall further until a new catalyst or technical barrier influences its direction. I used the 20, 50, and 200-day moving averages in this chart to highlight a few different points. The 20-day moving average has broken support, meaning it is no longer a barrier to downside price movement, but instead has become a resistance to the upside. At the same time, the 50-day moving average has broken support only once since early November. That break came intraday on March 27, but SPY recovered before the close and moved higher over the following week.

As the 20-day and 50-day moving averages draw in closer to each other, one will break support or resistance and will likely lead to a few weeks of trading in the direction that "wins". If the direction is higher, SPY could trade up to its upper trend line, close to \$243-244. If SPY closes below its 50-day moving average for two straight days and that drop coincides with a move below its trend lines of higher lows, the next stop could be the 200-day moving average, currently around \$222 and ascending. A drop to the 200-day moving average would be approximately 7.5% below the intraday high reached on March 1 and about 5.5% below Friday's close. A price decline of 5.0% to 7.5% should be enough to shake out the investors who spook easily and open the door to a new leg to the bull market.

The Williams %R technical indicator can be used as a strong predictor when the signals align. When the 14, 28, and 56-day indicators offer buy or sell signals weeks apart, as they did in March, the reliability of Williams %R decreases substantially. It's worth keeping an eye on these three time frames for when they regroup. In this chart, the 14-day indicator fell below the overbought range at the beginning of March, foreshadowing more selling was to come, but the 28 and 56-day indicators didn't follow suit until mid-month when most of the selling had already run its course. While the 14-day indicator fell close to the bottom of the oversold area, the other two did not. This lack of conviction in the combined indicators leaves technicians in a wait and see position, just as we are waiting to see which direction takes command above the 20-day moving average or below the 50-day moving average.

Much like value investors recently, investors who rely on charts to help make their trading decisions are being forced to be patient and wait for a better buying or selling opportunity when the data changes. After such a long run without much of a decline, stocks need a new catalyst for change or an extended period of consolidation. The S&P 500 has been in a consolidation phase for the past seven weeks and could take twice as long, if not longer, to allow the 200-day moving average to draw in closer and to allow earnings to improve and help the broader market's P/E ratio.

AF Capital Management, LLC

PO Box 566241
Sandy Springs, GA 31156

404-395-2752

alex@afcapitalmanagement.com

Twitter: [@AlexRFoster](https://twitter.com/AlexRFoster)

Facebook: [AF Capital Management](https://www.facebook.com/AFCapitalManagement)



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