AF CAPITAL MANAGEMENT
Registered Investment Advisor

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Perspectives

Europe, or more precisely the fear of what could happen in Europe, controlled the US markets again in November. After a fantastic October the markets were due for a little breather. Instead of a small drop or sideways move the S&P 500 saw a 7.5% min-correction only to bounce back to the October closing level by this past Friday. Volatility has ruled the markets for months and does not show signs of slowing down. Stocks saw their worst Thanksgiving week since 1932 and then the next week was the best week of any period going back two and a half years.

These dramatic moves in the markets can be blamed on fears more than any other single factor. Even with the US macro-economic indicators improving, the fear of Europe's inability to get a handle on their woes caused panic selling in the US markets. The panic flipped to the other side due to upside fear of missing out on the next big gains once central banks from around the world announced efforts to ease pressure on global money markets

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According to Bank of America Merrill Lynch, only 23% of stock-fund managers were ahead of the S&P 500's return this year through November 30. Technical indicators have been the only reliable tool for traders with stocks disregarding fundamentals on most days. Emotions show up in charts and allow traders to capitalize on the sentiment shifts of the masses. Hedge funds often hire developers to create algorithms that trade on key technical break points without any further human involvement. This is why the swings are so sudden and violent. Mass selling or buying ensues when a commonly used technical indicator breaks support or resistance and the underlying index is tossed around like a ragdoll. ETFs that attempt to produce double or triple the daily return (or inverse) of an index are forced to chase these moves and exacerbate the swings. This can be seen in how often the last 30 to 60 minutes of the trading day pushes or pulls an index another 30-50% in the direction it spent most of the day moving. This extreme price shift doesn't happen on days that have moved less than 1% earlier in the day.

Along with technical analysis, many professional investors watch bond markets to see where the so called "smart money" is moving. Bonds haven't rolled over completely yet and even bounced off of their lows on Friday. This indicates fears of downside risks in equities are still present and the bulls don't have an easy path higher so far.

The improving fundamentals and accommodative European Central Bank (ECB) reduce the probability of another recession in the near term. This is what bulls are clinging to and will be rewarded eventually if they can weather the extreme volatility of the current markets. The troubles in Europe are far from over, but the leading government officials are beginning to show serious resolve in their efforts to save the euro and the entire European Union. At some point, more countries will have to take bigger write downs on their debt. Europe will continue to suffer until this happens and they have a chance to restart from a more stable level. The only remaining question is if the US will be held back during this waiting period. Early indicators say that is not going to be the case and the US will push forward again. A risk to the advance of the US economy is the strength of the dollar. Exports will take a hit and weaken the chances of a lasting recovery if the dollar strengthens too much.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
Stock Indexes					
DJ Industrial Average TR	12/2/2011	6.47	8.62	15.88	2.48
NASDAQ Composite PR	12/2/2011	-0.98	1.84	21.91	1.71
Russell 2000 TR	12/2/2011	-5.11	-0.88	20.15	0.15
S&P 500	12/2/2011	0.87	3.98	16.13	-0.16
S&P MidCap 400	12/2/2011	-1.65	1.36	24.31	3.23
Bond Indexes					
Core Bond	12/1/2011	6.62	6.1	6.68	6.33
Intermediate Core Bond	12/1/2011	6.13	5.59	6.43	6.52
Long-Term Core Bond	12/1/2011	13.85	12.78	11.26	8.35
Short-Term Core Bond	12/1/2011	2.05	1.93	3.65	4.3

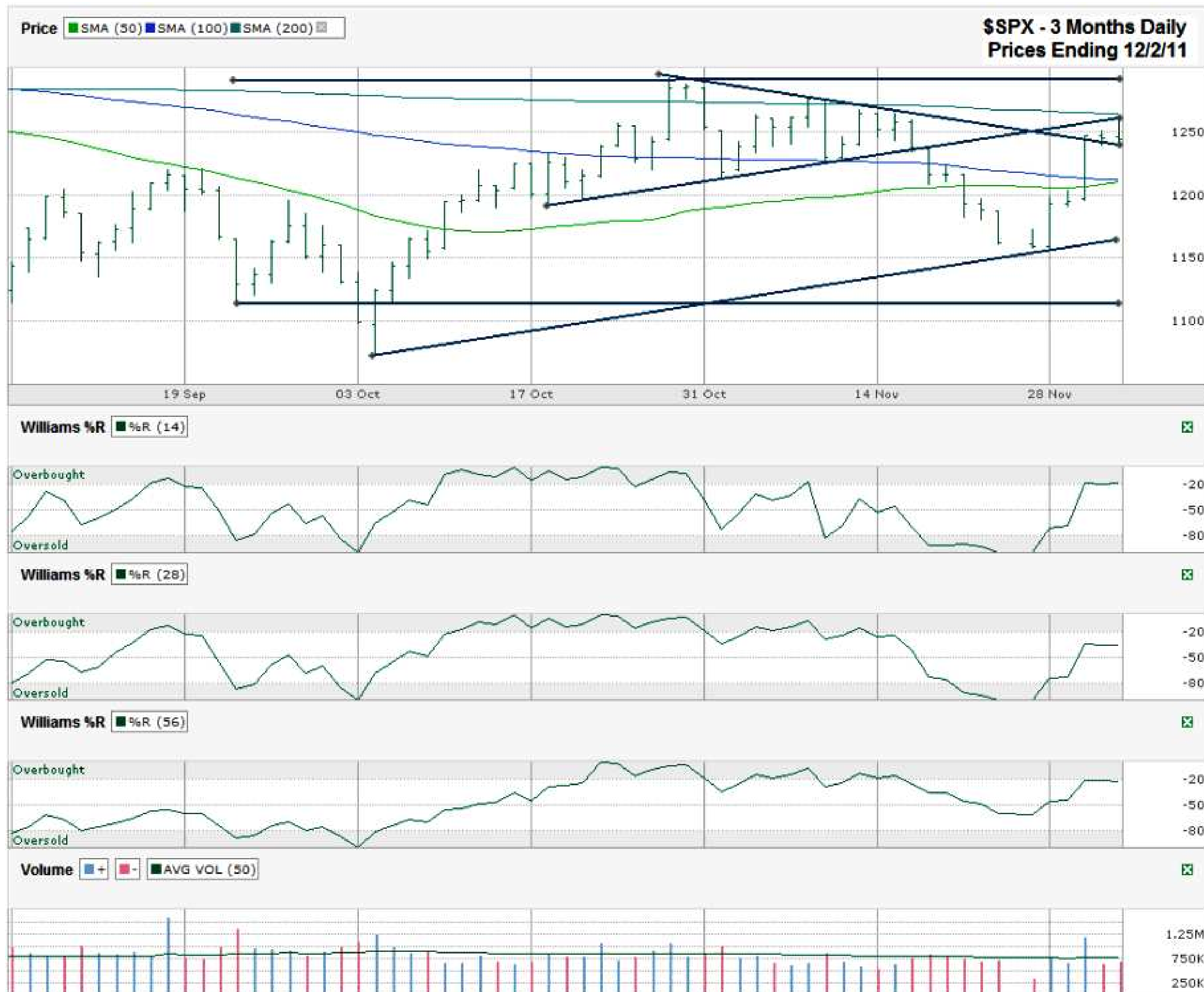
Market Movers

- Papandreau and Berlosconi were replaced as the leaders of Greece and Italy respectfully. The new leaders are Lucas Papademos and Mario Monti. Each of these changes brought buyers to the markets with hopes that new leadership would mean a better chance for dealing with the necessary changes throughout the European periphery.
- Record retail sales on Black Friday and the Thanksgiving weekend surprised traders and made buying stocks the next best item on many Christmas lists.
- China's central bank said it would lower banks' reserve-requirement ratio by 0.5 percentage point in an attempt to boost the economy. While this is a sign of a major world economy that is losing steam the markets liked seeing that China was on top of it and was attempting to slow the easing momentum.
- The Fed and other central banks are coordinating efforts to address pressures in global money markets. The markets pay attention when world bankers get together and decide they are going to do whatever is needed to keep liquidity flowing. Bears fear the central banks were forced to do this due to crumbling conditions in Europe that are beyond repair. Bulls believe delaying the issue outweighs the risk due to the expected result of easy money.
- Reports surfaced that the European Central Bank (ECB) would lend EUR 100-200 billion to the International Monetary Fund. This showed the markets that leaders are starting to understand the gravity of the situation and are acting to prevent a major bank or government failure.

Fundamentals & Indicators

- Retail sales for October rose by 0.5%, which is slightly better than the 0.4% increase that had been expected. Excluding autos, sales increased by 0.6%, which is much better than the 0.2% increase that was anticipated.
- The trade deficit contracted to $43.1 billion in September from $44.9 billion in August. Traders were looking for a $45.9 billion deficit for September.
- Producer prices for October declined by 0.3%, which is a little less than the 0.2% decline estimated earlier. Core prices were flat for the month, contrasting slightly with the 0.1% increase had been widely expected. The lack of price increases helps the Fed maintain "easy money" while trying to perk up the economy.
- The Empire State Manufacturing Survey improved to 0.6 from -8.5 and exceeded the expectation for a reading of -0.8.
- The October Consumer Price Index came in close to the consensus. Overall consumer prices slipped by 0.1%. Core prices grew by 0.1%. Year-over-year, overall CPI is up 3.5% and core CPI is up 2.1%.
- Industrial production rose by 0.7% in October, much better than the forecast for a 0.4% increase.
- Personal spending during October improved by 0.1%, which is short of the anticipated 0.3% increase.
- Personal income increased by 0.4%, which exceeds the outlook for a 0.3% increase.
- Durable goods orders for October continued to slide with a fall of 0.7%; however this is still better than the earlier calls for a 0.9% decline. Excluding transportation related items, durable goods orders moved higher by 0.7% while the Street was looking for no change.
- New home sales numbers showed that sales during October hit an annualized rate of 307,000. That is not as high as the forecast, but is still up some from the downwardly revised pace that was posted in September.
- The Consumer Confidence Index jumped to 56.0 in November from 39.8 October. Although not directly correlated to spending, a more confident consumer tends to buy more goods and services. Being above 50.0 is a bullish signal.
- The Chicago PMI advanced to 62.6 in November from 58.4 in October. The consensus call was for a decline to 57.5. This is another very bullish indicator and the Street took notice and rallied off the report.
- Pending home sales for October spiked up to 10.4%, which is much better than the nearly flat reading of 0.1% anticipated.
- Productivity and cost data for the third quarter showed less bullish data than earlier indicators. Productivity was revised downward to reflect an increase of 2.3%, while an increase of 2.6% was expected after the 3.1% increase posted in the preliminary reading. Labor costs were revised downward also and reflected a 2.5% decline, worse than the 2.1% decline that many were targeting.
- Domestic manufacturing activity improved more than forecasted during November which lifted the latest ISM Manufacturing Index to 52.7. This number indicates an economy that is picking up the pace on its expansion.
- Just when the bulls thought they would have room to run, China reported a decline in manufacturing activity during November and investors were reminded to remain cautious.
- Construction spending exceeded estimates and increased by 0.8% in October.
- Weekly initial jobless claims fell below the important 400,000 benchmark in the middle of November, but by the end of the month had crept back to even with the level many consider the dividing line between positive and negative.
- Unemployment rate dropped to 8.6%, a surprise for the market. Part of the improvement came from a large decline in the workforce participation which in turn skewed the number slightly.
- Nonfarm payrolls for November came in at 120,000, just below the earlier calls for 123,000. Nonfarm private payrolls increased by 140,000, in line with expectations.
- U-6 unemployment dropped from 16.2% to 15.6%. This is often viewed as the real unemployment number since it includes the number of part-time workers looking for full-time jobs and discouraged job seekers who have stopped looking for work. Overall the employment report favored the bulls.

Index Chart & Analysis



This S&P 500 ($SPX) chart shows the past three months of daily prices after the index finished the week at 1,244.28 on Friday, December 2, 2011.

The large cap index just finished its second best weekly point gain ever, but is facing resistance from its 200 day moving average (dma) now. Although the SPX has made it above the key moving average this fall, it hasn't closed above it for three consecutive days since July.

One bright spot comes from the bullish break of resistance from the trend line of lower highs. This past week's rally took the index above this trend line only to see it use the same line as support the next two days. The line that was once resistance could (as it often does) turn into support, albeit with a declining trend. At the same time the line that was ascending support for two months in the form of higher lows now appears to be acting as resistance. This sets up an expanding wedge where the days' highs and lows could get wider until a new trend is found.

Please see Index Chart & Analysis on page 5

Continued from Index Chart & Analysis from page 4

The 200 dma will have to break resistance before this upper line of resistance can come back into play for more than another day. To the downside, support could come from the 50 and 100 dma which just converged. The 50 and 100 dma are actually showing a bullish crossover. The index tends to be at the cusp of a multi-month trend when these two moving averages cross. For now, this trend favors the bulls which means this past week's 7+% gain might just be the beginning. The Williams %R indicator is also favoring the bulls. At the end of Thanksgiving week the indicator ran off the bottom of the chart for its 14 and 28 day periods. This is an extremely rare occurrence and showed an excessively oversold market. This aided the bulls when shorts were squeezed out of their positions and were forced to buy back their positions.

If history does not repeat itself and the bears have more fight left in them, the S&P 500 could fall back to its lower ascending trend line of higher lows that started with this year's low and touches the Thanksgiving week low. This trend line is the next major line after the moving averages that computer based algorithmic traders will be watching and a break below this could send the index back down closer to the 1,100 area. If history does repeat and this is the beginning of a new long term uptrend, the bulls will have to be patient before going all in until the October high of 1,292.66 is taken out. This is the magic line for the computer models and a close above this line should send in mass buy orders over the following days. That line is almost 4% above Friday's closing level and leaves a lot of room for day traders to toy with longer term investors before patient bulls are fully rewarded.

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