AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

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INSIDE THIS ISSUE

"One of the keys to being a successful investor is separating emotions from facts when choosing the right time to buy and sell."

Perspectives

The Dow Jones Industrial Average followed suit from the past six years and lost ground in June again making it seven years in a row that June was not a good month to be bullish. The fall during June ended up somewhat muted though as the final week experienced some healing as the reality of continued company profits started to overshadow the global worries that dominated the headlines, mainly from Greece.

One of the keys to being a successful investor is separating emotions from facts when choosing the right time to buy and sell. Emotions steered many investors out of stocks and into bonds for the first few weeks of June, but that pushed yields on bonds to minuscule levels and reduced the risk/reward ratio back in favor of stocks again. The same risk/reward ratio that made bonds look less attractive made stocks look more attractive when emotions were removed from the equation. With companies still producing strong earnings (the "E" in P/E ratios) many companies' stocks started to look like value buys with the price (the "P" in P/E ratios) dropping lower than they should be given the current economic conditions.

The fear of what the future economic conditions will turn into has hindered this P/E ratio's multiple to the point that many investors are not willing to take on much risk. Now that the risk has diminished somewhat for the near term future, the "risk on" trade appears to have returned for now. By keeping emotional decision making to a minimum, these anomalies become much clearer and investors can profit from the discrepancy.

The second round of the Fed's quantitative easing (QE2) ended on the last day of June and leaves us all guessing how their lack of buying will affect the markets. With such a telegraphed end to the plan much of the change should be baked into current equity and bond prices. Essentially, this moves us back to a more realistic free market with reduced artificial influences. One of the question marks that remains from the end of QE2 is how the dollar will react. The US dollar should get stronger with less of an overt monetary weakening, but with the Greek debt issue at bay for the near term the picture isn't as clear. The dollar could continue to weaken as the euro stabilizes and the Fed keeps US interest rates at historically low levels. The direction of the dollar will have a large impact on the direction of the stock and bond markets.

Overall, data (excluding jobs) started to improve during June. This improving data coupled with the drop in oil prices have set the stage for a much stronger finish to the year for the markets. Another major cause of fear was removed temporarily with Greece taking steps forward in delaying a default on their debt. An inevitable default is still expected, but the delay gives European banks more time to prepare for the day and build their assets in the meantime to help cushion the blow.

The day after a positive ADP Employment report on Thursday that had the market in rally mode, the nonfarm payroll report for June increased by only 18,000 which is a small fraction of what was expected. Not only did the June number disappoint, the May number was revised lower and shifted the unemployment rate up to 9.2%. This disappointing news erased the gains from the prior day, but didn't do much more which could be seen as a silver lining.

While many economic indicators started to improve through June the disappointment in the payrolls data will help keep the markets in check for the foreseeable future. The next catalyst that could change this outlook will be companies'

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earnings reports which start in earnest this week.

Just as was expected last month, the most profitable approach to this market remains to sell options. Selling options allows investors to profit from the ceiling on stocks through covered calls while also profiting from the apparent floor by selling naked puts. As long as the majority of stocks trade in the range that has had us bookmarked for months this strategy will continue to provide profits and steady cash flow.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
Domestic Stock Indexes					
DJ Industrial Average	7/8/11	10.79	28.14	6.67	5.48
NASDAQ Composite	7/8/11	7.8	31.46	7.62	6.07
Russell 2000	7/8/11	9.45	39.11	9.22	5.16
S&P 500	7/8/11	7.95	28.07	4.11	3.38
S&P MidCap 400	7/8/11	11.52	39.09	9.72	7.4
Core Bond	7/8/11	2.67	3.7	6.58	6.74
Intermediate Core Bond	7/8/11	3.04	4.04	7.18	7.09
Long-Term Core Bond	7/8/11	3.46	4.58	8.48	8.13
Short-Term Core Bond	7/8/11	1.42	2.35	3.89	4.91

Market Movers

- The US dollar came off its lows from early June which hurt the markets, but later weakness in the dollar opened the door for a return to better gains for bulls.
- The urge to sell subsided as bulls found there was still a light at the end of the tunnel after the Greece prime minister received a vote of confidence and other members of parliament resigned.
- A few days later, Greece voted to pass its latest austerity plan the markets took this as the spark the bulls have been waiting for and stocks saw the best one week rally in nearly two years. Oil's slide ended along with stocks moving higher and energy plays recovered quickly.
- Most of the month hinged on the uncertainty in Greece and once the short term outlook improved the path of least resistance was higher
- Fed Chairman Bernanke announced during his press conference that the Fed now believes 2011 GDP will range from 2.7% to 2.9%, down from the range of 3.1% to 3.3% that was announced in April.
- Mr. Bernanke also stated unemployment for 2011 is now expected to range from 8.6% to 8.9%, up from the previous range of 8.4% to 8.7%. Core PCE inflation for 2011 is now expected to range from 1.5% to 1.8%, up from the range of 1.3% of 1.6% that had been forecasted earlier.
- The International Energy Agency said it would release 60 million barrels of oil from the Strategic Oil Reserve (half from the US' reserves). This is worth about three days of the average US oil imports and was enough to help drive oil prices down substantially for more than a week.

Fundamentals & Indicators

- On June 8, 2011, the Fed released its latest Beige Book. As expected economic activity continued to expand for the most part since the last report, although a few Districts showed some deceleration. Manufacturing activity continued to expand in most parts of the country.
- U.S. exports increased by 1.3% in April after rising by 4.9% in the prior month and the U.S. trade deficit for April came in lighter than expected. The latest deficit is also less than the downwardly revised March deficit of $46.8 billion. A possible cause for this improvement could be from a decrease in exports from Japan, post Tsunami. This was one of the first indicators during June that the fundamentals might not be ready to crumble yet.
- Japan reported a pick up in industrial production during April. The country's central bank decided to keep lending rates cheap and kept its target interest rate at extremely low levels.
- China's central bank continued to raise the reserve requirement ratio in an attempt to slow inflation which still seems to be moving ahead in spite of the central bank's efforts so far.
- Retail sales fell by 0.2% during May, but that was better than the 0.7% slide that had been expected. Retail sales for April were revised lower to reflect a 0.3% increase. Excluding autos, retail sales actually increased by 0.3% in May. Sales less autos had been broadly expected to increase by 0.2% after a 0.5% increase in the prior month. After such lowered expectations, this positive news started to turn heads and made many start to second guess their plans to sell.
- Producer prices increased by only 0.2% during May, but an even softer 0.1% increase had been expected. Core producer prices also increased by 0.2%, which was right on target for expectations.
- The Empire Manufacturing Survey reading of -7.8 for June kept expectations for a quick recovery in check. The consensus had called for a reading closer to the previous month's reading of 11.9.
- Consumer price inflation data for May increased by 0.2%, slightly better than the 0.1% increase that had been anticipated. Core CPI increased by 0.3%, after a 0.1% increase was expected. Inflation has to stay in check for the Fed to keep easy money flowing.
- Weekly initial jobless claims stayed above the key 400,000 level during June and did not seem to be tipping in either direction as they remained relatively flat throughout the month.
- Housing starts for May hit an annualized rate of 560,000, which is better than the rate of 540,000 units expected by the Street. Building permits improved to an annualized rate of 612,000 in May from 563,000 in the April reading. They had actually been forecasted to fall to a rate of 548,000. Once again bulls got another glimmer of hope that the economy still has some fight and recovery in it.
- Existing home sales for May hit an annualized rate of 4.81 million units, which is close to what had been expected. Although, the rate for May was slightly slower than the rate for April.
- New home sales for May dropped by nearly 2% from the prior month to an annualized rate of 319,000 units, but was still better than the pace of 305,000 units that had been anticipated
- First quarter GDP was revised upward to reflect growth of 1.9%, better than the expected growth of 1.8%.
- Durable goods orders for May jumped 1.9%, also greater than the 1.5% increase that had been widely anticipated. The greater-than-expected increase in orders came despite a marked upward revision to April's orders. Excluding transportation, durable goods orders increased by 0.6%, however that wasn't quite as strong as the 0.7% increase that had been broadly expected. Orders less transportation for the prior month were revised upward to reflect a modest decline of 0.4%.
- Personal income for May increased by 0.3%, slightly less than the 0.4% increase that had been expected. Personal spending during May was flat which was disappointing after a slight increase was expected. On a positive note, core personal consumption expenditures for May increased by 0.3%, which is greater than the anticipated 0.2% increase.
- Home prices rose 0.7% in April according to the S&P/Case-Shiller Index. This is the first increase in eight months, but is partly due to the buying season starting.
- Pending home sales rose 8.2% in May month over month and 13.4% from May 2010. This marks the first time in 13 months that the activity was above levels from 12 months earlier.
- Chicago PMI for June rose over the May report. This is a big hint that the soft patch is easing and maybe it was transitory, just as the Fed Chief, Ben Bernanke, said it was.

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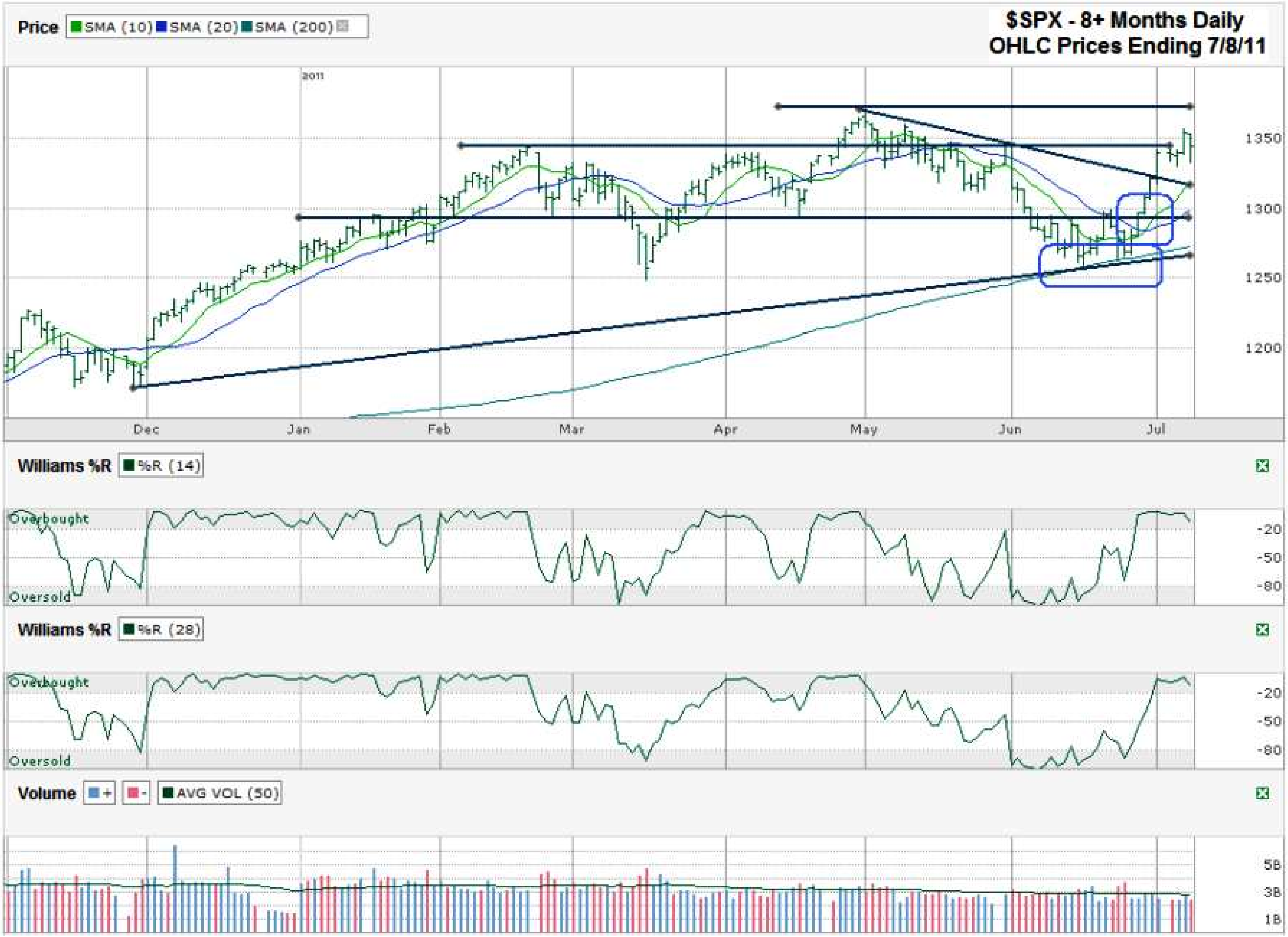
Index Chart & Analysis



This chart shows a little more than the past eight months of the S&P 500's ($SPX) daily prices after it finished the week at 1,343.80 on Friday, July 8, 2011. After ripping higher from the floor set by the rising 200 day moving average (dma), the SPX looked like it was going to be on a run to new highs without taking much of a break - and then the jobs data had to rain on that parade. While the crack in the lagging indicator gave investors a scare, from a technical view Friday wasn't such a bad day. Fear took the large cap index down nearly 20 points in the morning and then the dust started to settle. Before the end of the day the losses were halved, finishing at the highs of the day. Such a quick recovery after surprisingly bad data bodes well for the bulls.

This failure to collapse might not be such a surprise for technical analysts. First, the 200 dma held support and then the SPX crossed 1,300 yet again with barely a pause. Subsequently the SPX had the very bullish 10 dma crossover above the 20 dma. If that wasn't enough, the short two month trend line of lower highs that defined this mini-correction's top broke resistance after only one day of holding the market back. The rally was due for a breather by the time this past week rolled around, especially with the July 4th holiday thrown in at the beginning. Volume was low and the market was left to drift sideways.

Based on all of that it's easy to expect the rally to pick up where it left off before the holiday shortened week, but there's a caveat. With such a quick rally at the end of June the SPX has moved back near the top of its trading channel, just under 27 points from its multi-year intraday high. This intraday high of 1,320.58 hit on May 2nd is the next key line to watch for major resistance. A move above 1,321, with a couple of confirmation days following the break, could spell much more upside potential that could last through the end of the year. Downside support still appears to be moving higher along with the 200 dma and the new trend line of higher lows that started in November 2010 and was touched

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last month. Putting all of that together shows more downside risk than upside potential in the very near term, but once resistance breaks at 1,321 we could be off to the races again.

Investors should keep an eye on the Williams $R indicator to get an early warning of a bigger collapse. It broke higher in mid-June as yet another indicator screaming to buy at the right time. It's going to be one of the first technical indicators that lets us know when to head for the exits again. Just because it is in the "oversold" range already doesn't mean the time to sell is here. Wait for %R to fall below the -20 range on both the 14 and 28 day periods to have a clearer signal. This will be after the first few points are lost, but will keep investors from jumping ship too early just because the seas are getting rocky again.

With this bull market around 28 months of age it might be too early to think the fun could be over already. The average bull market is over 38 months. Another 10 months of higher stock prices could move the SPX back to being well above its 200 dma and then it might be a better time to be longer term bearish. For now, the rest of the year doesn't look like we're headed for a major sell off. Keep an eye on the technical indicators for any change to that view.

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- ISM Manufacturing Index improved in May to 55.3. A reading above 50 shows expansion. This better than expected reading helps the case that the Japan effect was short lived.
- ISM Non-Manufacturing Survey for June came in at 53.3, just below expectations and also below May's report.
- May factory orders rose 0.8% from a 0.9% decline in May. Although a positive reversal, it was still less than the 1.0% increase many expected.
- The ADP Employment Report private payrolls increased by 157,000 in June. This is much better than was expected and caused a one day spike in the markets.
- Nonfarm payrolls increased by only 18,000 for June. This was a severe disappointment after expectations had the number pegged closer to 80,000. Economists mistakenly notched expectations higher due to the ADP report coming out better than expected the day before. This caused the markets to wipe away the gains from the prior day immediately.
- The underemployment rate (includes discouraged workers and part-time workers who are looking for full-time jobs) rose to 16.2% from 15.8%. This is one of the least talked about data points that is showing growing weakness again in this case.

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