AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

June 5, 2011
Volume 1 Issue 1

INSIDE THIS ISSUE

1 Perspectives
2 Summary of Indexes
3 Market Movers
4 Fundamentals & Indicators
5 Index Chart & Analysis

"We're still seeing growth in most of the indicators, but the slowing pace has already given the bears an excuse to come out of their caves."

Perspectives

June has seen the Dow Jones Industrial Average lose ground in each of the past six years. This year could be different after being down for four straight weeks through May (and the first week of June), but based on the weakening pace of most economic indicators, it gets hard find a reason to push the markets higher in the near term. Either way, don't expect the move to be too big in either direction through the summer. On one hand the limited decline in May after such a long period without a healthy mini-correction leaves a lot of slack in the market that still needs to be sold off. On the other hand, until a bigger catalyst hits us it will be tough for the bears to take charge long enough to take the markets too deep.

We're still seeing growth in most of the indicators, but the slowing pace has already given the bears an excuse to come out of their caves. This also has given the bulls an excuse to take some profits. I expect the buying to pick up after we get a small sell off. The downside still seems limited based on the average valuation for S&P 500 stocks. Even at a slowed pace, growth is still the direction we need for higher stock prices. From the earthquake and tsunami in Japan, to the tornadoes and flooding here in the US, natural disasters have played their role in slowing demand for products and thus growth for our economy. Once Mother Nature's influences begin to subside demand should resume and the world's economies will return to recovery mode.

One of the biggest threats to the US stock market right now is strength of the US dollar. (Employment and housing are both still big threats too, but that's a topic for another another day.) The euro is in serious risk of devaluing faster than the dollar due to all of the European Union's issues related the PIIGS (with Greece acting as the first wobbling domino before Portugal, Italy, Ireland and Spain). This exit from the euro to the dollar will drive oil prices lower which will feel like a tax break for those of us who drive cars and purchase goods that are driven to market, but it will hurt multinational companies and exporters. The US markets and the dollar have had an inverse relationship and if that trend continues the markets could sell off quickly, but briefly. Before this correction goes too deep the valuation mentioned above should halt the bears' attack to some extent. As oil prices fall and gas prices follow suit consumers will have more purchasing power and companies will benefit. Companies will become too cheap to resist and profits should start to rise again as production costs decrease with lower commodity prices and stronger demand from consumers.

The stalemate in between this shift is where it will be interesting to be an investor. I'm still longer term bullish, but have shifted from a dig-my-heals-in-bull to being on my toes, ready to sell if needed over the summer. Buy and Hold as an investment strategy continues to look like a poor choice for the remainder of the year, just as it has for the past decade. In the near term, selling options seems to be the best way to capture some of the upside while reducing downside risk at the same time. If the market continues to move slightly higher most months this strategy will match or outperform buy and hold while holding less downside risk. This options strategy will easily outperform if the market moves sideways-to-lower, as long as the account is not run heavily on margin.

Bond prices have rallied for nearly two months. This has pushed the yield much lower, but not yet to the lowest yields of the past few years. Demand for bonds has a strong chance to decrease with the end of the second round of the Federal Reserve's quantitative easing (QE2) due at the end of June. Look to a turn lower in bond prices (and increase

Please see *Perspectives* on page 2

Perspectives from page 1

in yield) for an early indication of an upcoming market recovery. This will happen when bond prices get low enough that the advantage to allocating money to them will be so diminished that stocks will become the wiser investment. That's when the newest leg of this bull market begins.

Coupling seasonality with the poor economic indicators we've seen lately, this five week downturn is a longer term bullish indicator. The fact that the markets haven't rolled over completely is encouraging. The markets have enough fear and pessimism baked in that a lot of those who plan to sell have already done so.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
Domestic Stock Indexes					
DJ Industrial Average	6/3/2011	6.1	21.62	2.27	4.33
NASDAQ Composite	6/3/2011	3	18.66	3.28	4.25
Russell 2000	6/3/2011	3.6	22.54	4.49	3.23
S&P 500	6/3/2011	4.2	20.25	0.32	2.33
S&P MidCap 400	6/3/2011	6.5	26.94	4.85	5.8
Broad Market Bond Indexes					
Core Bond	6/2/2011	3	5.85	6.6	6.72
Intermediate Core Bond	6/2/2011	3.3	5.94	7.03	7.04
Long-Term Core Bond	6/2/2011	4.3	9.24	8.92	8.18
Short-Term Core Bond	6/2/2011	1.4	3.16	3.97	4.89

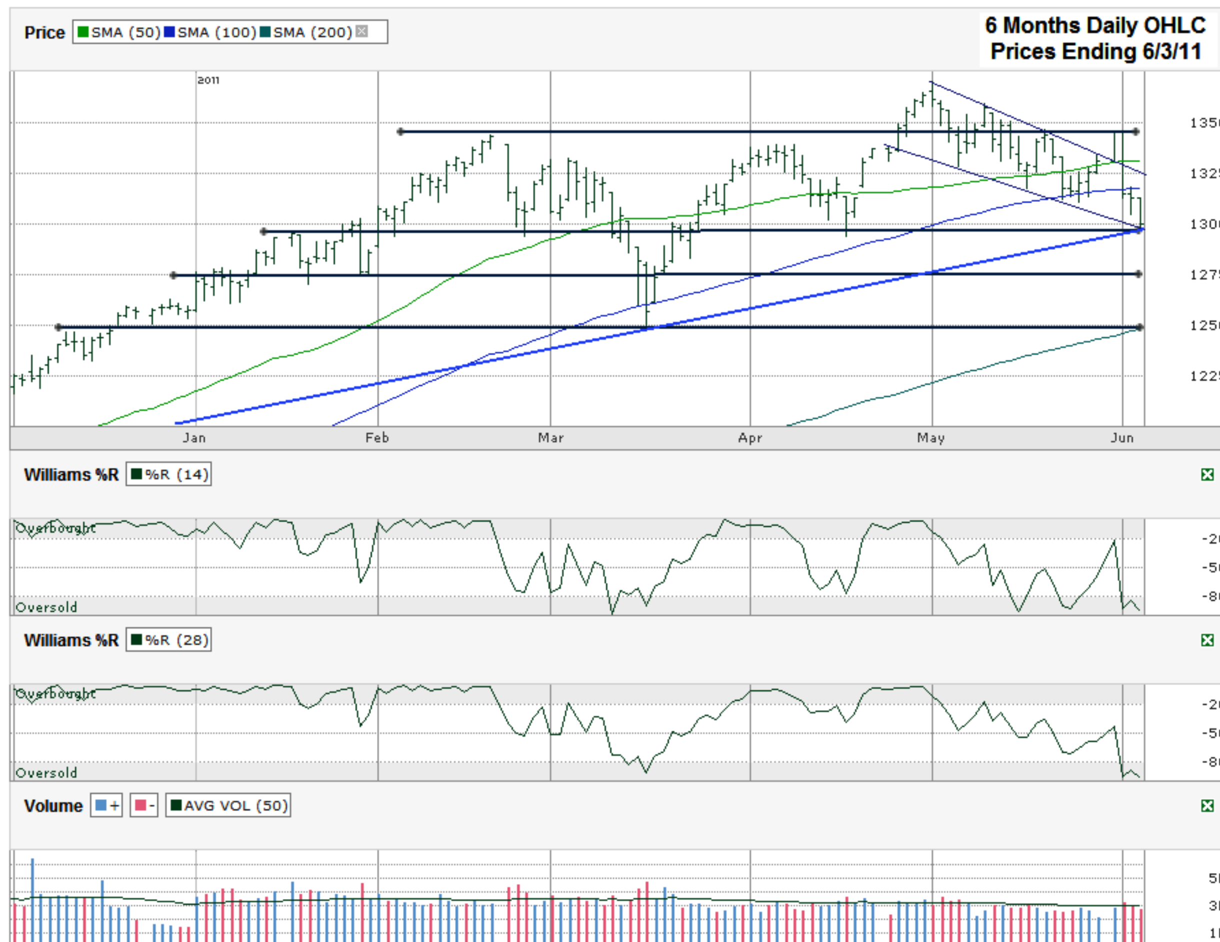
Market Movers

- The mood on the market shifted to pessimism from the first trading day of May. Part of this was due to such a fantastic start to the year in the first third that possibly got overbought. The "sell in May and go away" mantra made others quick to sell. The fundamentals listed in the next section didn't help the bulls' case to buy either.
- Continued concerns over Greece's debt caused more uncertainty in the markets which tends to decrease the amount of risk investors are willing to take. This also put more pressure on the euro and helped strengthen the dollar until the end of May. Barron's ran a cover story on May 30th that covered Greece's debt issues. The question of Greece's default isn't if, but when. Any restructuring and principle reduction should weaken the euro and strengthen the dollar.
- Due to a lack of other major news in the first half of May, most of the market's movement came from its inverse relationship with the US dollar. As the dollar strengthened the markets fell, especially commodities and commodity related stocks. Towards the end of May our evident slowing growth helped push the markets lower.
- The debt of the U.S. and European governments continues to increase worries about the long term outlook, especially amount the PIIGS (Portugal, Italy, Ireland, Greece and Spain).
- US bonds rallied in May. This came in the face of "fear talk" of the rising US debt ceiling and the upcoming end to QE2 (the Federal Reserves' second round of quantitative easing) at the end of June.
- The VIX volatility index, often described as the fear index, is hovering near three year lows. This complacency has kept any sudden large drops or rallies in the market from materializing, but may also be setting the stage for a bigger drop whenever the mood changes. It's rare to see a large rally when the VIX is already so low. A melt higher is more often the case.
- For now, the dominating belief on Wall Street is that the S&P 500 will finish the year higher than it is right now and that continues to force money managers to buy any dip before it turns into a real correction.
- Just as the month of May started with an attitude of "risk-off" it ended with the mood swinging back to "risk-on" as investors decided the risk was worth the potential reward in stocks again. As June started we saw a lot of second guessing that decision due to poor employment numbers and risk was removed once again. The quick about face in both directions shows the bulls are chomping at the bit to get back in the game.

Fundamentals & Indicators

- Housing starts for April came in at an annualized rate of 523,000, which is less than the rate of 563,000 units that had been expected. The good news was that housing starts for the prior month were revised upward to reflect an annualized rate of 585,000 units. While the March revision higher is good news, the drop shows a move in the wrong direction and created a drag on the markets.
- Building permits came in at an annualized rate of 551,000, which is less than the rate of 590,000 permits that had been expected. The prior month's data were revised lower to reflect an annualized rate of 574,000 permits. This added to the negative view of what's to come.
- Existing home sales for April fell slightly from March to an annualized rate of 5.05 million. This is slower than the rate of 5.23 million that had been expected.
- April new home sales improved to an annualized rate of 323,000 units from a pace of 301,000 units in the prior month. This slight uptick over the expected rate was one of the few bright points in April's data.
- Pending home sales for April fell 11.6% from the March. This was a much bigger decline than most economists expected. Expectations for a strong housing recovery were already muted and this just puts more sand on the fire and brings back calls for a double dip in housing.
- The Philadelphia Fed Index, which measures changes in business growth, fell to 3.9 for May from 18.5 in April. Although we're still seeing factory-sector growth it was slower in May than expected.
- April durable goods orders dropped 3.6% and orders less transportation fell 1.5%. The worse than expected results did not cause a sell off since the declines were blamed on a spike in orders during March. The slowing pace doesn't draw the most bullish picture though.
- First quarter GDP confirmed the earlier reported annualized rate of 1.8%. Many economists expected that GDP would be upwardly revised to reflect growth of 2.0%. Some were estimating a rate above 2.2%. Estimates for second quarter have been revised lower, but third and forth quarters are both expected to be much stronger still.
- Weekly initial jobless claims bounced around during May while continuing claims came down slightly as the jobs recovery continues to inch forward. Claims stayed above 400,000 for eight straight weeks though which continues to show weakness still. A sustained move below 400,000 would help get the markets moving higher again.
- Chicago PMI (Purchasing Managers Index) came in at 56.6, lower than the 67.6 from April and lower than the expected 62.5 for May. May marked the 20th consecutive month of growth, albeit now it is indicating an expantion of economic activity at a decelating rate. A reading above 50 still shows growth, but the slowing pace is consistent with the other data listed above.
- The S&P/Case-Shiller Home Price Indices reported home prices from the first quarter are below the bottom from the first quarter of 2009. This is such a late lagging indicator that it didn't even move the markets lower on the day it was announced, but it's still worth watching for the sake of where it could leave banks if the decline continues.
- The ISM Manufacturing Index for May came in at 53.5. This was less than had been expected, just as most of the other data for April and May has been.
- Construction spending during April increased by 0.4%. This one was a shocker as it came out on Wednesday, June 01, 2011, after the bad run of other data. Expectations were for a decrease of 0.5%.
- Nonfarm payrolls for May increased by 54,000 which is less than a third of what had been expected. The private payrolls portion of the total count increased by 83,000. This is also less than expected. However the government sector portion decreased which could be considered a positive sign we are on our path to reduce government spending which will in turn help our debt issues. Surprisingly, this low data point caused a kneejerk selling reaction at first. After such disappointing data throughout the month, a lower payroll number should've been expected. As the day dragged on, the markets recovered as that idea gained credence and then trailed off again as traders decided to cut exposure before the weekend.
- The headline unemployment rate came in at 9.1%, which is greater than anticipated. Part of this increase in the unemployment rate comes from a higher number of people looking for work. In other words, people who were sitting on the sidelines are trying to re-enter the workforce and although more jobs are being added the total percentage of unemployed appears to have increased. The good news is that more people are working now than any time in the past couple of years.
- The ISM Non-Manufacturing Index for May came in at 54.6, which is up from 52.8 in April and better expected. This piece of data helped to turn the markets up from their lows on Friday, June 03, 2011, after they were sent reeling from the nonfarm payrolls data.

Index Chart & Analysis



I charted the S&P 500 index ($SPX) after it finished the week at 1,300.16 on Friday, June 3, 2011, just above the key psychological round 1,300 mark. This week marks the end of the first five week losing streak since July 2008 for the index. Back then it fell almost 9% in the same span. This time we're only down less than 5%. The decline feels like it's been worse than it has because our current bull market has had so few mini-corrections. Even another five percent lower is still healthy and by that point expect support to surface and that's if we even get any lower than Friday's lows.

As opposed to a couple of weeks ago when the moving averages gave us insight into where the markets were heading, this week it seems to be more about the trend lines. This chart has four horizontal lines that mark various levels of the broad trading channels we've seen for the past six months and three other ascending and descending trend lines. The SPX finished the week at the bottom of its main trading channel of the past four months. This puts it at a major area of potential support for the near term. If the index behaves like it has for most of this year it should start attracting buyers again very soon and could move back up another 3-4% until it nears the uppers side of this major trading channel. Upside beyond the 1,350 area still looks iffy for now.

Expect another 20-25 points to the downside if line just below 1,300 doesn't hold. This could only be a speed bump all the way down to 1,250 though. Expect strong support to surface quickly from there. This same area held support earlier and that alone can be enough of a reason to see the selling stop, but also we find the 200 day moving average (dma) moving up to the 1,250 line. The 200 dma often is the line to really watch for longer trends. Staying above it means the bull market should continue. This area is also around a 9% correction from the intraday high reached at the

Index Chart & Analysis from page 4

end of April. Those three points together should be enough to keep this market going after a healthy shake-out. Any upside move from Friday's close is going to have to climb past the 50 and 100 dma. Each could act as a hurdle on the move back towards 1,350 just as they both briefly stalled the descent toward 1,300.

The blue line marks the trend line of higher lows that started in September 2010 and hasn't been broken yet. On Friday we saw support surface there which just happens to be along the same line as the bottom of the trading channel mentioned above and the shorter trend line of lower lows. These three lines converged to hold support and next week we'll see which line wins, the longer running blue line or the shorter thin line of lower lows. Chances are greater for the longer term line to have greater staying power, but it could be short lived as the short thin trend line of lower highs comes back into play. This one month descending trading channel is only good for short term speculation in my view. It's too steep to last another full month.

Keep an eye on the Williams %R indicator to get an early indication of when any positive day can turn into a new rally. We saw both the 14 and 28 day indicators fall below the overbought area at the beginning of May signaling a time to take profits. Now that the S&P 500 is down in the oversold area of this indicator we have to wait for it to move above the shaded area and preferably have two to three confirmation days before we jump back in too strongly. Ideally we'll see a pick-up in volume from the past two plus months of below average volume when the move to the upside begins. Strong volume on a surge higher could mean a much longer next step up in the rally is here. The same to the downside could happen too, but after a month of bad data that hasn't happened yet.

From Friday's close the S&P 500 appears to be situated with about 4% more downside potential and 4% more upside potential. With such an even risk/reward it seems wise to use more of a wait and see approach for the next few days and see which side gains momentum. If we do see another 3-4% move to the downside the risk/reward will shift strongly in favor of adding risk again and allocating *some* reserves back into stocks.

AF Capital Management, LLC
6935 Hunters Knoll NE
Sandy Springs, GA 30328

404-395-2752
alex@afcapitalmanagement.com

Twitter: @AlexRFoster
Facebook: AF Capital Management

If you are not on our distribution list yet, you can Join our Newsletter for free at any time.

DISCLAIMER: AF CAPITAL MANAGEMENT, LLC IS A REGISTERED INVESTMENT ADVISER. NO MATERIAL HEREIN CONSTITUTES INVESTMENT ADVICE NOR IS IT ANY OFFER OR RECOMMENDATION TO BUY OR SELL ANY SECURITY. THE PURPOSE IS LIMITED TO THE DISSEMINATION OF GENERAL INFORMATION REGARDING THE ECONOMY AND MAJOR INDEXES. NO PART OF THIS NEWSLETTER SHOULD BE CONSTRUED AS PERSONAL FINANCIAL ADVICE.

OTHER ARTICLES, LINKS, AND INFORMATION PRESENTED WITHIN THIS NEWSLETTER ARE OBTAINED FROM SOURCES BELIEVED TO BE RELIABLE, BUT THEY ARE FOR INFORMATIONAL PURPOSES ONLY AND AF CAPITAL MANAGEMENT DOES NOT GUARANTEE THEIR TIMELINESS OR ACCURACY. CLIENTS SHOULD CONSULT THEIR ADVISOR WITH REGARD TO ANY QUESTIONS THEY MAY HAVE. NOTHING WITHIN THIS NEWSLETTER SHOULD IMPLY THAT PAST RESULTS ARE AN INDICATION OF FUTURE PERFORMANCE.