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Perspectives

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"Exiting the market this late into the correction creates upside risk."

Historically, the fourth quarter is the best time of the year to own stocks. This year stocks are coming off the worst quarter since the end of 2008 which might have created an oversold condition ripe for a "Santa Claus rally". History does not always repeat itself in the same pattern, but it does give a bright spot to look towards for investors who have braved the recent dips in the markets and even added to their positions. As much as the talking heads continue to try to talk the economy into a recession, the data does not show this scenario is guaranteed or even likely.

These are the times that test investors' time horizons. Investors who are truly dedicated to a long stay with stocks can handle *relatively* small (<20%) declines in the stock market without losing sleep. The fear of recession caused many investors to abandon their long term plans at the worst possible time. If the US economy is bound for a recession, much of the downside in stocks is already priced in. A recession typically pushes stocks into a bear market that declines less than 30%. On Tuesday, October 4, the S&P 500 passed the 20% decline mark intraday. If average previous declines act as an accurate predictor of future returns then the markets should have no less than 10% more left in downside risk. Exiting the market this late into the correction creates upside risk. Upside risk is the cost of not being invested during a recovery rally. For some investors, removing the stress of downside risk is worth the cost of upside risk. For prudent long term investors this should be a time to buy, but with caution and the understanding that the market may fall further before recovering to new highs.

The risks of how much damage Greece's pending default will do to the US economy are unknown. The direct risk is expected to be low, but the potential for spillover into neighboring nations is the biggest cause for worry. Italy and Spain's debt was downgraded at the end of the week and the cracks in the European Union are getting bigger. Nearly two weeks ago stocks started to rally when CNBC reported that euro-zone officials are planning for a European investment bank already in existence to use special purpose vehicles to issue bonds that would help finance the purchase of debt. The European Financial Stability Facility (EFSF) would also be used to shore up bank capital. If European banks can actually be stabilized then much of the near term market stress will be relieved and stocks will have a much greater chance of maintaining a rally beyond three days.

The European Union (EU) is starting to come to grips with reality and appears to be much closer to enacting change that could be meaningful. If the EU can institute a broad based stimulus package, possibly similar to the US TARP program, the markets will respond with a major upside push. Rumors have been building that something could be in the works, but until it becomes reality the markets are likely to chop along up and down with every hint traders hear.

Corporate earnings announcements start this coming week and could be the catalyst the market needs outside of Europe to get it moving in a positive direction again. Not many companies have pre-announced downside

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revisions to their original estimates. Investors have feared these revisions for the past two months and sold in anticipation of bad news. Stocks have a lot of negativity built into their prices and the S&P 500's average trailing Price/Earnings ratio is down to 12.54. If companies' earnings do not fall or only slip slightly then the upside could be huge. Returning to a P/E ratio that is closer to historical norms near 15 might be asking a lot of investors until Europe is on more solid footing and the US employment outlook improves, but a return to a 13.5 or 14 multiple is possible in the near term. Such a reversion to the norm would take the S&P 500 up to 1,250-1,300. That said, if the US slips into a recession the P/E ratio could slip to 11 or lower and with reduced earnings the S&P 500 could fall to 920-950. This is why each rumor matters so much lately. If any single data point can tip the scales towards or away from recession the difference could be as much as 400 S&P points between the downside and upside targets. With so much uncertainty it is easy to see why many investors and traders have turned to technical analysis to try to get one step ahead of major market moves.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
Domestic Stock Indexes					
DJ Industrial Average	10/7/2011	-2.13	4.11	8.67	1.43
NASDAQ Composite	10/7/2011	-6.54	4.01	12.21	1.51
Russell 2000	10/7/2011	-15.44	-2.88	7	-1.03
S&P 500	10/7/2011	-6.66	1.81	7.46	-0.96
S&P MidCap 400	10/7/2011	-11.01	0.57	11.87	2.3
Bond Indexes					
Core Bond	10/6/2011	6.35	4.4	7.3	6.74
Intermediate Core Bond	10/6/2011	5.55	4.43	7.02	6.86
Long-Term Core Bond	10/6/2011	14.39	8.28	12.57	9.21
Short-Term Core Bond	10/6/2011	1.76	1.31	3.85	4.52

Market Movers

The market's intraday gyrations have reached epic levels with moves as much as 4% in as little as 40 minutes. In most cases, these larger than normal swings have come off of rumors. In all cases fear exacerbated each move. Sometimes the fear was based on downside risk caused recessionary concerns, other times the fears were based on upside risk and caused by short covering rallies based on stimulus hopes.

The announcement by German and French leaders to keep Greece in EU propped the market up briefly. News that the European Central Bank (ECB) collaborated with other central banks (including the Fed) to offer European banks loans denominated in dollars sent the markets higher also. Every whispered hint that Greece would default sooner than later pushed stocks lower. Fundamentals played a minor role in moving the market and that's what is dangerous right now.

Mid-day on Friday, October 7, Fitch Ratings downgraded Spain and Italy's debt which helped strengthen the dollar and added to the market's selling pressure after employment data failed to produce a sustainable rally.

Fundamentals & Indicators

- The ISM Non-Manufacturing index for August rose to 53.3 from 52.7 in July and better than the expected reading of 51.0.
- Retail sales were close to flat in August. Excluding autos, they increased by 0.1% which was less than projected.
- The Producer Price Index (PPI) was also flat in August as expected. Core producer prices increased by 0.1%.
- Consumer prices increased by 0.4% in August. This is more than the 0.2% expected increase. However, core consumer prices increased by 0.2% as expected.
- The Empire State Manufacturing Survey for September fell another 1.1 points from August to -8.8. Expectations were for a -4.0 reading.
- Industrial production rose 0.2% in August as a rare bright spot for fundamentals early in the month.
- Housing starts fell to an annualized rate of 571,000 units in August, down from 601,000 in July. This was lower than anticipated. However, building permit numbers improved to 620,000 in August, up from 601,000 in July. This was better than anticipated.
- Existing home sales rose 7.7% in August to an annualized rate of 5.03 million units sold, up from 4.67 million in July. That is better than the 4.7 million rate economists predicted.
- New home sales fell to 295,000 in August from 302,000 in July. This was close to in line with expectations. As residential construction remains in a downward trend, inventories dropped to 173,000 in August from 295,000 in April. Although not at a bottom yet, the drop in inventories shows a potential nearing to a turning point in housing. At the same time the median new home price fell 7.7% in August as builders dropped prices to move properties and buyers gravitated to deals found in distressed properties.
- Total durable goods orders and orders less transportation fell 0.1% in August. This came on the heels of July's 4.1% increase in overall orders and 0.7% gain in orders excluding transportation. The moving average remains positive, but not stable.
- The third and final reading on second quarter GDP showed growth of 1.3% which is better than the 1.0% rate show in the earlier reading and better than the 1.2% growth rate economists had expected.
- Personal income for August slipped by 0.1%, but personal spending increased by 0.2%. The unexpected slip in income comes after it had increased by 0.3% in July.
- Chicago PMI rose to 60.4 from 56.5 in July. This is better than the expected reading of 54.0.
- The ISM Manufacturing Index for September showed a surprise improvement to 51.6 from the 50.6 reading in August. Although the reading doesn't show robust growth, it does show growth and the fact that it was better than predicted helped to allay recession fears for the day.
- ISM Services Index (aka non-manufacturing) for September came in at 53.0 which is slightly better than the expected reading and continues to show growth, albeit at a slow pace.
- Construction spending in August rose by 1.4%. This shows a strong reversal of the 1.3% downturn seen in July and was also better than the expected decline of 0.5%.
- September non-farm payrolls rose 103,000 and private payrolls grew by 137,000, both better than expected, but not good enough to reduce the unemployment rate which stayed steady at 9.1%. (45,000 of these additional jobs came from striking Verizon workers returning to work.) Although the unemployment rate did not fall, investors found some comfort in the likelihood of a recession subsiding slightly.
- The U-6 rate of unemployment, which includes discouraged workers no longer looking for work and part time workers looking for full time work, rose from 16.2% to 16.5%. This is often looked at as the real number to watch and does not look as promising.
- On the positive side, 99,000 workers were added to payrolls through revisions to the past two months, average hourly earnings increased 0.2% in September after dropping in August and the average workweek added six minutes to get back up to 34.3 hours/week.

Index Chart & Analysis

This S&P 500 ($SPX) chart shows the past three months of daily prices after the index finished the week higher at 1,155.46 on Friday, October 7, 2011. The large cap index has been stuck in a trading channel for two full months now with the extreme top side around 1,230 and the bottom plumbing a new recent low at 1,074. The majority of the daily prices have traded in a narrower range between 1,200 on the upper limit and 1,120 to the downside. Active traders have found this an easy range to operate in – sell when it gets closer to the top and buy when it approaches the bottom. Moving averages and other technical indicators such as Williams %R have not factored in with their usual precision during this period, but that might be changing soon.

A classic pattern for technicians to watch for is a "Head and Shoulders" pattern. The SPX created just such a pattern over the past two months and could be positioned to react to it. In a head and shoulders pattern a stock or index has three peaks with the middle one higher than the ones on each side; much like a head is higher than the shoulders that border it. After the second shoulder fails to reach a new high the next step moves lower in a final wash out before a lasting surge higher. Not every head and shoulders pattern turns into a new lasting rally, so the key is to decide when to add additional exposure. Most technicians wait for the "neckline" to break. This line is marked in red in the chart above and is edging close to the 1,200 area. A breakout above this neckline accompanied with high volume is a screaming buy signal for technicians and tends to signify a new longer leg higher has begun. Failure at this line can send the stock or index to new lows.

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The current chart isn't completely cut and dry with this approach. On Friday, the trend line of lower highs (shown in orange above) that started in late July came into play and acted as resistance before the SPX could make it up to the neckline. This line happened to coincide with the 50 day moving average (dma) which is the only dma that has remained reliable as resistance during the past two months. After failing at these two points the 10 dma held support at the 1,150 line where previous temporary support and resistance has worked repeatedly over the past 60 days.

Eventually Williams %R and the 10 and 20 dma will regain their predictive powers. If their time has come it's worth noting that Williams %R has moved above the oversold area for multiple days consecutively. Seeing one or two days above the oversold area is not as important as the second and third confirmation days for Williams %R. This past week saw those confirmation days on the 14 and 28 day periods and is close to it on the 56 day period. If Monday is a positive day for the S&P 500 then Williams %R could beckon in more buyers. At the same time the 10 and 20 dma are setting up for a bullish crossover if the index can stay above both of these lines for a few days. These two indicators could be setting up for bullish signals at the same time the SPX breaks above resistance from the neckline and trend line of lower highs to create a chorus of buy signals. If any of these indicators fail, then the chances of all of them failing and the market moving lower is fairly high. If investors wait for a clear buy signal above the neckline they risk missing out on some profit to the upside, but the wait is worth the missed opportunity in case the next big move is lower. Wealth preservation should never be abandoned as part of any investment model.

Key Technical Levels:
1,277.3 – 200 dma
1,200 – Top end of trading range and current approximate neckline level.
1,179.9 – 50 dma, offered resistance on Friday
1,170 – Trend line of lower highs
1162.7 – 20 dma
1146.8 – 10 dma, offered support on Friday

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

404-395-2752
alex@afcapitalmanagement.com

Twitter: @AlexRFoster
Facebook: AF Capital Management
Website: www.afcapitalmanagement.com

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