

## Perspectives

### INSIDE THIS ISSUE

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

---

***“The current economic situation is very different than it was in 2008-2009.”***

---

Historically, September has been the worst performing month for the markets, but the past two Septembers have been great, rising 9% in 2009 and 4% in 2010. This year could be set up for a third September in a row to buck the trend. It's possible the correction in August moved the pessimism forward and the market is due for a continuation of the recovery that started in late August.

More than likely the markets will remain stuck in a relatively tight trading range until a new stimulus package is announced by the Fed or the President works out an agreement with Congress for creating job growth. Economic data has been mixed and the technical indicators show a narrow range for support and resistance. Other than fear, the markets do not have a major reason to change course. Fear doesn't always mean the markets will move lower. Investors afraid of further losses will push the market down, but the fear of missing a rally (upside risk) on government intervention will bring in the buyers, even if the stimulus doesn't work for the longer term. Without a catalyst to push the markets out of this range there is no reason for stock prices to make a great move in either direction. Businesses are not hiring, but they are not issuing mass layoffs either. The US is in an employment stalemate and companies have little reason to add jobs without an increase in demand pushing them to expand their payrolls. The same old government stimulus is not

going to create lasting demand and businesses know this. If anything, the economy needs something more creative this time, possibly in the form of a nudge for housing/mortgage aid.

The memory of The Great Recession is still fresh enough in investors' minds to create an unreasonable fear of what could happen to the downside and that caused most of the rapid selloff seen in August. At the same time investors recall how the markets reacted to the upside once the Fed issued quantitative easing twice (QE1 and QE2). These two conflicting sides of fear are trapping the markets. Short sellers are hesitant to overdo their selling in fear of a powerful short squeeze and bulls can't find a reason to start buying again, outside of cheap stock valuation, which can always get cheaper.

The current economic situation is very different than it was in 2008-2009. Corporate balance sheets are strong as a whole right now and should be able to weather any intermediate term decline in consumer demand. Energy prices are lower than during the lows of 2008-2009. Lower energy prices keep inflation in check and keep consumers from having to spend such a large portion of their income on fuel. This is a big factor with so many Americans living from paycheck to paycheck. Interest rates are lower which allows home owners who are refinancing at lower rates to save money and have more disposable income each month.

The disappointing August payrolls report on September 2<sup>nd</sup> argues for further downside for stocks. On the other hand, economic reports, such as durable goods orders, surprised to the upside and sparked a short rally. This leaves the troubles in Europe close to the top of concerns that drive the US markets. A substantial portion of S&P 500 companies' revenues come from Europe. A decline in demand from European Union countries could start eating away at the earnings of US companies. If this happens, the current P/E ratio for the S&P 500 of around 13 might not be low enough yet. On the other hand, this possible decline in earnings seems to be priced in already. Even if earnings for S&P 500 stocks fell 10% in 2012 from 2011 levels and then the index P/E ratio returned to the historic norm of a 15-16 multiple, the S&P 500 should be closer to 1,280 – 1,370, at least 10% higher than Friday's close. Now what happens if earnings don't fall? The S&P 500 could be over 1,500 by the end of next year. These fundamentals make it hard to want to sell in this market. Perhaps the technical indicators will provide better insight.

## Summary of Indexes

*Courtesy of Morningstar.com*

Name	As of Date	YTD	1-Year	3-Year	5-Year
<b>Domestic Stock Indexes</b>					
DJ Industrial Average	9/2/2011	-1.14	11.79	2.14	2.35
NASDAQ Composite	9/2/2011	-6.5	12.74	1.83	2.49
Russell 2000	9/2/2011	-12.12	9.39	-1.17	0.26
S&P 500	9/2/2011	-5.38	9.86	-0.57	-0.08
S&P MidCap 400	9/2/2011	-7.38	11.7	2.65	3.53
<b>Bond Indexes</b>					
Core Bond	9/1/2011	6.48	5.45	7.5	6.9
Intermediate Core Bond	9/1/2011	6.54	6.08	7.9	7.19
Long-Term Core Bond	9/1/2011	12.21	8.15	11.18	8.98
Short-Term Core Bond	9/1/2011	2.26	2.37	3.96	4.73

## Market Movers

The stock market came off of its August lows on news that Warren Buffet bought into Bank of America (BAC) with a sweetheart deal. His vote of confidence convinced many bears to pull back from their selling and encouraged the bulls to rejoin the upside activity. Not long after Buffet's deal, two large Greek banks announced a merger that showed a consolidation and potential strengthening of one of the EU's weakest member nations. Skittish investors didn't sell off longer dated bonds during this rally in stocks which created a brief period where AF Capital Management's Market Timing Service had a buy rating on gold, long term treasuries and equity ETFs at the same time.

All of these positive hopes were dashed when rumors of Italy's lack of follow through with austerity measures began to surface. Italy is due to release an updated plan within a few days. The dollar strengthened and stocks lost their footing again due to worries of what Italy will do.

The August payroll data released on Friday added to fears and quickly pushed the markets much lower. Traders exited bullish positions prior to the long weekend out of fear something bad would go down in the EU before US trading markets were open again on Tuesday.

Adding to Friday's malaise, the Federal Housing Finance Agency (FHFA) announced it is suing more than a dozen large banks over their alleged misrepresentation of the quality of mortgage securities they created and sold during the housing bubble. The financial sector fell over 4% on this news.

The next big market mover might not come until after President Obama speaks on Thursday evening (September 9) to unveil his plans to revive the economy through job stimulus and a possible new mortgage refinancing/housing plan. Just as traders tried to "game" Fed Chairman Bernanke's actions, traders will attempt to predict what the president will say and try to get in front of it. This could create a bounce off of Friday's lows running through Thursday. However, the amount of that bounce depends on what happens in Europe before then. That said, many traders doubt the chances of a "game changer" from the President based on the belief that if he had a magic pill to offer he would have prescribed it already.

Keep an ear out for the newest buzz word, "Operation Twist". This is the next expected move by the Federal Reserve. In short, this maneuver involves the central bank buying longer dated securities (thus pushing prices higher and yields lower) and selling shorter dated securities in an attempt to lower long term rates.

Whatever happens to move the markets in September, it won't be a straight line in any direction.

## Fundamentals & Indicators

- Retail sales rose by 0.5% in July and data for June was revised up to 0.3% from an earlier reading of 0.1%. This was a bullish reading that came in during a tumultuous week.
- The Empire State Manufacturing Index showed further contraction as it came in lower than estimates. The index fell to -7.7 in August from -3.8 in July.
- US industrial production rose by 0.9% in July. This is more than double the expected increase and is the best move in nearly three years. The strong number shows the economy has not rolled over completely yet.
- The Consumer Price Index (CPI), which tracks retail inflation, increased by 0.5% in July, greater than expected. Core consumer prices, which exclude food and energy costs, increased by 0.2%, as expected. The higher inflation goes, the less likely the Fed will be able to initiate a third round of quantitative easing (QE3). For the past year, inflation has remained below the 2% target the Fed typically targets so the door is still open for the Fed to implement further easing in another attempt to spark the economy.
- Existing home sales for July fell to an annualized rate of 4.67 million, which is less than had been expected. The small silver lining came from a revision higher to the previously released June data.
- July housing starts dropped to 604,000 from 613,000 in June and building permits fell to 597,000 from 617,000. The only benefit to this slowing pace of new homes being built is that it gives the economy a better chance to clear off the large inventory of vacant houses and buildings.
- New home sales for July also came in lower than expected, down to an annualized rate of 298,000.
- The Case/Schiller home price index showed that prices rose 1.1% during June from May (up 3.6% for 2nd quarter), but are down 4.5% for June over the past year. Stocks took this as a sign the housing market is stabilizing and may find a bottom soon.
- Durable goods orders for July showed a surprise spike to 4.0%. This was much better than the consensus call for 1.9%. Orders for the prior month were also revised upward. This data point alone helped reduce recession fears for many economists.
- Personal income increased by 0.3% during July. This was slightly lower than the expected increase, but spending grew by 0.8% which was much better than the expected 0.5% increase. A stronger consumer spend is crucial in getting the economy moving again. This was a positive sign consumers are ready to start buying again.
- Second quarter GDP was revised lower from 1.3% growth down to 1.0% growth from the preliminary report.
- Chicago PMI (Purchasing Managers Index) came in at 56.5 for August. This was the lowest number reported in nearly two years, but was better than expected. A reading above 50.0 shows growth and while August's reading shows a slowing pace it is still expanding and indicates the economy is not as close to a recession as many feared.
- July factory orders rose 2.4%. This is better than expected and adds to the bullish case for investors.
- The ISM Manufacturing Index for August slipped to 50.6 from 50.9 in July. This is consistent with other data released over the past month. It shows an economy that is still growing, but at a slowing pace. Even though the August report showed a decrease from July, it was still better than the number that was expected.
- The unemployment rate stayed at 9.1% and average hours worked dropped by six minutes per week. Typically, average hours worked will increase as an early sign of an improving economy. This measurement moved in the wrong direction for the bulls.
- Government employment figures dropped significantly. This came on the heels of government construction dropping earlier in the week. As the stimulus wears off, the benefits it was giving are starting to show in its absence. On the positive note, government spending is dropping. The negative is obvious, fewer people are working.

## Index Chart & Analysis



This S&P 500 (\$SPX) chart shows the past three months of daily prices after the index finished the week at 1,173.97 on Friday, September 2, 2011. The large cap index had a great run off of its August lows, but faced resistance at the 50% retracement line from the July high to the August low. In other words, the SPX halved its losses from its highs. The key technical level was too much for the rally to handle as traders were more inclined to sell on any questionable resistance. The index made two attempts at breaking through 1,230 and then rolled over after not being able to close within 10 points of the line on either attempt.

This rollover came just two days after the very bullish indicator of the 10 day moving average (dma) pulling above the 20 dma. This simple moving average crossover foreshadows most major market moves, but is not flawless – especially in the current volatile market that turns on a dime with every hope and fear. Many traders saw the most recent rally as a selling opportunity from the day it began. The question was only when to sell. The 50% retracement line proved to be an easy exit point as it often is.

*Please see Index Chart & Analysis on page 5*



*Continued from Index Chart & Analysis from page 4*

After gapping down to start the day on Friday, bulls had to wait patiently to see if the next key area of support held. Technicians tagged 1,170 as the area that was do or die for support – and it held, for now. The SPX managed to bounce off of its intraday low slightly and closed just above its 20 day moving average. These two lines are crucial to watch. Bulls want to see the index move back above its 10 dma and resume its rally. Bears want to see a close below the 20 dma and the 1,170 demarcation line. If the bears can break support at 1,170 the next area of support that is likely to give support is the trend line of higher lows, currently close to 1,150 and ascending quickly. A dip to the 1,150 area is only 2% below Friday's close, but if it gives way then the next two stops might not be until 1,120 (4.5% lower) and 1,101 (6% lower).

If support holds at any of these levels, bulls will have to face resistance at the 1,230 line again (almost 5% higher) on any rally. Above that, resistance might not be seen again until 1,260 (7.4% higher) and then 1,300 (nearly 11% higher). The 50 dma is in the middle of these lines, at 1,250 and falling. It might not act like much more than a one or two day speed bump on any move higher. The big gaps in resistance levels should be filled quickly as shorts have to cover their bearish bets as fast as possible. A run back up to 2011 highs near 1,360 is just a dream for bulls right now and can be debated once 1,300 is more than a hazy object in the distance.

The Williams %R indicators for 14 and 28 day periods have given two false starts to the rally. This is extremely rare and adds to the pessimism the bulls have for this new collapse in stock prices. Probability shows that any move back into the oversold area of Williams %R (below -80) should be short lived and the next move out of this region could last much longer.

**AF Capital Management, LLC**

6935 Hunters Knoll NE  
Sandy Springs, GA 30328

404-395-2752  
alex@afcapitalmanagement.com

Twitter: [@AlexRFoster](#)  
Facebook: [AF Capital Management](#)

**Need help deciding when to buy and sell? Subscribe to AF Capital Management's [Market Timing Service](#).**

**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.