AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

April 8, 2012
Volume 2 - Issue 4

INSIDE THIS ISSUE

"…the hint of a tightening monetary policy caused traders to back off their relentless buying spree..."

Perspectives

Investors have made the easiest money of the current rally already. After a fantastic run for the bulls through the first quarter, the forward P/E ratio of the S&P 500 index has risen to 13.43. That's still leaves a lot of room for multiple expansion through the rest of 2012 and into 2013, but the obvious bullish trade becomes less obvious with each tick higher for the index. The S&P 500's P/E ratio is below its historic average and will have a hard time rising above it with potential trip wires on the both sides of the oceans.

The known risks to the market from China and Europe are already built into US stock prices. China's growth is questionable over the next 12 months and Europe's economy is weakening. Even at a slowing pace, China's growth is expected to move forward at or above a 7.5% annual pace. For a country the size of China, this will continue to create a strong demand for goods for years to come. Portugal and Spain are still worrisome for Europe, even with Greece's troubles pushed out a few years again. US stocks would be even higher than they are now if these concerns were not hanging over the world economy.

Spain's economic troubles have been known since Greece's debt worries surfaced, but Spain's issues moved away from the front pages of the news as Greece's drama came to a climax. The threat of contagion through the European periphery appeared to have been contained with Greece's default, but last week's debt auction in Spain showed little demand. This pushed Spain's debt prices lower and yields higher. Spain will have a harder time servicing this debt as yields rise. That return to reality brought the worry of the country's debt default back to a bigger position on investors' radar and gave investors a renewed reason to slow down the bull market. The second quarter is unlikely to see such a straight trajectory upward again as was seen in the first quarter.

Market tops are often marketed by an increase in volume as retail investors jump into a rising stock market late in a rally. However, market participation declined during the first quarter of 2012. This leads active investors to expect any second quarter dip in the market to be bought before the decline pushes stocks more than 5% lower. Many traders see 10% as the largest potential decline for US stock prices, but only if data from Europe and China weakens more quickly than expected. To help the longer term bullish case, the US economy has been able to decouple from Europe's woes recently and has continued to grow while Europe moves further into recession.

Inflation has been tame in recent years and has given the Fed the opportunity to keep rates low, but the case for "easy money" is starting to diminish as the US economy improves. Fed Chairman Bernanke has eased off his wording that previously indicated a likely third round of quantitative easing (QE3). Investors should be pleased to learn the economy might not need such government assistance for much longer, but traders who influence much of the intraday price movement for stocks and bonds saw it differently. Just the hint of a tightening monetary policy caused traders to back off their relentless buying spree seen through the first quarter. These traders fear liquidity will dry up without the Fed's help and lending will be even tougher for borrowers. Interest rates will also rise which will cost corporations more to service new debt and it will slow the struggling housing market's chances of recovery.

The idea that QE3 is not eminent also sent the US dollar higher against the euro. This improvement for the dollar lowers the cost of imported goods which benefits US manufacturers' bottom lines and also helps keep inflation at bay as commodity prices are kept in check. One of the biggest benefits to a stronger dollar is lower oil prices. As the US economy improves, higher oil prices threaten to derail growth by taking a larger percentage of consumers' fixed expenses and leaving less for discretionary purchases. Consumers have the opportunity to spend more freely if oil and gas prices flatten or decrease. Long term investors still have little to fear, but shorter term traders might be wise to look for a quick pull back in stocks soon.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average TR	4/5/2012	7.68	8.34	20.98	3.60
NASDAQ Composite PR	4/5/2012	18.25	10.37	23.84	4.51
Russell 2000 TR	4/5/2012	10.82	-2.75	23.13	1.51
S&P 500	4/5/2012	11.83	7.25	20.92	1.54
S&P MidCap 400	4/5/2012	12.38	-0.19	25.16	4.20
Global Stock Indexes					
Developed World (Ex-US)	4/4/2012	8.40	-9.20	15.13	-2.92
Emerging Markets	4/4/2012	12.81	-11.74	21.70	5.10
Bond Indexes					
Core Bond	4/5/2012	0.40	8.25	6.53	6.53
Intermediate Core Bond	4/5/2012	0.93	7.79	6.03	6.68
Long-Term Core Bond	4/5/2012	-0.90	16.79	11.77	9.08
Short-Term Core Bond	4/5/2012	0.51	2.63	3.42	4.21

Market Movers

- Disappointing Purchasing Managers Index (PMI) readings showing contraction came out of China and the eurozone which cast a negative sentiment on the market and pushed it lower due to fears that slowing demand would hurt economic growth.
- Bearish sentiment moved into the market as traders responded to underwhelming demand for a recent debt offering from Spain. This showed uncertainty related to the country's ability to implement and honor austerity measures.
- The most recent Federal Open Market Committee (FOMC) meeting minutes showed an increased concern for inflation and a reduced likelihood of new quantitative easing measures being implemented by the Fed.

Fundamentals & Indicators

- Retail sales for February rose 1.1%, which is better than the upwardly revised 0.6% increase in January and the expected increase of 1.0%. Excluding autos, retail sales were up 0.9% in February, ahead of the consensus call for a 0.6% increase. In addition, January numbers were revised upward to reflect a 1.1% increase.
- The Empire Manufacturing Survey rose to 20.2 in March from 19.5 in February. This is much better than earlier predictions for a reading of 15.0.
- Producer price data for February showed an increase of 0.4% month over month, slightly lower than the 0.5% increase that was anticipated. Core producer prices increased by a more moderate 0.2% month over month, as expected.
- Consumer prices increased by 0.4% during February, after overall prices increased by 0.2% in January.
- Core consumer prices climbed by only 0.1%, half of the 0.2% increase in January. This indicates inflation is still in control.
- Monthly housing starts dropped to an annualized rate of 698,000 units, close to forecasts.
- Building permits improved to a rate of 717,000, beating expectations.

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- Existing home sales in February came in at an annualized pace of 4.59 million units, close to what was anticipated. January's pace was revised upward to 4.63 million.
- New home sales for February decreased an annualized rate of 313,000 units, less than earlier consensus calls. In addition, January's numbers were revised downward to an annualized rate of 318,000 units.
- Pending home sales fell in February by 0.5%, while economists were looking for a 0.5% increase.
- The Case-Shiller Housing Price Index for January reported a 3.8% decline
- Overall orders of durable goods increased by 2.2% during February. This shows expansion, but is at a slower pace than the 2.8% increase that had been expected. January orders data were revised slightly higher to reflect a 3.6% decline.
- Excluding transportation items, durable goods orders were up 1.6% in February. This shows a strong improvement from January's 3.0% decline.
- Personal income increased by 0.2% during February. Personal spending increased by 0.8%, which is faster than the 0.6% increase that was forecast. Core personal consumption expenditures (PCE) prices for February were up 0.1%.
- The Chicago Purchasing Managers Index (PMI) fell more than expected to 62.2 in March.
- The University of Michigan's consumer sentiment survey improved unexpectedly to 76.2 by the end of March. This signals a positive consumer and bodes well for continued increases in spending.
- The ISM Manufacturing Index rose to 53.4 in February from 52.4 in January, beating expectations.
- Construction spending slipped 1.1% in January, short of earlier forecasts.
- Orders for goods produced in U.S. factories rose 1.3% in February.
- Factory orders were revised down to a 1.1% decline in January from a prior estimate of a 1.0% drop.
- Orders for durable goods (products meant to last at least three years) rose 2.4% in February.
- Orders for nondurable goods rose 0.4% in February, compared with a 1.0% gain in January.
- The ISM Services Index for March came in at 56.0, which is down from the prior month reading of 57.3 and slightly less than the reading of 56.7 that economists expected
- The four week moving average of new jobless claims fell 4,250 to 361,750. This is the lowest level since April 2008 and is an indication of an expanding economy as it is well below the key 400,000 level.
- The US unemployment rate dropped to 8.2%, down from 8.3% the previous month. Rather than the improvement coming from a strong increase in new jobs added, it was the denominator in the equation that sank as fewer people were included in the workforce.
- 120,000 new jobs were added in March. This was far short of the consensus estimate of 200,000. However, manufacturing added 37,000 new jobs which some economists view as a growing trend of what is to come for US factories as companies ramp up production and pull jobs back to the US from overseas.
- Average workweek dropped 0.1 to 34.5 hours. A strong economy should have an increase in hours worked.
- Average hourly earnings rose 0.2% in March. This was one of the few positives in the employment report as it shows demand is still present in the labor market.
- The U6 unemployment rate dropped to 14.5 from 14.9 in February. Many investors view this as the true employment rate because it includes people employed part-time who want full-time work but have had to settle for a part-time schedule and discouraged workers who are no longer looking for work.

Index Chart & Analysis

This S&P 500 ($SPX) chart shows the past six months of daily prices after the index finished the week at 1,398.08 on Thursday April 5, 2012. Thursday's close left the SPX in a precarious position. It remained above its four month trend line of higher lows, but closed below its 10 and 20 day moving averages (dma). At the same time, the Williams %R indicator fell below the overbought area for the 14 and 28 day periods. The 50 dma and the Williams %R 56 day indicator have not given in yet. That could change as early as Monday when stocks resume trading after a disappointing employment report on Friday when US markets were closed for the holiday.

Futures traded for an hour after the data was released and indicate a much lower open after the weekend. Such a lower open will pull the 10 dma lower quicker than the 20 dma falls. Short based moving averages move quicker than longer ones and will lead the SPX chart to show a bearish 10/20 dma crossover within days if stocks don't snap back quickly. This is often a signal of the beginning of multiple days or weeks lower for an index or stock. The first possible area of support for a declining market will be at the 50 dma which is currently around 1,370 and moving higher. If support surfaces this early, the market will have only corrected 3.6% from its recent intraday high.

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The Williams %R indicates a bigger fall could be coming. As mentioned above, the 14 and 28 day periods already show a change in momentum. A lower close on Monday will give the 14 day indicator a key third confirmation day and a second confirmation day on the 28 day indicator. The 56 day period has not registered a day below the overbought area in 2012. Monday's open is likely to push it below overbought and will show a true momentum shift is underway.

Volume trailed off going in to the holiday weekend and should see a spike on Monday as anxious traders return to their desks ready to pare losses or profit from the decline using short positions. In the past two years, spring has been the time to exit stocks temporarily and the market has lived up to its mantra, "Sell in May and go away". The changes in these technical indicators could be an early warning that the selling season has started a month early and taking profits in April might be a safer trade than waiting until May this year. Investors should proceed with caution as the probability of a correction increases as temperatures rise.

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