AF CAPITAL MANAGEMENT
Registered Investment Advisor

# The Investors' Newsletter

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***"…the S&P 500 is up more than 20% since bottoming intraday on October 3, 2011."***

## Perspectives

The S&P 500 had its best January in 15 years. Some investors look at this and recall the "January effect" which says if January is positive, then the markets tend to have a bullish year. If January is down for the month, then markets are likely to finish the year with a loss. As stock market lore goes, this has a big following and rightfully so since it is often correct in its forecasting ability. The trick is that any 12 month period that starts with a gain is more likely to finish with a gain because it has a head start. If a month starts in a hole, then the next 11 months need to make up for that loss before returning to a gain. Investors could do well by directing their attention to the cause of the recent rally rather than focusing on calendar tricks.

Bears have stayed out of stocks since last spring based on fear that troubles in Europe would bring the US markets down and cripple growth in the US. However, the US stock market has begun to decouple from issues surrounding the European Union (EU) and those fearful investors who bailed early have missed a great rally from the lows of early October. In fact, the S&P 500 is up more than 20% since bottoming intraday on October 3, 2011.

The US dollar hit an interim high the same week the S&P 500 bottomed in October and then US stocks rallied when the dollar weakened. This inverse relationship between the dollar and stocks held for most of 2011. Sentiment shifted when 2012 started. Investors no longer perceived US companies' growth potential to be as reliant on the outcome of the EU. Stocks were able to continue rallying even while the euro fell and the dollar strengthened. Some of this disconnect comes from the belief that the European Central Bank will not allow any member country to default on its debt and although Europe is heading into a recession, the US is strengthening and will be able to withstand any slowdown in Europe without falling back into a recession.

Stocks are allowed to return towards their average price to earnings (P/E) multiple as fear recedes. The trailing 12 month earnings give the S&P 500 a P/E ratio close to 15, just below its historical average. Consensus earnings estimates for the next 12 months give the S&P 500 a P/E ratio closer to 12.5. If S&P 500 companies can meet estimates and the market trades at today's trailing P/E ratio, then the S&P 500 would be able to pass 1,600 within a year, nearly 20% higher than it is today. Most investors do not expect this to become a reality by the end of 2012 as the pace of corporate profit growth is slowing for most companies (excluding a few such as Apple) that have reported so far this quarter. Even if corporations do hit their earnings estimates, but fear of Europe's influence on the US returns, then investors could see the P/E ratio contract for the S&P 500 and drop back down to 11. This would bring the index down below 1,200 again, more than 10% lower than Friday's close.

Based on this valuation analysis, stocks should have little more than 10% downside risk in the near term and more than 20% upside potential over the next 12-18 months. Investor confidence returns when stocks have such strong returns. Greed becomes the emotion dominating trade rather than fear. Money managers are forced to allocate more to equities than bonds or cash or they will lag their benchmarks. The outcome is an overshoot of the average historical P/E ratio. A P/E ratio overshoot to 18 with the current earnings forecasts would take the S&P 500 to nearly 2,000. That is the time to fear markets.

The path to these lofty levels starts with improving fundamentals which include higher home prices and lower unemployment. Employment is steadily heading in the right direction for bulls, but new home prices have yet to join the movement. A housing bottom within the next 12-18 months is what the market will need for the next leg of this bull market. If even half of this scenario plays out, 2012 looks like a good time to invest for the long term.

# 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 | 2/3/2012 | 5.46 | 9.53 | 20.14 | 3.11 |
| NASDAQ Composite PR | 2/3/2012 | 11.54 | 5.51 | 24.21 | 3.25 |
| Russell 2000 TR | 2/3/2012 | 12.25 | 5.48 | 24.11 | 1.92 |
| S&P 500 | 2/3/2012 | 7.11 | 5.09 | 19.62 | 0.68 |
| S&P MidCap 400 | 2/3/2012 | 10.58 | 4.83 | 26.33 | 4.42 |
| **Global Stock Indexes** | | | | | |
| Developed World (Ex-US) | 2/2/2012 | 7.97 | -8.02 | 17.08 | -2.19 |
| Emerging Markets | 2/2/2012 | 14.82 | -3.44 | 29.59 | 5.88 |
| **Bond Indexes** | | | | | |
| Core Bond | 2/2/2012 | 0.83 | 9.32 | 6.72 | 6.93 |
| Intermediate Core Bond | 2/2/2012 | 0.9 | 8.24 | 6.41 | 6.98 |
| Long-Term Core Bond | 2/2/2012 | 1.04 | 20.79 | 11.67 | 9.84 |
| Short-Term Core Bond | 2/2/2012 | 0.52 | 2.74 | 3.36 | 4.48 |

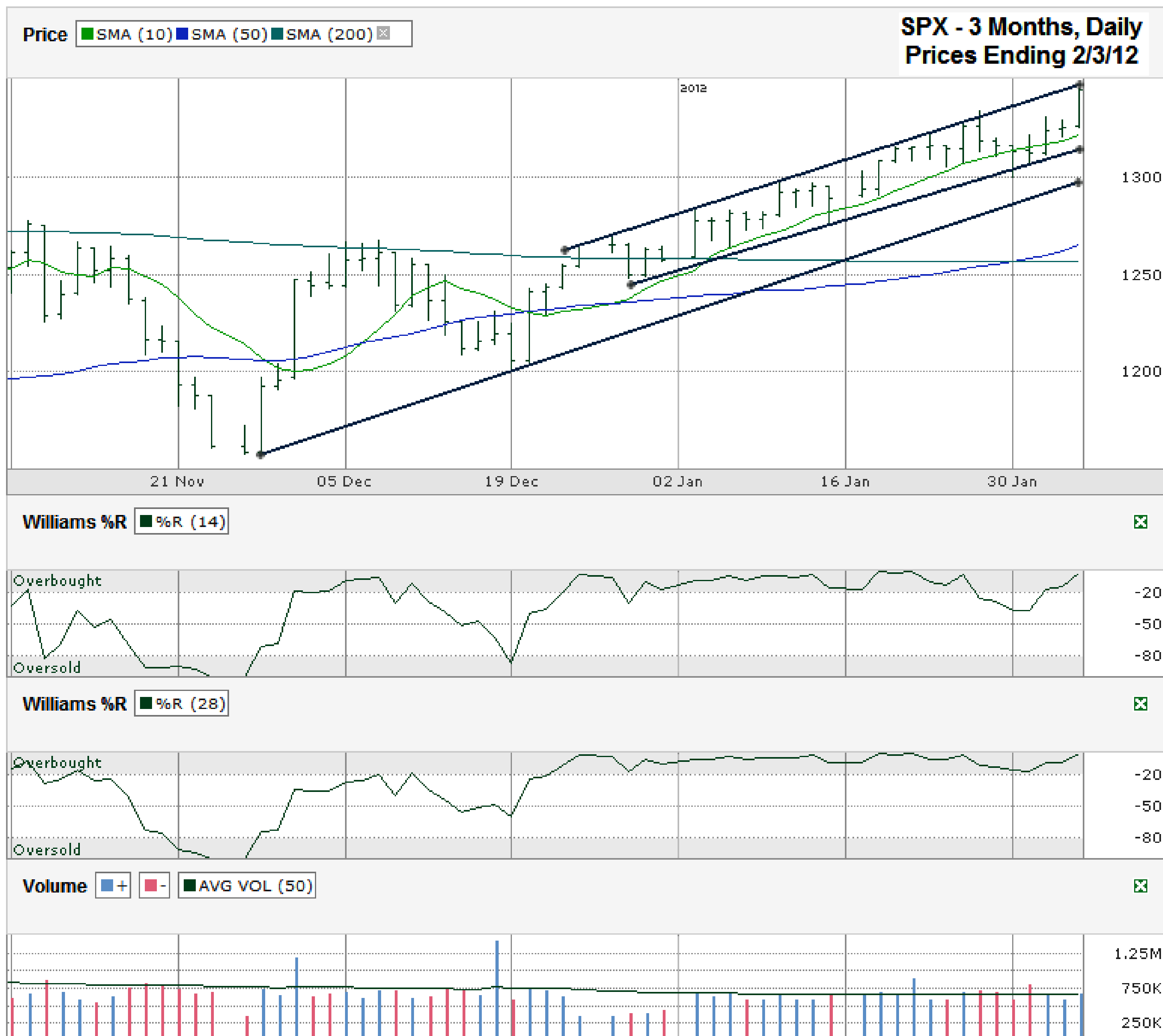
# Market Movers

- Standard & Poors downgraded France's credit rating from AAA to AA+ and lowered Italy and Spain two notches to BBB+ and A respectfully. This caused the Dow Jones Industrial Average to fall below its 10 day moving average, albeit briefly, for the first time in weeks.
- The Federal Open Market Committee (FOMC) announced that it will keep the federal funds rate at 0.00% to 0.25%. It also stated that economic conditions are likely to warrant such exceptionally low rates through at least late 2014. The market took this to mean borrowing money would remain cheap, bonds will continue to offer low yields and the best way to beat the expected inflation is through owning stocks.
- The advance following the Fed's announcement was interrupted briefly when the Fed disclosed that it now expects GDP for 2012 to grow in a range of 2.2% to 2.7% in 2012, down from the range of 2.5% to 2.9% that it had stated previously. Fed Chairman Bernanke added that if inflation remains below target and employment remains slow there is a case for further policy action.
- China reported a better-than-feared 8.9% increase in Q4 GDP. This was down from 9.1% in the Q3, but offered solid increases in industrial production and retail sales data. The Q4 GDP report eased hard-landing concerns while at it also maintained a rationale for a further easing of monetary policy.
- The International Monetary Fund would like to expand its lending capacity, reportedly in the range of $600 billion to $1 trillion, to be able to meet a perceived financing shortfall. The news came the same day that the World Bank lowered its global growth forecast.
- The January ZEW economic sentiment survey out of Germany was better-than-feared, as it increased to -21.6 from -53.8 in December. With everything that is unfolding in the eurozone, and Germany reportedly being dragged down by it, it is safe to say many participants did not expect to see this improvement in economic sentiment in January, let alone any improvement.
- Financially fragile Portugal's successful debt offering pleased the market as it showed a sign of strength.
- Various PMI Manufacturing readings from the eurozone made incremental improvements added to the positive tone for the markets.

# Fundamentals & Indicators

- Retail sales during December increased by only 0.1%, which is less than the 0.4% increase that had been expected. Excluding autos, sales actually sank 0.2% when a 0.3% increase had been anticipated.
- Industrial production rose by 0.4% in December, which is only slightly less than the 0.5% increase targeted by economists.
- The Housing Market Index improved to 25 in January from 21 in December. Economists expected the Index to remain at 21.
- Overall consumer prices were unchanged in December from November. They had been forecast to make a 0.1% increase. Core prices inched up 0.1% in December from November.
- Housing starts for December hit an annualized rate of 657,000, which is down from the November rate of 685,000 units and less than the rate of 673,000 units that was anticipated.
- Existing home sales during December hit an annualized rate of 4.61 million units, beating the 4.55 million units that had been expected.
- The latest monthly pending home sales report showed that pending home sales for December fell 3.5%, 0.5% lower than earlier estimates.
- New home sales for December fell 2.2% to a seasonally adjusted annual rate of 307,000 units. Analysts had targeted sales to climb to a rate of 321,000 units. Adding to the miss, median home prices declined 12.8% to $210,300.
- The New York Fed's Empire Manufacturing survey increased to 13.5 in January, well above the 8.2 report in December showing continued expansion in the district.
- The Philadelphia Fed Survey for January improved to 7.3 from 6.8 in the prior month, but was still less than the reading of 10.0 that had been forecast.
- Personal income rose 0.5% and personal spending was flat. A healthy economy needs both incomes and spending to increase. However, an increase in the savings rate is beneficial longer term.
- Durable goods orders for December improved by 3.0% better than the consensus for a 2.0% increase. That came in addition to an upwardly revised 4.3% increase for November. Excluding autos, durable orders climbed 2.1%, which is much better than the 0.7% increase that had been commonly expected. Orders less autos for November were revised upward to reflect a 0.5% increase.
- The Chicago PMI report for January came in at 60.2, less than the expectations for 62.8 and down from the 62.5 that was posted for December. The miss still shows expansion, but at a slower rate than earlier.
- The ISM Manufacturing Index for January came in at 54.1,not quite as strong as the 54.5 economists were looking for. However, the January report is up from the downwardly revised 53.1 that was posted for December.
- Construction spending data for December climbed by 1.5%, which beat the 0.4% gain in November.
- The ISM Service Index jumped to 56.8 in January from 52.6 in November, well above forecasts for 53.1.
- Factory orders in December they increased by 1.1%, below an anticipated 1.5% increase.
- Initial weekly jobless claims stayed well below the key 400,000 level and reached levels not seen since 2008. This was a foreshadowing of the strength in the monthly employment report issued on Friday.
- A very strong monthly jobs report pushed stocks to the highest levels since last summer. The unemployment rate dropped to 8.3% from 8.5% (the lowest since February 2009), even as the number of job force participants increased.
- Private sector payrolls non-farm payrolls jumped in January by 243,000, more than 50% better than earlier estimates. In addition, December payrolls were revised up to 203,000 from an initial report of 200,000 and November payrolls were revised up to 157,000 from 100,000.
- Hourly wages increased 0.2% which highlighted the depth of the report. The average workweek was unchanged at 34.5 hours
- The Labor Department also issued its annual "benchmark" changes to employment data over the past 21 months. The newly revised data showed that the U.S. gained 1.82 million jobs in 2011, up from an initial target for 1.64 million.
- The U6 unemployment rate came in at 15.1%, down from 15.3% last month. This data includes people with part-time positions who are looking for full-time jobs and those who are "discouraged" and have recently given up looking for work.

# Index Chart & Analysis




This S&P 500 ($SPX) chart shows the past three months of daily prices after the index finished the week at 1,344.90 on Friday, February 3, 2012. Three trend lines stand out in this chart. All are ascending. The lowest line traces the trend of higher lows that started in November. The top line tracks the trend of higher highs and the middle line follows the trend of higher lows, but only since late December. The top two trend lines create the boundaries of the trading channel that the SPX has been trading within for a month and a half. Each touch of the upper trend line (as seen on Friday) results in a flat to lower market for the following few days until the lower trend line catches up to offer support. This trading channel will break apart at some point and the cracks tend to come to the downside, especially after such a long run within a narrow path. That is when the lowest trend line will be tested again. This line is not much lower, but would give the index a much needed rest period to consolidate its gains. A fall below this trend line could foreshadow much bigger losses to come before another area of support is identified by traders.

*Please see Index Chart & Analysis on page 5*

*Continued from Index Chart & Analysis from page 4*

While the trend lines battle out support and resistance, the moving averages have their predictions to make. The large cap index is trading above all of its moving averages from as short as 5 days to 200 days. This is a bullish sign in itself, but always comes to an end eventually. The first key moving average to watch is the 10 day moving average (dma). The SPX has not had a full day trading below the 10 dma since mid-December, when the last mini-correction bottomed out. This past week saw multiple intraday crosses of the line which in itself is a red flag for bulls. Early in the week the S&P closed on the moving average one day and beneath it the next day. If the following day would've been a confirmation day lower, chartists would have expected a much bigger sell-off to ensue. Instead it recovered and kept the bears off the playing field a little longer.

Traders will quickly shift their attention to the nearest area of potential support once the 10 dma breaks. This will result in a sudden drop in stock prices until the index reaches its target. That target could be the 50 dma which just had a bullish crossover above the 200 dma. Moving average crossovers that see a shorter time frame move above a longer time frame tend to signal better days ahead. Unlike trading channels marked by trend lines, rallies defined by moving averages do not move in such straight paths. A retest of the 50 dma would be considered healthy before the next leg of the bull market took place. If traders see support work at the 50 dma they will pull money off the sidelines and into stocks very quickly and investors will be in store for another long run higher.

As with the trend lines and moving averages, the Williams %R indicator is not giving a sell signal yet, but does show a reason to suspect a period of consolidation is due. As long as the indicator is in the gray overbought area then the rally still has momentum on its side. Investors can expect further declines to follow once the indicator moves below -20 for at least two days in both the 14 and 28 day periods. When the indicator climbs above the -1.0 area as it did on Friday, the next few days tend to be flat to lower. In other words, Williams %R is in agreement with the trend lines. While the future has promise, the next few days are not the time to buy into it. While an active trader might risk shorting the index now, an investor with a longer time horizon would be wise to wait for a clearer bearish signal before taking profits.

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