AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

January 10, 2016
Volume 6 - Issue 1

INSIDE THIS ISSUE

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

"…big market moves, such as the past five trading days, are sparked by emotions more than any change in data...."

Perspectives

Recessions and bear markets are not synonymous. A recession occurs when a country's GDP declines for two consecutive quarters. A bear market occurs when a stock or bond index falls at least 20% from its highs. A bear market can precede and or coincide with a recession and lasts for an average of 18 months. Bull markets last an average of 97 months. A steep market correction (a decline of at least 10%) can happen in the middle of a bull market and a growing economy and averages about 14 weeks.

The US stock markets had a correction in September and again at the low point of Friday's trading (using the same intraday high from May 2015 as a starting point). Because the US economy has not fallen into a recession, the correction in September was short-lived and October was a fantastic month for stocks. The euphoria faded quickly and stocks drifted lower in November and December as investors grew nervous about falling oil prices and geo-political influences. By the beginning of January, investors' trepidation turned into panic and the S&P 500 saw its worst 4-day start to the year in the history of the index. The question on investors' minds now is if this is a buying opportunity or if it's better to get out of the way.

Investors have a few fundamental indicators available to help predict the next bear market and recession. Increased unemployment, falling interest rates, and declining home sales are all common for an economy that is reversing. None of these is present in the current US economy, which means any further declines in stock prices in the near-term should not derail the plans of an investor with a time horizon beyond five years.

Investors are bombarded by fear-inducing headlines on a daily basis. To avoid being dragged into a panic with each attempt by media outlets to hold our attention, investors need to stay focused on what drives stock prices. Earnings are the key factor that influence stock prices more than any other input. On daily, weekly and sometimes monthly timeframes, emotions and sentiment can influence how much stock prices move within a range that is anchored to earnings estimates. Economists adjust their estimates with each new piece of data available, but big market moves, such as the past five trading days, are sparked by emotions more than any change in data.

According to S&P Dow Jones Indices, 2015 S&P earnings are forecast to finish 2015 at $106.38, far below estimates from a year ago of $131 for the index. Energy was the main sector that caused the earnings miss. In fact, S&P 500 earnings declined 5.9% in 2015, but without including energy, the S&P 500 would have increased earnings by 5.7%.

S&P Dow Jones Indices forecasts 2016 earnings to reach $125.56 with energy being the wildcard again. If oil prices recover and this forecast becomes a reality, the S&P 500 could climb to 2,412 using the same 19.21 trailing P/E ratio as 2015. Such a gain would push the index more than 20% higher in 2016 including the 2.14% dividend yield and is unlikely to play out as predicted.

China's slowing demand for oil will keep energy prices subdued until the supply side cuts output further. When this production slowdown reaches a tipping point, oil prices will rise. Oil companies will make more money per barrel, but will be selling fewer barrels. The cumulative effect is a year with lower earnings than forecast, but better than 2015. Companies outside of the energy sector will continue to increase profits as more people find jobs and buy houses. Lower energy costs will continue to benefit those companies that have lower production and transportation costs. A more realistic forecast is for 2016 earnings to finish the year closer to $112. Without any P/E multiple expansion, the S&P 500 could finish the year at 2,151, up 7.42% including dividends for the year.

Stocks are not overvalued since share prices were nearly flat in 2015 and have declined 9.2% from the November high. While prices could fall further in the coming days and weeks, the current panic will wear off as they all do and the stage will be set for the bull market to continue. The upside is limited for stocks until oil recovers, but the main alternatives for investors are cash or bonds. Cash has no upside potential and will lose value due to inflation. The risk/reward balance favors stocks over bonds while the yields are nearly equal. Bonds have much less upside potential and much more downside risk. 10-year US treasuries are yielding 2.11% compared to the S&P 500's 2.06% yield. Stocks can gain 10% from Friday's close to reach the November high. Bonds are close to historic highs with a finite top.

Dividends issued from S&P 500 companies are expected to increase by 4% in 2016. This amount is lower than average, but still positive for income seekers who want more than they can find from bonds. The sub-par increase in yields comes back to low oil prices too. Companies in the energy and materials sectors will continue to hold back dividend increases until oil prices increase for a sustained period.

As interest rates in the US begin to rise, global investors will continue to flock to the dollar. A stronger dollar is great for importers, but hurts those companies trying to export goods from the US. Some commodities, such as oil, are priced in US dollars. This dollar standard will help keep all prices low on top of the supply of oil outplacing the demand for oil.

Summary of Indexes

Courtesy of Morningstar.com

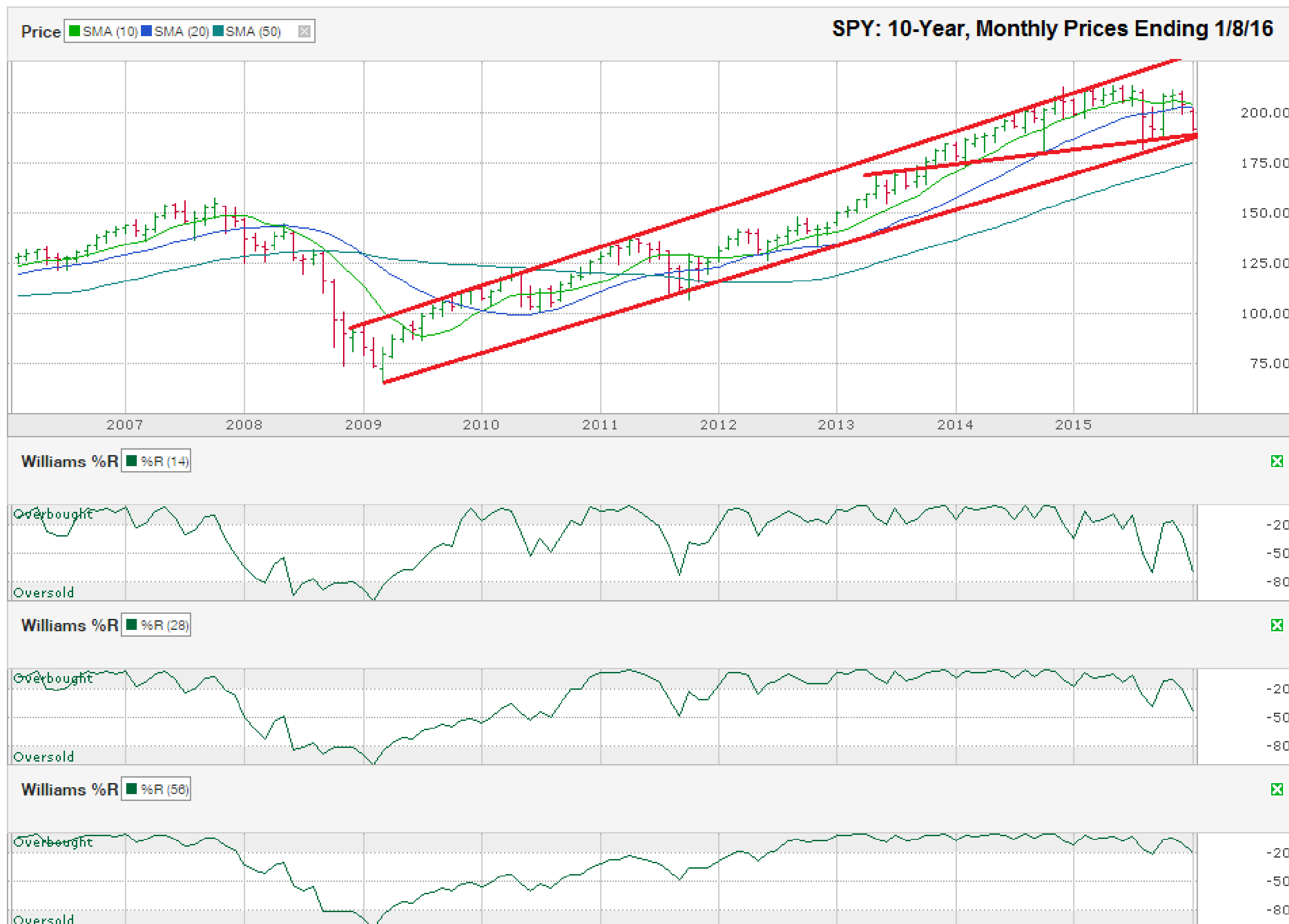
Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	1/8/2016	-6.13	-6.44	9.65	9.70
NASDAQ Composite	1/8/2016	-7.26	-1.95	14.52	11.43
Russell 2000	1/8/2016	-7.88	-11.33	7.57	7.29
S&P 500	1/8/2016	-5.91	-4.80	11.99	10.95
S&P MidCap 400	1/8/2016	-6.42	-8.52	9.22	9.13
Global Stock Indexes					
MSCI Emerging Markets	1/8/2016	-6.81	-22.82	-11.56	-8.39
MSCI World, Excluding US	1/8/2016	-6.16	-6.77	1.32	1.66
Bond Indexes					
Core Bond	1/8/2016	0.69	0.99	1.99	3.60
Intermediate Core Bond	1/8/2016	0.65	2.12	2.38	3.62
Long-Term Core Bond	1/8/2016	1.29	-1.83	2.53	6.52
Short-Term Core Bond	1/8/2016	0.27	0.86	0.88	1.32

Fundamentals & Indicators

- The Empire Manufacturing Survey has had a disappointing past three readings. October data improved over the prior month's reading, but still reported a reading of -11.4, followed by more weakness in November and December with readings of -10.7 and -4.6.
- The Philadelphia Fed's Business Outlook Survey followed a slightly better trend than New York's (Empire Manufacturing) survey. The Philadelphia Fed Survey rose to -4.5 in October from -6.0 in September and even went positive in November with a reading of 1.9, but faltered again in November with a reading of -5.9.
- Retail sales slipped 0.1% in September, but gained 0.1% in October and 0.2% in November.
- The Producer Prices Index (PPI) fell in September by 0.5% and by 0.4% in October before rising 0.3% in November. This decline in producer prices, which has stretched for 10 consecutive months on a year-over-year basis, helped allow the Fed to keep interest rates low for longer than many expected.
- The Consumer Price Index (CPI) was down 0.2% in September, up 0.2% in October, and flat in November. On a year-over-year basis, core CPI, which excludes food and energy, was up 2.0% in November. Two percent matches the Fed's long-term target for inflation.

- The Case-Shiller 20-city Home Price Index indicated the housing sector remains strong with year-over-year increases of 5.1%, 5.5%, and 5.2% in August through October 2015.
- Housing starts rose from 1,126,000 in August to 1,191,000 in September, but fell to 1,062,000 in October before rebounding to 1,173,000 in November.
- After increasing 4.7% in September, existing home sales fell 3.4% in October and fell 10.5% in November.
- New home sales slipped 61,000 to 468,000 in September, then rose to 470,000 in October, and up to 490,000 in November.
- Pending home sales fell 2.3% in September, then recovered only 0.2% in October before falling 0.9% in November.
- Factory Orders were nearly flat on a cumulative basis over the past three reports. September decreased 1.0%, followed by an increase of 1.3% in October and then a decrease of 0.2% in November.
- Total durable goods orders fell 0.8% in September, rose 2.9% in October and remained unchanged in November.
- The ISM Manufacturing Index dropped 0.1 to 50.1 in October and then indicated a contraction (below 50) in November and December with readings of 48.6 and 48.2 respectfully.
- The ISM Services index remained in an expansion over the past few reports. October's reading of 59.1 was up from 56.9 in September. The November and December reports came in at 55.9 and 55.3.
- Construction spending increased 0.6% month-over-month in September and 1.0% in October before decreasing 0.4% in November.
- The advance estimate of third quarter Gross Domestic Product (GDP) showed an expansion of 1.5%. The second estimate increased to 2.1% and then the third estimate reduced the expectation down to 2.0%.
- Weekly unemployment claims fell to 255,000 in mid-October, matching the low from July. Prior to July, claims had not been this low since November 1973. The 4-week moving average fell to 265,000, also the lowest reported since 1973. Since then, the 4-week moving average has risen to 276,000, still well within the 250,000 to 300,000 range that supports overall employment growth of at least 200,000 per month.
- Non-farm payrolls remained strong through the fourth quarter. Including revisions, the US added 307,000 new jobs in October, 252,000 in November and 292,000 in December.
- The unemployment rate held steady at 5.0% in each of the past three months. This consistent rate is even better than it appears on the surface due to the increase in the labor force participation rate. After bottoming at a 38-year low of 62.4 in September, the participation rate improved to 62.6 over the past few months. While still close to historic lows, the shift in the trend is important to watch.
- The U-6 unemployment rate (includes the total number of unemployed and those employed part-time, but seeking full-time employment is viewed as a more realistic picture of total unemployment) added to the bullish outlook for employment throughout the fourth quarter. After bottoming at 9.8% in October, November and December came in at 9.9%. These are the lowest readings since May 2008.
- The average workweek rose to 34.6 in October, but declined to 34.5 in November and December. This narrow range has held steady since March 2014.
- Average hourly earnings rose 0.4% in October, 0.2% in November and were flat in December. Wages are up 2.5% on a year-over-year basis.

Index Chart & Analysis



The chart above shows the monthly prices for the past 10 years on SPY, an S&P 500 Index ETF, after closing the week at $191.92 on January 8, 2016. Traders have to broaden their time horizons when an index breaks through short-term technical support. The daily and weekly charts for SPY offer little guidance for where the ETF could find its next area of support, but a multi-year chart using monthly bars helps bring clarity in a volatile time.

Stocks have been in a sustained bull market since bottoming in March 2009 and have traded within a broadening trading channel for this seven-year period. So far, each move to the trend line of higher lows has brought out calls that the end is near, but every drop has been a buying opportunity. Eventually this rubber band effect will end and the supportive trend line will break. Until this technical event hits the charts, traders will continue to profit from the dips with the risk of a collapse increasing at every test of the trend line.

The question always comes to, is this price drop the one that will break the trading channel or is it another buying opportunity? Rather than take an oversized risk, traders would be wise to wait and see. SPY finished the week within a $5 margin of error of the supportive seven-year trend line and a two-and-a-half-year trend line that is converging in January.

A short-lived drop below the trend line, as we saw in August 2015, would not signal the end of the rally, but a multi-day break in support could be the red flag preceding further declines that bears have been calling for. SPY was down 10.39% from its all-time highs at the lows of the day on Friday compared to the 14.67% drop SPY had in August 2015. A 10% decline is likely another healthy correction in an aging bull market, but until SPY can pull above its 10 and 20-month moving averages (close to $202), traders with a shorter-term focus should use caution

before overloading on stocks. Those investors with a longer-term outlook should consider buying partial positions at the current 10% discount to last year's all-time highs.

Beyond the trend lines, traders should watch the 10 and 20-month moving averages mentioned above for resistance and the 50-month moving average for support below the multi-year trend lines. If SPY breaks above $202 for more than three days, the stage would be set for more than $20 of upside. The 50-month moving average is 8.8% below Friday's close and is slowly ascending. SPY will need more than geopolitical pressures to push it below this low point into bear market territory. Worst case, anyone buying into SPY at the $175 level would have limited downside risk beyond the next one to two years and a lot of upside potential. The Williams %R indicator fell below the -20 range on the 14 and 28-month indicators, but has held above this breaking point for the 56-month indicator. If Williams %R falls below -20 on the 56-month indicator for two months, a clear sell signal will be in place and even longer-term investors should consider cutting some losses before they lose even more money.

AF Capital Management, LLC
PO Box 566241
Sandy Springs, GA 31156

404-395-2752
alex@afcapitalmanagement.com

Twitter: @AlexRFoster
Facebook: AF Capital Management

Need help rolling over a 401(k) plan to an IRA, call or email Alex Foster for a no cost review of your needs.
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 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 (BRIEFING.COM, CNBC, BARRON'S, MARKETWATCH.COM, TD AMERITRADE & DIRECTLY FROM INDEX SOURCES), 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.