AF CAPITAL MANAGEMENT
Registered Investment Advisor

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… 2017 will go down in history as one of the least volatile years ever.

Perspectives

As a group, investors stopped fearing the bull market in 2017. While stocks pushed higher into what is the second longest bull market in US history, the overall sentiment was not positive until this past year and had been dubbed the "most hated bull market in history". This sentiment shift helps explain why 2017 will go down in history as one of the least volatile years ever (not even a 3% correction since November 4, 2016) and the S&P 500, including dividends, was up 14 months straight through December 2017.

The stock market will have another 25 to 30 percent drop. That is not a question. It's a statement of fact. The question is when will it happen and how much higher will stocks climb before this bear emerges?

The Dow Jones Industrial Average gained 28.1% in 2017. This could make investors question why their 401(k) accounts haven't had such amazing returns. The answer is that the Dow is only made up of 30 individual companies and does not represent what individual investors hold in their accounts or at least should not be an equal representation of someone's portfolio. In fact, only five stocks accounted for 50% of the gain for the price-weighted Dow from 20,000 to 25,000.

Diversification is the key to strong long-term results. While it's not fun to see the Dow speed pass your investment accounts' returns in a year like we just had, the focus needs to remain on what works in a market correction also. The S&P 500 index had its first calendar year ever without a down month, including dividends, in 2017. This streak will end, as all streaks do, and investors need to be positioned correctly before the reversion to the mean hits their unbalanced accounts. In a year with such big gains, especially for large-cap stocks, allocations for most investors are out of balance. While it's hard to remove any investments from a bull market that is still surging, it can be harder to take the losses for being ill-prepared when the inevitable happens.

Rather than simply selling positions that have pushed allocations into unbalanced levels, a smarter move may be to use a trailing stop order. A trailing stop allows a stock or ETF to stay in your account while the stop order set to sell trails behind the price and adjusts higher with each tick higher for the investment. If the bull market continues its trajectory without correcting, you continue to reap the rewards. If it corrects, your order is triggered and potential losses are reduced. The risk with such orders is that the investment could decline just to your triggered sell-point and then resume its run higher. Also, in a rare flash crash, sell orders could be triggered at lower prices than you wanted to sell if buyers are scarce.

The point of how shallow or deep to set your order depends on your risk tolerance, your goals, and how unbalanced your allocation is. If your account needs a large allocation rebalance, a 1% trailing stop could be a wise safeguard. If your allocation is close to your plan, a 3.5% trailing stop would avoid triggering a sell on a normal 2-3% correction, but still protect losses from a true 10% or greater correction.

One reason to delay rebalancing too quickly is the historical pattern for how stocks have behaved after each time every S&P 500 industrial group traded above its 200-day moving average. Since 1990, this set-up has happened 10 times and on every occasion the S&P 500 was higher three, six, and twelve months later. The trend could break this time, but would need a catalyst to change the market's direction. Two of the biggest factors that can affect the market's direction are housing and employment. Both are still strong, but employment levels have little room to improve without influencing wage pressures and, in turn, inflation. Some inflation is good for the economy, but excessive inflation can be detrimental when it forces the Fed to raise interest rates more quickly than companies and individuals can adjust.

The Fed is watching inflation closely and has already begun to raise interest rates at a steady pace to avoid creating a prime climate for hyperinflation. Even with the Fed's three interest rate increases in 2017 and its expected three to four more increases in 2018, economists expect inflation to increase beyond the Fed's 2% target. Inflation will increase due to the recent tax cuts, a possible (not probable yet) infrastructure stimulus package, rising oil prices (oil reached a multi-year high again last week), and consumer prices reverting to normal trends after being held back in recent years by the shift to cheaper options for consumers, such as Amazon. The shift to lower cost online retailers kept prices lower, but price increases will emerge now that there is no cheaper option to shift down to. Much of US manufacturing has been outsourced to countries with cheaper labor and we do not have another option left to further reduce labor costs. Interest rates are coming off all-time lows and have room to rise without causing a panic for borrowers, but it should be on investors' radars for possible triggers after this year.

And then there is valuation. At what price to earnings (P/E) ratio will stocks be overvalued in the eyes of investors? Bull markets don't fizzle and die on valuations, but valuations can be a reminder to take more risk off the table. In 2017, analysts reduced their full-year S&P 500 earnings estimates after each quarterly earnings announcement. This is typical for analysts who often are overzealous with their estimates. Estimates for 2018 earnings are currently at $145.37 compared to $124.96 expected for 2017 with three of four quarters already reported.

On a trailing basis, the S&P 500 P/E ratio is 21.40. On a forward basis, the P/E ratio is 18.39, but that's if earnings hit the analysts' target. If earnings are $6 below the estimates for 2018 as they were in 2017 and if the trailing P/E ratio remains at 21.40, the S&P 500 could hit 2,982.52 by the end of the year, 11.55% above 2017's closing level. Investors need to watch for revisions to earnings estimates to adjust targets for year-end since the influence of tax cuts could be slower to produce an effect than some think. If earnings stay flat (unlikely) and the P/E ratio for the index falls to 17 (best case if a recession become eminent), the S&P 500 could fall to 2,124, 20.54% below Friday's close.

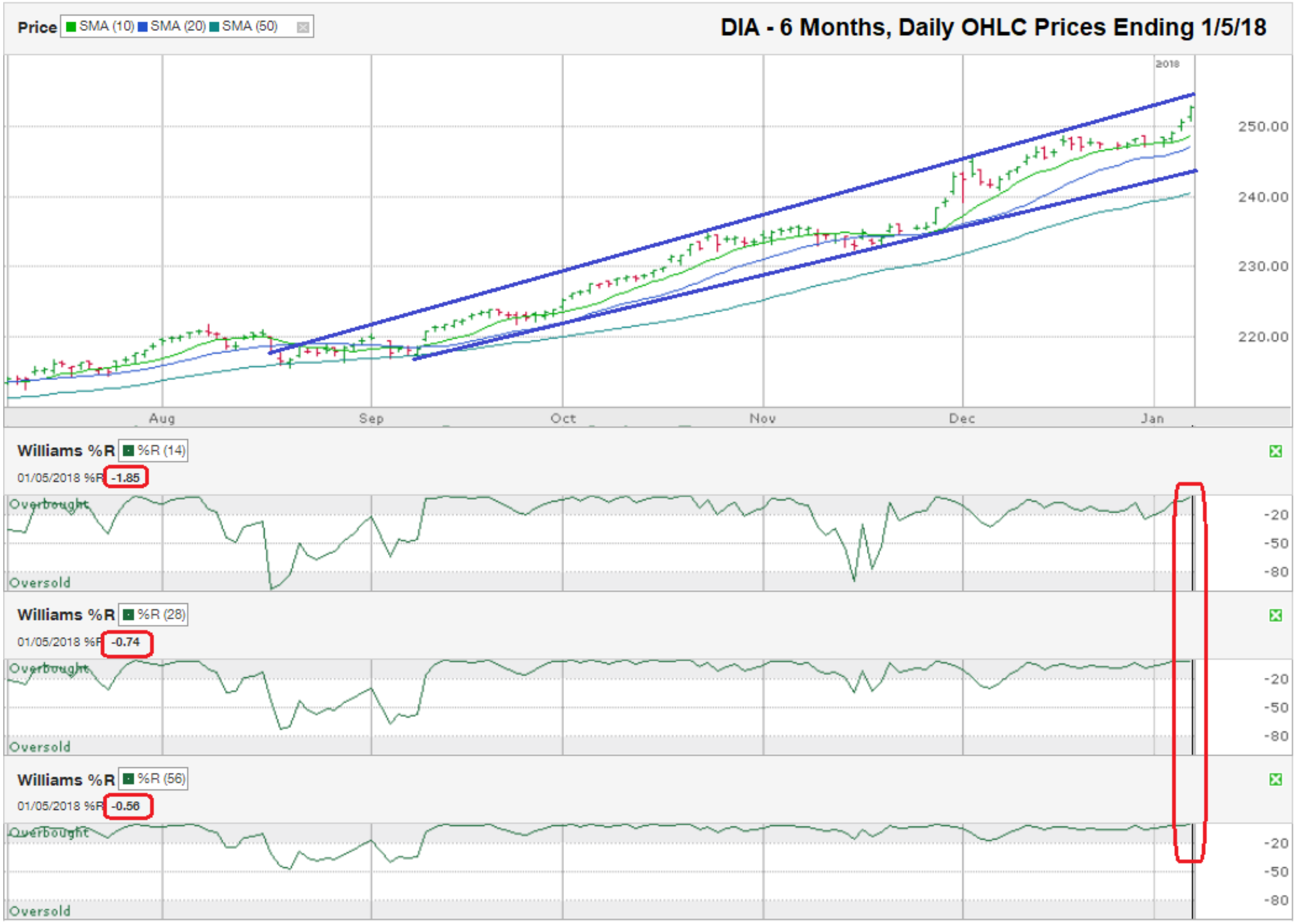
A recession is improbable in 2018, but when it does hit eventually, the P/E ratio will contract even more and losses for stocks could be greater than 30% very quickly as the stampede leaves Wall Street. Investors need to decide how much longer into an aging bull market do they want to stay invested in riskier assets before preparing for the next reversal. Bull markets tend to overshoot beyond what is reasonable for valuations at peaks and, if history repeats, it will be worth taking the risk of maintaining stock investments a little longer.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	1/5/2018	2.37	30.19	15.95	16.32
NASDAQ Composite	1/5/2018	3.38	30.04	15.33	18.14
Russell 2000	1/5/2018	1.61	15.22	11.26	13.70
S&P 500	1/5/2018	2.63	23.34	13.08	15.74
S&P MidCap 400	1/5/2018	1.88	16.82	12.46	14.65
Global Stock Indexes					
MSCI Emerging Markets	1/5/2018	3.67	36.21	8.48	2.19
MSCI World, Excluding US	1/5/2018	2.44	24.32	9.25	7.59
Bond Indexes					
Core Bond	1/5/2018	-0.30	2.78	2.13	2.27
Intermediate Core Bond	1/5/2018	-0.20	2.10	2.07	2.24
Long-Term Core Bond	1/5/2018	-0.68	6.16	3.21	3.88
Short-Term Core Bond	1/5/2018	-0.13	0.89	1.06	0.98

Index Chart & Analysis



The chart above shows the daily prices for the past six months on DIA, the SPDR ETF that tracks the Dow Jones Industrial Average, after closing the week at $252.72 on January 5, 2018. DIA finished Friday within a few cents of its all-time high set only five minutes before the close. Such a strong close at the end of a day, and even more so at the end of a week, illustrates how investor sentiment has swung to an extremely bullish outlook. Investors didn't want to end the week without having as much money invested as possible. This rush to buy could be more of a bearish indicator from a contrarian point of view because there are very few bears left. When bears become scarce, it leaves fewer buyers who are not already fully invested and that's when stocks tend to weaken. The American Association of Individual Investors survey showed 58.8% bullish in its most recent survey compared to the historical average of 38.5%. Only 15.6% of those surveyed considered themselves to be bearish. That's nearly half of the 30.5% historical average.

These qualitative numbers complement what the more subjective technical analysis shows – the market may be overbought and due for a correction finally. I only drew two trend lines on this chart. The lower line shows the trend line of higher lows and the upper line shows the trend line of higher highs. When the large-cap ETF hits the upper trend line it tends to take a break and move sideways, if not lower. When the ETF revisits the lower trend line, it finds support and moves higher. Eventually this trading pattern will break higher or lower and the trend will change. As of Friday's close, DIA is close to where it could find resistance to higher prices again and will begin the retreat towards the lower line.

The trend line of higher lows is less than 4% below Friday's close. If DIA follows the pattern of the past few months, this 4% drop would be exactly what the index needs to reset again before resuming its rally. When traders see support from the lower trend line again, buyers will jump back into their bullish stances and push stocks higher.

Cautious investors need to wait for support and possibly miss the short-term low before allocating more cash reserves into the riskier investment. Aggressive buyers can enter their orders when DIA gets close to the ascending trend line and risk support not working this time.

The three moving averages shown on this chart are the 10, 20, and 50-day moving averages currently at $248.56, $247.08, and $240.51 respectively. Each of these moving averages could provide temporary support for the ETF. Each break below a moving average is another reason for the bears to gather momentum and pull stocks lower. A decline to the 50-day moving average would be a 4.8% drop, but even if stocks began to decline on Monday, the moving average would continue inching higher and may provide a level of support for DIA closer to a 4.0% decline, the biggest drop for the Dow in over a year. I didn't include the 100 and 200-day moving averages at $231.96 and $221.85 respectively, but they will be worth watching if the 50-day moving average breaks support. The 200-day moving average is 12.2% below Friday's closing price. A drop of 10% is considered a "correction" by definition and can be a catalyst for bulls to return. With a correction such as this, the DIA would be very close to its 200-day moving average, thus offering a second reason for buyers to return to the market.

The Williams % R indicator shows overbought and oversold conditions. A stock or index may remain overbought or oversold for weeks or months at a time (see the past four months on the 56-day indicator at the bottom of the chart). The change in sentiment is what matters. When Williams %R falls below the gray overbought area in each of the three periods noted on this chart, traders know a price decline could be more severe than the usual daily and weekly ebbs and flows. As of Friday's close, Williams %R is close to extreme overbought levels, which signals a warning, but insufficient to abandon a thriving market yet. The warning sign could switch to an obvious sell signal soon and will keep traders' attention as we wait for the inevitable correction. I still see this market as one that investors should buy the dips, but we don't have to rush into any dip before we see the falling knife has landed.

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

404-395-2752
alex@afcapitalmanagement.com

Twitter: @AlexRFoster
Facebook: AF Capital Management

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