AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

October 8, 2018
Volume 8 - Issue 4

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Perspectives

Elected officials and the appointed members of the Federal Reserve are often at odds with each other. Politicians want to push the economy to grow faster, sometimes at any cost (e.g. bubbles within the economy and higher deficits). On the other side of the fight, the Fed's mandate is to keep inflation in check. The Fed's best tool to control inflation and slow economic growth is to raise interest rates.

When the US economy was in crisis mode, the Fed cut interest rates to historic lows and maintained the low levels for longer than previous cycles. Their case was that the economy was not recovering fast enough and needed easy access to low rates to encourage lending and help stimulate the economy. The fear among investors was that when the US economy reverted to a recession as part of the normal business cycle, the Fed wouldn't be able to lower rates further to stimulate growth again. In December 2015, the Fed began raising interest rates at a relatively slow pace for the next two years. Beginning in December 2017, the Fed began quarterly "normalization" of the interest rates, taking the rate to 2.25% in September 2018 with the expectation that this pace of quarterly 0.25% increases will continue for the next year.

The fear that the economy couldn't digest higher rates a few years ago has turned into a fear that the economy is growing too quickly and inflation will grow too fast. The US unemployment rate peaked at 10% in October 2009 and then began a steady decline through the most recent jobs report released on Friday that showed the unemployment rate is down to 3.7%, levels not seen since 1969. The third estimate for Gross Domestic Product (GDP) pointed to 4.2% growth for the economy. We are far from a crisis mode now based on the multi-decade low in unemployment and the greater than 4% GDP growth. The need for crisis era interest rates has long since passed.

If the Fed continues at its current pace of 0.25% rate increases each quarter, it should be in a reasonable position to help stimulate the economy by lowering rates when we reach a tipping point again. Some economists argue the Fed will cause the tipping point to come sooner as borrowing costs increase and companies slow down their expansion. At the same time, investors could reallocate their funds from heavily weighted into stocks to a higher percentage of bonds as the yields become more attractive.

The rush to bonds seems to be in the distant future based on how bond prices have behaved recently. Bond prices move inversely to bond yields. This means as rates go up, bond prices go down. The transition to lower bond prices, aka higher yields, does not normally pose a problem if the pace of change is not drastic. Last week, the yield on the benchmark 10-year treasury note rose sharply to 3.2%, levels not seen since 2011. The 2-year yield rose to 2.89%. The leap higher in yields caused a rush to sell stocks on Thursday and again on Friday. Those investors who maintain a 60/40 stock to bond balance are losing more in the decline in bond prices than they are earning in interest. A smaller allocation to bonds still allows for good diversification from stocks, but without risking too much downside in bond prices.

With the trajectory of the Fed's interest rate increases fairly certain, the biggest unknown over the next year is how the economy will handle the implementation of tariffs. The consensus on Wall Street is that the tariff talk is more of a negotiation tactic than a true plan of action. History shows tariffs hurt all economies involved by reducing growth and raising inflation, but if the administration can work out agreements that favor the US without implementing overly burdensome tariffs, the US economy could continue its path of growth, even with higher interest rates each quarter. In either scenario, the economy appears to be on a solid foundation into 2019 and possibly into early 2020.

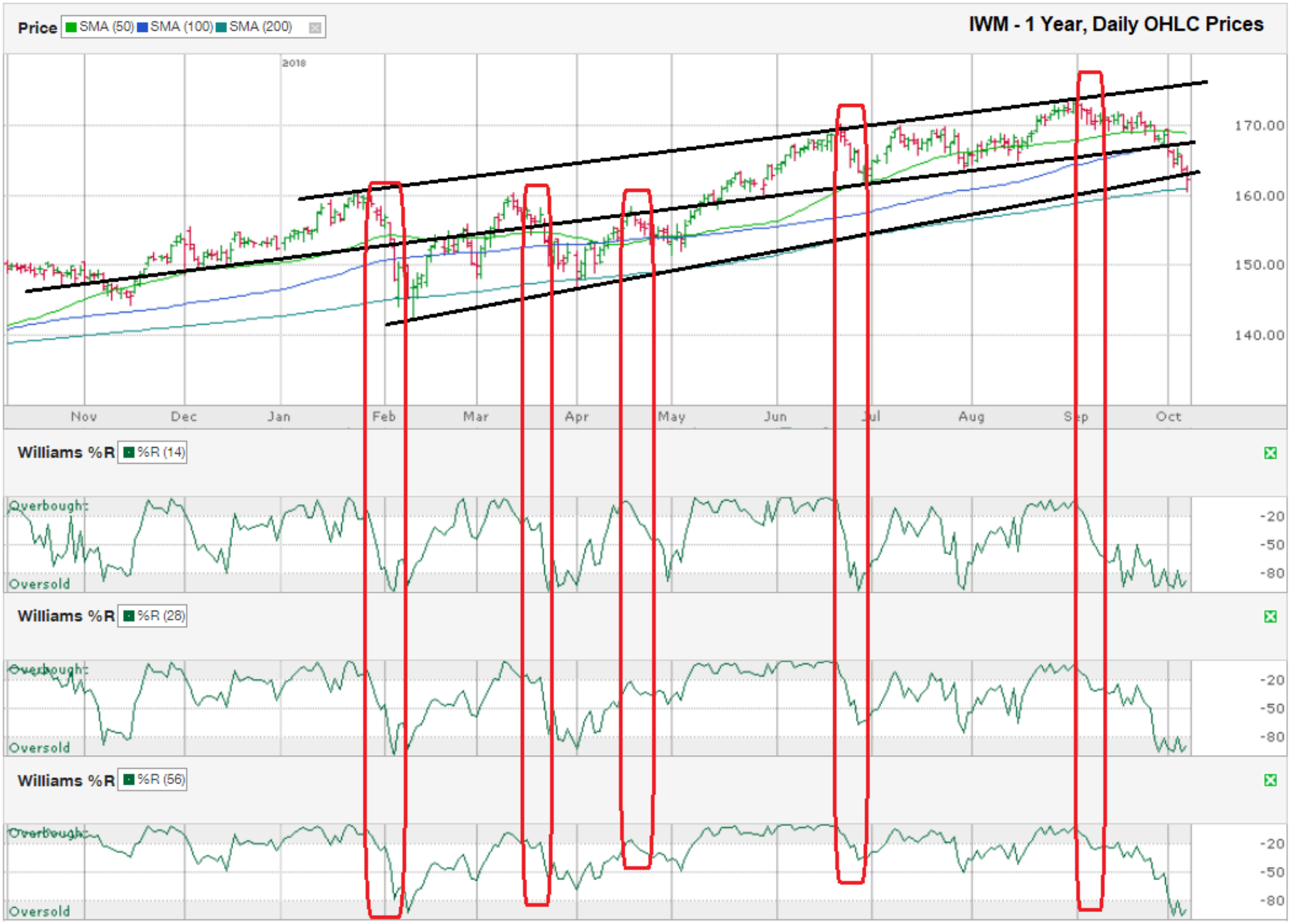
Stocks have had another strong year and while the long-term outlook is strong, we could see a correction (a 10% or greater drop in stock prices) hit the market as interest rates move higher, the tariff talks show actual harm to the economy, and the mid-term elections create uncertainty in future legislation. Until the economy sees a material change and the fundamental indicators begin to weaken, traders will see weakness in stocks as a buying opportunity.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	10/5/2018	8.83	18.75	19.29	14.65
NASDAQ Composite	10/5/2018	12.82	18.27	17.66	15.39
Russell 2000	10/5/2018	7.29	9.31	14.22	10.13
S&P 500	10/5/2018	9.52	15.27	15.60	13.60
S&P MidCap 400	10/5/2018	4.76	9.83	13.47	11.12
Global Stock Indexes					
MSCI Emerging Markets	10/5/2018	-13.61	-9.25	6.81	-0.14
MSCI World, Excluding US	10/5/2018	-3.65	0.35	7.26	3.81
Bond Indexes					
Core Bond	10/5/2018	-2.60	-2.20	1.00	2.06
Intermediate Core Bond	10/5/2018	-1.98	-2.01	0.78	1.97
Long-Term Core Bond	10/5/2018	-6.51	-4.68	1.83	3.75
Short-Term Core Bond	10/5/2018	0.00	-0.26	0.69	0.92

Index Chart & Analysis



The chart above shows the daily prices for the past year on IWM, the iShares ETF that tracks the Russell 2000 Small-Cap Index, after closing the week at $162.16 on October 5, 2018. Small-caps outperformed most indexes in the first half of this year because they were viewed as a safer alternative to large-cap stocks that were more likely to be affected by tariffs due to their reduced exposure to international trade. When the risks of a full-blown trade war (at least with Mexico and Canada) began to subside recently, small-cap stocks sold off quickly. After peaking on August 31 at $173.38, IWM fell to an intraday low of $160.66 on Friday, 7.34% below its all-time high. IWM rallied from its Friday low and finished the week 6.47% below its high.

I drew three main trend lines on this chart. The upper line shows the trend line of higher highs. The middle line shows where IWM found support for most of this past year, outside of the late winter and spring months when it was recovering from a correction. The lower line was the line of higher lows and where many technical analysts expected IWM to find buyers. The trend line held support on Thursday amid the broad sell-off, but broke support on Friday when the pressure was too strong.

The 200-day moving average is slightly below the lower trend line and after the trend line of higher lows broke support, the 200-day moving average proved too strong for the bears and prices reversed. IWM traded below its 200-day moving average for two hours on Friday, which might be a warning signal that it could test another dip in the near-term. However, closing above the moving average tilts the momentum back toward the bulls' side.

Williams %R is one of my favorite technical indicators because it tends to give a clear indication of how momentum within the market is changing beyond the day-to-day or week-to-week trends. In a low volatility market, this indicator is less reliable. I highlighted five of the recent breaks in momentum in red on this chart. The first fall below the oversold level (moves out of the gray oversold and overbought areas are trade signals, not simply being in the extreme areas of the indicator) at the end of January was an accurate sell signal. The next three were false positives. They indicated weakness, but not the beginning of a major price correction.

The most recent sell signal from Williams %R has taken small-cap stocks much lower as highlighted above. The signal that the selling is over won't be issued until all three timeframes (14, 28, and 56-day) move above the oversold area. While traders might miss the first two or three days of upside prices, waiting to allocate more funds to small-caps will reduce the risk of losses if the slide continues.

Traders should keep an eye on all three of these indicators and wait for a better entry point before adding more to their positions. The 200-day moving average needs to hold support, IWM needs to move above the lower trend line, and Williams %R needs to show a reversal in momentum out of the oversold area of the indicator.

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