AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

January 7, 2019
Volume 9 - Issue 1

INSIDE THIS ISSUE

stocks have more upside potential than downside risk in 2019

Perspectives

Many economists expected the stimulus high to last more than a year, but traders, being forward looking creatures, decided if stocks are due to fall in 2020, we should get out of the way now and avoid being caught in a stampede later. That idea spread like wildfire and the stampede (partially thanks to computer algorithms that trade faster than humans) hit in December after historically normal weakness that began at the end of the summer. The result, so far, is a market full of stocks priced cheaply based on market standards.

P/E ratio, a/k/a market multiple, will define the next two years in the stock market. The multiple varies based on investors' expectations of what is to come. During a raging bull market, ratios can break above 20 and during bear markets, they can fall below 12. That's a massive difference based on potentially the same earnings. The difference is direction of earnings expectations. If traders believe earnings will grow, the multiple expands, and stocks move higher. If traders believe we are entering a recession, meaning earnings will contract, stock prices will fall with a lower multiple.

Economic growth slows as macroeconomic events change, such as interest rates going up or tariffs crimping revenues and profits. When rates rise, companies that have more debt will have to spend more on interest expenses. This increased expense will leave less cash available to expand production, hire more workers, and buy back shares and will slow demand for stocks. Economics 101 taught us lower demand and steady supply will force lower prices in most situations, but if earnings continue to grow, stock prices could stabilize at a minimum and possibly still rise even without corporations acting as the buyers of last resort, as long as the price to earnings multiple seems to offer value.

When governments enact tariffs, companies have to decide how much of the additional input costs to pass on to their customers. Any part of the cost they do not pass along to customers hurts earnings and brings down stock prices. When the price of the end product goes up, customers have to decide if the goods are still worth the extra cost. The less exact effect of tariffs is how nationalism plays its part. For example, Apple noted last week that sales in China slowed substantially. Some analysts attribute this change to many Chinese buyers looking for a Chinese product rather than an American product to use as their status symbol. While this might be anecdotal, Apple is the second largest company in the world and is a large contributor to the declines in stock indexes.

Since the Great Recession, fear has caused sell offs a few times on events that amounted to nothing after the dust settled. An early cause of panic selling was the possibility that China would have a hard fall from its massive growth, followed by the concern of Greece and Italy's debt defaults. The Brexit vote shocked the markets and caused intense selling that was short-lived, just as fear of the bird flu epidemic did to a lesser extent. The current unknowns are related to interest rates and tariffs. Has the Fed already gone too far too fast in raising rates or have they paused at the right time after raising rates from emergency levels, but not so much that the economy will collapse? Will the US and China reach an agreement that will benefit the US enough to help our companies, but not destroy the Chinese economy, which in turn would hurt our exporters?

The only input that matters in the end is the trajectory of earnings. All other data is trying to predict this single input. Earnings saw a huge increase after the stimulus from tax cuts and regulation cuts, but traders like to see continued improvements, and without more stimulus, the year over year comparisons will suffer. The current 2019 mean S&P 500 earnings forecast is $172 with a wide range of estimates on both sides. Even with a wide range of estimates, it's worth the exercise of projecting where stock prices could move as the data is reported to give us an expected range of movement for the S&P 500. This range helps identify the risk/reward potential for the market.

S&P 500 earnings for 2018 are estimated to be $156.99, giving the index a trailing P/E ratio of 15.97 as of December 31, 2018. Using the $172 estimate for 2019 earnings and the same P/E ratio that we had at the end of 2018, the S&P 500 would hit 2,746.84, a gain of 240 points or 9.6% plus dividends. If the P/E ratio expands to 18 and the consensus $172 earnings is correct, the S&P 500 could reach 3,096, a gain of more than 23%. While highly unlikely, it is possible. If earnings are on the low side of estimates, as companies like Apple are beginning to lower guidance, and the P/E ratio drops to 14, the S&P 500 could decline to 2,310, a 7.85% decline, not counting dividends. When the possibilities are viewed together, stocks have more upside potential than downside risk in 2019.

If we have an end to the tariff war and a halt of interest rate increases during 2019, stocks will move higher with little resistance until the next fear surfaces. At some point in 2019, or possibly 2020, investors will anticipate a recession to surface again and that is when we could see a true bear market. Now is not that time. If the government shutdown drags on for months, US GDP will slow faster than forecast currently and a recession could hit sooner than later. This collection of unknowns, with vastly different potential outcomes, is why the stock market has seemed schizophrenic over the past few weeks with multiple days posting gains or losses greater than two percent. The market will calm down as each issue works through its process. By then, we'll have something new on which to focus.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	1/4/2019	0.50	-4.41	13.72	9.94
NASDAQ Composite	1/4/2019	1.56	-4.79	11.18	10.28
Russell 2000	1/4/2019	2.40	-10.07	9.10	5.04
S&P 500	1/4/2019	1.03	-5.21	10.19	8.91
S&P MidCap 400	1/4/2019	1.29	-11.25	8.63	6.44
Global Stock Indexes					
MSCI Emerging Markets	1/4/2019	-0.07	-19.08	7.92	-0.30
MSCI World, Excluding US	1/4/2019	1.13	-14.70	4.37	0.74
Bond Indexes					
Core Bond	1/4/2019	0.20	0.41	2.11	2.66
Intermediate Core Bond	1/4/2019	0.18	1.22	1.95	2.68
Long-Term Core Bond	1/4/2019	0.44	-2.30	3.36	4.55
Short-Term Core Bond	1/4/2019	0.02	1.61	1.34	1.18

Index Chart & Analysis

The chart above shows the daily prices for the past six months for the S&P 500 index, a/k/a SPX, after closing the week at 2,531.94 on January 4, 2019. The S&P 500 fell 20.2% from its intraday high of 2,940.91 on September 21 to its intraday low of 2,346.58 on December 26. The technical definition of a bear market is a 20% drop from high to low. Some technical analysts use closing highs and lows, but most of us use intraday prices. The fine line doesn't matter as much to the individual retail investor who only needs to know that some computer algorithms are set up to sell until an index reaches the 20% threshold and that buying can resume after the index moves above the 20% demarcation line.

So far, this technical benchmark has worked in turning the market's trend and the Williams %R technical indicator supports the idea that a near-term floor is in place for stocks. I circled the points on the Williams %R indicator where it reached a maximum reading of 100%. In most cases, when a stock or index shows a 100% reading on each of the 14, 28, and 56-day periods, it indicates a reversal of the trend will occur within the following one or two days. The SPX hit this point on December 24 and bottomed the following trading day on December 26. While reaching the 100% reading is key, the absolute buy signal comes when Williams %R moves out of the oversold range, which indicates the worst of the selling is over and sentiment has changed. All three of these periods showed a clear break above oversold on December 27.

An index can retest its previous low after rebounding and if it doesn't fall below the previous low, a "double bottom" is in place and stocks will have a green light to move higher. If the test of the previous low does not hold support, the index is likely going to push lower and follow the trend line of lower lows that it hit again on December 24. Any bounce off of this lower trend line could be a buying opportunity, but the probability of a rally to last increases when Williams %R agrees with the momentum shift.

The SPX traded below its 10-day moving average from December 4 until December 28. The move above the 10-day moving average in late December is another bullish signal. After a massive rally on Friday, the SPX hit resistance at its 20-day moving average, but after an 83-point (3.4%) gain on the day, it can be excused for not pushing further into the green. The 20-day moving average has acted as resistance in the past and will be important to watch in the coming days. If the SPX can move above its 20-day moving average, currently at 2,538, it does not have another technical barrier to face until its 50-day moving average, currently at 2,645.

After the large cap index breaks above its 50-day moving average, the trend line of lower highs that began on October 3 and was touched again on December 3 will come into play. The descending line is slightly above 2,700 now, but it could be closer to 2,675 or even 2,650 by the time the SPX climbs that high. This trend line marks the top of the trading channel for the index and will be close to a 50% retracement of the past few months' price decline. Traders will pay close attention to this point of the chart and should expect the rally to pause and possibly dip two to three percent before regaining support enough to push through. Either way, this will be a point to reassess the technicals for further forecasts.

AF Capital Management, LLC
6935 Hunters Knoll NE
Sandy Springs, GA 30328

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.