AF CAPITAL MANAGEMENT
Registered Investment Advisor

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INSIDE THIS ISSUE

Investors need to see through the screams and smoke screens to stay focused on true economic fundamentals

Perspectives

Wall Street likes to see growth in earnings from corporations to show their profitability is expanding. It's not enough to have a steady stream of income. Investors want to see the faster growth to outpace inflation and the more static income from fixed income (bonds, REITs, etc.). After the tax cuts and the regulation changes from over a year ago, stocks rose quickly, but corporate earnings face challenging year over year comparisons with some predictions for earnings to fall short of last year by as much as 3.8%.

This change in expectations has many investors wondering if the economy has peaked and is destined for a recession sooner than later. Those worries have sparked some traders to call for the Federal Reserve to lower interest rates at their next meeting rather than wait for the fundamentals to slow. The White House has called for lower rates too, but they also claim we are in the middle of the greatest economy the US has seen in decades. The two statements do not go together in the minds of most economists. If the economy is great, why do we need further stimulus? If the economy needs stimulus, why is it considered the greatest in decades?

The Fed has been relatively quiet in its plans after announcing a few months ago that it would pause before the next interest rate hike. As the Fed says, it is "data dependent" and will wait for the data to change before reacting. The reasons behind this philosophy are that interest rates remain at historically low levels and the Fed would like more room (aka higher rates) before the next recession hits so it can cut further when necessary. Also, the Fed has two objectives in its mandate: (1) to keep inflation in check, which means close to 2.0%; and (2) to keep unemployment low.

The unemployment rate remains very low and close to what is considered full employment, even when those who are employed part-time, but are seeking full-time employment, are included in the figures. Inflation is in check and could fall below 2.0% in 2019. The cries for rate cuts are based on this second point. Those in favor of lower rates argue that the US needs more inflation to allow companies to grow more (see paragraph one). Higher inflation also will help the US deal with its rising debt issues, which both major political parties seem unable to get their arms around. The idea is that if we can't cut spending or raise revenues (some want further tax cuts), then we need to reduce what the US dollar is worth to cover our debts.

These views are near-term focused only. In an age of instant gratification, politicians and Wall Street proponents are focused on what keeps them employed now, not what is best for the economy for future decades. The good news is that the Fed is independent and is unlikely to heed the calls from those outside their committee. The bad news is that the pressure from the outside might cause them to delay the next rate cut longer than they should to prove they are not influenced by others. For now, no interest rate cuts or increases are needed while the dust from the past few rate hikes settles and the economy adjusts to more of a normalized interest rate environment.

Wall Street works in waves of storylines that move the markets. The validity, or lack thereof, of these storylines can be where investors can find opportunities while others chase rumors, fears, and hopes rather than reality. The current market moving focus is on the bond yield inversion, also known as an inverted yield curve. The story goes, when a shorter duration bond has a higher yield than a longer duration bond, the market is due for a recession. The inversion happens because investors are pessimistic about the near-term prospects for the economy and are trying to go into hiding before stock prices fall. A recession is predicted to begin 18 to 24 months after the yield curve inverts and the duration of the bonds that invert matters. Recently, the three-month Treasury bill yielded 0.01% more than the 10-year note. Commentators on business TV and on the internet impersonated Chicken

Little, crying that the end was near. This inversion lasted for five days before reverting to normal. The interesting part of this anecdote is that these two specific bond instruments do not have the same predictive reliability that the 2-year and 10-year notes have. That didn't stop the screams of panic. The final point worth noting is that with a prediction so far into the future, it's hard to be wrong. If it doesn't hold true in the first 18 months, we can wait another six months or longer and still can be correct with the prediction. In other words, if we predict another recession will happen eventually, we all know we'll be right if we wait long enough.

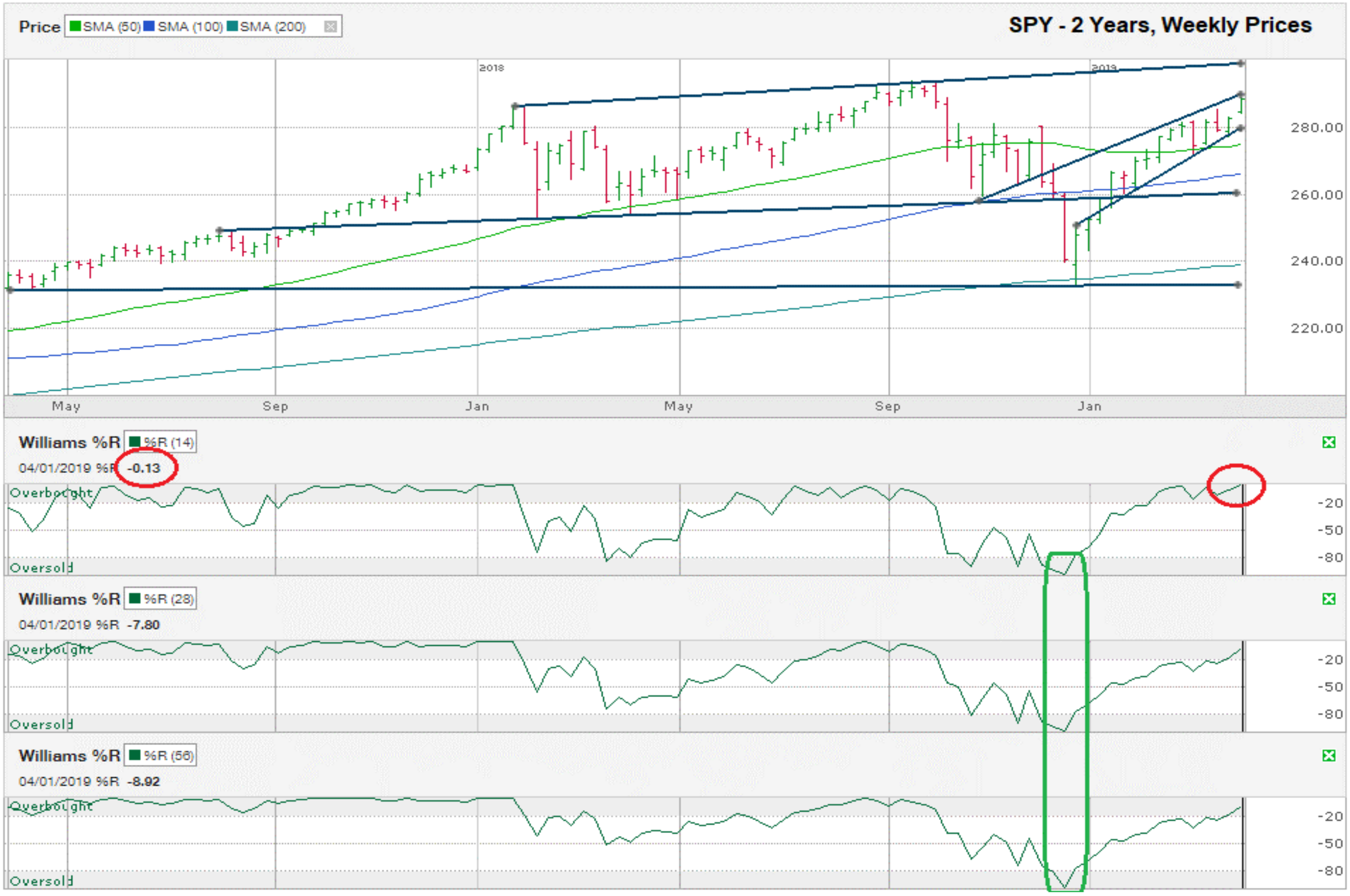
The takeaway remains the same as always. Investors need to see through the screams and smoke screens, stay focused on true economic fundamentals, and not rush into panic selling with every new or repeated doom and gloom theory. Fundamentals are more mixed recently than they have been over the past few years, but the economy is still growing at a reasonable pace, which means any market dips in the near-term will be buying opportunities until macro-economic inputs change.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	4/4/2019	13.82	11.31	16.94	12.66
NASDAQ Composite	4/4/2019	18.94	12.07	17.28	13.84
Russell 2000	4/4/2019	16.66	3.74	13.79	7.80
S&P 500	4/4/2019	15.48	11.09	13.99	11.34
S&P MidCap 400	4/4/2019	16.83	4.79	12.18	8.91
Global Stock Indexes					
MSCI Emerging Markets	4/4/2019	11.90	-6.48	9.34	1.52
MSCI World, Excluding US	4/4/2019	12.51	-0.51	8.51	2.40
Bond Indexes					
Core Bond	4/4/2019	2.55	4.37	1.88	2.76
Intermediate Core Bond	4/4/2019	2.14	4.55	1.76	2.73
Long-Term Core Bond	4/4/2019	4.76	5.31	2.75	4.50
Short-Term Core Bond	4/4/2019	1.36	3.28	1.38	1.30

Index Chart & Analysis



The chart above shows the weekly prices for the past two years for SPY, an S&P 500 index ETF, after closing the week at $288.57 on April 5, 2019. SPY has moved higher in a tight trading channel since its low on December 24, 2018. As of Friday's close, the large-cap ETF rested at the top of that narrow trading channel marked by its trend lines of higher highs and higher lows. At a glance, technicians would normally call for the next move to be lower, towards the trend line of higher lows. The price action may play out like that, but the downside is limited to around eight points in this scenario. This tight range makes it something to watch, but not something bulls should fret over unless support at the lower trend line does not hold the prices within its upward trend.

The more important trading channel is the longer one that goes back to the summer of 2017 on the low side and early 2018 on the high side. The downside risk within this trading channel is approximately 9% lower from Friday's close. The upside potential is close to 4%. In most investors' eyes, that ratio is not the risk/reward balance we're looking for. Bulls will have to expect this resistance line of higher highs to break and allow the S&P 500 more upside room to move. Bears are starting to lick their chops in the hopes of a return to $260 for SPY, if not all of the way down to its lowest trend line of lower lows. This bottom trend line could offer support after an 18% decline. If stocks fall this low on a reaction to the technicals, value investors and technical traders will back up their trucks to buy as much as possible at depressed prices during an economic cycle that's still expanding.

The 200-week moving average might help stop SPY from reaching the lowest trend line, but only by $5-10 based on the current spread between the two indicators. In other words, we should expect to see cash coming off the sidelines on the buy side if SPY reaches the lower $240s.

The Williams %R indicator may help validate the call for limited upside. This technical indicator is an art rather than a clear-cut trade signal. For now, the 14-week period indicates an extremely overbought market. Ideally, to signal a sell warning, the 28 and 56-week indicators should match the 14-week's signal, as we saw in late December when all three timeframes lined up to signal a buy call. This is where the "maybe" part of the prediction comes in. If SPY reaches the upper trend line of higher highs within the next two weeks, the 28 and 56-week indicators for Williams %R should show an extreme overbought signal at the same time.

If the upper trend line acts as resistance to higher prices, the Williams %R indicators show momentum has moved too far too fast, and the SPY is 25% above its 200-week moving average (SPY at $300 and the 200-week moving average at $240), then the bears will be in the catbird seat with a huge gap to fill to the downside.

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