AF CAPITAL MANAGEMENT
Registered Investment Advisor

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Interest rates are not where they should be right now, but until the smoke clears it isn't safe to run at full speed in any direction

Perspectives

Investors have been focused on the interest rates for years. Most investors have an opinion on what the Fed should do based on how they, as investors, interpret the facts as to where the economy is headed. The arguments to raise rates, cut rates, or maintain rates can sound very logical when articulated by a reasonable person.

Those who want rates cut can see the economy is slowing. The stimulus from Trump's first term already has worked through the system and we don't have another catalyst to push revenues and earnings higher. The main catalysts hurting earnings now are tariffs and the threat of more price increases from additional tariffs if the leaders can't reach an agreement. At a minimum, tariffs have caused some companies and individuals to pause decisions to purchase more goods. At the maximum, tariffs have been a direct hit to the bottom line of companies which can't raise prices enough to cover their increases in import prices.

Investors who want another rate hike point to the stock market trading at all-time highs and how well the economy is performing based on historically low unemployment levels and high housing prices. This group argues that if we are actually in the middle of the "greatest economy our country has ever seen," rates should be higher so that when it does slow, the Fed will have room to lower interest rates and stimulate the economy when it needs it rather than to, once again, push us into a larger bubble.

The final group who do not want a change understands too much is in flux now to make a move either way. If the US and China reach a trade deal, the economy should move higher without much of a headwind. Such a deal would require the Fed to reverse its rate cut and possibly raise rates another quarter of a point (if not more) to keep the economy from overheating. If a deal is postponed, the economy will need a rate cut sooner than later and any rate increase would have to be reversed to help the economy that is trying to digest higher input costs. In other words, this third group suggests that it makes more sense to await what happens next rather than having to change course too soon. Most investors who follow this logic would agree that interest rates are not where they should be right now, but until the smoke clears it isn't safe to run at full speed in any direction.

At some point, one side, will have to give up some of what they are asking for in the negotiations. The US might be at a disadvantage with this timeline since the President faces an election next year and will need to show that his efforts are helping the economy. Without a deal, the economy will continue to slow and his chances for a reelection will diminish. Some investors do not vote based on the economy's strength, but the center of each side's base is more likely to let someone less desirable than they'd like to remain in office as long as they are personally prospering under that elected leader. This middle group decides elections and rarely looks for change when life is working out for them.

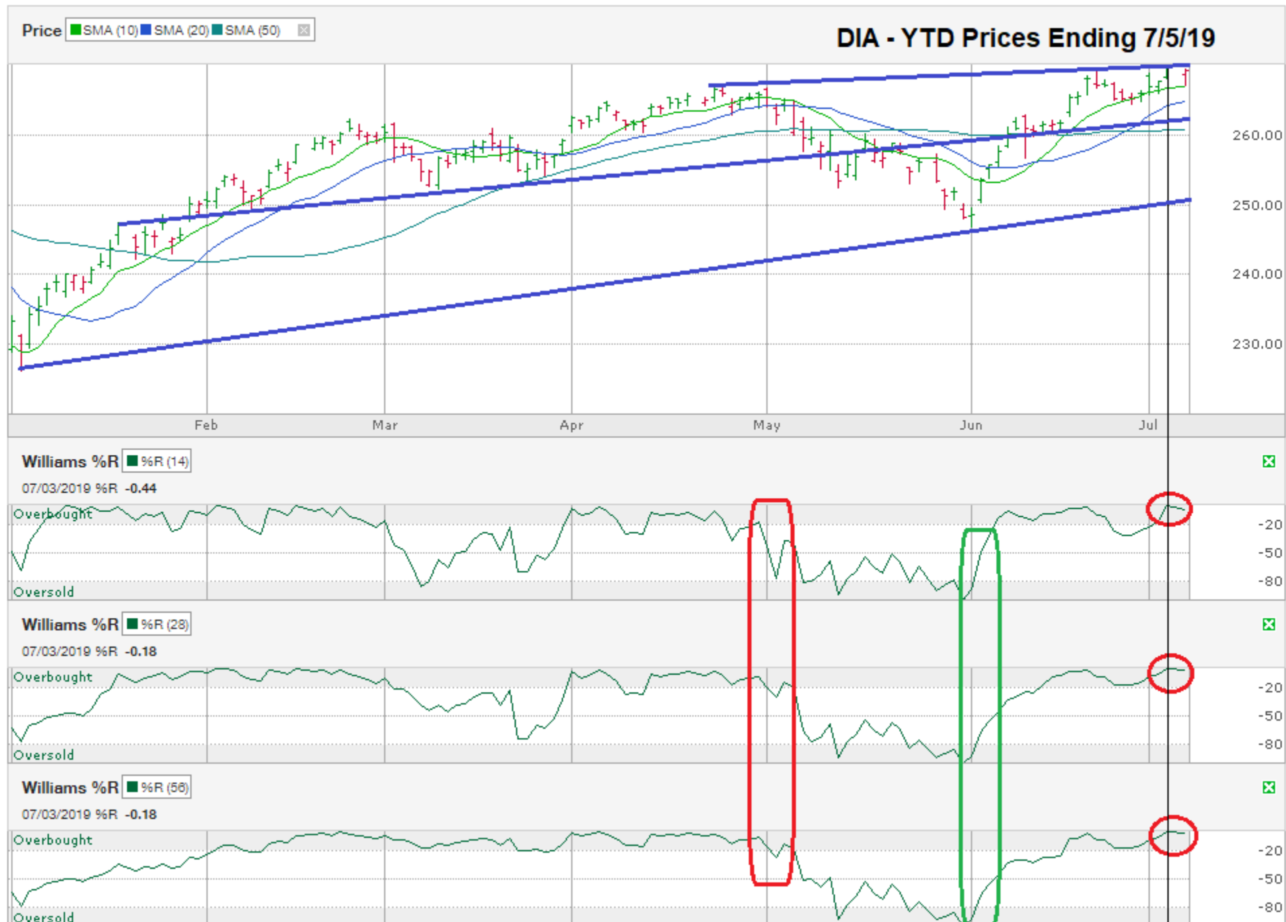
With a country as divided as ours is, it won't take many voters to sway the election in either direction. This uncertainty will begin to weigh into the market next year and the price to earnings multiple investors are willing to pay tends to shrink in election years. While the economy has prospered under both democrats and republicans at different parts of the business cycle, the rhetoric from both camps will hurt investor sentiment and make 2020 a more challenging year for investing. Until then, it's best for investors to stay nimble and be ready to change their portfolios to adjust for a signed policy change, not just rumors and tweets.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	7/5/2019	16.87	13.19	17.48	12.25
NASDAQ Composite	7/5/2019	23.01	7.58	19.17	12.72
Russell 2000	7/5/2019	17.68	-4.86	12.93	6.92
S&P 500	7/5/2019	20.55	11.51	15.01	10.80
S&P MidCap 400	7/5/2019	19.23	1.25	11.65	8.08
Global Stock Indexes					
MSCI Emerging Markets	7/5/2019	9.75	0.53	8.42	-0.05
MSCI World, Excluding US	7/5/2019	15.25	2.04	9.36	1.94
Bond Indexes					
Core Bond	7/5/2019	5.93	7.57	2.05	3.16
Intermediate Core Bond	7/5/2019	4.63	6.82	1.98	2.94
Long-Term Core Bond	7/5/2019	11.86	12.35	2.72	5.33
Short-Term Core Bond	7/5/2019	2.99	4.67	1.60	1.64

Index Chart & Analysis



The chart above shows the daily prices for the year-to-date through July 5, 2019, for the Dow Jones Industrial Average ETF, after closing the week at $269.27. DIA moved higher quickly since bottoming at the beginning of June. The moving averages favor the bulls with DIA trading above its 10, 20, & 50-day moving averages. So far, the large cap index has found support along its 10-day moving average, but it faces a couple of technical hurdles now.

The Williams %R indicator points to changes in sentiment. Touches on the extreme levels of this technical indicator signal likely changes in market direction. On July 3, DIA nearly reached the absolute maximum overbought level (shown in small red circles). The same pattern hit in early May (shown in the red rectangle) before stocks sharply sold off. The reverse, close to absolute levels of being oversold (shown in the green rectangle), emerged at the beginning of June as stocks began their recovery. If the indicator is correct again, stocks will move lower soon.

DIA has traded in a wide trading channel this year and the trend line of higher highs is acting as resistance again. This trend line could be enough to stop further price improvements until stocks can consolidate their gains after the Dow's best June since 1938. At best, stocks might move more sideways than higher. At worst, the other technical indicators could be correct, and the Dow Jones index would be due for another retreat.

The middle trend line drawn on this chart shows where DIA has faced both resistance and found support at different points. A drop to this line would equal close to a 2.0 to 2.5% decline before rebounding. That's small enough to be part of the normal ebbs and flows of the market's cycles. A decline to the longest line drawn, the trend line of higher lows, would be nearly a 6.5% drop. Historically, the market tends to have declines of 5% a few times per year and 10% at least once per year. This expected trading range means

any near-term decline should not cause panic for those who have a time horizon of more than a few weeks or months.

On the fundamental side, data is mixed, but generally positive still with low inflation, strong jobs data, and firm housing prices. Unless the fundamental data change or a larger macroeconomic event changes the outlook, any near-term dip in prices will be a buying opportunity after stocks find their footing again.

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