AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

April 6, 2020
Volume 10 - Issue 2

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… rebalancing decisions have to be made with a long-term outlook.

Perspectives

Over the past couple of months, investors received a tough reminder that "buy and hold" is very different from "buy and forget". Knowing when to sell and rebalance investments is just as important as timing entry points into the markets. In my January newsletter, I wrote, "…it is a time to consider reducing some risk from investments and keeping some cash available for when, not if, we see prices drop again." I also added, "…the upside potential in stocks appears to be much lower than the downside risks over the next two years."

This outlook was not based on the belief in early January that the world's economy would be devastated by a respiratory virus, but by common sense investing and discipline. Stocks were overbought coming into 2020 and the earnings forecasts did not match the rise in stock prices. Stocks tend to rise above what is considered a reasonable valuation late in bull markets and then they correct to remove the excesses. This is the pattern stocks follow in every business cycle. By January, I pointed out that we needed a correction in prices to keep the bull market healthy for the longer-term. In other words, the destruction in the markets was not completely caused by COVID-19. Part of the decline came from popping the bubble that had formed. Investors were attempting to hold on until the last minute to squeeze out an extra few dollars in stocks rather than potentially miss out on timing the exact top to protect years of unrealized gains.

Just as stocks overshoot to the upside, they overshoot to the downside also, which creates buying opportunities for those who rebalance their investments on a regular basis. Predicting when that overshoot to either side reverses is far from obvious, but maintaining a disciplined investing strategy removes some of the uncertainty, locks in gains, and creates "dry powder" for when a better buying opportunity presents itself.

The fundamentals made my January prediction relatively easy, but the data releases in recent weeks are worthless now because they are reporting information from before the economy completely broke down. Most of these data points are lagging indicators of what is to come and because too much has changed since the information was gathered. We all know few companies will be able to meet their earlier projections. So, in a vacuum, investors need to continue to focus on the long-term, just as they should have been doing in January. These unforeseen economic events are why advisors recommend keeping an emergency fund and a separate savings account for large purchases planned for the near-term.

Investors who do not need cash from their investment accounts for the next couple of years do not need to panic. The downfall is creating a buying opportunity rather than a selling opportunity this late in the cycle. Those who are still employed and have access to a company retirement plan (401(k), SEP-IRA, etc.) already are automatically buying at much lower prices already and will benefit from their recent purchases when the recovery begins. Investors who do not have automated regular contributions need to maintain their long-term plan, rebalance their asset allocation, and be happy they do not need to sell while prices are low.

While fundamentals cannot help guide our buying decisions in a short-term outlook, these data points are going to be key over the next couple of years when compared to the previous year's reports because they will show year-over-year growth again. Most stock market gains are based on expected growth. We know the economy had negative growth (a pleasant term for losses) in the first quarter and will be worse in the second quarter. We do not know when economic activity will bottom, but we do know it will reach a bottom at some point and that turning point is probably going to be this year. The stock market does not wait to see the bottom in economic activity before reversing declines. Investors anticipate economic turn arounds and begin adding to new long-term positions before the reality of the turnaround is evident.

Investors who do not maintained a disciplined approach will get spooked when told that the US economy is in a recession. A recession is defined as two consecutive quarters of negative growth. As noted above, we should expect at least two quarters of negative growth and plan for it now, not after the official announcement. By the time the recession is official, the economy should already be on the road to recovery and the stock market should be much higher. At the same time, investors need to manage their expectations for how high stocks will move before valuations get extended again. The new reasonable maximum price for stocks is lower than it was a few months ago and, remember, that maximum price was already stretched before the world went on lockdown.

Three of the key factors that helped push stock prices as high as they were have changed in the following manner:

(1) companies have been buying back their own stock shares for years which created a temporary floor to prevent major price declines. Most of those buyback programs have been eliminated now due to lack of profits available while revenues are down substantially and by government mandates to companies that take part in the relief bill;

(2) companies are cutting dividend payments based on the same two reasons. Dividends created a steady income stream for investors who could not get those returns from fixed income markets. Without reliable dividends, investors have less reason to risk stock market fluctuations; and

(3) tax cuts gave a short-term stimulus to the economy before the year-over-year comparisons accounted for the change. As the government doles out trillions of dollars to save lives, our national debt is growing faster than ever. Most models show the need to raise taxes to pay for these expenses. Whether or not politicians will understand this point is yet to be seen.

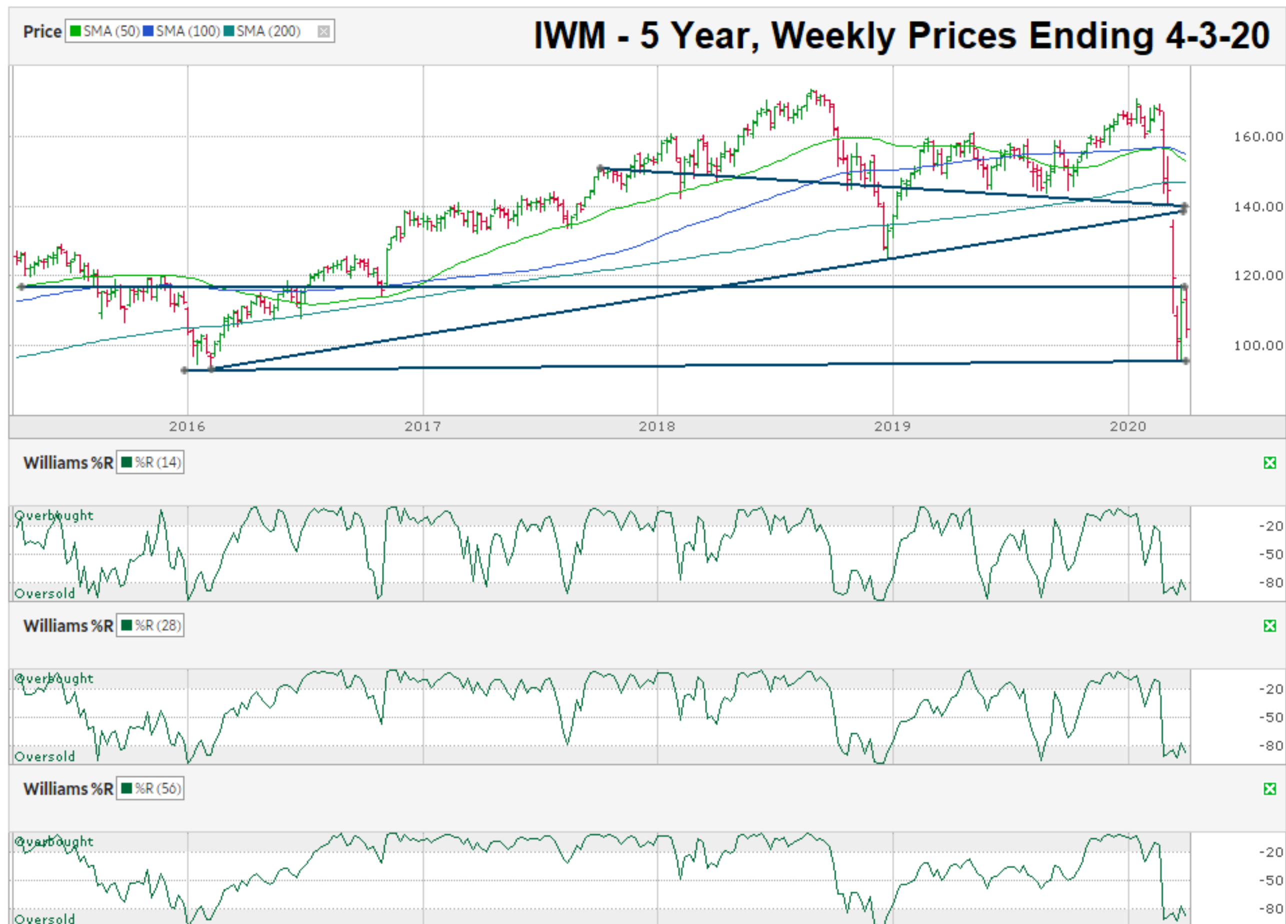
As a silver lining, investors need to remember how percentages work for losses and gains. A stock that loses 50% will have to have a 100% gain to return to its previous level. For example, if a stock was valued at $100 and fell to $50 it will have lost 50% of its value. For that stock to return to $100, it will have to gain 100% (aka double in price). The benefit in this example is that if investors begin to rebalance their accounts and put cash reserves into stocks while prices are down, their gains will be phenomenal, even if we do not get back to previous highs within the next year or two. These rebalancing decisions have to be made with a long-term outlook. In a world without a definitive end to the chaos, stock prices could fall further. Investors have to remember their stock investments are not for today's needs, but for needs in the distant future.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1 Year	3 Years	5 Years
US Stock Indexes					
DJ Industrial Average	4/3/2020	-26.23%	-19.70%	0.65%	3.46%
S&P 500	4/3/2020	-22.97%	-13.39%	1.80%	3.78%
Russell 2000	4/3/2020	-37.52%	-33.71%	-9.29%	-4.20%
S&P MidCap 400	4/3/2020	-31.15%	-25.03%	-3.54%	-0.34%
NASDAQ Composite	4/3/2020	-17.83%	-6.62%	7.74%	8.57%

Index Chart & Analysis



The chart above shows the weekly prices for IWM, an ETF that tracks the Russell 2000 small-cap index, after closing the week at $104.62 on April 3, 2020. Most charts have an easily recognizable pattern when I look at them. Due to the recent carnage in the markets, I had to zoom out to a five-year view to find any hints of what just happened and what could be on the horizon. Even on a five-year weekly prices basis, some indicators do not help much still.

The moving averages are so far away from current prices that they have become irrelevant, other than to show how much we've seen prices fall. In most cases, when an index or individual stock is 20% above or below its 200-week moving average, we have reason to expect a change in the pattern. IWM is trading nearly 30% below its 200-week moving average. While this distance doesn't give chart technicians a nearby target to pick, it is likely the rubber band effect will narrow the gap in the coming weeks and months.

The Williams %R indicator hasn't shown oversold conditions that were as pronounced as the brief drop in December 2018. Without a reading closer to -99, we need to wait until the small-cap ETF's indicator moves out of the oversold area for at least three days. One or two days above the oversold area could be an anomaly while an extra confirmation day can point to a lasting recovery. This signal delay will cause traders to miss timing the absolute bottom, but will also prevent buying before the final bottom is recorded.

The trend lines offer the best guidance for now. The week of March 9 gapped lower at the open which pulled IWM below its trend line of higher lows that began in February 2016. In the same week, IWM lost support of its trend line of lower lows that began more than two years ago. The result was a massive sell-off by the algorithms that produce the vast majority of trades.

IWM found support slightly above the floor established over four years ago. The bounce from the lows pulled IWM more than 20% higher to reestablish a wide area of resistance and support last seen in 2015-2016. The key point to watch for an upside breakout is this long trend line that is currently at $117.60, the intraday high from March 26. After breaking above $117.60, the small-cap index could rally another 15% before it meets the trend line of lower lows mentioned above.

To the downside, the key point of support is the March 19 intraday low of $95.69. This is more likely to hold on a retest as the outlook begins to improve for businesses to open up again in the coming months. Each week we get closer to an answer of when the virus' curve will flatten and that expectation should provide stocks with a floor. If the virus' curve worsens more than expected and stocks cannot hold onto the previous low, we could see IWM move as low as $75 before finding support from its 2012 lows.

The charts do not say to buy or sell right now. They say wait for the indicators to change and be ready to react when they do. At the same time, for longer-term investors, the idea of buying IWM below $105 when it was over $170 less than three months ago and should return to $135-140 within a year (if not much sooner) is very tempting and likely a good buy now, given enough time to recover and the stomach to accept further losses in the short-term if the headlines get worse.

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