AF CAPITAL MANAGEMENT
Registered Investment Advisor

The Investors' Newsletter

January 11, 2021
Volume 11 - Issue 1

INSIDE THIS ISSUE

…are stocks priced for perfection now and due for a temporary correction?

Perspectives

For the past few years, one of the key points of my January newsletter was to focus on the valuation of the stock market with the goal of gaining some insight into where the market could trade by the end of the year. In 2021, the economy has too much uncertainty built into it to provide any reliable prediction for corporate earnings. This ambiguity means 2021 will be harder to navigate than 2020 for investors. A year ago, I argued stocks were overextended and due for a sell-off. By my April newsletter, my outlook reversed, and I said, for those who "put cash reserves into stocks while prices are down, their gains will be phenomenal". While nearly every asset class benefited from the change in sentiment away from panic, none performed better than small-cap stocks that have more than doubled since their springtime low. This outperformance begs the question: have they gotten ahead of themselves again?

Bulls make the obvious case that earnings will be better in 2021 because we are not expected to have a multi-month complete nationwide lockdown again (although rolling regional lockdowns are likely). Year-over-year comparable data will be easy to beat for many industries as the economy continues to reopen. Uncertainty over who will win elections is behind us and we have verified vaccines that are rolling out. Interest rates remain low and Congress is likely to pass more stimulus/relief legislation to help the economy even more. According to DataTrek Research, since 1948, when Democrats control the White House and Congress, the S&P 500 has gained an average of 14% and the Dow Jones has gained an average of 15.7%.

It's hard to argue with any of the bulls' logic, but as investors we have to look for the counter argument in every situation to be sure we are not blindsided by obscure risks that could push stocks in either direction. The obvious risk is that all of the inputs listed above might be factored into stock prices already. The fact that the world economies would not stay muted forever is why stock prices rebounded so quickly once panic selling abated. The question is, are stocks priced for perfection now and due for a temporary correction?

We've seen the speed of the vaccine rollout fall far short of early predictions. Since the vaccine's ability to change how consumers act is at the root of most forecasts, the pace of vaccinations is crucial to earnings in 2021. The difference between "jabbing" most people by the end of May or the end of September creates a vastly different story for earnings. This change in timing affects more than individual incomes and corporate earnings. If more people remain unemployed or earn a lower salary due to an extended pandemic, the government is likely to push for further relief efforts, which could be required to get us through the short-term struggles many are facing; however, additional spending means the national debt will grow further too.

At some point, we are going to have to raise taxes to pay for the massive spending required during this pandemic. The new administration's plan is to limit tax increases to those who make more than $400,000 annually. If that plan becomes a reality, 90% of American citizens will not be affected directly. However, an increase in corporate tax rates will reduce earnings, which should affect stock prices. Since creating more tax revenue is becoming a requirement sooner than later, raising taxes while the economy is recovering might be smarter than waiting until after the economy has peaked. Once we are close to herd immunity, a small increase in the tax burden will not stop consumers from the expected spending spree we are due to see.

Stocks rarely go up steadily for too long without a correction of at least 10% and we should expect the same historical pattern to repeat in 2021, but as more people are vaccinated or recover from moderate symptom infections, the economy has an extremely low probability to fall into a recession within the next 18 months. The key to 2021 will not be to predict when we will have a correction, but to have the wisdom to reinvest during the dip if the cause of the sell-off seems transitory. At least the next correction shouldn't be caused by a tweet.

Index Chart & Analysis

The chart above shows the daily prices for the past year through January 8, 2021, for SPY, a large S&P 500 tracking ETF, after closing the week at $381.29. SPY is moving through an ascending wedge pattern, which means that after falling from an earlier high, the recovering pattern shows a tightening wedge shape. In other words, both trend lines are rising, but the lower trend line has a steeper trajectory. SPY's trend line of higher lows is moving towards a point of convergence with its trend line of higher highs.

Identifying ascending wedges can be tricky, but this SPY chart shows it clearly. Even when I include two different possible trend lines of higher highs, the ascending wedge remains obvious. To confirm the pattern, volume needs to show a declining trend from the widest part of the wedge at the beginning towards the point of convergence. The SPY chart confirms this drop in trading volume. Also, the lower trend line needs at least two touch points coupled with at least three touch points on the upper trend. The reverse works too. Over the past two months, the touch points on the upper trend line have become more frequent, which indicates resistance to higher prices continues to be in place. The two touch points on the lower trend line are clear, but do not create a certainty that a collapse is imminent. SPY could retest the lower trend line and recover to new highs before breaking through support to the downside weeks later.

The good news is that SPY has had a fantastic run from its lows; the bad news is an ascending wedge pattern is a bearish indicator, meaning a trend reversal is likely before the lines converge. While no technical indicator is infallible, the ascending wedge pattern is more reliable than most, especially the longer it lasts. Investors need to keep an eye on the trend line of higher lows to watch for weakness in the large-cap index. SPY could bounce off of its trend line of higher lows and push to new highs again, but the advantage left to gain by waiting is diminishing. Eventually, the SPY's upward trend will falter and at this point the ETF seems more likely to fall 10% before it adds another 10%.

SPY's 50 and 100-day moving averages are close enough to the trend line of higher lows that they could help with support in the near-term, but once they break support along with this trend line, the next area of support might not be until the 200-day moving average. The 200-day moving average is over 14% below Friday's closing price and should provide ample support after the S&P 500 has shaken out most of its near-term froth. Assuming COVID counts are waning by the time SPY falls 10-14%, the market should recover quickly.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1 Year	3 Years	5 Years
US Stock Indexes					
DJ Industrial Average	1/8/2021	1.61%	8.19%	7.14%	13.73%
S&P 500	1/8/2021	1.83%	17.57%	11.65%	14.75%
Russell 2000	1/8/2021	4.97%	20.33%	8.27%	13.27%
S&P MidCap 400	1/8/2021	3.24%	19.99%	10.89%	14.52%
NASDAQ Composite	1/8/2021	2.43%	44.61%	22.64%	23.24%

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? Need help deciding when to buy and sell? Call or email Alex Foster for a no cost review of your needs.

If you are not on our distribution list yet, you can Join Our Newsletter free at any time.

DISCLAIMER: AF CAPITAL MANAGEMENT, LLC IS A REGISTERED INVESTMENT ADVISER. NO MATERIAL HEREIN CONSTITUTES INVESTMENT ADVICE NOR IS IT ANY OFFER OR RECOMMENDATION TO BUY OR SELL ANY SECURITY. THE PURPOSE IS LIMITED TO THE DISSEMINATION OF GENERAL INFORMATION REGARDING THE ECONOMY AND MAJOR INDEXES. NO PART OF THIS NEWSLETTER SHOULD BE CONSTRUED AS PERSONAL FINANCIAL ADVICE.

OTHER ARTICLES, LINKS, AND INFORMATION PRESENTED WITHIN THIS NEWSLETTER ARE OBTAINED FROM SOURCES BELIEVED TO BE RELIABLE (BRIEFING.COM, CNBC, BARRON’S, MARKETWATCH.COM, TD AMERITRADE & DIRECTLY FROM INDEX SOURCES), BUT THEY ARE FOR INFORMATIONAL PURPOSES ONLY AND AF CAPITAL MANAGEMENT DOES NOT GUARANTEE THEIR TIMELINESS OR ACCURACY. CLIENTS SHOULD CONSULT THEIR ADVISOR WITH REGARD TO ANY QUESTIONS THEY MAY HAVE. NOTHING WITHIN THIS NEWSLETTER SHOULD IMPLY THAT PAST RESULTS ARE AN INDICATION OF FUTURE PERFORMANCE.