KALOS *Market Commentary*

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Growing U.S. Strength Should Overcome Global Instability

In late August, the S&P500 established another all-time high, and closed above the symbolic level of 2000 for the first time in history. The U.S. market high came despite ongoing international skirmishes which drove volatility measures up about 70% in early August before they retreated rapidly toward the end of the month.

While one could argue that stocks could be overvalued, particularly given recent levels of global volatility, I believe a major correction or near-term bear market remains unlikely. Very simply, U.S. and global economic conditions are improving, and international conflicts still appear to pose only a muted economic threat. Moreover, the U.S. economy is building momentum faster than any other developed economy. These and other trends contributed to a U.S. annualized growth rate of 4.2% in the second quarter with mid-August estimates for the third quarter ranging from 2.5 – 3.0%.

Manufacturing output rose broadly in July and automobile production recorded its largest increase in five years during the same month. Adding to robust manufacturing data, U.S. service industries expanded in July at their fastest pace since December 2005, surpassing June's strong growth.

The energy renaissance continues to positively impact industries ranging from transportation to manufacturing to power generation. Moreover, increased expectations and preparation for exporting oil and gas mean the trend is likely to continue strongly and possibly even accelerate.

Unemployment, though still high, is declining. For the first time since the recession, wages are also beginning to rise. Lower unemployment and increased incomes are helping consumer spending recover, and the trend will likely accelerate with wage growth.

Predictably, as consumers have more money to spend because of increased jobs and wages, consumer confidence is rising, reaching its highest level in almost seven years in August. Consumer confidence has also been helped by the wealth affect as more people have seen their total net worth climb with the recovery of the stock market and housing prices.

Interest rates persist at historical lows while inflation remains a non-factor while still staying high enough to ward off concerns regarding deflation. Moreover, global monetary policies will likely remain extremely accommodative until economic conditions in Europe improve well beyond current levels. Central bankers here and abroad continue to implement policies that encourage investment in real assets such as stocks, property, and even commodities.

An increase in rates by the Federal Reserve is expected sometime in 2015, although estimated dates for increases have come and gone many times already. An increase in rates shouldn't derail the recovery. Historically, Fed tightening seems to have little impact on equity markets because the Fed attempts to wait until the economy strengthens to the point that its actions have little impact on markets. As a result, other drivers seem to be much more important. Hopefully, the Fed can time their increases well, and as the economy strengthens, concerns over rising rates should diminish.

Investor attitudes, which can be admittedly hard to measure, appear to offer another positive. As a group, investors have retained a healthy level of skepticism. Because unrestrained enthusiasm tends to create stock market bubbles, the lack of over-optimism for stocks combined with still reasonable valuations likely signal the absence of a market bubble.

At this point, the biggest concerns for the U.S. market probably lie beyond our border. Germany, having led the euro bloc out of its longest-ever recession last year, suffered its first economic contraction since 2012 as their economy shrank 0.2% in the second quarter. France also unexpectedly stagnated in the second quarter. Italy succumbed to its third recession since 2008, with GDP falling 0.2% in the April-June period. These contractions seem to be largely driven by the uncertainty resulting from the Ukraine conflict. Yet, at the same time, the Spanish economy expanded at the fastest pace since 2007, and the Netherlands and Portugal returned to growth. GDP also increased in Belgium, Estonia, Latvia, Lithuania, Austria, Slovakia and Finland, according to Eurostat. Overall, the euro-area economy grew at an annualized rate of 0.7% in the second quarter, which was surprisingly strong given the Ukrainian turmoil.

Across the other ocean, the Chinese government's attempt to manipulate their economy is producing mediocre results. The manufacturing sector is reacting well, but the service sector is stagnating. Japan continues to see some improvements, but Abenomics, named after the Prime Minister Shinzo Abe's economic plan to jolt Japan out of its 25-year funk, remains a controversial and unproven approach. Various countries from Russia to Brazil to Indonesia continue to send mixed messages. While international markets don't provide a simple, clear indicator, taken as a whole, there still appears to be more good news than bad with growing numbers of economies appearing to move in a more positive direction. The combination of improving conditions in the U.S. and abroad has lead most equity investors to expect markets will continue moving up or sideways barring a major change.

The most concerning issue from an economic standpoint could be the rising possibility of a major terrorist act that could shock world economies far more than "predictable" wars in confined regions such as Gaza, Syria, or the Ukraine. (This is not to diminish the human toll of these conflicts, but this discussion refers only to financial markets.) The rise of the Islamic State of Iraq and Syria (ISIS), which gives a growing terrorist network an increasingly stable operational platform funded by oil revenue, poses a uniquely different threat to world stability and global economies. ISIS's rapidly increasing strength suggests that the threat of terrorism may be much higher today than it was five years ago.

Still, against this backdrop, I believe the previous economic data and trends suggest that equity markets are likely to continue moving generally sideways and up with a fairly average level of volatility. The market may no longer be cheap, but it still likely represents a good investment, particularly when compared to bonds. But, if a major terrorist act occurs, a significant correction becomes dramatically more likely as many investors are likely to flee first and assess later. Even so, equity markets have always recovered over reasonable timeframes, and likely would again even if the ride becomes particularly rocky. As always, equity market investors need to be focused on the longer-term.

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