KALOS *Market Commentary*

June, 2015

Near-Term Rate Increase Likely

The U.S. market has bounced around a fair amount in recent weeks, with expectations and comments from the Federal Reserve providing a major driving force. In the strange world of Quantitative Easing and mediocre economic growth, interest rates have become unusually important in driving equity prices. In the last couple weeks, a better jobs report and an unexpected increase in the Consumer Price Index (CPI) – which relieves any worries of deflation – has made it much more likely that rates will rise in September. As we have seen before during this anemic recovery, perceived strengthening of parts of the economy results in a drop in the market, at least in the short term, because of concerns over interest rates hikes.

Yet in past recoveries, rising rates up to around 5 or 6% have generally coincided with a rising stock market. In this case, I believe the same trend will repeat because the Federal Reserve will continue to raise rates only if they believe it will not hurt asset and stock prices. Rate increases will likely be more similar to speed bumps than ditches.

Regardless, bond holdings will likely suffer as rates ratchet up. Fixed income can be an invaluable component of a portfolio providing flexibility and diversification, but total returns are likely to struggle over the next few years.

In the longer term, more traditional measures of economic growth should return as the primary drivers of equity markets. Most likely, gross domestic product (GDP) will continue improving in the second half of the year. Consumers are slowly increasing spending and the housing market continues to lurch forward. New-home and existing-home sales swelled in the first quarter, prompting builders to increase construction.

While inflation ticked up a bit, it is still well under control and is a relative nonfactor in spending decisions. Economic growth should rebound during the rest of 2015 after sputtering in the first quarter due to severe winter weather, port disruptions, and deep spending cuts by oil and gas firms. Projections still put growth above 2.5% for the year, which would put the U.S. ahead of the rest of the world's average.

The unemployment rate dropped to a near seven-year low of 5.4 % last month, which is a major factor expected to push the Federal Reserve toward a rate hike soon, probably in September. The jobs gain came in spite of the weakness in mining and layoffs in the oil and gas industry, and gains were also reported in hourly earnings which should further boost consumer sentiment.

Although plummeting energy prices caused much anxiety last year given the amount of our economy tied to producing oil and gas, firms are quickly adjusting. While spending has dropped off dramatically for energy firms, most companies are benefitting from lower energy prices. Across the southern U.S., many areas seemingly tied to energy may not even see a significant drop off in economic activity because of their diversified economies. In Texas, the booming technology, health care, defense and transportation sectors will likely propel the state to a faster growth rate than the rest of the country even though 20% of the state's economy is linked to slumping oil and gas.

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Outside the U.S., more positive news is emanating from Europe in spite of concerns over a potential Greece default and exit from Eurozone. For the first time since the first half of 2010, all four of the Eurozone's largest economies – Germany, France, Italy, and Spain – grew. Eurozone economies even grew more rapidly than both the U.S. and the U.K's., an event that has not occurred since the first quarter of 2011. Progress is likely to remain slow given Europe's poor economic policy choices of the past several decades, but the U.S. is relatively unaffected as long as Europe stumbles forward rather than backward.

Investments in Europe also appear poised to perform well. Europe's substantial monetary stimulus from their respective central banks, which is similar to the U.S.'s recent Quantitative Easing, should help equity markets. In addition, lower oil prices are a boon to European industry which frequently pays energy prices two and three times as high as U.S. companies. Lower currency values relative to the dollar is also spurring exports.

In Asia, China's growth has slowed to around 7%, which is still solid but beneath levels for the past 20 years. Slowing growth should not hurt other major economies such as the U.S. too much, but their slowdown will likely make other markets a bit more nervous.

More positively, India's growth is unexpectedly increasing. The country is heavily dependent on imported oil and coal, and lower costs provide savings which are being directed into other areas. Foreign direct investment from many countries including Japan, the U.S., and the Eurozone is providing more capital for growth. The rising middle class is also spending more on nearly everything. The country has an educated workforce and nearly half of their 1.2 billion population is under 25. By 2020, India will have the world's youngest population and possibly the world's largest workforce as well.

For the U.S., India's growth should provide numerous benefits. We enjoy stable relations with the country, and trade is rapidly increasing. In the defense sector alone, exports should average around $3 billion per year for the next several years, up from just $200 million in 2009.

Overall, global and U.S. economic news remains fairly positive. There are obviously many domestic and international concerns which can always blossom into bigger problems. Stocks have not seen a 10% to 20% correction since 2011, and corrections usually occur every two years. Still, even though the broad market has turned in very strong annual performance since the economic meltdown, it could still continue posting records. As mentioned in last month's newsletter, large cap stocks are priced at about their historical average according to price to earnings multiples while smaller stocks are a bit more expensive but not overly pricey. The current bull market could conceivably continue on for a while longer, but investors seem wise to expect a rocky ride given numerous international hotspots and a market that is no longer cheap.

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