Kalos *Market Commentary*

August, 2013

Can the Market Keep Going?

The stock market continues to hit new highs raising questions about its future performance. Yet, in spite of recent gains, I believe the market will probably remain fairly solid even though ample issues pose challenges, and the recent run-up is making stocks look more expensive. The reasons range from ongoing good news to the unattractiveness of fixed income, the most common investment alternative for many investors.

Investors appear to be convinced that the U.S. economy may finally be ready to move beyond sluggish GDP increases that have averaged only 2% since 2009. Growth in the private sector over the last 12 months is up 3.1% which compares very favorably to 1.4% in 2011, 0.9% in 2010, and -2.5% in 2009. While GDP growth will likely fall short of 2% for this year, the International Monetary Fund (IMF) projects next year's growth at 2.7%, which far exceeds any economy in Europe.

U.S. bank loans to commercial and industrial customers are at record highs. Orders for capital goods are up. Auto sales are at their highest since 2007. Financial data firm Markit said its preliminary Manufacturing Purchasing Managers Index rose to 53.2 in July, a four-month high (a reading above 50 indicates expansion). Jobless claims have fallen to 2004 levels which were low because they occurred in the middle of the post dot.com recovery. Over the past 12 months, wages have increased faster than inflation so real wages have increased after a decade of declining median income.

As reported already many times in this newsletter, corporate America is sitting on piles of cash and is less leveraged than at any time in the modern era. Household debt is back to 2003 levels, and on an inflation-adjusted basis, is as low, or lower, than it was in the 1980s. Against this backdrop, banks are encouraging more borrowing by relaxing lending standards for both individuals and businesses. Consumer borrowing in May rose by $20 billion, doubling the April growth rate. Consumer borrowing signals greater confidence and more spending which boosts growth and hiring.

Housing prices have skyrocketed 15% over the last year while sales increased 13% during this year's first five months. For 2013, price gains are expected at around 8-9% with sales up 9-10% for the whole year. The housing recovery is adding jobs and also helping raise consumer sentiment, which in turn is helping spur consumer spending.

The U.S. is still in the midst of an oil and gas boom, and the recent removal of the decades-old ban on exporting natural gas will enable producers to tap new revenue sources. The boom adds jobs and fuels GDP growth while also reducing energy imports and energy costs. The lessened dependence on coal is also lowering our carbon emissions.

More recently, the trends of bigger government and massively expanded regulatory rules have slowed which provides private industry a much needed respite from changing rules and new bureaucracy. The Sequester, even as ill-conceived as it is, is helping to tame runaway spending and the discretionary spending freeze is also slowing government growth. The Federal Budget Deficit is even moving in the right direction.

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Fed Chairman Ben Bernanke indicated in mid-July that the Fed will keep the money coming and said "that highly accommodative monetary policy for the foreseeable future is what's needed for the U.S. economy." The chairman's comments seem to be an attempt to calm markets after bond and stock markets plummeted in late June after the Fed hinted that it might start winding down stimulus.

Internationally, there also appears to be cause for optimism. In late July, Japanese voters gave their prime minister, Shinzo Abe, the mandate to move forward with Abenomics, his economic plans to reduce government control of agriculture, labor markets, retailing and more. The recent election provides Japan, the world's third largest economy, a unified government for the first time in decades. Investors, who are optimistic about Abe's plans to breathe life into an economy that has struggled for decades, have propelled the moribund Japanese stock market up a very surprising 40% over the last year.

China, the world's second largest economy is sending a more mixed message. The government is working to reduce the effects of the recent credit binge, and their success is slowing GDP growth to around 6%. China's manufacturing sector lost momentum in July and the job market weakened complicating a transition to consumer-driven growth. Still, the government's efforts are likely to be successful and should help China grow more sensibly in the future.

Mexico also appears to be moving in the right direction. Their president Enrique Peña Nieto, was elected in December 1, 2012 on a platform promising to reduce the drug violence racking the nation. He's making progress as the two most violent drug Lords have been eliminated in the last couple months. The nation is also considering more private development of its energy which has been largely stalled under government control.

This is not to say all is well. The huge new costs, taxes, and complexities of Obamacare will foist a new drag on U.S. growth. Corporate revenue growth and consumer spending may be improving, but they remain weak. Unemployment is abysmally high at 7.6%, and this metric doesn't count the large numbers of long-term unemployed and underemployed. The economies of the developed world outside of the U.S. are still a mess and needed policy changes remain painfully slow.

Still, when combining all the different trends, it's not surprising that money is flowing into equity markets, particularly when the seemingly unattractive trends facing fixed income are taken into account. Bad news, such as budget battles, unwelcomed Fed policy changes, Chinese missteps, or European struggles, can all slow or even derail a solid, if restrained U.S. recovery. Recent market increases reduce expectations for annualized gains, and also make near-term corrections more likely. Yet, we believe investors can sensibly place their faith in the long-term prospects of the economy and related markets.

More simply, there appears to be significantly more good news than bad, valuations remain fairly reasonable, and fixed income alternatives look much less attractive. I believe the combination is likely to continue to drive investors toward stocks in spite of ongoing concerns.

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