KALOS Market Commentary

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Strong Long-Term Fundamentals, But Volatile System

U.S. stock market investors as well as investors in many international markets have been on a great run. Markets are hitting new highs and investors who braved the less favorable conditions of a few years ago have been well rewarded. Given the market's incredible success since March 2009 (up around 180%), it seems like it might be a good idea to look at how long this might go on. After all, our world and economy still face numerous challenges.

I believe there are several key trends and ongoing developments that can guide investors to make wise and profitable decisions both now and as circumstances inevitably evolve.

Over the past several decades, a new global economic system has been steadily emerging. It is very different from our previous system, and fortunately, it's very robust. It is also rapidly changing the world at a pace never experienced in human history. We've seen challenges under the new system, but our ability to keep marching forward and quickly adjust remains astonishing.

First, the level of political stability that we enjoy now across the globe is unprecedented. In spite of the conflict in Ukraine and a couple minor skirmishes in Thailand and Venezuela, the world is enjoying a period of incredible peace essentially without historical equal. As recently as the 1980s, there were 18 proxy wars spanning the globe. Today, in spite of threats of terrorism, nations spend far smaller percentages of their global wealth, including time and energy, to protect their people or conquer others than ever before.

Second, the world is benefitting from incredible economic convergence. By the early 1990s, Capitalism won the philosophical socioeconomic battle. The Berlin Wall fell in 1989, and Deng Xiaoping, China's famous leader, supposedly spoke his famous words "To get rich is glorious" in 1992. The unchallenged rise of capitalism has unleashed a phenomenal wave of progress and development.

Third, the information revolution is changing our world. We are now incredibly interconnected and interdependent. We are all part of the same system versus simply trading partners like a couple generations ago. A General Electric jet engine is made in 22 countries. Whose GDP should it count on? If we go back to the dark ages of no Internet, no cell-phones, no tablets or ipads, we're only back in 1990.

Today, news of an event goes global in minutes if not seconds. The world reacts largely together rather than as separate pieces. We are no longer limited by manufacturing growth rates that saw incremental return. Computers double their capability every two years. If that happened with car engines, over the past 40 years, the subcompact with 100 horsepower in 1970 would now have an engine with 100 x 10^{42} horsepower (yes, that's 100 followed by 42 0's).

The results are incredible. In 1979, 32 countries were growing at 3% or better. In 2007, the number mushroomed to 124. Even today, as economies are supposedly struggling, 85 countries are growing at better than 3% including over 30 countries in Africa. Moreover, there's no single right answer. You simply need some level of free trade, free markets, education, and infrastructure. Just moving in the general right direction is the key. China succeeds because of its government, India in spite of theirs.

All these trends are working together to generate new wealth, bringing improvements to health-care, education, the environment (this is highly accurate), personal

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freedom, and more to billions of people. And, the U.S. remains the leader in the system. America's role will diminish as poorer and more populous countries grow faster, but we continue to benefit from our dominant role in global growth. The infrastructure advantages the U.S. enjoys provides tremendous advantages to anyone living in the U.S., even workers, particularly those less skilled, who feel the impact of global competition. Yet in this system, investors really benefit because capital can move to areas of opportunity much more easily.

While all three of these developments affect markets, technology probably has the most visible impact, at least on market movements and volatility. Pre-2000 market dynamics are very different from post-2000. The correlation of the S&P 500, MSCI emerging markets index, MSCI EAFE (developed markets) was about 0.4 pre-2000. After 2000, correlation skyrocketed to around 0.9. It's no coincidence that Blackberries, followed by iPhones and the cornucopia of options we have today, started to become common in the late 1990s greatly accelerating access to real-time data.

A system this interconnected is much less likely to generate normal return distributions – meaning returns that follow patterns that revert back to predictable norms quickly after a disturbance. The system as a whole has become much more complex than the sum of the parts. For instance, many institutions discovered in 2008 that they tried to reduce risk the same way which unintentionally increased risk to the whole system – and themselves. When they reacted in the same way to changes in markets, their actions increased rather than decreased volatility. The flash crash on May 6, 2010 drove the market down nearly 10% in minutes and its exact cause was never really determined. Markets are likely to grow increasingly volatile with technology's influence. Returns are likely to move farther from the average with more extreme highs and lows. Time between cycles is also likely to shorten.

Bottom line: Long-term economic trends should continue to be solidly positive, but the road upward will likely be rockier given today's investor's ability to react and their propensity to react simultaneously to the same data.

Looking much nearer term, most current economic signals remain positive. Corporate profits, the primary driver of equity market returns, remain solid and are expected to keep going up. Interest rates and access to capital also remain highly favorable. Valuations are about average by historical standards. U.S. stocks are no longer cheap, but they don't appear expensive either. Various other measurements such as corporate cash, small business optimism, expected Federal Reserve policy, European Central Bank policy (dedication to helping Europe's markets recover), projected U.S. GDP growth, consumer confidence, consumer wealth, consumer debt, etc., etc. point to an ongoing recovery that, even though weak, is now in its 60th month, which is longer than the average.

For investors, the world's transition to a new economy should continue to generate tremendous wealth here and abroad while interconnected financial markets along with other technological changes are likely to increase volatility. For investors, this necessitates good upfront planning to be certain inevitable storms can be weathered. Equities should continue to offer solid returns, both in the near and long term, but may provide them more haphazardly than in the past. And, many portfolios are likely to benefit from diversification into various other types of investments that may shield portfolio values from some of the effects of increasingly interconnected U.S. and global equity markets. The new environment will likely provide even greater rewards to investors better able to control their emotions while also taking advantage of new means to access new types of investments. Best of luck in this exciting new world of opportunity!

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