Kalos Market Commentary

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Encouraging Market Psychology and Fundamentals

The Dow Jones Industrial Average (DJIA) has been hitting new highs regularly in November, and its recent performance has some investors questioning how long the run can last. The market is no longer cheap so the question warrants attention.

Fortunately, there appears to be enough good news coming from diverse places to not only support current stock levels, but possibly to keep pushing prices up. Fundamentals and valuations remain solid, and possibly more importantly at this stage, investor psychology appears to favor equities. A renowned stock picker, John Templeton, once said bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria. After almost five years, we seem to be only barely moving past skepticism to the early signs of optimism.

Through the end of 2012, inflows into equity mutual funds by individual investors were negative in 19 out of the previous 21 quarters (The Investment Company Institute, 2/28/13). During that time, record investments were made into bond funds which now look very precarious given the threat of interest rate hikes. Most likely, it will take significant time, possibly years, for markets to reach the euphoria stage. Of course, standard corrections can happen at any time. But, only now are we finally seeing individual investors gather enough optimism to collectively add to their investments in equity funds. This bull-run could last a while longer even though it's been running since March of 2009.

Fundamentals also remain promising. Revenues continue to grow faster than the economy, and increasing productivity should result in profits rising even faster. Fourth quarter earnings are hitting all-time highs and probably about 70% of companies will exceed analyst projections. In the near-term, ongoing hiring restraint at bigger firms should boost profits in 2014. Firms of all sizes continue to stockpile cash leaving them ample room to expand as desired or survive economic slowdowns.

In Washington, government challenges will continue to grab headlines and perceived struggles could spook markets. Another government shutdown, however, appears unlikely as no one in Washington has the appetite to repeat a process that saw both parties and the President's approval ratings take hits last time around.

Instead, we will likely see the Sequester continue in spite of criticisms. There's little public angst over the cuts, and an alternative budget deal to replace it seems highly unlikely. It will probably remain in place at least until after the next president takes office in 2017. Eventually, some softening may be required to lessen its impact or reverse more biting cuts, but by then, the effect of the Sequester on the budget and economy will not be as clear, enabling politicians to avoid blame.

While many citizens decry Congress's inability to accomplish anything of significance, the lack of new major legislation and regulatory change continues to benefit the economy. Unclear policy on immigration, tax rates, borrowing costs, health-care costs, energy regulation, the deficit, and so on, remain and are contributing to instability which hampers the private sector. But these factors are largely already

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Factored into conservative corporate plans. Now, the stalemate in Congress is limiting the introduction of yet more new changes and unpredictability enabling companies to gain a bit higher level of clarity.

The Federal Reserve looks set to continue its massive bond-buying program because of ongoing weakness in the jobs market. Low interest rates benefit corporate America through keeping borrowing costs low. The policy is likely to continue well into 2014 with no official rate hikes expected until 2015. Low interest rates and likely future rate increases continues to add to the attractiveness of equities over bonds.

Looking across the Atlantic to Europe provides cause for both concern and optimism. The euro zone finally logged growth numbers in the last quarter after six consecutive quarters of contraction. But, the increase was tiny. Stronger economic health is probably at least a year off. Yet, even dour numbers present cause for optimism because the continent appears to be heading up rather than down. Also, Europe seems to have reached general consensus on solutions for many of its more pressing financial problems including a strong conviction to maintain the euro as its common currency. Only a year ago, experts were declaring the imminent death of the euro, which was soon to be followed by countless catastrophes. Today, those predictions are distant memories. Europe's struggles will continue to dampen our exports, but the continent's weakness also seems unlikely to derail global growth.

Across the other ocean, China unexpectedly announced its biggest expansion of economic freedoms since at least the early 1990s. Beijing pledged a slew of changes including ending some monopolies, improving state owned enterprise (SOE) management, allowing the private sector to co-invest with SOEs, liberalizing prices on commodities such as water and natural gas, speeding deregulation of interest rates and capital flows, reducing curbs on foreign investment, and allowing private investors to create small banks. China's leaders also vowed to expand farmers' land rights and allow couples to have two children if either parent is an only child. While the actions come partly because of concern over China's slowing growth, the significant steps demonstrate an ongoing commitment to progress that should keep pushing the country forward past its constrained state-led economic development model.

In light of these and other encouraging international developments, I continue to believe there is wisdom in investing beyond our borders. During the recent past, the U.S. stock market has done better than the rest of the world as investors have fled to safety. Assuming that we don't see an immediate contraction in the U.S., market valuations are likely to move closer together pushing foreign markets up more than the U.S. Many emerging markets have suffered in the recent past making their valuations attractive, and even European stocks could continue to react positively. The same cycle of pessimism, skepticism, optimism, and euphoria exists overseas, but it's likely that some of these markets are still stuck in an earlier stage which could offer an attractive future for the right investors. It could make them a good compliment to investments in U.S. markets.

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