Kalos Market Commentary

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Economy Slow, but Should Improve and Propel Markets

After a dismal January and early February for U.S. and global equity markets, the past couple of months have gone well. Once recession fears mostly dissipated, broad-based equity markets reversed losses of over 10% on the year to rise back into positive territory by the end of April.

Still, as expected, first quarter U.S. economic growth was anemic, slowing to its weakest pace in two years as global demand remained shaky and the strong dollar hampered exports. According to the Labor Department's advance Thursday estimate, GDP increased at a 0.5% annual rate, an even slower rate than the 0.7% original forecast of Economists polled by Reuters. The Commerce Department's late April report also suggests business spending and economic growth were weak in the first quarter.

While it may be surprising to see markets recover against such an uninspiring backdrop, muted optimism results from several different areas. First, fears of an impending recession – and all the overhyped talk associated with the subject – appear to have largely passed. While an expansion of 0.5% is weak, it's still an expansion. Moreover, stronger future growth appears very likely.

For the first several weeks of 2016, recession prophecies predictably caused sharp drop-offs in consumer and business spending, particularly on big-ticket items. Sustained low oil prices and the resulting carnage in the energy sector adversely impacted all business spending, sending equipment investment down at an 8.6% rate for March, the steepest decline since the second quarter of 2009.

While business spending was broadly down, the figures are misleading because they result mostly from the severe cutbacks of the oil and gas industry. The Institute for Supply Management's manufacturing and nonmanufacturing surveys, which are closely correlated to economic activity, have rebounded in recent months signaling potentially better times in the future. Business spending on software, computers, R&D and various other infrastructure items rose during the first quarter further emphasizing the overall health of U.S. businesses not connected to oil.

The labor market is probably the largest single factor contributing to confidence in future U.S. growth. Through March, total non-farm payrolls exceeded 240,000 in four of the past five months and outpaced last year's average of 229,000. Against all the negative noise in the market place, the strong jobs market is particularly meaningful. Companies appear more willing to hire permanent workers rather than using temporaries. The number of long-term unemployed is finally dropping significantly as well, boosting ongoing wage growth and confidence. Unemployment benefit applications are also near a 43-year low.

More jobs mean more cash for consumers, and consumer spending growth averaged 2.0% for the three months ending in March. While the numbers are solid and provided a welcome boost to the economy, they are still not as strong as job gains or low oil price savings suggest they should be. Normally, the drop in business investment resulting from low energy prices would be more than offset by increased consumer spending. Instead, during the current energy price decline, consumers are saving and decreasing personal debt levels. Recently, consumers seem

more likely to spend their extra cash, but the change has been slow. This summer's driving season will be the cheapest since 2004. The response of consumers to cheap fuel over the summer will be one of the largest factors impacting U.S. growth in 2016. If wallets loosen, growth will likely accelerate. If not, growth will be impeded as more dry powder is saved for the future.

One place consumers are spending remains housing. The sector has also been very strong and has contributed positively to the economy through the many ancillary businesses it drives. Spending on residences climbed 14.8% in the first quarter, the fastest pace in over three years.

Like many investors, the U.S. central bank appears to believe that global economy and financial markets threats have diminished and also noted that labor market conditions had "improved further." Yet, in spite of progress, the Fed delayed a rate increase after first quarter's typically weak growth. U.S. consumer prices are not helping. U.S. consumer prices nudged up in March, but the 0.1% gain remained modest. Given various headwinds, the earliest rate increase will likely come in June or July followed perhaps by another increase by year-end. The Fed wants to return interest rates to a more normal level after years of near-zero rates. But fragile global economies and muted inflation will force the Fed to move cautiously, which fortunately has been welcomed by financial markets in the past.

Looking overseas, expectations remain muted, but early first quarter's doomsday fears have largely dissipated. After posting its slowest economic growth since 2009, new debt appears to be driving a recovery in factory activity, investment, and household spending. New loans, service sector growth, retail sales, industrial output and fixed asset investment were all better than expected.

In Europe, the European Central Bank (ECB) left its policy mix unchanged in April, but ECB President, Mario Draghi, kept the option open for fresh interest-rate cuts to spur higher growth in spite of German concerns regarding the impact of low interest rates on their economy.

Mr. Draghi's willingness to ignore Germany, its largest shareholder, displays a determination to stimulate euro growth that is welcomed by many investors looking for some reason to expect progress. Overall, Europe remains mired in slow growth and a near deflationary environment, but concerns of sharp dislocations have diminished. Instead, the zone is expected to slog along at its seemingly perpetually dismal low growth rates, led mostly by the workhorse Germany.

In spite of international challenges, anemic GDP growth numbers, and generally weak corporate earnings growth, the U.S. still enjoys multiple tailwinds including strong consumer income growth, higher savings rates, an increasingly attractive jobs market, a strong housing market, low debt servicing costs, low gas prices and many more. Taken altogether, we believe growth will improve over the remainder of 2016 and should boost U.S. equities. Internationally, lower valuations could also make many different markets attractive as well, in spite of their many challenges.

Daniel Wildermuth
Kalos Management, Inc.
CEO

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11525 Park Woods Circle, Alpharetta, GA 30005
Phone: 678.356.1100, Toll Free: 866.525.6726,
Facsimile: 678.356.1105,
ClientServices@KalosFinancial.com