KALOS *Market Commentary*

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Markets Up in July in Spite of Global Uncertainty

July has treated investors surprisingly well with gains on the month well over 2%. The rise is somewhat surprising given a relative lack of notable positive news in the U.S., the noise and uncertainty of elections, and the high visibility of other threats such as Brexit and terrorist attacks in France.

The strength of U.S. markets likely derives from the continued perception that near-term risks to the U.S. economy are relatively low. At the time of writing, the U.S. economy is projected to have expanded at a 2.3% annualized rate in the second quarter—solid if uninspired.

While the Federal Reserve cited reasonable economic growth, strong job gains, increasing labor utilization, and household spending "growing strongly," it left its benchmark overnight interest rate unchanged in the range of 0.25 - 0.50%. However, references to numerous areas of strength and lessening concern that shocks could push the economy off course signal that the Fed may resume monetary policy tightening this year. Good news, just not very exciting.

Brexit undoubtedly raises concerns and uncertainty, mostly abroad, yet some U.S. sectors should benefit from Brexit, particularly banking. In 2007, the eight biggest European banks' fixed income, currencies and commodities revenue was $48 billion, compared with the $38 billion generated by the five largest U.S. banks, according to data from analytics firm Tricumen. Last year, the same sources of revenue for the European banks totaled $26 billion while U.S. banks generated $43 billion, turning Europe's 26% advantage into a 40% deficit. Markets are pricing in expectations of further declines post Brexit. After the vote, shares in Deutsche Bank (DBKGn.DE) and Credit Suisse (CSGN.S) dropped quickly to record lows, while U.S. banks generally appreciated sharply throughout July.

Beyond Brexit, international events in France and Turkey have dominated news. I've been in France during parts of the last month, and heightened security is notable not just in airports, but in public areas across the country including small town squares and any significant event. Nothing like a pleasant dinner overseen by heavily-armed military men. The immediate human toll is obviously tragic, and the impact on the culture remains immeasurable. While the actual probability of suffering harm from an attack remains nearly nonexistent (any major American city remains more dangerous than Paris or Nice), tourists are changing their behavior, and it will impact economics. On a mid-July flight to France, my daughter had four seats to herself because of cancellations, and the stewardess mentioned it was the emptiest flight she had seen in her career.

The economic impact will hit France and Europe. France is the world's top tourist destination, welcoming 83 million foreign tourists a year, and tourist spending accounts for 7% of French GDP. Since 1999, it has accounted for the main balance of payments surplus, and post economic meltdown, growth had been extremely strong. For instance, spending improved from a respectable €7.5 billion in 2011 to an incredible €13 billion in 2012. France is also the world's top skiing destination and a growing business touring destination as well. Since the tourist industry is diversified across far more than just summer vacations, the summer's impact of cancellations will have a smaller impact, and tourism in France could still grow in 2016.

Hopefully, weakened tourism will not significantly impact France and Europe, both of which are finally gaining economic strength. France's first quarter growth was even above 2% annualized for the first time in years and Europe is starting to contribute to global growth.

Turkey's declaration of Martial law on July 15 signals the depth of the uncertainty within the country after the recent failed coup attempt. Turkey's growth has been strong in recent years, but after notching rates north of 8% annually as recently as July of 2013, growth has fallen to less than 4% per year – strong, but not great for an emerging economy. Still, Turkey's issues should have negligible impact on global economies and markets.

In looking at potentially increased risks from terrorism and who knows what else, should investors change their behavior or portfolios? As always, the time to make changes is before something happens, not afterwards, so recent market strength offers investors a good opportunity to assess portfolios and their ongoing risk tolerance.

But, research seems to indicate that people worry too much about unlikely events that are difficult to predict*. These events are generally referred to as "Black Swans," a term popularized by Nassim Nicholas Taleb's book *The Black Swan: The Impact of the Highly Improbable*.

The problem with rare events is that they're almost impossible to predict. In 2007, Harvard economist Martin Weitzman demonstrated that people expect black swans to occur far more frequently than they actually do. As a result, investors over-estimate the probability of market crashes and under-perform those who simply buy and hold.

Recent studies add more credence to this work by highlighting behavioral bias. Investors appear to suffer from something behavioral scientists refer to "availability heuristic." Amos Tversky and Daniel Kahneman found that people judge probability through mentally referring to events they easily recall and are therefore mentally "available." Essentially, after the media reports bad news, investors tend to overreact to market corrections.

More recent data further confirms the pattern. For 26 years, William Goetzmann and Robert Shiller of Yale, and Dasol Kim of Case Western Reserve have asked investors to estimate the likelihood that a severe crash will occur over the next six months. They defined severe crash as a stock market decline of at least 12.82%, an event which occurred on October 28, 1932.

Over the 26-year period, investor's mean estimate was 19%, and the average was 10%. Yet, historically, the actual probability of a decline of this size is about 1%. As part of the study, they also found that increased negative references in the media raised expectations for negative market results, and negative references influenced expectations much more than positive ones. Simply, humans tend to give recent events, especially negative ones, far too much weight. Not surprisingly, this research confirms the wisdom of a realistic and long-term investment approach. Bonne chance (good luck)!

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

KALOS MANAGEMENT

* Source: https://www.bloomberg.com/view/articles/2016-04-15/everyone-worries-too-much-about-black-swan-events