KALOS *Market Commentary*

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International Volatility and Rate Rise Should Not Derail Market

China and Greece have generated many headlines over the past few months. But, as disruptive as their challenges may be in the short term, we don't believe either of these situations are overly significant longer term.

Of the two countries, tiny Greece likely poses the bigger problem because the path it forges may be followed by other flailing economies, namely Italy, Spain, and Portugal. Greece will struggle for years, and is still likely to eventually exit the Eurozone. Ongoing instability will probably force the euro down further versus the dollar, hurting U.S. exports by making them more costly.

Still, as bad as all this sounds, most of the challenges should be relative non-events. Going forward, new challenges may create uncertainty again, but after initial concerns abate, strengthening European financial markets should continue to bounce back fairly quickly. Even after recent volatility, European markets as a whole are up on the year. Europe is much stronger than in years past, and markets were already fairly cheap.

What about China? Extreme volatility began July 2 when the Shanghai index fell 3.5%, despite the Chinese central bank announcing easing of its monetary policy. This past Monday (July 27), the Shanghai Composite Index suffered its biggest loss since 2007, when it fell 8.5%, taking the market 28% below its June 12 peak.

The market drop makes for great headlines, but again is relatively inconsequential. China's market is small compared with the U.S. and Japan. Most Chinese citizens keep their money in the bank rather than in the stock market. Since the market had been up a whopping 113% since last November, the 28% fall in the market since June appears to be little more than a bubble popping.

China's shift to a more consumer-driven economy continues. For 2015, growth is expected to hit 6.5% instead of 6.9%, which remains above the 6% rate seen as desirable and realistic for an economy at their stage of development. The slowdown may take global growth down from 3.1% to 3.0%, but U.S. growth will remain unaffected. U.S. markets should hardly blink. Still, emerging markets have been shaken. Recent losses across much of the globe have plunged emerging markets into negative territory for the year, making them even cheaper.

Closer to home, the U.S. is entering its seventh straight year of growth which should hit 2.3-2.5% for the full year. The previous period of growth, which ended in 2007, lasted a more typical six years. This time, growth shows no sign of slowing. Odds appear strong that the expansion will reach the 10-year mark, equaling stretches seen only twice since World War II, one from 1960 to 1970, and the other from 1991 to 2001. The length of this expansion was helped by a very slow start and many government regulatory changes that hobbled corporate America. Now, many parts of the economy are just getting back to normal and remain far from overheating.

Key economic indicators flashing green include housing, job growth, and consumer sentiment. Low interest rates, even after inevitable increases, will help further. While the strong

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dollar and cutbacks in energy development will act as drags, no problem areas appear big enough to derail the expansion any time soon.

Housing provides a good illustration of ongoing economic strength. Prices of existing homes sold in the U.S. reached a record high in June, surpassing the mark set in 2006, and home sales increased at their strongest pace in 8 years. Higher prices also give homeowners more flexibility to refinance, sell, or make improvements. That's good news for the economy overall, and especially for the scores of home builders, craftsmen, suppliers of building materials, and others who rely on this key industry for their livelihood. Still, prices would need to rise an additional 20% in order to set a record when accounting for inflation. Current prices don't point to an overheating market, just a healthier one.

The housing market and rising consumer sentiment has been helped by the improving job market. The number of Americans filing new applications for unemployment benefits the third week of July fell to its lowest level since November of 1973, more than 41-1/2 years ago. While the number can be volatile, especially during the summer months because automakers usually shut down assembly plants to retool, it suggests that the labor market will show solid growth in July. Unemployment, which currently sits at 5.3%, is expected to drop to 4.9% next year and to 4.8% in 2017, according to a Reuters' poll of 81 economists.

Business spending is also slowly ramping up with orders for durable manufactured goods, climbing 3.4% in June versus a month earlier, according to the Commerce Department. The increase was the first since March and appears to confirm conjecture that the earlier slowdown was driven by weather and the West Coast port strike.

The sturdy jobs picture and strengthening housing market likely brings the **Federal Reserve a step closer to raising interest rates** this year, probably in September. The Federal Reserve has kept its short-term lending rate near zero since December 2008. Fed comments on July 29 hinted at a possible rate increase. Whether rates are raised in September, or later in the year, for the foreseeable future, rate increases should be small and slow. A rate increase will likely jolt markets a bit simply because it's been so long since one has occurred, but markets should move on quickly given the widespread anticipation of the increase.

With recent increases in the U.S. stock market, U.S. stocks are back in positive territory for the year, albeit, not by much. Because most U.S. economic indicators remain fairly positive, U.S. stocks may continue to perform well, and could outperform international equities even though the U.S. markets are more expensive. For bolder investors looking longer term, international markets may be more attractive. As a whole, international equity dividend yields are about double U.S. yields, and valuations are much lower, offering potentially greater returns. Concerns remain regarding ongoing investments, but investors who wait for a perfect environment rarely do well in any market.

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