KALOS *Market Commentary*

December, 2015

Domestic Strength Should Overcome International Challenges

After U.S. and global equity markets swooned and recovered several times from mid-August through October, November's market has been a bit boring, with most global markets experiencing almost flat performance or very modest losses. Before dividends, the S&P 500, developed markets, and emerging markets were all nearly flat with performances ranging from 0% to losses of less than 0.5% for the month.

Still, while recent returns may be similar, the economies, particularly Europe and the U.S., appear to be heading in different directions. The distinctions can be easily seen in the divergence of monetary policy which the U.S. Federal Reserve (Fed) and European Central Bank (ECB) are expected to take in December. Since the economic crisis of 2007-2009, U.S. and euro zone central banks have followed a fairly similar path of monetary easing. But now, the Fed appears likely to deliver its first interest rate increase in almost a decade, while the ECB appears set to extend or even increase their monthly purchases of 60 billion euros worth of stimulus in an attempt to prevent deflation and spur continuing weak economic growth.

Japan will likely follow a path similar to Europe as it is expected to provide as much as $40 billion in financial aid to struggling businesses and consumers in hopes of boosting spending. Tokyo's economy has slipped back into recession, and the central bank injection hopes to provide a modest pickup in fourth-quarter growth.

In the U.S., the first rate increase will likely come soon with financial markets betting on a quarter percentage point increase in December. The strong jobs gain of 271,000 in October and the decline in the unemployment rate to 5%, which is widely viewed as full employment, gives the Fed the job growth they wanted before boosting rates. Job gains are coming from nearly all sectors of the economy with pay gains also trending higher. Yet, even though wages are rising, labor costs remain muted as older, higher-paid employees retire and are replaced by younger, cheaper employees. The trends are good for workers, job seekers, and employers.

While the first rate increase is meaningful, the really important rate increases are the subsequent changes which are expected to come slowly given anemic GDP growth numbers. Rates will likely remain unusually low for an extended time period.

Financial markets are reacting strongly to the rate increase expectations with the dollar and short-term U.S. bond yields soaring while the euro and euro zone bond yields plunge. Analysts at Goldman Sachs predict a new low for the Euro of $0.80 in 2017 versus a current value of $1.06, and a value 2 years ago of $1.36.

The dollar's value is also rising against most other currencies from the yen to the Australian dollar bringing the U.S. dollar's value against a basket of currencies nearing a peak last seen in 2003.

Diverging policy reflects the contrasting economic outlooks. In the U.S., the Fed believes the U.S. economy no longer requires emergency-level interest rates of zero, while the ECB feels yet more stimulus is needed to battle deflation. The U.S.'s freer economy helped U.S. industry deal with our economic challenges several years ago, while Europe is still mired in many of theirs.

The Fed's confidence in the economy is a welcome endorsement, even if growth remains anemic at only 2.1% for the third quarter with expectations for around 2.0% for all of 2015.

Challenges for the U.S. economy exist in many areas, but are likely most pronounced beyond our border. The U.S. is increasingly interconnected with the global economy through trade. Global expansion has brought tremendous prosperity to the U.S. as we have provided goods and services to increasingly wealthy global consumers. Yet, now when international markets struggle, their slowdowns impact us more than previous generations.

Adding to international growth challenges, the strength of the dollar is weighing heavily on various parts of our economy, particularly those that are export-driven. For instance, heavy equipment sold by caterpillar has become much more expensive internationally. The same challenge hits nearly all international companies in the U.S. ranging from electronics to consumer products to pharmaceuticals.

Against the backdrop of international sluggish economies, U.S. indicators are predictably mediocre, with some parts of the economy flourishing while others struggle.

Domestically, U.S. consumer spending barely rose in October. As incomes rose, somewhat surprisingly, households chose to boost savings to their highest level in three years, which helps longer term growth, but will likely result in more moderate growth in the fourth quarter.

Factory activity in the Midwest shrunk in November, yet data on business capital spending plans and factory output suggest that manufacturing's decline has bottomed. Looking a bit longer-term, the manufacturing sector should post modest gains over the next two years, paced in large part by automakers, home builders and aerospace firms. Domestic demand for vehicles and homes should offset weak international sales resulting from the strong dollar and weak international growth.

U.S. home resales fell more than expected in October, the underlying trend suggests housing remains on firm footing. Despite the drop last month, sales held above their average for the year and are on track to record their best annual sales in eight years.

In summary, the overall picture remains fairly solid, but uninspiring. The U.S. economy continues to trudge forward, steadily but slowly, while the rest of the globe struggles to hit reasonable targets. Indicators across the board in the U.S. are solid, but lackluster, at least in the short term. Still, U.S. markets appear poised to continue moving forward, although the pace may be uninspiring and the ride may be more exciting than some investors might like. Internationally, economies will likely struggle, but equity markets could perform well given currently low valuations. International equity markets will likely require a bit more courage given ongoing economic challenges, but for investors willing to brave these markets, current problems may present an attractive entry point.

Daniel Wildermuth
Kalos Management, Inc.
CEO/CIO

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