KALOS *Market Commentary*

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Is the Economy Finally Getting Stronger?

The U.S. economy continues to give off mixed signals regarding growth and recovery. Frequently conflicting economic growth signals are often further confused by declared or expected changes to the Federal Reserve stimulus policy which has repeatedly turned good news into bad and vice versa – at least from the stock market's perspective.

Since the Federal Reserve drove both stock and bond markets down sharply in June with hints that it would start winding down its stimulus program, the Fed has worked steadily to downplay the immediacy of its policy change. This approach seemed sensible given mediocre economic data that appeared to show the U.S. economy wasn't strengthening as much as expected.

Orders for durable goods fell in July by 7.3%, the most in almost a year and the first decrease in four months. The retreat was broad-based showing that business investment was off to a slow start in the third quarter. Housing, a recent mainstay of the expansion, added to perceived weaknesses, when it showed signs of cooling as higher mortgage rates jumped a record 25% in very short span. Demand for military gear also declined in June, highlighting the risk that the Sequester mandated budget cuts could continue to act as a significant fiscal drag in the U.S. for the second half of the year.

The bad news resulted in lower GDP growth forecasts. The Commerce Department initially estimated that GDP expanded at 1.7% in the second quarter. Barclays Plc cut its growth estimate in the second quarter to 1.9 percent from 2.1 percent. The median forecast of 77 economists surveyed by Bloomberg called for a 4 percent drop in U.S. orders for durable goods.

And, following the strangely predictable pattern of the last year or so, U.S. stocks rose on the bad news as investors speculated that the downturn would delay stimulus cuts.

But in another turn of events, as investors settled into weaker growth expectations, the economy quickly threw investors a surprise when it showed a stronger acceleration than expected with surging exports providing a major boost. According to revised estimates from the Commerce Department, GDP grew at a 2.5% annual rate in the second quarter, more than double the pace of first quarter. The report boosted confidence that the economy really is turning a corner despite government austerity measures.

The government also said data from retailers showed that businesses had restocked their shelves at a faster pace in the April-June period than initially estimated. Cars and light trucks sales recorded their strongest back-to-back readings since late 2007, according to Ward's Automotive Group. Factory orders added to the good news with the backlog of orders increasing 0.4% in July after surging 2.1% in June. U.S. Labor Department data also showed new claims for jobless benefits held near a six-year low last week, adding to signs the U.S. employment situation is stabilizing.

Outside of the U.S., purchasing managers surveys showed better-than-expected growth in the euro zone. Even China offered up some good news with an increase in the Purchasing Managers Index.

Many economists expect the economy to accelerate further in the second half of the year as austerity measures begin to weigh less on national output. A Bloomberg survey of economists from Aug. 2 to Aug. 6 already predicted second half growth at 2.6%, and the estimates will likely be revised up based on recent economic performance.

But again, in the somewhat upside down world driven by heavy Fed involvement in the economy, the good news sparked fears that the Fed might act more aggressive in tapering its stimulus, possibly as early as September.

In spite of the seemingly conflicting trends and market movements, I believe there are some clear developments that longer-term investors can look to. History also offers some possible insight into what could develop. The strange dynamics that result in markets recently moving in the opposite direction of the economy should be temporary, but the adjustment to less Fed stimulus is likely to result in choppy markets. Still, the upward market trend should continue as the economy slowly gains a more solid footing. Corporations are still sitting on piles of cash, and greater confidence should result in expanded investment and spending, reinforcing a virtuous growth cycle.

The bigger issue for investors could be whether or not the ongoing rise in stocks can continue given the rally's growing age and increasing equity valuations. Against the ups and downs of the market, Fed policy, and government challenges (Sequester, Fiscal Cliff, Budget Deficit, Debt Ceiling, etc.), price gains of stocks in the S&P 500 are outpacing profits by the fastest rate in 14 years. The bull market, which started in the market abyss of March 2009, now extends beyond the average length of rallies since Harry S. Truman was president in 1946. Valuations last climbed this fast in the final year of the 1990s technology bubble, just before the index tumbled 49%. Bears say the failure of earnings to keep up with prices signals the bull market is in its last stages. Bulls point to increasing valuations as proof that individual investors are finally growing confident enough in the economy to return to stocks. Throw in stimulus reduction and government gridlock, and investor confusion seems almost certain.

Historically, the final phases of rallies have provided some of the biggest market gains. Although the S&P 500's valuation has grown this year with the market's increase, it still remains below the level at which previous rallies peaked. The average multiple during bull runs since 1957 has been 17.4 times profits, which is about 10 percent higher than today's ratio according to Bloomberg. Advances ended at 20.2 times earnings on average, 26 percent higher than the present level.[1] Of course, history virtually never repeats exactly, and circumstances never precisely duplicate.

These numbers suggest that the market could keep moving upward for a while. Furthermore, equities continue to look remarkably attractive relative to bonds. Recent good news will probably reinforce this perception for most investors, and it is likely to result in decent market performance over the longer-term horizon. Still, with an asset class as volatile as stocks, anything can, and often does, happen.

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