KALOS *Market Commentary*

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U.S. Fundamentals Remain Solid, Despite China and Oil Concerns

The new year has not been kind to investors. Equity markets across the globe delivered a roller coaster ride in January before U.S. indices, aggregate foreign markets, and combined emerging markets all recovered a bit to end down only 5% to 6% for the month. Fears mostly centered on the China slowdown and oil oversupply, which may signal greater economic malaise and growing problems across multiple economies. Fourth quarter U.S. annualized GDP growth averaged only 0.7%, which seems to reinforce concerns that global problems may seriously impact U.S. growth, and could even cause a recession. Pundits have been loudly proclaiming challenges to exports and U.S. manufacturing from the strengthening dollar and sluggish overseas demand.

Yet, against this backdrop, we remain optimistic about the U.S. economy and domestic and international equity markets. U.S. growth for 2016 should be steady if modest.

Exports and manufacturing account for only about 13% of GDP, making the US far less dependent on exports as a driver of GDP growth than other large economies. Domestic demand, largely led by an increasingly confident consumer, should offset external weaknesses. Moreover, recent industrial production decline has been driven almost exclusively by the collapse of the oil industry. Similarly, when energy companies are excluded, corporate profits for S&P500 companies are almost unchanged over the past year.

The U.S. job market is one of the best recession indicators, and this measure is signaling growth, not recession. December's job growth numbers were exceptionally strong, although they were temporarily buoyed by hiring in construction because of the mild weather. January will probably see a slight dip with February's numbers reverting to the solid upward job-growth trend that has existed for a couple years. In addition, wage growth appears to be accelerating adding to disposable income, improving household financial strength and confidence. Declining consumer debt and greatly reduced debt service costs now sit at a 35-year low. Residential housing gains are also strengthening household finances, and credit markets are adding to consumer purchasing power. While it's possible that a falling stock market could lead to consumers reigning in purchases causing a slowdown, there is no evidence of this to date, and economic conditions normally need to worsen considerably to trigger this effect.

While pundits moan about the price of oil, the net impact on the U.S. and global economy remains positive with far more industries and individuals benefitting from cheap oil and gas than the small number of energy companies struggling due to falling prices. The likely boost to global demand through cheaper energy should help the world grow at a steady pace, although there will be individual winners and losers.

A few key indicators also suggest that investor fear is not as pronounced as press coverage suggests. A favorite Wall Street fear measure, the CBOE Volatility Index, hasn't surpassed last August's levels, when it spiked to its highest since 2011. Another volatility measure, the VIX, hasn't surpassed levels seen just last month. In essence, this indicates that investors are not positioning themselves for an explosion in volatility. The price of gold, which often sees major prices increases when investors grow worried, has barely budged this year. And the difference in yields between long and short-term debt (the yield curve), remains decidedly positive. This highly reliable indicator strongly signals a recession is not expected.

Issues in emerging markets also don't appear to be as bad as hyped. As China transitions away from infrastructure investment and the property market, and toward services, slower growth is expected. China may face major challenges and adjustments, but growth is not collapsing and underlying data has been more positive than headlines suggest. In fact, large parts of the Chinese economy, such as the service sector and consumption, are improving.

Slowing China growth is also quite predictable. Long term trends suggest that a more normal growth rate should be around 5.0 to 5.5% versus the current rate of mid to high 6's. Demographics have shifted, and productivity growth gains, as a middle income country habitually declines. For the next 5-10 years, we are going to hear repeatedly that China's growth rate is the lowest it has been in 25 years. Past growth rates are simply unsustainable for an economy no longer on the cusp of development.

Beyond China, the current panic about emerging markets seems to reflect an inability by analysts and investors to distinguish between financial markets and economic fundamentals. Apart from Argentina and Ukraine, which are unique cases, there have been no sovereign defaults, no significant increases in corporate defaults, no runs on foreign reserves, and no balance-of-payment crises. Emerging markets hold 80% of foreign reserves and have a third of the government debt of developed markets. In spite of the decline in the price of oil, the terms of trade have improved for two-thirds of emerging markets because the price of other commodities has declined less than oil.

Moreover, the middle class is growing rapidly, lessening the impact of external demand. Demographics with young, growing populations and increasing income levels also favor emerging markets. Africa's median age is 20, Asia's is higher at 32, while Europe's sits at 40. Rapid urbanization is also adding to the labor pool and increasing affluence.

Despite the slowdown largely driven by weak commodities prices, emerging market economies are expected to generate faster rates of growth than advanced economies. Recent market weakness also presents investors potential opportunity. In emerging Asia, price to book ratios sit at 10-year lows, a full standard deviation below the historical average.

Europe also appears stronger than many assume. Eurozone economic indicators are strengthening, buoyed by cheap oil, loose monetary policy, expansionary fiscal policy, and favorable exchange rates. A mid-January ECB survey of independent economists' forecasts Eurozone growth this year at 1.7%, which is unchanged from earlier projections. Forecasts reflect the belief that stronger domestic demand will offset weaker exports.

Very simply, there remains little evidence to support fears of a major global downturn. While China continues to face challenges, its economy is not collapsing and recent data from other major economies, both developed and emerging, has generally been good. Geopolitical events, Fed interest rate increases, and uncertainty regarding global growth may generate volatility, but we expect solid returns for U.S. stock investors and many global markets over the next year based on current and expected valuations relative to fundamental economic measures.

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