KALOS *Market Commentary*

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Much Good News, but Fears Could Become Self-Fulfilling

For much of 2016, risk assets have performed poorly, but risk appetite has seen an even larger decline. While some global and domestic indicators have been weak or weaker than expected, many others remain strong with several key areas even appearing to strengthen in recent weeks. Yet, many investors and the press remain focused on areas of weakness or potential problems. Plunging oil prices, China's slowdown, the Brazilian recession, Russian sabre rattling, international instability, the strong dollar, anemic European growth, deflation concerns, a very uncertain U.S. election climate, and a general feeling of uncertainty seem to be overwhelming more positive economic data.

Against this backdrop, we maintain a more optimistic viewpoint. The march toward full employment continues unabated. A mid-February jobs report delivered more good news, with wages rising at an annual rate of 2.9% over the past six months, the fastest pace since the recession. The uptick, with a particularly strong number in January, could suggest a diminishment of slack in the workforce as a lower unemployment rate compels employers to pay more to hire and retain staff. The U.S. also began the year by continuing the longest stretch of private-sector job growth on record. Steady job creation in the U.S. propels consumer spending on homes, cars and other goods and services. The big jump in hiring by manufacturers, the largest increase in 14 months, was particularly notable. The unemployment rate is now down to 4.9%, a nearly eight-year low. While the recovery has been painfully slow, it remains steady.

So far in 2016, GDP growth is above 2% in spite of the typical cold weather which tends to slow growth. After fourth quarter's numbers of only 0.7%, which puzzled economists because it was inconsistent with job gains, the return to relative growth suggests ongoing stability.

Housing overall remains intact. While the new homes market cooled a bit in January (from a 10-month high) because of a drop-off in sales in the West region, the tightening labor market which is increasing wage growth and bolstering household formation, continues to fuel a steady housing market. Housing is also helped by relatively low supply levels which barely increased in-spite of the recent sales drop-off.

Manufacturing, which accounts for 12% of the economy, is also turning. While U.S. manufacturing activity contracted in January for a fourth straight month as factories grappled with a strong dollar, and lower oil prices continued to hammer energy firms, the pace of the decline slowed. Last month, more factories reported an increase in orders and production, and inventory levels and order books appeared to be steadying. The signs of stabilization in manufacturing were also captured in a separate report from data firm Markit, which reported that its U.S. manufacturing Purchasers Manager Index rebounded last month from December's 38-month low and also noted faster growth in production and new orders.

Regardless, it would also be highly unusual, if not unprecedented, to see the country tumble into recession before the November election.

KALOS MANAGEMENT
11525 Park Woods Circle | Alpharetta, GA 30005
1.888.356.1950 | 678.356.1100
www.kalosmanagement.com

Furthermore, downturns are normally precipitated by rising unemployment and high oil prices, and both are now heading in the opposite direction.

Part of the current market concerns likely arise from the confusion and dislocation in many markets. While global growth should exceed 3% in 2016, it's projected to be highly uneven, paced largely by the developed markets of the U.S., U.K, and some Eurozone countries.

Cheap oil tends to be good for many economies, including many commodity dependent emerging markets, which import more oil than they export other commodities. The impacts of cheap oil are broad and shallow while the pain is very deep and clear.

Global Growth should also be assisted by increased exports to the U.S. because of our steady growth and strong dollar. European trade will benefit, and Canada and Mexico should be even larger beneficiaries.

All is not bad in emerging markets either. While China's growth rate is slowing, demand for many items including energy, continues to grow albeit at a slower pace. And India should enjoy a slightly stronger expansion this year than last year as its robust manufacturing sector benefits from cheaper prices of raw materials. Ongoing low interest rates should help India achieve the fastest growth among all of the major emerging economies.

The Federal Reserve also appears unlikely to cause problems. It has clearly signaled its intention to implement gradual adjustments to monetary policy over several years. Since 1946, there have been 12 rate hike cycles: five were "slow" cycles where rates were not raised at every or even most FOMC meetings and seven were "fast" cycles where rates were raised at most consecutive FOMC meetings.

Stocks have performed quite well (+10.8%) in the year following the initial rate hike when the Fed was historically moving slowly. Conversely, a fast moving Fed unsettles the market and has historically delivered a small loss (-2.7%). We continue to expect the Federal Reserve to raise interest rates just once or twice this year. Fairly-sluggish U.S. and global economic growth has the Fed in a cautious mode and it's hard to raise interest rates when Japan and others are easing them.

Lastly, the U.S. equity market itself seems to suggest that stocks hit levels deemed "too cheap to ignore" once the Standard & Poor's 500 Index falls to between 16.5 to 17 times earnings. When the S&P 500 set this year's low on Feb. 11, the price-earnings ratio dropped to the bottom of that range. The index rebounded 6.1% from that low through Friday. While this may not repeat, investors seem to be willing to look past various areas of uncertainty once the market drops to a certain point.

As we look forward, we remain cautiously optimistic, but note a significant area of concern. If the market remains depressed and volatile, and negative sentiment continues to drive markets long enough, history suggests that these concerns can eventually influence consumer activity and business hiring. Essentially, the fear of a slowdown eventually causes one. While we don't believe this is likely, and a slowdown of this nature tends to be shallow, this potential outcome will become more likely if high levels of concern remain into late spring and summer. Reasonable valuations and solid domestic data should lead to a decent year for markets, but ample uncertainty in many areas will likely keep the ride quite rocky.

Daniel Wildermuth
Kalos Management, Inc.
CEO

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