KALOS *Market Commentary*

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# Equity Markets Likely Will Remain Strong

**Last month, I outlined various reasons why I believe the long-term prospects for continued global growth remain strong**, even if world equity markets may be more volatile in the future. However, with U.S. stocks hitting record highs, does it still make sense to leave money in stocks? The bull market has now gone more than two and half years without a 10% correction. Moreover, first quarter GDP figures were recently adjusted sharply down with the new rate showing the economy contracted at a 2.9% annual rate.

At some point, we will obviously see a major correction, perhaps much larger than 10%. And, higher valuations make severe corrections potentially more likely. **Yet, I still believe the markets appear well positioned to move forward for numerous reasons.**

**Even though GPD contracted in the first quarter, most conditions did not signal a slowdown.** Jobs were added at a healthy pace; large and small business sentiment were up; and in June, U.S. consumer confidence rose to its highest level since January 2008. The recent GDP contraction resulted from two short-term issues. First, terrible winter weather across much of the U.S. slowed nearly all parts of the economy. Obviously, the bad weather will not continue, and we will likely see a strong bounce in future numbers as companies and individuals catch up on delayed activities. The other major factor was a nearly unprecedented contraction in medical spending. This resulted from the confusion surrounding the Obamacare rollout. This trend will not continue. The contraction, however, will result in another year of weak GDP growth.

**Yet, markets will likely continue moving up for various reasons**. While valuations have crept up to historical averages, markets are still not expensive. Equity valuations are still hovering around historical norms. Moreover, during bull markets, investors tend to push valuations well past historical averages before losing enthusiasm. As I've written before, John Templeton, a renowned stock picker, once said bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria. We seem to be approaching optimism with euphoria still a long way off.

**While more investors have embraced equities during the long-running recovery,** as a group, individual investors remain unenthusiastic about the stock market. They still appear to be more concerned about minimizing risk. As evidence, mutual fund investors continue pouring more money into bonds than stocks. Bond funds worldwide took in $6.3 billion during the final week of May (most current data I have) for an amazing 12 consecutive weeks of investor inflows. Meanwhile, equity funds inflows trail bonds and are losing the popularity contest with fund investors. The combination tends to be good for future price increases because money remains on the sidelines that may eventually jump in the market and drive prices up.

**While the Fed is slowly tightening the money supply, money remains very cheap** which acts as a constant tailwind for equities by increasing average profit levels across corporate America. Avoiding equities for the past several years has been the equivalent of fighting the Federal Reserve (Fed), and the

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Fed looks likely to continue down this path for the foreseeable future.

**Strongly linked to Fed policy, inflation remains low** with fairly high confidence that inflation is unlikely to cause significant problems, at least in the near-term. While inflation is probably one of the scarier issues that could harshly jolt the market at some time, it seems at least some distance away in a world growing more slowly than after nearly any past recession.

**Given today's low inflation, it's not surprising that commodities prices, key inputs into many businesses and the frequent cause of rising inflation, remain subdued and stable.** The lack of price appreciation helps keep input prices down and profits predictable, while the lack of falling prices also keeps various parts of the economy from stagnating.

**U.S. energy production is growing at an incredible rate** providing cheaper inputs into all kinds of industries while creating jobs throughout the U.S. The renaissance surrounding vastly increased natural gas production has even resulted in the U.S. lowering its carbon footprint since 2006, making it the only developed country in the world to achieve this goal.

**Manufacturing has been a direct beneficiary** of reduced energy costs. "Re-sourcing" or bringing foreign operations back onto soil is a growing trend. The rate of growth for the U.S. manufacturing sector advanced to their highest levels in more than four years in June. The financial data firm Markit said its preliminary or "flash" reading of the U.S. Manufacturing Purchasing Managers Index rose in June to its highest reading since May 2010 at 56.4. (a reading above 50 signals expansion in economic activity).

**Many of these contributing factors have driven corporate profits to record levels**, creating tremendous excess cash that largely remains on balance sheets. Usually, high cash levels drive increased mergers and acquisitions (M&A) and business investment. While the normal trend has been slow to materialize during the recovery given the financial and political instability in the U.S., M&A activity has increased markedly in recent months as companies search for ways to put their ample cash to work. This factor alone is normally a strong indicator of future strength in equity markets.

**Still, not all is rosy.** European economies continue to struggle to really take off. Yet, even across these challenged economies, the worst of their various recessions appears over. Recently, the European Central Bank cut interest rates, which provides a favorable global monetary tailwind. Europe is unlikely to act as a strong engine of growth, but it should be a contributor to the global economy rather than the drag it has been. Their moderate growth should mean better times for the global economy and the U.S.

**Taken altogether, the near-term and longer-term economic environment signals a moderately pro-growth outlook.** Corporate earnings, the primary driver of equity markets, should continue rising suggesting that equities remain a solid investment choice. Bond yields, however, probably will begin increasing by the end of the year suggesting traditional fixed income will likely struggle for the foreseeable future.

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