Kalos *Market Commentary*

September, 2015

Market Plunges – Now What?

Papers, websites, Twitter, and anything else communicating news has been shouting about U.S. and global stock declines. And there has been much to shout about. On Monday, August 24th, the Dow Jones Industrial Average was down around 1,000 points or 13% before recovering to "only" lose about 3.5%. The Dow and S&P500 remain on track to have their worst month since February 2009, and the NASDAQ looks even worse, experiencing its steepest drop since November 2008.

The recent sell-off was driven by many factors: the weakness in the Chinese economy, including the surprise devaluation of the Yuan; falling commodity prices lead by oil dropping well below $40 a barrel; unexpected slowing of European economies, likely resulting from ongoing political and economic instability in Greece; and uncertainty over the timing of Federal Reserve rate hikes.

But the primary fears that motivated the recent sell-off appear strongly linked to perceived problems in China and what their slowdown could mean for the global economy. Beyond the recent market collapse in China (8.5% on Monday, 8% Tuesday, following weeks of previous losses), global investors seem to be more concerned about longer-term growth challenges for an economy that has provided much of the recent fuel for global growth. Investors were first shocked by the surprise devaluation of the Chinese currency, and then recent manufacturing numbers confirmed fears that growth is not recovering, and could even be slowing further. The preliminary Caixin/Markit China Manufacturing Purchasing Managers' Index (PMI) delivered its worst reading since the depths of the global financial crisis in March of 2009. The reading marked the sixth straight month of manufacturing contraction and the release of the index sent investors fleeing.

Beyond China, other factors are also unsettling markets. In the U.S., earnings for energy and materials sectors were predictably dismal in second quarter. Industrials also turned in disappointing numbers. And GDP growth for the year looks like it will yet again fail to reach the 2.5% predicted earlier.

Still, much of the news remains quite upbeat. Positive earnings surprises were up almost 4%, largely because of consumer spending. U.S. retail sales rebounded in July as households boosted purchases of automobiles and various other goods. Jobs increased by 215,000 last month, and August job creation is also expected to be strong. Third quarter U.S. growth should be solid, and global economic fundamentals remain largely positive in spite of all the headlines suggesting otherwise. The strength of U.S. and global economies will likely result in the Federal Reserve increasing rates in 2015 as expected, although recent volatility could cause the Fed to wait until December rather than acting in September.

Overall, the pullback, while quick, remains relatively shallow to date. The market has not only performed incredibly well for past several years, it has also delivered its performance with remarkable predictability, possibly lulling investors into expecting continued calm. U.S. equities historically go through 20% plus corrections approximately twice every decade, and we have now gone almost 7 years without even a 10% correction. To some extent, we're due. We may see more declines, but after a tremendous run-up in recent years, recent losses remain unspectacular. But, now what is prudent?

While we cannot know the future, current circumstances seem to suggest we are in for more volatility. Numerous factors are contributing to recent fluctuations, and none of them are likely to quickly dissipate. Contributing factors are also complicated. Conceptually, investors generally understand that China's economy is slowing more than expected, and the Eurozone is still adjusting to various challenges including Greece. However, that doesn't mean the exact ramifications of these challenges are well understood.

Furthermore, because much of the trading world in Europe and U.S. is on vacation, the recent news will be more slowly digested then at virtually any other time of the year. It is not unusual for equities to struggle in September, because so many people are returning from vacations and it takes longer to assimilate the information and decide on a course of action. Often, this results in a lot of sideways movement in September, and this year, the complexity of distant, global factors could result in even murkier signals on what the market may or may not do.

Recognize that there is no reason to panic. As mentioned, in spite of the recent sell-off, fundamentals remain strong enough to warrant long-term confidence. Valuations also remain reasonable. The outlook for the future remains positive, and corporate profits, the primary driver of the stock market, should continue to grow rewarding patient investors.

It may be helpful to accept the inability to predict or know when these drops will occur. No one knows what the market will do next. Stocks could head back up, they could keep going down, or they could just trade sideways. No one knows how far or what the timeline may be. It goes with territory. Long-term, history has shown that markets rise over time, so the bigger question nearly always focuses on an individual's timeframe.

The recent sell-off does present an opportunity for some people. If you have wanted to reposition your portfolio but did not want to pay capital gains, taxes would likely be less than there were just a few days ago. But, if you make changes, resist the temptation to sit on the sidelines. The few people who manage to correctly time their exit from equities rarely do well in the long-run because they wait too long to get back in and miss the recovery. Most who exit, simply succeed in locking in losses.

The recent sell-off also creates the opportunity to reassess your portfolio design. If you are already panicked, you likely need to perform a realistic risk assessment because this pullback and volatility is very normal for the stock market. It simply goes with the territory. If you're uncomfortable, you may also want to diversify into assets other than stocks, although now is likely not the ideal time to start the process. My best advice is to ignore the near-term noise, even if it gets louder, and focus on your long-term goals. It sounds boring, because it is. But, it's also been shown to work wonderfully well over time.

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