KALOS *Market Commentary*

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Volatility Returns with a Vengeance

Stock and bond markets have been quite volatile the past 6 weeks, and markets really swooned after recent comments by the Federal Reserve Chairman, Ben Bernanke. On June 19th, Mr. Bernanke laid out a tentative one-year timetable for winding down the Fed's $85 billion-a-month bond-buying program aimed at pushing down long-term rates to spur the economy. Stocks and bonds plunged as bond and stock traders acted on fears that the Fed's cutbacks could lead to higher interest rates which could adversely affect the economy.

If you've been reading this newsletter, however, the markets' strong reaction to the Federal Reserve's mention of slowing bond purchases was not a surprise. In last month's newsletter, I wrote "*Ironically, if the economy slowly strengthens as expected, good news could actually drive markets down because it could signal less support from Central Banks.*" Well, that's exactly what has happened. I also mentioned that "*The Fed will attempt to make adjustments that avoid spooking investors.*"

Predictably, this past Monday (June 24th), officials tried to contain the damage done by Mr. Bernanke's statements. In an unusual step, Narayana Kocherlakota, president of the Federal Reserve Bank of Minneapolis, released a statement and held an impromptu conference call with reporters to emphasize that the Fed is committed to continuing its bond-buying program until the U.S. jobless rate falls further. In addition, he argued that the Fed is committed to keeping short-term interest rates near zero for an extended time period and the Fed's commitment will last beyond the end of bond purchases. Other recent comments from Fed officials suggest that it will be 2015 before the Fed raises rates. Simply, it's probable that any rise in interest rates will likely phase in over a couple years providing bond investors time to adjust. As a result, it seems likely that bond prices will ease back up in the near future and erase much of the recent sharp price declines.

Similarly, equity markets seem to have reacted too sharply, and I believe the recent pullback will be temporary. The eventual withdrawal of Fed stimulus should not materially affect growth. The reasons to expect future growth are straight-forward. Although global and domestic economies still face challenges in multiple areas, good news, particularly in the U.S., continues to pile up from diverse sources.

Orders for long-lasting manufactured goods (durable goods) rose 3.6% in May which bettered expectations of 3.0%. According to the Commerce Department, May's rise in demand for goods ranging from toasters to aircraft matched April's increase that was revised up to 3.6% percent. In addition, a gauge of planned business spending increased for a third straight month according to Reuters.

Separate data showed prices of U.S. single-family homes jumping in April to rack up their biggest annual gain in seven years. A second report on housing indicated sales of new U.S. single-family homes rose to their highest level in nearly five years in May, confirming the housing

market's strengthening recovery. Notably, a key contributor to the improving housing market remains the decline in inventory of homes for sale, which bodes well for future prices, also. The perception that the housing market is becoming a seller's market is making Americans less fearful about spending on big-ticket items.

Housing's impact on individuals generally dwarfs the influence of market movements. So it's not surprising that U.S. consumer confidence jumped in June to its highest level in over five years. Moreover, most U.S. economic data has exceeded consensus forecasts. Positive data has driven the dollar higher against foreign currencies, which is welcome news for international summer travelers.

Job gains also remain steady, if still slow. May added 175,000 jobs along with a 1 cent uptick in average hourly earnings to $23.89. Since the U.S. needs to add about 150,000 jobs a month to keep pace with population growth, the net addition remains small, but still positive. Perhaps as encouraging, the total U.S. workforce grew by 420,000 as more people began looking for work. Total employment remains 3 million less than in 2007 and around 4.4 million unemployed have been out of a job longer than 6 months. Still, adding jobs, increasing wage rates, and growing numbers of job seekers reveal strengthening pieces of an improving economy.

These various data points ranging across various areas of the economy align with the Federal Reserve's assessment that the U.S. economy is improving.

Another bigger picture and longer-term trend also favors corporate America. U.S. firms are continuing their strong expansion into emerging markets. While news of demonstrations in Brazil and Turkey have made headlines, and Chinese markets have struggled recently because of cash and credit management issues, the private sector in emerging markets continues to flourish. In many cases, the growth of the private sector is even stronger than national GDP growth suggests because of their shrinking government involvement in the economy. And, in spite of recent headlines, political volatility is actually lessening in most of the world. Across Asia, South America and Africa, U.S. business investment continues to expand. The U.S. economy and banking systems remain stronger than Europe's, and Corporate America's cash troves provide it ample stores to fund investment in business-friendly economies growing faster than the U.S.

Against a fairly positive backdrop, the recent market frenzy should dissipate as traders look beyond immediate concerns toward longer range issues. The Fed appeared to use recent economic strength as a means to warn markets that change is coming even as it worked to quickly reassure investors that the changes will not come too fast. History has shown that there's always plenty of room for error when increasing rates as anything can go wrong. Yet, ongoing developments likely support the Fed's belief that the economy is slowly continuing to strengthen, which should be good news for corporate earnings and asset prices. Bond holders, however, should heed this recent pullback as it's likely a glimpse of the future when rates eventually rise.

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