MARCH 2013
MARKET COMMENTARY

Strong Stock Market Start

U.S. stocks have moved up sharply this year – at least until this week's hiccup caused by Italy's unclear election results. Through the third week of February, the S&P 500 was up over 6% and had nearly reached its 2007 high. Few investors appear thrilled with the U.S. economy, yet confidence that moderate U.S. growth will continue has been steadily increasing. January's "reasonable" resolution to the fiscal cliff raised hopes regarding future growth and encouraged investors regarding Washington's ability to eventually address upcoming sequestration, the mandated budget cuts that take effect March 1st.

Europe's Blues

While Germany and England are making economic progress, much of the rest of Europe is still struggling, casting doubts on the hoped for recovery in the second half of 2013. In Italy's elections this past week, deadlock heightened fears that no coalition strong enough to maintain austerity measures would result. While slow progress remains likely, the market's reaction to this Eurozone threat highlights ongoing headwinds to economic recovery around the globe. Yet, in spite of this setback, challenges associated with Europe's calcified welfare states and deep debt problems likely will be seen in the U.S. as only temporary interruptions to forward progress that will not overwhelm the ongoing U.S. recovery.

Reasons for Optimism

Corporate Earnings continue to instill confidence. According to Thomson Reuters data as reported by Reuters, 69% of companies exceeded profit expectations with 83 percent of the S&P 500 having reported results through February 25th. This compares favorably to the 62% average since 1994 and 65% over the past four quarters. In addition, earnings for S&P 500 companies during last quarter are estimated to have risen 6 percent, exceeding the measly 1.9 percent forecast.

Capital Spending plans in the U.S. are mostly exceeding Wall Street forecasts even with the uncertainty created by arguments in Washington over the fiscal cliff, the debt ceiling and now, automatic spending cuts. Corporate America's willingness to spend on new offices, plants and machinery, as well as making deals, shows that they are becoming more willing to use some of the massive cash piles sitting on balance sheets.

Manufacturing is projected to grow about 2% this year, and 2014 and 2015 are expected to see stronger increases. Productivity continues to rise dramatically as companies increase automation and innovate. Low energy costs, decreased union power, and access to low cost money is also spurring growth. Even the lower dollar helps especially when combined with increasing wages overseas in places like China.

Consumers are buying larger ticket items such as cars and trucks as the housing market steadies and consumer confidence slowly climbs. February new cars sales results are expected to be quite strong with a 4.3% increase projected. Consumers are starting to replace aging vehicles and move forward with deferred purchases.

A renewed willingness to borrow should continue to fuel increased consumer spending. After reducing debt at the fastest rate in history after the financial meltdown and resulting credit crunch, use of credit is increasing again. In addition, Americans are using 25% less of their disposable income to make debt payments than they were five years ago, the lowest share since 1983.

Problems with Bonds and Inflation

Bonds record low rates and the prospect of future rate increases are spooking notable investors, managers, firms and even regulators. This isn't surprising since a bond fund with 10-year duration will decrease in value by 10% if rates rise one percentage point. Dan Fuss, 79, whose Loomis Sayles Bond Fund beat 98 percent of its peers in the last three years, is very explicit. In a recent interview, he said "This is the most overbought (bond) market I have ever seen in my life in the business (55-year career)."

Big investment firms are attempting to avoid problems. UBS Wealth Management Americas, Bank of America Merrill Lynch and Wells Fargo & Co. all have begun reducing the proportion of government and investment-grade debt in the model portfolios they offer financial advisers with the biggest changes occurring in the most conservative models.

An analysis of inflation reveals more bond headwinds. Since the 1970's the preferred government inflation metrics have changed so thoroughly that they bear little resemblance to those used during the "malaise days" of the Carter years. Peter Schiff, CEO of Euro Pacific Capital, has garnered much attention in various domestic and international publications by charging that the current CPI reporting system vastly underestimates real inflation. Using a basket of goods and services that could be compared to official CPI numbers over different time periods, he calculated that between 1970 and 1980, his basket rose by 121%, or just 8% faster than the CPI's rate of 112%.

But, between 2002 and 2012, the CPI rose 27.5% while his basket rose by nearly double that rate at 52.1%. He ran the same experiment with 10 different goods and services and the results were notably similar. Another independent data service, Shadow Government Statistics, found that the U.S inflation rate over the past few years has been around 6% — or three times the declared government rate. Paltry bond yields combined with high interest rate risk and inflation pose uniquely difficult challenges.

The need to maintain purchasing power in an ultra-low interest rate environment with a high threat of inflation poses investment challenges. Ironically, for most investors, adding investments with a higher level of risk as traditionally defined and reducing bond holdings could make sense given some risk assets' reasonable valuations and likely future performance relative to bonds. However, ongoing uncertainty in global and U.S. economies make solid portfolio design and wise diversification particularly valuable. Times like these can more richly reward solid strategies or more severely punish inept planning.

Daniel Wildermuth and the Kalos Team
CEO/Money Manager

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Contact ACoetzee@KalosFinancial.com.