KALOS *Market Commentary*

May, 2013

Markets Near All Time Highs – Is it Likely to Continue?

April saw both broad U.S. stock market indexes, the Dow Jones Industrial Average and the S&P 500, hit record highs. After a strong surge early in the month, stocks dipped on somewhat less favorable news before again rising strongly near month end. At this point, I believe valuations and various other indicators suggest that the market seems likely to slow in the coming months.

Economic growth regained strength in the first quarter after fourth quarter's zero increase largely brought on by the fiscal cliff. Still, the 2.5% annual growth rate reported by the Commerce Department fell well short of economists' expectations for 3.0%. And, the 2.5% rate appears unlikely to repeat, as part of the acceleration resulted from farmers' refilling silos after last summer's drought decimated crop output. The growth rate was only 1.5 percent if their inventory replenishment is excluded. Ongoing growth this spring and summer is likely to continue around a slower 1.5% pace before likely picking up to 2.5% later in the year because of the reawakening housing sector.

Slow GDP growth largely results from many companies slow sales growth even as they report record profits. Causes vary across companies but mostly include incredible policy uncertainty emanating from Washington, a stronger dollar, sluggish consumer spending, and for bigger exporters, China's uneven growth. More recently, Europe is also causing more problems than anticipated. While the conditions were expected to be difficult, companies have found them to be worse than feared.

While the recent GDP gains have been weak, at least they resulted from growth across nearly all areas of the economy – other than government – leaving the economy less dependent on any single sector. Manufacturing is losing some steam this year, but it should still power the economy forward as its growth should continue at a stronger pace than the general economy. Consumer spending, which accounts for more than two-thirds of U.S. economic activity, increased at a 3.2 percent pace - the fastest since the fourth quarter of 2010. As the housing market picks up, wood product demand should increase around 10% as demand for lumber, flooring, kitchen cabinets, etc. all should increase. Aerospace should also see strong growth in spite of the Department of Defense cutbacks. Boeing is looking at 6% more commercial deliveries this year even without Dreamliner sales.

Looking longer term, chip advancements making them faster, smaller, and dramatically more energy efficient are expected to spur faster growth in a slew of industries. The big improvements are expected to revolutionize existing products, from mobile phones to medical devices with an impact that should ripple throughout the economy. While the global economy should benefit, the U.S. is expected to take the lead in regions with research centers likely to see the earliest impacts. Some predict that nanotechnology growth alone could create 2 million jobs by 2020. Bioelectronics are bringing the bionic man of yesteryear closer to reality.

Hydraulic fracturing (fracking) is also contributing to current growth and future growth projections. It has been partly responsible for the tremendous energy bonanza enjoyed by the U.S. The biggest threat to the long-running boom remains state and federal regulation. But in this fight, fracking has some surprising new allies. Environmental groups believe practices can be acceptably improved adding to its benefits as a cleaner burning fuel that has dramatically reduced carbon dioxide emissions over the past several years. Several groups are cooperating with energy firms to create voluntary drilling standards aimed at easing fracking's ecological impact.

Oil output in the Gulf of Mexico is also recovering as new seismic imaging technology has been used to find some of the Gulf's deepest oil-bearing geological layers. In five years or so, current discoveries could push total Gulf oil production from today's 1.4 million to 2 million barrels per day, more than compensating for the decline following the drilling halt after BP's 2010 spill.

A less positive influence on the economy remains the uncertainty tax – the ongoing drag on the economy resulting from changing and uncertain policy out of Washington. Factors include the sequester, lack of a U.S. budget, confused fiscal policy, contentious monetary policy, unclear tax policy, massive levels of new regulation, skyrocketing national debt, the recent fiscal cliff, and the list goes on and on. According to Stanford University's Nicholas Bloom and Scott Baker and the University of Chicago's Steven Davis, U.S. economic policy uncertainty has been 50% higher in the past two years than it has been since 1985. And in 1985, the uncertainty was viewed as positive since changes were favorable for business, where today's issues are seen as uniformly causing pain. Vanguard, the mutual fund company, used data from their study to estimate that since 2011, the rise in policy uncertainty has created a $261 billion cumulative drag on the economy (more than $800 per person) or about 1% of GDP. They also estimate, that the drag has cost more than 1,000,000 jobs over the last couple years.[i] The uncertainty generally prevents businesses from investing and consumers from spending.

Still, against this backdrop, good news remains. In the immediate future, government action, or inaction, regarding the sequester is likely to start making a larger impact, but shouldn't quell growth completely. The recent FAA artificially produced crisis that delayed flights was dealt with via a side deal. A similar approach will likely be used to isolate the more painful elements of the sequester and help avoid more damaging effects of inaction.

More importantly, the U.S. private sector continues to grow and increase in efficiency. Cash cushions and increased flexibility should help corporate America pull the economy forward even if the pace is muted. Eventually, uncertainty will decline, and focus will shift more to growth rather than trying to divine future government policy. However, for the time being, uncertainty and obvious problems, in the U.S. and abroad, also suggest that slower growth will continue making today's valuations look reasonable, but probably not cheap.

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[i] *Uncertainty is the Enemy of the Economy*, Wall Street Journal, Bill McNabb, p. A17.

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