MARCH 2011: MARKET COMMENTARY

In Billionaire Warren Buffett's annual letter this past Saturday to shareholders, Mr. Buffet said he still believes America's best days are ahead. He also said he wants Americans to be optimistic about the country's future but wary about borrowing money. He sounds a bit like a good parent. He's backing his optimism with action. His companies are going on a spending spree with significant increases in capital spending across the board. Notably, he also added that he believes a housing recovery will likely begin within the next year.

For those of you who have been reading our newsletter for any length of time, you'll recognize these same sentiments. However, it's always nice to have someone as noteworthy as Warren Buffet echo very similar beliefs to our own.

Reinforcing Mr. Buffet's optimism, GDP growth this year is expected to be well above 3%, up from 2.9% last year. Over the past year, almost half of GDP growth has resulted from business investment in equipment. Like Mr. Buffet, these companies are investing to build capacity and raise productivity in anticipation of stronger demand in the future.

As suggested by these trends, business confidence continues to rise. Nearly 60% of CEOs plan to increase spending and 45% plan to add people. Optimism among purchasing managers for manufacturers is at a seven-year high. Managers at service firms say conditions are the best since 2005. Small company confidence is also rising, leading to rapid hiring increases.

The consumer is also returning and their confidence in the recovery is growing. In spite of the snowiest January in six years, major U.S. retailers open at least a year, generated sales increases of 4.2% versus analysts' expectations of a 2.7% gain. The increase exceeded a year-earlier rise of 3.3%, according to Thomson Reuters data. Most car companies have also experienced tremendous sales increases. Most saw double digit sales increases over last year.

An extraordinary month in the Middle East brings back strong reminders of the breakup of the Soviet Union in 1989. In this instance, there's a major difference – Oil. The world had very little exposure to Soviet supplies unlike today's dependence on the Middle East.

However, even with the uncertainty introduced through recent turmoil, major disturbances to supply and our economy seem unlikely. Saudi Arabia, the world's largest exporter of oil, is very stable and is unlikely to experience the problems of its neighbors. The United Arab Emirates, Kuwait, Oman and Qatar also seem to be quite stable in spite of their restlessness and high unemployment. In these countries, a willingness to spend to maintain stability combined with cradle to grave welfare states are likely to diffuse any tensions that arise.

Iraq and Iran are different. They are both top 10 oil exporters experiencing major change with an increasingly emboldened populace. If these countries experience major uncertainty, global oil markets will react much more sharply than similar problems in Egypt or Libya. The uncertainty, not current supply, is driving price volatility. And even after regimes stabilize and unrest subsides, uncertainty will remain.

While stability is lacking, supply is less of an issue. OPEC has a 6-million-barrel surplus, and various other sources can add to supply as well. As a result, oil probably won't go much above

$110 a barrel unlike the $140 top price in 2008. However, because of various other factors, these oil prices are likely to push gas past the $4 per gallon level and could surpass the 2008 record of $4.11 by June. And, as always, it's possible that these numbers could be way off. Some analysts have predicted prices as high as $220 a barrel although these predictions appear to be exceptional.

Regardless, even with increases in oil prices, we don't believe high prices will seriously hamper longer term growth in the U.S, and GDP growth is unlikely to slip much below 3% because of oil/gas prices. There appear to be too many positives building on each other to allow this one, albeit major, factor to seriously dislocate the economy.

Other commodity prices are also increasing as global economies strengthen. While various precious metals saw increases near and over 100% in 2010, food sources saw mild inflation. For 2011, increases are expected to be larger, particularly in grain prices. The global growing middle class's taste for meat and dairy products creates a higher demand for basic agriculture products. While supplies appear to be sufficient to meet most needs, price increases are expected to be fairly substantial with estimates ranging from 20 to 50%. And potential weather issues could drive up prices further.

For the U.S. economy, high commodity prices are expected to increase food prices by about 3% in 2011, but will also increase farm income and land values. Our food price increases are muted because the vast majority of food prices are derived from factors outside of commodity prices such as advertising, distribution, labor, and packaging. As a result, the US will experience both benefits and costs related to increased food prices.

As widely reported, the jobs picture continues to improve, and is probably better than reported. Through the downturn and recover, the ADP (Automatic Data Processing) employment report has been providing much more accurate jobs information than government statistics. The government dramatically overestimated the amount of new business formation in the early stages of recovery, and now appears to be underestimating the strength of recovery.

ADP is showing that job gains since November of 2010 are much stronger than in previous months and government estimates. The drop in new jobless claims since August has been one of the swiftest in four decades. Various indicators including loan growth and confidence suggest better conditions are coming for small businesses. In fact, more than half of the 187,000 new jobs ADP reported in January were from businesses with fewer than 50 employees.

While the many factors that interrelate to create economic growth are very complex, the positive theme appears quite constant. We believe many factors are combining to create sustainable growth that is accelerating. While this may or may not result in stock market gains, economic prosperity usually increases corporate profits which are normally the driver of stock market performance. Of course, as confidence in the economy has grown over the past many months, stock prices have risen with expectations. Stocks are no longer the tremendous bargain they were, but they also don't appear to be expensive either. As a result, we, along with most experts, continue to forecast a solid year for equities subject to inevitable uncertainties and volatility. In contrast, the future probably isn't so bright for bonds as increasing confidence is likely to increase interest rates and adversely affect prices.

Daniel Wildermuth and the Kalos Team
CEO/Money Manager

Investment Advisory Services offered through Kalos Management, Inc., an SEC Registered Investment Adviser.
Parkside Terrace West, 3780 Mansell Road, Suite 150, Alpharetta, Georgia 30022
Phone: 678.356.1100, Toll Free: 866.525.6726, Facsimile: 678.356.1105, ClientServices@KalosFinancial.com