KALOS *Market Commentary*

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International Conflict Unlikely to Derail U.S. Markets

During the last several months, conflicts, standoffs, and sanctions have flared in Iraq, Syria, Israel/Gaza, Ukraine, Russia, Egypt, Venezuela, and yet more places where crisis's haven't been deemed major enough to receive wide spread news coverage. Yet, even with all the conflict, the U.S. stock market remains at or near its all-time high, and the VIX index, a measure of volatility, is up only about 10-15% from its historical lows seen as recently as June. The combination may be strange, but results from fairly basic circumstances.

The US economy remains a notable bright spot on the global economic stage, and a broad range of factors continue to strengthen. While we have not seen a stock market correction over 10% in almost three years, current circumstances and valuations don't suggest that it's time to abandon stocks or even lessen long-term equity allocations. International conflicts can be unnerving, yet historically, problems overseas do not significantly affect our economy unless they escalate to the point of significantly altering world trade.

Given all of the locations of all the global conflict, energy prices could be a concern. Yet, even though crude oil prices lifted briefly on the upsurge of violence in Iraq and Syria, net moves have been slight to non-existent with oil remaining around the same price as it's been for the last several years. Amazingly, energy price volatility recently sunk to its lowest level on record.

Part of this results from the U.S.'s increasing ability to provide for our own energy needs, and even produce exports. A recent ruling from the Department of Commerce approved overseas sales of condensate, a liquid that's similar to very light crude oil. The ban on exports is expected to weaken further over the next couple of years resulting in continued declines in net oil imports which should further reduce our exposure to potentially destabilizing global conflict.

An expanded Panama Canal, due in 2016, will also provide the U.S. another economic boost. Preparation for its arrival is already spurring development of ports and rail infrastructure. The $5.25-billion enlargement will enable ships with triple the capacity to transit the canal, providing shippers a cheaper, albeit slower, alternative to trains to haul Asian cargo from Pacific ports to the East. Competition will also drive down shipping rates across the U.S. The new canal will dramatically increase volume at U.S. ports on the Gulf and Atlantic coasts with waterborne cargo expected to double by 2030. Increased trade will also flow both ways. Larger ships will also reload at U.S. ports with more grains, fuels and manufactured goods produced here.

Manufacturing continues to contribute solidly to the economy. Recent numbers from the Empire State and Philadelphia Fed manufacturing indices both handily beat expectations and reached new multi-year highs. While they are regional surveys, they are the first data points from July, and increase expectations for the rest of the country.

Housing starts appeared a bit weaker than expected, but the numbers were deceiving. Housing starts were down in the south, but permits were up, implying future gains. More importantly, property repossessions hit their lowest levels since June of 2007 according to a report from RealtyTrac. And total US residential foreclosure activity decreased during June to the lowest level since July 2006 according to GlobeSt.com.

Consumer spending rose solidly in June, providing more evidence that the economy was adding momentum toward the end of the second quarter. June's gains and May's upward revision suggested an acceleration in consumer spending in the second quarter after it was held back by weak healthcare spending in the first three months of the year resulting from temporary Obamacare confusion.

The decline in unemployment is welcome, yet remains stubbornly slow. Wages are expected to rise more quickly in 2015 after anemic gains since the recession with increases hitting 4% per year by 2017. It's taken six years to recover the jobs lost in the recession, and the return of jobs back to pre-recession levels doesn't account for the population growth over the past 6 years leaving unemployment well above pre-recession levels. This has kept a check on consumer spending, which may be rising, but remains weak this far into a recovery. For corporate America, there is some good news here. Wage pressure remains limited, and Fed Chairman Yellen's commitment to restoring the job market means interest rates are likely to remain quite low for at least another year, and probably longer.

Internationally, the growth outlook remains slow but sustainable. U.S. exports are up a solid 6.3% year over year. The Eurozone appears to be moving in the right direction, even if it's very slow. Germany, the engine of developed Europe, struggled a bit during the second quarter, but Markit reported that the German manufacturing and service sectors both expanded robustly in July, beating forecasts. Having just spent a of couple weeks in Germany, I can testify first-hand to the large amount of infrastructure development underway across the country.

China's economy grew slightly faster than expected in the second quarter while new home prices fell in June for a second straight month, prompting speculation about further state stimulus. But, Singapore reported a surprise 0.8% annualized contraction in economic activity for the second quarter, led by a steep drop in manufacturing.

Russia's GDP shrank 0.5% during the first quarter and likely contracted further during the second quarter. Massive capital flight, estimated at more than $50 billion in the first three months of the year alone, are contributing to the problem. More recent sanctions, although still quite limited, will likely accelerate the capital flight. The country's problems shouldn't derail other economies, but they will drag on global growth, particularly in Europe.

Bottom Line: The economy continues to improve with expectations that trends will continue and strengthen. Equity market valuations remain far from peak levels and are supported by low rates. Dividend yields, far from the bottom at 2%, remain competitive with treasuries. Cash flow multiples remain supported by strong cash flow growth. Profit margins appear sustainable with low wage inflation and low interest expense. Inflation is very moderate and inflation expectations remain well anchored, the Fed will likely stay on hold until well into 2015 if not beyond. Overall, equities still appear to be an attractive asset class in today's environment despite conflicts overseas.

Daniel Wildermuth
Kalos Management, Inc.
CEO

11525 Park Woods Circle, Alpharetta, GA 30005
Phone: 678.356.1100, Toll Free: 866.525.6726,
Facsimile: 678.356.1105,
ClientServices@KalosFinancial.com

KALOS
MANAGEMENT