KALOS *Market Commentary*

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Conflicting Signals, Same General Direction

As widely predicted (by many in addition to me), Washington did not default on our debt, and the brinksmanship waged in Washington provided investors with a buying opportunity when stocks temporarily dipped during the uncertainty. The market is up nearly 10% since early September, and nearly 8% since the second week of October when debt discussions appeared to reach a low point. Unfortunately, at least some of the recent uncertainty will continue since the new debt cushion only extends through February 7, and spending is authorized through January 15 of next year.

Yet, the next round of negotiations will likely be much less acrimonious. Compromises and progress will be limited, but neither party wants to suffer through another round of government shutdowns. Congress will probably take the easy route and simply accept the next round of sequestration cuts without attempting to accomplish much else.

The bigger story affecting investors remains the Federal Reserve's plans regarding bond buying. In today's upside down world with equity valuations closely tied to the Federal Reserve's stimulus programs, bad news often equals good news for stocks because of expectations that the Federal Reserve will maintain its economic stimulus program. For example, the weaker-than-expected job creation in late October (post debt crisis) drove the S&P 500 to a new intraday record. Almost nonexistent inflation combined with weak home sales, uninspiring manufacturing production, and slow hiring, should motivate the Federal Reserve to maintain monthly bond purchases well into next year which will likely be good for stocks. As expected, this past Wednesday (October 30), the Fed said it will keep buying $85 billion of bonds per month.

Before the shutdown, the economy was already slowing. In the 12 months through September, wholesale prices marginally rose 0.3%, the weakest reading since October 2009. Post shutdown, economists estimated fourth-quarter annualized GDP will be reduced 0.6% through decreased government output and damaged consumer and business confidence. Economic growth forecasts for the quarter are currently just below 2% after a 2.5% annualized pace in the second quarter.

In other areas, the economy continues to offer seemingly conflicting data. A measure of U.S. consumer spending rose in September as Americans bought Apple's new iPhone and other leisure goods. Retail sales, excluding automobiles, gasoline and building materials, increased 0.5% last month versus economist's expectations of 0.4%. This followed a 0.2% gain in August according to the Commerce Department. The U.S. continues to benefit from inexpensive energy, and the natural gas and oil boom we are enjoying should propel the U.S. past Russia this year as the largest global energy producer.

But, other measures are less positive. New orders for long-lasting U.S. manufactured goods outside of transportation equipment fell in September. The decrease signals a possible pullback by companies reluctant to invest due to uncertainty over government policy. New orders for durable goods including everything from toasters to tanks (but not jets) fell 0.1% during the month. Declining sales of automobiles pointed to likely sluggish economic growth during the third quarter.

An October 28 report showed factory production rose only 0.1% in September after a revised 0.5% gain in August that was smaller than initially estimated, according to figures from the Federal Reserve.

Even the residential home market contributed contradictory information. In September, fewer Americans than forecasted signed contracts to buy previously owned homes resulting in the fourth straight month of decline. The index of pending home sales slumped 5.6%, the biggest drop in more than three years. Mortgage rates last month reached two-year highs which seemingly chased many home buyers out of the market. Yet, sellers are happy. Single family home prices were up 12.8% over the past year, posting their largest annual gain in more than seven years in August. Taken as a whole, the housing data appear to strongly suggest an uneven yet ongoing housing recovery. Even though rising interest rates may dampen the pace of recovery, the trend remains solid and should continue.

Looking at two companies announcing earnings on the same day highlights the conflicting dynamics of today's markets. United Parcel Service Inc (UPS) posted an increased quarterly profit, led by higher demand for domestic ground shipments. Forecasts by UPS along with chief rival FedEx Corp are considered an indication of overall economic health because of the vast amount of goods they transport. UPS said it expects peak season daily volume to increase by 8%, and an even larger 10% increase on Cyber Monday, the Monday after Thanksgiving that is traditionally a big day for online holiday sales. FedEx forecasts an 11% rise for the same day.

But another bell-weather company reporting on the same day, Caterpillar Inc., told a completely different story, posting a 44% drop in third-quarter earnings. Caterpillar is lowering expectations due to the global mining slump brought on largely by slowing demand for commodities from emerging market economies. Revenue for the year is expected to fall nearly 17% from $66 billion to $55 billion.

Taken individually or out of context, ample data exists that could support either an overly pessimistic or optimistic outlook. Yet, as a whole, the economy seems likely to continue on a its very slow but fairly steady upward trajectory. The recent government shutdown again increased uncertainty, but the impact should be minimal over time. This continues a pattern that has been playing out over the past several years. The private sector is growing and has compiled tremendous cash hordes, but ongoing uncertainty and regulatory costs keep investments subdued and growth muted while companies act cautiously.

For investors, current stock valuations are no longer low, and the combination of higher valuations and ongoing restrained growth will likely lead to lower returns over the next 5 years than we've seen over the past five years. Yet there is enough good news to suggest that corporate earnings could continue to climb over the next few years even if inevitable interest rate increases dampen growth. The result will likely be fairly average returns mixed in with some significant gains and losses given the unusual influence of unpredictable external factors such as the Federal government and the Federal Reserve. As always, anything can and often does happen in the economy and the stock market.

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