January 2012
Market Commentary

This year has been a challenging one for many stock market investors. Uncertainty, and its close relative, volatility, tormented domestic and global markets leading to large swings up and down. Yet, after a tumultuous year, most broad based U.S. indices ended up pretty much where they started. Unfortunately, most developed and emerging foreign markets fared much worse as broad based returns across markets ended the year down an average of 20 percent.

Yet, multiple indicators and general economic conditions look strong. U.S. earnings will break records again this year and conditions appear favorable for more of the same in 2012. I've been emphasizing this point for many months given its tremendous impact on market prices. Profits ultimately drive pricing fundamentals, and profits look great. In addition, U.S. GDP keeps holding steady, and should continue to grow at moderate and sustainable levels of around 2.5 to 3.0 percent in 2012.

Linked to profits, the market appears undervalued. Whether looking at price to earnings, price to sales, price to cash flow or price to book, the market is significantly undervalued versus its five- and 10-year historical averages. Eventually, market prices revert back to fundamentals. I believe it's just a matter of time until they do. I've got company in my beliefs. Warren Buffett's Berkshire Hathaway Inc. invested $23.9 billion in the third-quarter, the most aggressive move by him in at least 15 years. Even European markets offer great opportunity, and it appears to be the best time in 15-20 years to buy European equities. Emerging market prices also present great value.

Corporate profitability is finally pushing unemployment down as companies spend on hiring. The trend should remain decidedly positive for the next several years in spite of all the economic, financial market, regulatory, and government challenges.

Employment levels usually drive consumer sentiment and rising employment carried U.S. consumer sentiment to an eight month high in December. Not only did the Conference Board's consumer confidence index rise to 64.5 from 55.2, it trounced economists' expectations of 58.3. Consumers account for around 70 percent of total U.S. spending, so their increasing confidence will likely lead to stronger spending and increased economic activity.

Consumer confidence should also help the stabilizing housing market. Housing starts and building permits jumped to a 1-1/2 year high in November before dropping slightly in December. A more stable economy and increased consumer confidence should attract more buyers into the market. In addition, banks and mortgage lenders are gaining experience with the mountain of new regulations introduced over the past three years, and credit is becoming a bit easier to secure. Housing may not be a major growth engine in 2012, but it's no longer a drag on growth. Furthermore, any positive contribution should have a multiplying affect creating not only jobs, but confidence and increased activity as people more easily relocate.

Internationally, emerging market economies remain strong, even if their stock markets were mostly pummeled in 2011 mostly because of fear, not fundamentals. Growth should continue providing growing export markets and demand for commodities.

Yet, obviously all is not rosy. No economy the size of Europe has ever faced a crisis on the scale of today's. The combined European economic region at $12 trillion trails only the U.S. at $14.5 trillion. But even here, progress should continue. In the bond auction the last week of December, Italy's short-term debt costs dropped by half illustrating increased investor confidence resulting from the European Central Bank's injection of cheap long term capital. There is enormous incentive for the countries to support austerity. After September's crises, the governments in Greece, Italy and Spain all transitioned during three weeks in November. No politician ever likes to lose their job, and governments should continue to stumble forward even if progress will be slow and highly distracting.

China has voiced its ongoing concern over Europe's and U.S. debt problems and is planning a new $300 billion sovereign wealth fund rather than invest in more European or U.S. bonds. China appears to be changing investment strategies through purchasing risk oriented assets with higher potential performance such as equities, corporate bonds, and real estate rather than buying more "risk-free" bonds. I believe their new direction is very sensible given the potential return of risk assets and challenges likely to face bonds.

Investors may want to follow the lead of the Chinese. Bonds, as well as they've done recently, seem to offer more risk than safety. Given all the government borrowing, interest rate increases and inflation seem very likely. Traditionally safe assets appear almost certain to lose money in real terms. Inflation-adjusted yields on 10-year developed market bonds, whether U.S., German or British, are all strongly negative. This year, food prices will rise 3.5-4.5 percent, their sharpest year-to-year increase since 1978. The S&P500 has a higher average dividend yield than 10-year treasury notes. This has *never* happened.

As said previously, gold appears to be the other major bubble. Its industrial value is only about $600. Even though it's dropped about 25 percent from record highs and inflation remains a very real threat, prices could easily drop much further as confidence increases. When late-night TV starts promoting easy ways to make money, whether it's been stocks (late 1990), housing (mid 2000s), or now gold, it's often a good sign that there's not much upside. Gold is worth a lot because people think it is. Sentiment can change surprisingly quickly.

Next year could also introduce another factor to drive up markets. In addition to improving fundamentals, markets and asset prices could be driven higher by investor's acknowledgement that panic and risk avoidance are no longer viable investment options. Protecting your purchasing power will require investing rather than hiding.

In addition, the ugly combination of sovereign debt, government impotence, slow western growth and high market volatility are unlikely to dissipate anytime soon. Investors can't wait for everything to turn rosy before jumping back into the market, and traditionally safe assets are unlikely to offer refuge. For these various reasons and more (the likely positive impact of elections weren't even mentioned), I believe 2012 offers good return potential even if domestic and international events continue to rattle markets and investors. Happy New Year and may next year be prosperous for you and yours!!!

Daniel Wildermuth and the Kalos Team
CEO/Money Manager

The opinions in the preceding commentary are as of the date of publication and are subject to change. Information has been obtained from third-party sources we consider reliable, but we do not guarantee that the facts cited are accurate or complete. This material is not intended to be relied upon as a forecast or investment advice regarding a particular investment or the markets in general, nor is it intended to predict or depict performance of any investment. We may execute transactions in securities that may not be consistent with the report's conclusions. Investors should consult their financial advisor on the strategy best for them. Past performance is not a guarantee of future results.