KALOS *Market Commentary*

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Economy Picking up Speed Here and Abroad

After a strong December followed by a solid first three weeks of this year, both US and international equities struggled in the last week of January. Concerns largely centered on tapering by the Federal Reserve that will slow the flow of cheap money into the world economy. Still, while the markets were a bit rattled by recent events, I believe multiple trends and indicators make it likely that this downturn is temporary even though valuations have crept up near, or even above by some measures, long-term averages.

The Federal Reserve is tapering its bond buying because they believe the economy is strong enough to continue moving forward on less stimulus. The Federal Reserve's logic appears sound. Gross Domestic Product grew at 3.2% annual rate during the fourth quarter according to the Commerce Department. When combined with third quarter's surprisingly strong 4.1% annual rate, the latter half of 2013 growth rate of 3.7% was the biggest 6-month increase since 2003. The growth was even more encouraging given the 0.3% drag from October's partial government shutdown. Encouraged investors drove the S&P500 up by more than 15% in the second half of the year.

US consumers are better-positioned to increase spending after having paid down (or defaulted on) nearly $1 trillion of household debt. Combined with low interest rates, household debt-service burdens are at their lowest level in more than 30 years. Core inflation, which strips out food and energy costs, increased at only a 1.1% rate in fourth quarter after a similarly slow increase of 1.4% in third quarter.

Technology is adding jobs at twice the pace of the broader labor market, according to Bureau of Labor Statistics (BLS) data. The trend should continue driven by profitable companies with global market share.

US real (inflation-adjusted) farm incomes are expected to remain near their highest level since World War II in 2014 according to the Department of Agriculture. The US, as the world's largest agricultural exporter, benefits tremendously from increasing food consumption in emerging markets.

The housing market continues to recover with home prices up 12.8% year-over-year in August and up 22.7% from their March 2012 lows, according to the S&P/Case-Shiller composite index. According to the Census Bureau, housing starts are on track to surpass 1 million units in 2014 for the first time since 2007 after falling to about 500,000 in 2009, the lowest level since records began in 1959.

Exports rose at their fastest pace in three years on the strength of slowly improving global growth. The euro zone's private sector started 2014 in much better shape than expected, with stronger growth across the region marred only by a continued downturn in the political and economic policy disaster of France. Markit's Flash Eurozone Composite Purchasing Managers' Index (PMI), the Purchasing Manager's Index for manufacturing, and a key gauge of manufacturing output all registered strong numbers indicating growth. All numbers looked the best since April 2011.

News from China was not as positive, and was partly responsible for some of the market malaise experienced in late January. Asia's biggest economy slowed to an annual expansion of 7.7% in the fourth quarter from 7.8% in the previous quarter. While these numbers still put 2013's growth at 7.7%, which was slightly ahead of the government's target of 7.5%, projections that estimate growth falling further in 2014 caused investor concern.

KALOS MANAGEMENT
11525 Park Woods Circle | Alpharetta, GA 30005
1.888.356.1950 | 678.356.1100
www.kalosmanagement.com

While rates of 7% seem incredible by US standards, as rates drop near the 7% level, other countries are adversely impacted. Overall, it's a concern, but not disastrous. A faster recovering Europe more than offsets China weakness.

Possibly the biggest single positive influence remains the US energy renaissance which continues to produce multiple economic benefits that were widely unanticipated until the recent past. Two months ago, the US produced more oil than it imported, and last October, the US became the world's largest oil producer, surpassing Saudi Arabia. The United States recently eclipsed Russia as the world's largest gas producer according to the International Energy Agency. Our energy trade deficit has been cut in half over the past 6 years, mostly because of hydraulic fracking which is succeeding in spite of Washington's general contempt for fossil fuels.

A fairly recent and growing benefit of energy's resurgence includes "reshoring" or bringing manufacturing plants back into US. Rising emerging market labor costs combined with restrained US labor costs and increased US productivity make abundant energy and low natural gas prices in the US even more attractive. The lowered cost gap enables the US to leverage other advantages such as a strong rule of law, superior infrastructure, labor market stability and advanced technology. The Boston Consulting Group asserts that once the "landed cost gap" reaches a level of around 15% to 17%, the economics of reshoring become positive. The US is now at 16%. Not only does reshoring bring more manufacturing to the US, upgrading outdated US plants further drive economic activity.

Outside of the US, the talk of tapering has hit emerging markets particularly hard as investors flee markets they fear will suffer growth slowdowns due to reduced foreign direct investment. Negative headlines involving countries such as Turkey, Egypt, and China have led to fund managers underweighting emerging markets by the greatest amount since the financial crisis of 2009 according to Merrill Lynch. Yet, this appears to be a mistake. Emerging markets have already been forced to make painful adjustments, and in many cases, they are further along than the US and Europe. Last year, more than 60% of foreign direct investment from global business went into the emerging markets according to the UN Conference on Trade and Development. Their higher expected growth rates also make them attractive. Possibly as important, the flight to safety over the past few years has left emerging market equity valuations significantly lower than similar companies in the US despite higher growth expectations in emerging markets.

Overall, equities in the US and abroad appear to offer reasonable prospects in spite of five straight years of market increases. Yet, more lofty valuations likely signal that investors should maintain much lower expectations for the next five years than we have enjoyed over the past half-decade. Corrections seem likely against the backdrop of ongoing events such as Washington squabbles, currency changes, inventory corrections, international conflicts, etc. Still, various trends suggest the US GDP growth is likely to continue moving forward at a pace possibly better than the last few anemic years. In addition, Europe's budding recovery and low emerging market valuations likely present attractive opportunities beyond our borders. As investors face likely short-term turmoil, keeping the longer term positive trends in mind will likely be profitable.

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