KALOS Market Commentary

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What are Drivers of the Recent Market Run-up?

So far, 2013 has been great for the U.S. stock market with the S&P500 up more than 15%. While there are numerous broad-ranging factors driving the market, Central Banks, through the Federal Reserve policy of keeping interest rates ultra-low, are playing a starring role. Right now and likely in the immediate future, good news is good for equities and bad news is also good for equities.

Because bad news has brought constant reassurance and commitment to record low interest rates from Central banks, markets have generally risen on bad news rather than declining. While this cycle could break at any time, it seems likely to continue in some fashion as long as the market remains convinced that the Fed will continue its easy money policy. Ironically, if the economy slowly strengthens as expected, good news could actually drive markets down because it could signal less support from Central Banks. The Fed will attempt to make adjustments that avoid spooking investors, but anything can always happen.

Fortunately, beyond Fed policy, numerous economic factors continue to look solid. Corporate profits remain strong and growth should continue at stable levels. Companies are becoming more optimistic that revenues will rise leading to profit increases driven more by top-line growth than cost cutting.

Annualized 2.4% GDP growth for the first quarter looks even better when taking into account the 4.9% reduction of government spending. The Sequester is biting, but damage remains mostly limited to the Washington D.C. area and a few key industries such as defense.

Ongoing hiring and increasing incomes are pushing consumer confidence up. As of the third week of May, the consumer confidence index rose to its highest level since February of 2008. Because consumer spending accounts for more than two-thirds of U.S. economic activity, its rise of 3.4% annualized has provided a welcome economic boost.

The best annual gain in nearly seven years for U.S. single-family home prices also contributed to consumer optimism and spending. Prices in the 20 cities tracked jumped 10.9 percent year over year, beating expectations for 10.2 percent. Price rises were also the strongest since April 2006, just before prices peaked in the summer of that year. Moreover, all 20 cities covered by the index saw yearly gains for the third month in a row putting average prices in March back at their late-2003 levels.

While various parts of the economy are on the mend, many investors and pundits doubt that gains can continue given the challenges that seem to be so clearly facing the U.S. Yes, our institutions, one of the primary advantages that the U.S. has enjoyed over the past several centuries, are failing us. Regulation is increasing on a massive scale, and Washington seems increasingly bent on creating overly complex and inflexible rules. As troubling, Washington is now reversing the historical trend of older generations, such as the World War II generation, sacrificing for the younger generation. Today's elderly and baby boomers consume massively more than any other age group, and entitlement programs are the primary trigger for our exploding debt. The legal system provides another example. It's becoming much harder for ordinary people to do business in America. While the economy has been slow, compliance related positions of all types across all industries are booming. Most of the world is seeking to emulate America's economic success and dynamic system. Yet Canada's Fraser Institute think tank calculates that since 2006, America is one of only 20 countries that have made it harder to do business. According to the institute, our pace of business has slowed 18% over that time frame putting us in the same category as sluggards such as Burundi and Zimbabwe.

Yet, even against this backdrop, there is realistic cause for optimism. The U.S. has the proven ability to change, and America has many other major trends working in its favor. The U.S. is aging much slower than much of the rest of the world. Although our immigration policies are a mess, at least we have one. Many countries, such as Japan, have nothing in place and are shrinking rapidly.

We still have a Federal system allowing states significant latitude. The system also fosters competition as states compete for people and business. The Great Plains states, the Gulf Coast, and the Southeast are all experiencing robust growth. Texas, Utah and North Carolina among others, are pursuing economic and regulatory policies that are favorable to entrepreneurship. Just last week, Texas lawmakers sent Governor Rick Perry more than $1 billion in proposed business tax cuts. Texas largely bypassed the last recession and housing bust because of its pro-business policies.

The U.S. has also gotten lucky. We have literally struck oil – and gas. The vast shale and oil discoveries are providing a tremendous boost to our economy. As long as the states prevail, the energy revolution should continue. If Washington's alliance of regulators, lobbyists and environmentalists take control, the benefits will shrink.

And, we still lead the world in innovation. For example, within a decade, phones will exist with the brainpower of IBM's Watson, the computer that beat a human on the game show *Jeopardy* in 2011. Moreover, phenomenal increases in processing power, artificial intelligence, and memory are in the works that should enable phones to act as invaluable personal assistants, further increasing productively.

I believe the combination of these and other trends have the potential to largely or completely offset many of the problems we're facing in other areas. I don't believe the Fed will change it ultra-easy money policy before the end of this year, and it appears likely it will extend the policy well into next year. Longer-term, America is likely to keep lurching forward in spite of the many apparent challenges. The economy should continue to move forward even if the pace remains uneven and slow, and our growth should keep us at the forefront of developed nations. Markets will likely remain solid. Susceptibility to a mistake by the Fed or an unexpected stumble in the economy is likely higher now because of current valuations, but the risk doesn't appear overly high that a major correction is more likely than usual.

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