

KALOS Market Commentary

October, 2013

Looking Beyond the Washington Circus

Over the next several weeks and possibly months, we will likely hear much about negotiations on raising the debt limit and attempts to delay or defund Obamacare. While the media will likely position current negotiations as a nail-biting conflict that could push the U.S. over some cliff, the outcome will likely be much more mundane with the two sides reaching an uneasy compromise on some issues and pushing other challenges into the future. The rancor will keep investors nervous and markets a bit twitchy, but the messy process will probably have little long-term impact.

These negotiations will likely divert focus from the other hot topic emanating out of Washington, the Federal Reserve's plans for bond buying. The Fed recently backed away from tapering bond buying when the economy yet again failed to live up to expectations. After the Fed shocked markets in late June with hints of curtailing bond purchases, in mid-September, the Fed again surprised two-thirds of economists and reversed their previous decision. Jobless rates are falling too slowly, workers are

still dropping out of the workforce, and GDP will likely not even hit 2% for the year.

Still, as I've been claiming for some time, good news continues to build, albeit, very slowly.

The U.S. government has dramatically slowed their changes to the rules under which the private sector operates resulting in a more stable business environment. While countless new regulations are still going into effect, massive new legislative changes have substantially slowed. Obamacare provides a quick example. Increased costs and confusing choices have yet to hit most Americans, but many of the destabilizing effects of the changes have already been factored into corporate spending plans. Larger companies have already booked write-offs, large tax increases were levied at the beginning of this year, and firms have been setting aside cash to offset increased costs. This same pattern repeats across numerous sectors of the economy affected by recent regulatory and government intrusions.

Beyond our borders, the global economy is healing. Europe enjoyed a flood of new orders in September according to the purchasing managers' index (PMI) which survey thousands of companies across the globe. The Eurozone PMI numbers were the highest they've been since June 2011. The expansion rate of the bloc's services sector also beat all forecasts in a Reuters' poll, and the survey also suggested that the recovery was becoming more broad-based and entrenched. Even in France, the second largest Eurozone economy, economic activity eked out a small increase for the first time in 19 months.

Recent uncertainty in Washington overshadowed Angela Merkel's September 22 election triumph in the German election. The win confirms her position as Europe's dominant leader during the country's continued efforts to move past its debt crisis. Her win was also seen as a strong vote of support for her efforts to keep the Eurozone together.

Germany remains the engine of Europe, and fortunately for the nation and the global economy,

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the country is no longer the "Sick Man of Europe" as it was dubbed a decade ago. Nearly a quarter century since German reunification (the Berlin Wall fell in 1989) and a decade after Germany began its major reformation of the Welfare state, German "angst" is fading, replaced by a more confident and contented country that is willing to assume a greater global leadership role. In spite of Germany's limited appetite for funding more Eurozone bailouts, 6 in 10 Germans view the EU favorably according to a Pew Research survey published in May.

As Germany has recovered, the probability of Eurozone disintegration, a distinct threat several years ago, has receded dramatically. Germany and the U.K. are continuing to gain strength even if smaller peripheral nations remain distressed.

Across the other ocean, the Chinese flash HSBC PMI climbed to 51.2 in September from August's 50.1, hitting a high not seen since March (a number above 50 indicates growth). The numbers were better than expected, and data also showed 10 of the 11 sub-indices rose in September indicating a broad-based pickup. It appears highly possible that China's growth slowdown has already ended.

Overall, the global economy seems to be gathering a bit more momentum even if it continues

to perform well below peak levels. U.S. factory numbers are expected to show that our domestic economy is continuing to recover. According to RealtyTrac, home foreclosure filings fell 34 percent in August while first-time defaults dropped to the lowest level in almost eight years. Rising home prices made it easier for distressed owners to sell, and August marked the 35th consecutive month in which total notices declined on an annual basis, with foreclosure starts plunging 44 percent. In various other sectors, from energy to autos to manufacturing to retail spending to commercial property values, the U.S. continues to slowly edge forward.

There's also ample cause for optimism when looking at the bigger picture. Even a cursory analysis of the technologies that drive almost every major industry from energy to manufacturing to medicine to information and entertainment reveal that the U.S. is either the world leader or very close behind. Multinational American companies are well-positioned to export these technologies to other nations. The U.S. has more favorable demographics than nearly any other developed nation and still retains a more innovative culture than most other developed nations.

In this type of slow-growth world, both the U.S. dollar and U.S. equities could continue to remain favorites with domestic

and global investors. Inevitably, the equity markets will dip and near-term challenges will rattle investors. Yet, various trends and longer-term developments could continue to propel markets forward even if ongoing challenges keep returns somewhat restrained. In spite of debt-ceiling arguments, confusing Federal Reserve policies, and various other ongoing challenges, I believe U.S. equities should continue to be a good investment for investors looking out several years beyond the immediate challenges.

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