

KALOS Market Commentary

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U.S. Economy Reasonably Solid, Richer Equity Valuations, Europe Struggling

The U.S. stock market represented by the S&P 500 has enjoyed a fairly good 2016, over 8% through August 30. The gains come in spite of concerns about corporate earnings, the Federal Reserve's announced intention to raise rates, international turmoil, and anemic U.S. GDP growth. Moreover, after the sharp decline in markets earlier this year, the market has been fairly calm.

For the medium term, markets still look reasonably solid. The lack of recession on the horizon for the U.S. along with various other indicators, appears to signal the current bull market ... which growing quite old, can continue. Yet, many issues in the U.S. and abroad could create market turmoil.

To take one example, current stock market valuations appear to fully incorporate current earnings levels into the price of stocks, leading to valuations that by some measures are above historical averages. Yet, average earnings have been lowered significantly by the exceedingly poor earnings of oil companies, a cycle that should lessen or even cease in the not-too-distant future. As investors interpret these and many other issues upon returning enforce from

summer holidays, markets are likely to bounce in any direction. An upcoming bizarre election will likely contribute more noise of its own.

U.S. GDP growth continues to disappoint, but not enough to ignite fears of a recession. Second quarter GDP growth was originally forecast at 2.4%, revised down to 2.3% in late July, and then revised down again sharply to 1.1% in August. After first quarter's annualized growth hit only 0.8%, economists had hoped business investment would push growth numbers higher, but strong consumer spending remained almost the only bright spot. Last year's 2016 growth projections routinely averaged above 2.5%, but the full-year expansion is now projected to hit only an uninspiring 1.4%.

Still, Good news can easily be found. As mentioned earlier consumer spending, which reflects nearly 70% of the U.S. economy, remains strong, increasing for the fourth straight month in July. Automobiles and home renovations are two of the more notably vigorous areas of spending, and both drive many other industries.

Home builders are growing increasingly optimistic about the market for single-family homes. Builders remain positive overall despite a slowdown in economic growth in the first-half of the year. The larger problem could be developing a lack of supply in many markets. While new construction has been increasing at a rate of 10% per year for the past several years, construction contracted so severely during the recession that housing starts continue to trail those before the bubble. And inventory is shrinking by as much as 30% in the hottest markets such as Charlotte, Salt Lake City, and parts of California. While some have voiced fears that lack of inventory could hurt sales, and will most likely drive up prices, the longer-term economic benefits of stronger demand should overwhelm supply problems. The positive effect will spur growth in other industries.

The demand for housing and consumer goods springs largely from a U.S. job market that has achieved nearly full strength. For the second month in a row, U.S. employment rose more than expected in July, after job gains

were revised upward in both May and June. Wages also rose 2.6% in July and increases are projected to reach 3% annually sometime next year. More opportunities are also enticing people to enter the job market, expanding the employment pool.

Given the Federal Reserve's emphasis on the jobs market as a key hurdle for future rate increases, it is not surprising the Fed strongly hinted in late August at a second 2016 rate increase, possibly as early as September. As we have been saying for well over a year, initial rate increases should not significantly impact markets as long as the increases are gradual.

Internationally, the news remains generally murkier and less optimistic. Economic sentiment in Britain and the 19 countries sharing the euro fell in August to its lowest level since March, as Britain's vote to leave the European Union (Brexit) is impacting business and investor sentiment. A mammoth 80% of British businesses plan to cut capital spending, and the British pound continues to trade near its 30-year low. Consumer confidence is plunging, and business sentiment is at its lowest since 2009. Despite actions by the Bank of England (BOE), which cut its benchmark interest rate to the lowest level in its 322-year history, Britain will likely experience a recession, or at least some form of stagnation. The BOE cut its growth forecast

the most sharply since it began publishing numbers in 1993.

In the eurozone, confidence fell in four of the eurozone's five largest economies, with France providing the only exception with a slight increase in the index in August. Germany's BGA trade association (the German Federation of Wholesale, Foreign Trade and Services), reduced its 2016 forecast for export growth sharply, predicting sales abroad would stagnate, largely because of Brexit. Germany still predicts growth in 2016, but exports increases have been adjusted down to 1.8 to 2.0% from 4.5%, far short of 2015's 6.5% increase.

On top of Brexit, Italian banking problems are not helping, and geopolitical worries, including Europe's concern about U.S. elections, are further hurting sentiment. In Europe, like in America, their current anemic growth pattern looks all too familiar, yet growth remains strong enough to likely avert major problems.

For the U.S., problems across the Atlantic are hardly good news, but their impact remains fairly muted as long as nothing too severe happens. Europe has not offered a robustly growing export market for years, so their problems mostly act as a constraint on our growth rather than a contributor to a slowdown.

Slow but solid ongoing US growth combined with increasing consumer and job strength should keep pushing the U.S.

economy forward, offsetting relative weakness abroad. Yet, investors will likely be well served through expecting some near-term volatility given international challenges, richer equity valuations, and frequent volatility in September resulting from returning vacationers.

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