MAY 2010: MARKET COMMENTARY

Despite various international shocks and continuing domestic challenges, the U.S. economy appears to be progressing pretty much as expected. Progress is sluggish, but momentum continues to build. In spite of Japan's earthquake and various international skirmishes, GDP numbers for first quarter were only slightly lower than expected coming in at an annualized rate of 1.8%. Unemployment remains stubbornly high and actually increased by 20,000 according to recently released figures. While the uptick isn't major, the increase breaks with recent positive trends. These numbers have obviously garnered headlines. However, we remain very encouraged by most continuing trends and believe the economy is positioned for continued improvement. Here are a few reasons why.

Corporate profits, the primary driver of equity market valuations, have produced record or near record profits for eight straight quarters. Corporate balance sheets and cash positions are incredibly strong and arguably the best ever. Even banks have built up tremendous reserves with over a trillion dollars of unlent excess reserves. Unfortunately, banks are still not lending at previous levels and firms seeking capital are often frustrated. But now, lending levels are lower by choice rather than lack of funds. The change in circumstances signals strong growth potential as confidence improves.

Indicators from multiple sources continue to highlight the recovery. IBM and Intel, two of the world's largest technology companies, reported a surprising surge in sales and profits in the first quarter. As has been the case during much of this recovery, business spending was a major driver with traditional corporate equipment such as servers and data center machines driving numbers. IBM's revenue growth was the highest in 10 years rising 7.7%. Mainframes, the large computers still critical to corporate America's infrastructure, saw a large sales increase and drove equipment sales up 19%. Intels' growth was even higher. Profit leapt 34% on a revenue increase of 25%. A similar pattern is playing out across much of corporate America.

If we look at bigger and longer term issues, I also believe there is ample cause for optimism. On Monday, April 18th, the Standard & Poor ratings agency reiterated its AAA rating on U.S. debt, but rattled markets by lowering its outlook on U.S. debt to "negative." The ratings agency cited a "material risk" that policymakers may not reach agreement on a plan to trim the large budget deficit. The downgrade in outlook was the first adjustment since 1941. U.S. equity markets initially fell on the announcement, though they recovered within a couple days. While the downgrade was bad news, investor reaction and jolt to policymakers are both positive.

While the ratings downgrade was unusual, investor reaction was downright peculiar. The threat to downgrade treasuries caused a quick flight to perceived quality as investors bought – treasuries. Logically, buying the asset that caused the panic makes no sense – old habits die hard. However, the move also pointed out the tremendous strength and confidence that still exists in our currency. Investors are not really worried about treasuries defaulting – at least in the near term.

These actions as well as many additional issues likely emphasize that the budget deficit is not a near-term problem warranting panic or overly conservative investor actions. The U.S. government has no problem financing its debt, and the 10 year treasury yields remain well under four percent. These numbers compare favorably to nearly any other country and starkly contrast with countries experiencing serious issues. Some have compared the U.S. to Greece which is laughable at this time. Greece is having trouble raising money while paying over 20% interest. Current U.S. debt spreads indicate little inflation concern, despite the massive increase in money supply over the last few years.

Possibly more importantly, the U.S. faces very different risks than many other countries with significant debt. The U.S. is still the only large debtor in history that has been able to borrow in its own currency. As a result, the U.S. can't suffer the same shock as many other countries which have experienced currency collapses and skyrocketing national debt as their currency drastically devalues. Our debt load is a problem that needs addressing, but it's not an imminent threat. And, the issue has become a focal point with the American public and Congress and significant progress is very likely.

The real debt issues are the long-term unfunded liabilities of Medicare and Social Security. While these issues create major challenges, they're not insurmountable. There are obviously other issues too, but the economy isn't broken – just a bit beaten up. And, it's recovering. While our government has been on a spending binge, change will happen even if the process is slow and messy.

The Federal Reserve has also voiced its confidence in the growing strength of the economy. It is phasing out its controversial program of injecting money in the financial system. This is the first step towards an eventual rate increase and signifies growing confidence that economic strength is solidifying.

Surging prices in commodities and Japan's recent natural disasters have had little impact on the global recovery. A poll in April by Reuters of around 350 economists revealed strong optimism as the United States and Canada continues to lead a rich-world recovery. Annual GDP growth for the U.S. and Canada were projected at 3.0% and 2.9% respectively. Global growth was projected at 4.2% this year and 4.3% next year.

The poll numbers held in spite of the likely contraction of the Japanese economy in the first quarter. The earthquake and surging oil prices have resulted in only slight reductions to growth forecasts. Possibly the biggest impact could be a reduction in consumer confidence with gas prices climbing past $4/gallon. However, this is already factored into expectations.

While all these issues appear positive, housing is still in the doldrums and refuses to really improve. While various indicators ranging from increases in existing home sales (up 3.7% last month) to housing start increases (up 7.2% last month) show positive trends, housing again subtracted from first quarter GDP numbers. In spite of this, the economy is rebounding. Housing is also suffering from self-inflicted pain. Vastly increased regulations combined with tightened underwriting policy and pricing are working together to make loans hard to secure. Housing is now exceedingly affordable by historical standards, but it still hasn't turned around. At some point, vastly increased housing affordability will turn into a tailwind, yet it may be a while before this materializes.

The economy's ability to move forward in spite of the major housing drag appears to illustrate the growing strength of the recovery. While progress will be continue to be slow, momentum should continue to build. Moreover, various parts of the economy have now swung back past equilibrium and are building up potential future capability and demand. For instance, banks now have vast sums of capital to loan and housing is at a 35 year plus affordability high (it's actually a longer time frame, but my data only goes back to 1975). In spite of the many existing challenges, I believe the growing good news will continue to overwhelm the ever present bad news.

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