KALOS *Market Commentary*

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Many Promising Trends Heading into 2014

In the final days of 2013, U.S. Stock Market investors continue to enjoy more record highs. Assuming the S&P 500 remains near its current level, it will have its best year since 1997. Investors have been encouraged by good news ranging from economic growth to the Federal Reserve's announcements regarding future bond purchases. Recent news and indicators from various sources are not only positive, but in many cases are the best the U.S. has seen since the recession.

The economy grew at a 4.1% annualized rate from July through September, according to the Commerce Department. The growth rate was the fastest pace in nearly two years and easily surpassed the 2.5% rate for the second quarter. As encouraging, growth is coming from both corporate America and consumers.

Business spending increased at a 4.8% rate instead of the 3.5% pace reported early this month. Much of the growth resulted from investment oriented products such as software, and research and development, although entertainment also provided some of the boost.

There were also upward revisions to consumption. The Commerce Department said on Monday that consumer spending, which accounts for more than two-thirds of U.S. economic activity, rose 0.5% after advancing by a revised 0.4% in October. It was the seventh straight month of increases. November's increase in so-called real consumer spending was the largest since February 2012.

Future consumer consumption also looks promising. This year, stock market gains and a double-digit recovery in housing prices pushed household net worth up the most since 2005. Consumers spend about $3 more for every $100 rise in home equity and about $1.50 more for the same increase in the market. Debt servicing drag has also declined to about 5% of income, a level not seen since the mid-1990s. Consumers will likely feel better about spending more in 2014 and enjoy the added bonus of having more capacity to spend.

Spending will likely continue to grow as consumers are accelerating their purchases of nonessentials much faster than overall consumption. Spending on sporting goods, toys, hobbies, boats, private planes, RVs, premium leased cars, jewelry, etc., is expected to increase 12% in 2014. Similarly, travel-related spending such as airline tickets, hotel rooms, and car rentals will like grow 10% next year. After 9% growth in 2013, construction in 2014 should also see around 10% gains from both public and private spending on offices, warehouses, and airports.

Even exports provided some good news with export growth climbing two tenths of a percentage point to a 3.9% pace.

Many of these numbers were surprisingly positive because much of the increase in GDP growth in the July-September quarter resulted from increased inventory. As a result, many economists anticipating a slowdown in the pace of inventory accumulation and associated growth. Instead, businesses continue to increase their stocks with retailers, auto dealerships, and wholesalers all solidly expanding their inventory in October.

Lower and steadier energy prices in 2014 should help both corporate America and consumers. As the Middle East grows calmer, and domestic oil and gas output rises, prices are falling and supply disruptions become less likely. Next year should also bring big production gains from Iraq. Libya and Iran could also pump more oil next year. Meanwhile, rapidly expanding U.S. output of crude, biofuels and other liquids along with existing Canadian imports should satisfy about 80% of U.S. needs next year. Booming North American oil and gas output will also contribute big profits to energy firms and continue to create abundant high paying jobs in drilling and distribution.

The price index for consumer spending (excluding food and energy) rose a modest 0.1% for the fifth straight month. Core prices were up only 1.1% from a year ago. Inflation measures remain below the Fed's 2% target. U.S. producer prices fell for a third straight month in November, further pointing to a lack of inflation pressure. Low inflation encourages investors because of expectations that the U.S. central bank will keep interest rates near zero in the immediate future even as it reduces its monthly bond purchases.

Recent unemployment numbers have also been more encouraging with two straight months of over 200,000 new jobs and few layoffs resulting in a joblessness rate of about 7%. While the rate is reaching closer to the 6.5% rate the Federal Reserve has said would indicate that it’s time to start raising rates, the Fed is well aware that the unemployment rate will likely fall more slowly in the future as more people grow optimistic enough to start looking for work again. Rates are likely to remain very low throughout 2014.

Given all these encouraging signs, it was not surprising that the Federal Reserve on Wednesday (Dec. 18) gave the economy a vote of confidence, announcing it would reduce its $85 billion monthly bond purchases by $10 billion starting in January. Unlike this past June, when a similar announcement elicited panic and sent stock and bond markets down sharply, this time investors seemed to agree with the Fed’s assessment. The reduced bond buying announcement buoyed markets.

I believe these and other trends and events make it likely that 2014 will see continued stock market gains, although any increase is likely to be much smaller than in 2013. The Federal Reserve seems to have convinced a growing number of investors that it can spur growth without sabotaging the economy. The private sector continues to strengthen, particularly as the government has curtailed its barrage of new rules and regulations (Obamacare remains an obvious exception.) The first week of 2014 should provide a further clue as it usually indicates the direction of U.S. markets for the following year. We wish you the best for 2014 and much prosperity!

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