KALOS *Market Commentary*

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A Rocky Ride, But at Least it's Up.

After a sluggish start in 2015, U.S. equity markets rebounded sharply in February, more than making up for January's losses. With one trading day left as this is written, both the Dow and S&P 500 were on track for their best monthly performance since October 2011. The NASDAQ index is also likely to enjoy its best month since January 2012. While most of February's gains were simply recapturing January's losses, the overall result provides a gain in most markets of over 2% for the first two months of the year, which is fairly strong given the current backdrop of global uncertainty.

Recent market strength appears to result from a combination of events, notably fairly solid broad indicators from the U.S., expectations that U.S. interest rates will stay low into the second half of 2015, and a strengthening European economy.

Starting with the U.S., strong job market growth, along with decent wage gains, have muted concerns regarding deflation and collapsing oil prices. Nonfarm payrolls beat forecasts with an increase of 257,000 for January, government data showed, while revisions brought the recent three-month gain above a million jobs for the first time since 1997.

The Commerce Department said a gauge of business investment plans rebounded in January after four straight months of declines. Non-defense capital goods orders excluding aircraft, a closely watched proxy for business spending intentions, increased 0.6% last month after a revised 0.7% fall in December. The numbers came in over double of those expected by economists polled by Reuters.

Savings at the gas pump are starting to filter into the broader U.S. economy. Spending on dining and recreation is increasing, driven by gas prices $1.25 lower than last summer. The extra spending across the economy will elevate overall U.S. GDP growth this year.

New U.S. single-family home sales fell less than expected in January and supply rose to its highest level since 2010, providing hopeful signs for a sluggish housing market. There is reason to be cautiously optimistic on the sector's prospects. Numbers look solid, and the strengthening labor market should continue to boost housing activity as more people get a paycheck. In addition, home prices appear to be reaccelerating after slowing for much of 2014. That will lift more homeowners out of "underwater mortgages" and increase home equity, encouraging some to put their houses on the market, and move, which will in turn help the labor market, creating a virtuous cycle.

The strong jobs report and housing recovery led to initial expectations that the Federal Reserve would raise rates, perhaps as early as June of this year. But, tumbling consumer prices appear likely to lead to another extension of lower rates. While most consumers love cheaper prices, which today derive almost exclusively from falling oil prices, the Fed is cautious because of concerns that deflation could lead to consumers and businesses expecting prices to keep falling which could delay purchases and drive prices lower.

Now, increasing numbers of investors appear to be convinced that a U.S. rate hike will come later than previously expected, meaning that today's low rates will hold into the second half the

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year. In late February testimony, Fed Chair, Janet Yellen, said the timing of a rate hike is still cloudy, which was a reversal of early statements hinting at earlier rate increases.

In Europe, economies are improving. The Eurozone's largest economy, Germany, recently posted healthy GDP growth for the fourth quarter of 2014. Smaller nations such as Spain and Portugal, also joined in for a change. This week, consumer morale in Germany was reported to have risen to its highest level in more than 13 years. Low oil prices are encouraging consumers. Bank lending also fell at a slower pace than expected.

The French and Italian economies are still stagnating, and Greece's recent election and disputed bailout continues to threaten economics and politics. But, cheaper oil, looser credit and a weakening euro are helping European economies, and growth is projected to hit 1.2% in 2015, higher than 2014's growth of 0.9%. While the pick-up remains anemic, any increase in the world's second-largest economic block helps global growth.

Recent numbers appear to confirm that Europe will avoid a dreaded deflationary spiral. Announcements by the European Central Bank are also buoying confidence. A trillion-dollar-plus bond buying spree launches in March. The program was created to keep interest rates down and flood markets with liquidity to encourage lending and consumer buying. While the move was seen as extreme, it has calmed global markets and increased confidence in the Eurozone economies in and outside of the region.

Increasing economic growth is showing up in European corporate numbers. About two thirds of the way through European companies' earnings reporting season, 55% of companies have met or beaten profit forecasts. Overall, fourth-quarter earnings are expected to grow by 19.5%, according to Thomson Reuters I/B/E/S, which would be Europe's best season in 3-1/2 years.

The generally good news drove global equities to a new record high on Thursday, February 26 as investors positioned for an extended era of cheap money ahead of the European Central Bank's bond-buying scheme.

While Europe's numbers are not dazzling, they are generally the most upbeat since the economic meltdown. The U.S. continues to roll forward at a steady clip. And the Fed's ongoing support of cheap money removes near-term fears that rates may rise before the economy is ready. Hence, the market has recovered solidly. It appears that these and other factors will likely continue to support U.S. markets.

We like the U.S. market's prospects, but also believe that longer term returns are unlikely to rival the past 5-year returns, which have averaged almost 15% per year. Today's valuations and modest growth prospects seem to point to future annual returns averaging below 10%. More simply, expectations should be tempered. However, given lower valuations outside the U.S., foreign markets may offer more interesting opportunities even if returns may be bumpier.

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