KALOS *Market Commentary*

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Economy Picking Up After Slow First Half of 2016

September offered investors a surprisingly smooth ride, with the S&P 500 ending only slightly down for the month on fairly limited volatility – not too bad for the only month that historically delivers investors negative returns. Part of the reason for the market's ongoing strength likely results from improving economic data. The U.S. economy appears to have accelerated to an estimated 3.0% annual growth rate in the third quarter. The strong 3.0% annual rate dwarfs second quarter's annualized rate of 1.4% and first quarter's paltry annual expansion of 0.8%. The average annual 1% growth rate for the first half of this year (and fourth quarter of last year) sharply trailed the weak expansion's average rate of growth of 2.1%. The recent economic acceleration adds a welcome jolt to the economy to bring the growth for the year near its tepid average pace since 2008.

The recent uptick also offered several good signs that could signal longer term strength, or at least avoidance of a near-term slowdown. Separate data from the Commerce Department released on September 29th showed an increase in exported goods in August and appeared to bolster the view that a prolonged slump in inventory investment is finally ending. Inventory reductions have slowed the economy for five straight quarters, which is uncommon during a period of general economic expansion. Notably, when the reduction of inventories is excluded from second quarter growth measures, real final sales of domestic product grew at a much healthier 2.6% rather than 1.4%. Economists believe the slump is over, which should significantly add to second half growth.

Consumers remain the primary engine behind economic growth, and multiple factors suggest this should continue. The jobs market remains solid, and wage growth appears to be picking up with expectations that the trend will strengthen. Low gasoline prices continue to add to consumers' pocketbooks, essentially acting as the largest tax cut in history.

Consumer spending has also been spurred by rising household wealth, which hit a record $89.1 trillion at midyear, driven largely by gains in home values. A decent stock market helped too. The so-called wealth effect should continue to spur spending, particularly because housing prices should keep rising given the shortage of houses on the market nationwide. The increase in net worth combined with very tame inflation, a strong dollar, and continued wage and job growth is giving consumers both the means and confidence to spend. Household debt has also been cut dramatically since the recession, leaving consumers with not only more cash, but increased credit reserves.

Confidence and wealthier consumers are likely to kick off a more successful Christmas season for retailers. Recent back-to-school sales were strong, and likely offer a preview of the Christmas season. Projections always vary, but pundits expect this year's sales to grow around 4% versus last year's increase of 2.5%. Because November and December revenues represent 30% or more of annual sales for many retailers, strong numbers for the season make a disproportionately positive impact.

Looking abroad, much recent attention has focused on Deutsche Bank's troubles and feud with the U.S. in what looks suspiciously like the U.S. exacting revenge on Europe for the $14.6 billion tax bill handed a few weeks ago to Apple by the European Commission. The scrutiny of the bank and its potential troubles take the focus off of the larger positive picture within Germany itself. The German Economy Minister Sigmar Gabriel said this past Wednesday that he expects growth in Europe's largest economy in 2016 and 2017 to be comparable to the 1.7% expansion achieved last year. Along the same lines, on the same day Germany's leading economic institutes revised up their 2016 growth forecast to 1.9% from 1.6%, according to Reuters.

For Europe these growth levels are solid, and largely allay fears that Brexit could derail other economies through disrupting exports and trade.

Looking in the other direction, the Asian Development Bank kept its growth estimates for developing Asia for this year and next at 5.7%, citing sustained expansion in China and India as key drivers that should also steady growth across the region. The Manila-based lender increased its growth forecast this year for China to 6.6% from 6.5%, and also raised its 2017 projection to 6.4% from 6.3% due to fiscal and monetary stimulus measures in the world's second-largest economy. The bank kept its projections for India at 7.4% for this year and 7.8%, driven by strong consumption and investment.

Amidst the positive report, the primary caution centered on the likely hike in U.S. interest rates, which could disrupt capital flows and complicate macroeconomic management in the region.

A hike in the U.S. federal funds rate appears likely in the fourth quarter. Recent evidence of a stronger U.S. economy combined with a solid labor market "have strengthened the case for an increase in the federal-funds rate," according to Fed Chairwoman Janet Yellen. In the U.S. the increase will likely be a relative non-event, although markets almost always react negatively in the first day or two after the announcement.

Overseas, the reaction could be sharper, because concerns remain that rising rates in the U.S. could lessen the attractiveness of opportunities in other countries, and disrupt investment plans. Still, given expectations in growth and lower valuations in emerging markets, rate increases probably will not alter the underlying fundamentals enough to significantly change long-term return expectations. The combination of high growth expectations and currently lower equity market valuations in emerging markets likely position them as the highest return opportunity over the next decade. U.S markets would be expected to come next, probably trailing by around a couple percent per year. Europe and Japan should bring up the rear, largely because of their greater structural impediments that perpetually slow their growth.

Yet, global and local changes can always upset expectations, and numerous factors inevitably impact growth trajectories. Minimally, emerging markets are likely to offer a rockier ride over the coming years. Their smaller economies are often more greatly impacted than larger developed nations by numerous, complicating such as U.S. interest rate hikes, commodity price swings, rapidly changing energy prices, and as always, politics. As strange as our politics are here, most emerging markets still find ways to make the U.S. political landscape look pretty good. They may help you feel a bit better over the coming weeks!

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