Global Investment Letter

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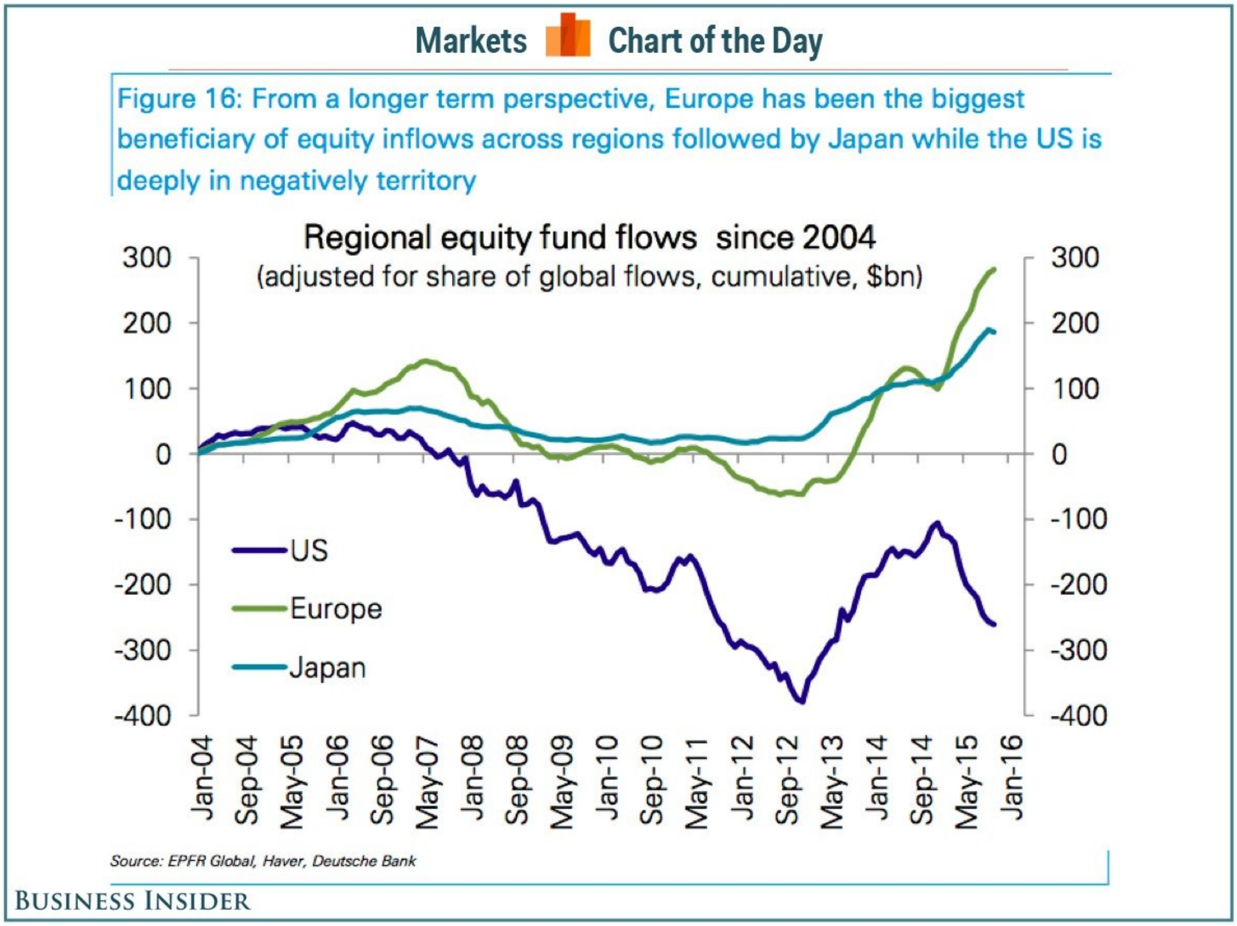
ARE US EQUITIES SET TO GAIN IN 2016?



Since my last blog post in late August, US equities have duly made a smart recovery from a low established in September. Do the Dow, Nasdaq et al still have room to advance or do opportunities lay elsewhere?

The Fed has continued to delay raising rates. The most recent pretext to delay was concern over a slowing Chinese economy. Consensus within the Fed seems to be building toward taking action, however, aided by relatively strong US job creation statistics. The Fed recognizes that it must raise rates to restore a tool (the interest rate mechanism) to respond to the next recession. Rising rates are coming, perhaps as soon as December. The fact that the Fed has dragged its feet is consistent with the axiom that central banks are always and everywhere behind the curve.

The chart posted above is one of the more remarkable charts I've seen in some time. It illustrates that for some years the United States has incurred negative capital flows, with Europe being the primary beneficiary. I believe that capital flows will swing strongly in favour of the United States through the end of the decade.

The strength of the US dollar is likely to continue for two reasons. Firstly, the United States remains a relative safe harbour in a world of macro threats. The fiscal situation of the United States may be stretched, but still compares very favourably to the Eurozone and China. The US dollar remains the world's reserve currency for a reason. Secondly, the US dollar will benefit if and when the Fed begins raising rates. A strong US dollar will drive capital to the United States.

If capital is destined to move to US denominated assets, what asset(s) will benefit? While bonds are often the quick depository of capital, it seems reasonable to suggest that US treasuries will be considered less than attractive in an environment of anticipated or de facto interest rate increases.

US equities would appear to be the most attractive asset class for capital. Commodity markets are not yet ready to rebound, and will remain under pressure due to dollar strength. US real estate and private equity may have a place, but they suffer by lacking liquidity compared to common shares. Despite the recent rebound from the September low, consensus forecasts are less than ebullient. The recent large short interest in US shares has likely been worked off by the recent rally, but optimism is hardly rampant. The general public has not embraced equities; they remain largely in yield oriented instruments. A period of short-term consolidation would not be surprising, given the market's recent move.

Selected US shares offer something that is becoming increasingly difficult to find worldwide, growth combined with a strong currency. The wide breadth of the US market still provides an assortment of attractively priced opportunities.

The prospect of raising US rates does offer a complication. However, history has demonstrated that an initial rate increase, and even a second, can be conducive to stock market strength as the increases are interpreted as evidence of economic buoyancy.

As I have discussed in previous posts, the world macro situation is likely to produce significant challenges for economies and investors through the end of the decade. Investment returns will generally be modest. US equities appear to have the potential of outperform competing asset classes, aided by a strong dollar and inflows of foreign capital.

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