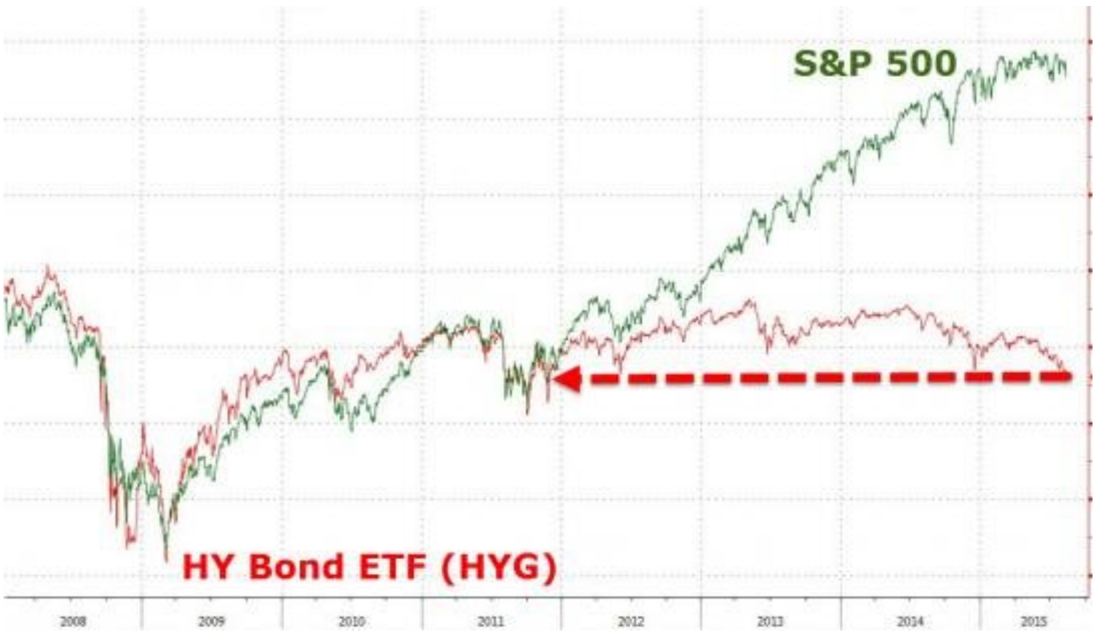
GREAT INVESTMENT OPPORTUNITIES THIS FALL?



The past several days have confirmed in dramatic fashion that world equity markets are correcting sharply. Forecasting capital markets with certainty is an impossible task, given the many variables that are filtered through human psychology. Navigating markets is a matter of probabilities rather than certainties. There has been evidence for some time suggesting that equity markets were due for a pullback. I commented in a previous post that historic volatility had contracted to very low levels in US equity indices, suggesting that a correction would serve to restore volatility to more normal levels. In addition, the chart above illustrates a growing performance divergence between US equities and high yield bonds. Such divergences have previously indicated growing risk.

The catalyst that has triggered the current selloff in world equities stems from concerns over emerging markets, most notably China. The recent collapse of Chinese equities after a near parabolic move higher has served to draw attention to China's slowing economy and assorted economic issues. That the Chinese economy is slowing should surprise no one. The law of diminishing returns states that growth rates must decline as size grows. Hence, small companies can grow much more quickly than their large counterparts, and small economies grow more quickly than large economies. Chinese growth has been remarkable the last 25 years, and is a credit to China. But that growth was ignited from a very small base that has now grown to the second largest economy in the world. China certainly has other problems, such as social issues, stock market speculation, and challenges with the banking system and debt levels. All of these hurdles were faced by that great emerging market of the 19th century, the United States. The much more interconnected world of 2015 means that China's "growth pains" will impact other economies and roil markets much more than 19th century America.

Emerging markets other than China have suffered because most have economies heavily geared to the commodity cycle. Most commodity prices have declined sharply due to a combination of two or more factors from among the following: slow global growth, reduced Chinese demand, geopolitical developments, supply growth and the effects of a strong US dollar. The commodity complex is facing a "perfect storm" of pricing pressures. Prices are likely to be under pressure for some time. Emerging markets will ultimately offer a very compelling buying opportunity. The devaluation of local currencies will aid competiveness. The decline in equity markets will produce attractive opportunities, especially for investors hedged against currency risk.

It would seem that the chances of a rate increase by the Fed have lessened considerably in light of recent events. However, I believe that the chances of an increase are greater than consensus opinion. The Fed is looking for any opportunity to restore rates to more historically normal levels. There remain considerable challenges ahead and the Fed would like to regain the interest rate mechanism as a tool to deal with future challenges. Fed rate cuts now would produce negative interest rates, which many consider an unattractive option.

The sharp drop of August 24 may have produced a low, though I would be cautious through October. Equity markets are likely to remain very volatile and may seek a new low in October, as is their wont. Also, there remains potential geopolitical risk, such as the election in Greece, in the next couple of months. Bond markets are the beneficiaries of the recent turbulence, particularly US treasuries. Cash is likely a better alternative as a safe haven at current prices.

I continue to believe that US dollar denominated equities will prove to be the best performing asset class over the next five years, and the expected volatility this Fall may produce an attractive purchase point.

By Jonathan Baird CFA