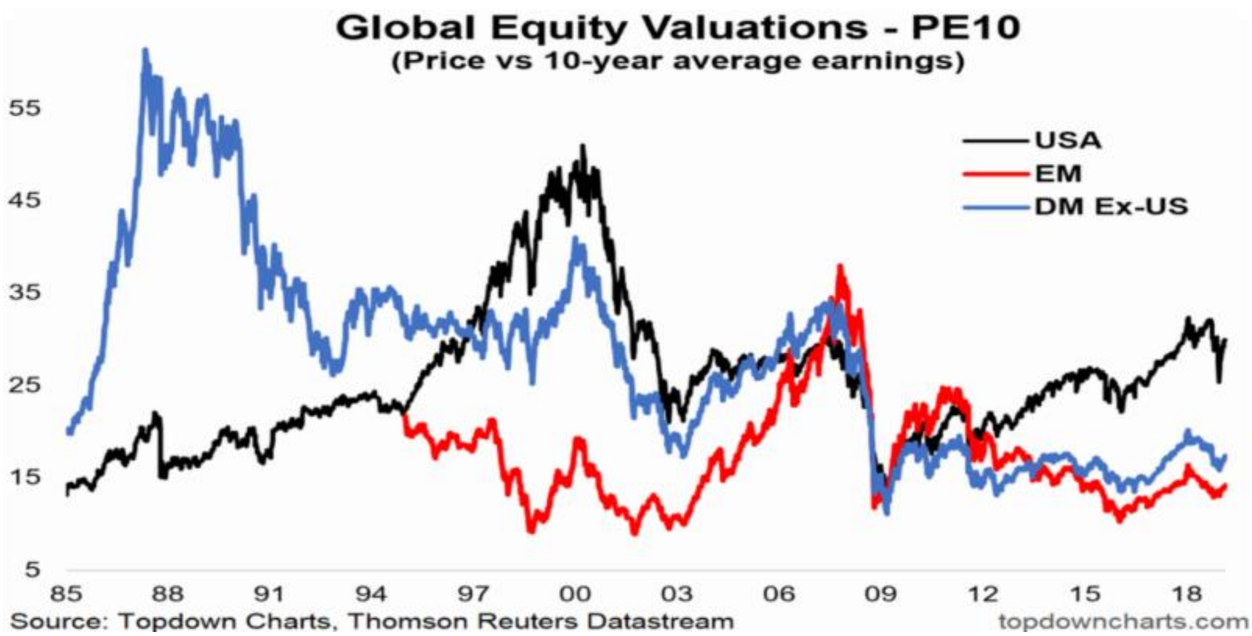
THE EFFECT OF CAPITAL FLOWS ON MARKETS

I look at hundreds of charts a week, and the most useful tend to teach multiple lessons or elegantly illustrate an important macro factor. The chart below depicting relative equity valuations since 1985 is a prime example.



Interestingly, U.S. equities traded at steeply discounted price/earnings multiples when compared to non-U.S. developed markets for the period 1985-1997/98. Following that, the dot.com bubble drove capital into U.S. markets, producing a period during which the United States had the most highly valued equities. American equities entered another such period of premium multiples in 2012. This relative premium persists to this day.

We do a lot of work at the Global Investment Letter on monitoring capital flows because we believe it is the single most important driver of investment returns over time. The two periods on the chart during which U.S. markets traded at premium multiples reflect foreign capital moving into U.S. dollar denominated assets. The U.S. dollar remains the best of a motley group of currency alternatives.

The period that began in the late 90s was clearly driven by the dot.com bubble. The United States was ground zero for investment around this theme. It is interesting to note that the valuation gap between the U.S. and non-U.S. developed markets began to narrow as the Japanese market started to collapse in

1989. Capital moved from Japanese to American equities, and the trend only accelerated with the advent of the internet.

The second period of premium multiples that began in 2012 is being driven by a different set of factors, which I touched on back in 2015 in an article entitled ***The Best Investment Over the Next Five Years?***. That article is available in the free commentary section of our website. I believe the key drivers of the persistent valuation premium of U.S. stocks during this period are geopolitical in nature, most notably driving capital from Europe to the United States. It has long been my contention that the euro is ultimately doomed and that the European Union may not exist in its present form in 10 years. I also wrote on this in mid-2015 in an article entitled ***"Will the Euro Ultimately Collapse?***" which is also available In the free commentary section of our website.

The downward slope of the line representing non-U.S. developed markets on the chart is testament to the declining relative importance of Europe and Japan. The array of economic and political issues facing the European Union and the generally deteriorating global geopolitical situation suggest that the United States will be the recipient of foreign capital for some time to come.

The recently published April issue of the Global Investment Letter, available to subscribers on our service, includes a more complete discussion of our expectations for U.S. equities, supported by a host of charts.

By Jonathan Baird CFA

Knowledge is Power..... Just one idea or insight a year can be worth many times the subscription price.