Bull & Bear Bulletin

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U.S. Economy Leading the Way:

The U.S. economy expanded more than 4% in the second quarter, reversing the first quarter contraction and marking the fastest growth since the third quarter of 2013. While improved consumer and business spending helped drive the U.S. economy, global demand was much more tepid during the second quarter. This divergence may have a unique influence on the U.S. financial markets.

With the economy likely to grow 2% for the fourth time in five years and projected to expand by 3% next year, there is support for the Federal Reserve's decision to end its money printing efforts in October. However, international central bankers are facing the opposite pressure. China's economy has been decelerating for the past several years, Japan just recorded its largest economic contraction in more than three years and the Eurozone continues to flirt with another recession (Chart 1). As the U.S. Federal Reserve begins to back away from direct monetary stimulus, global central banks are likely to step up in their place.

Looking back at the various quantitative easing (QE) measures – or asset purchases – conducted by the U.S. Federal Reserve over the past six years, there is a clear positive correlation between the Fed's asset purchases and the stock market returns (Chart 2). Despite financial markets already being awash with easy money, the additional stimulus from foreign central banks should only further support positive gains. The question is whether the benefits will be experienced domestically or abroad.

Currently, foreign money is pouring into U.S. financial markets. As discussed in last month's article, foreign bond investors are seizing on the comparative higher U.S. bond yields and placing downward pressure on U.S. interest rates, while the stronger U.S. growth outlined earlier has likely attracted foreign equity investors to the U.S. stock markets. Furthermore, as foreign central banks look to revive their economies by devaluing their currencies through money printing, the U.S. dollar has strengthened more than 5% against a basket of global currencies (Chart 3). A strong U.S. dollar is only likely to further support foreign capital coming into the country and our financial markets.

As long as U.S. interest rates remain low, the strong dollar attracts foreign capital and the economy expands at an average pace, we should see tailwinds to investing in the U.S. markets. The main risk associated with this scenario is the prospect of a financial bubble. Market tops are usually associated with higher than average valuation multiples and, while the stock market is close to fully valued based on the projected earnings and historical valuation metrics, we will be closely watching to ensure that any additional upside in the market is justified by revenue and earnings growth of corporations.

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Chart 1

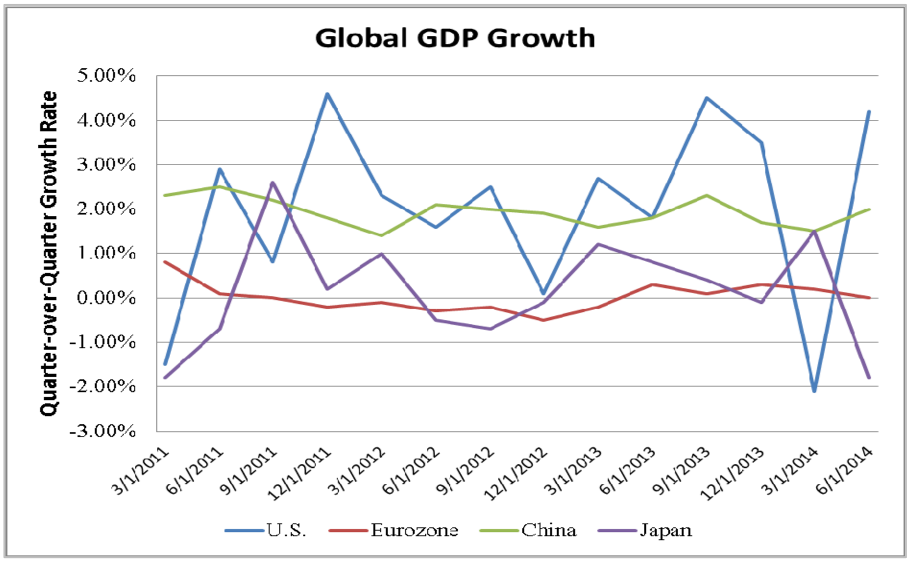

Chart 2

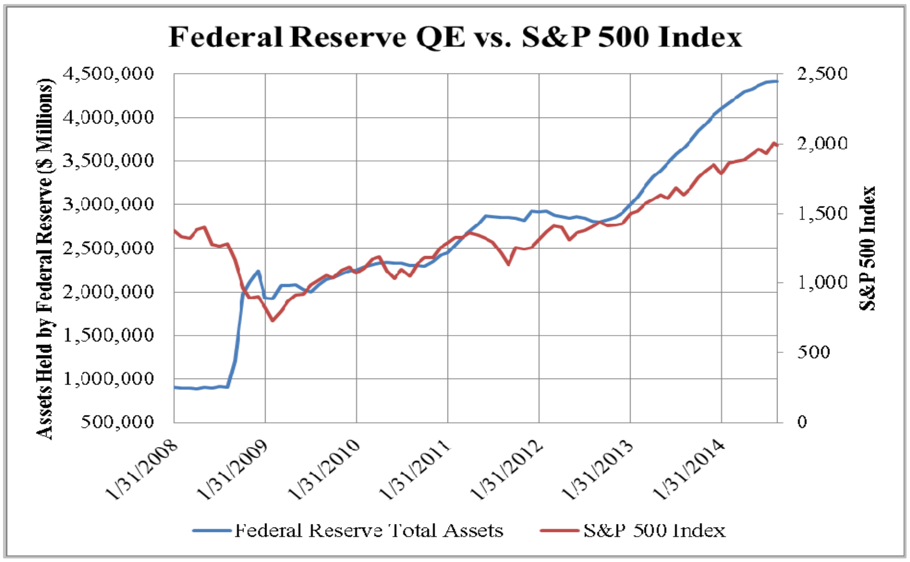

Chart 3