"By the Way"
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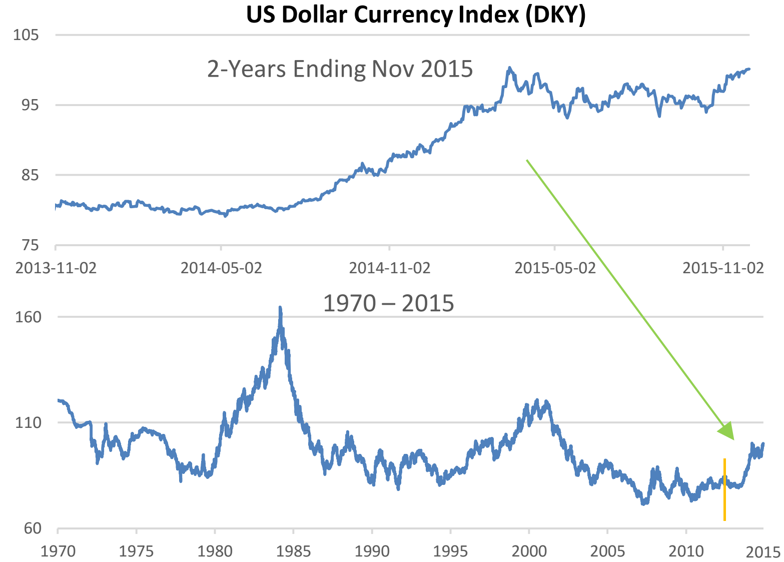
It's easy to be frightened these days. New causes for anxiety include the terrorist bombings in Paris and confrontations in Syria, not just with ISIS but with Russia as well. The market though, being dispassionate, shrugged it all off and went ahead with the historically normal fourth quarter/year-end rally. Terrorism, though, does have significant economic costs. An Australian think-tank estimates global property damage and medical costs totaled $53 billion in 2014, and certainly 2015 will exceed that. The number does not include the costs of responding to, or preventing further threats, or the lost revenues from closing down major cities such as Paris and Brussels. On the other hand, to be cold-hearted, the defense industry stands to benefit. One of the market's oldest adages comes from Nathan Rothschild who, 200 years ago, said "buy on the canons, sell on the trumpets". He was talking about the Napoleonic wars, and things aren't that dire today, but the point is still valid, military spending helps the economy.

In times of global disruption, such as now, money flows into the U.S. as it is considered the safest haven for investors. Combined with economic growth and the idea the Fed will raise rates, the U.S. dollar continues to be very strong. While good for financial markets and consumer prices, it is not so beneficial for a slowly growing economy since it is a negative for exports. A chart of the dollar is probably going to be one of the most useful tools for investors in the near term. It will reflect the divergent policies of major economies and their central bankers; it will indicate the likely direction of commodity prices (so important to us in Canada); it will have an effect on U.S. corporate earnings due to currency translation; and will tell us about investor's appetite to increase risk or to remain in dollar based assets. The two charts on the right are both of the dollar, but with different time frames. While in the short term the move looks extended, the longer term chart shows there is lots of room for a further strength.

US Dollar Currency Index (DKY)



There is a U.S. federal budget that needs to be passed in the next few weeks, but the militant wing of the Republican Party is standing in the way of passage. Two months ago the issue was no funding for Planned Parenthood; today it's the exclusion of Syrian migrants. Every time you think they've gone too far, they are busy going farther still. On a positive note the fiscal austerity of the U.S. Government has ended. After four years of having a negative impact on GDP, government spending was a positive in 2015 and is projected to be even more so in 2016.

Central bankers have a busy schedule with the ECB expected to announce an increase in the pace of quantitative easing this week. We have no reason to disagree with that consensus. The big one though is next week when the Fed makes the decision on raising rates. Several weeks ago, almost unanimously, board members were making speeches that appeared to be preparing markets for an increase. Since the Paris bombings the rhetoric has been much more muted. Certainly the economic news has been positive enough to justify higher rates, but the Fed used the international situation as an excuse not to raise in September, and I would not be surprised if it does so again. Think about this - the average cost of U.S. federal debt is 1.86% today, and 50% of that debt matures within the next 3 years. I'm not a mathematician, but I know if that debt is rolled over at much higher interest rates the effect on the budget deficit will be nasty. Financing long term liabilities with short term debt is always a dangerous policy.

We are keeping a positive bias toward the S&P 500, but recognize that breadth remains an issue as fewer stocks are participating in moving the market higher. The seasonal impact is a positive into the New Year. Let's hope breadth expands by then and we can become more convinced of a bullish outcome.

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