TD Economics

Topic Paper

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U.S. EQUITIES REMAIN A LONG-TERM FAVOURITE

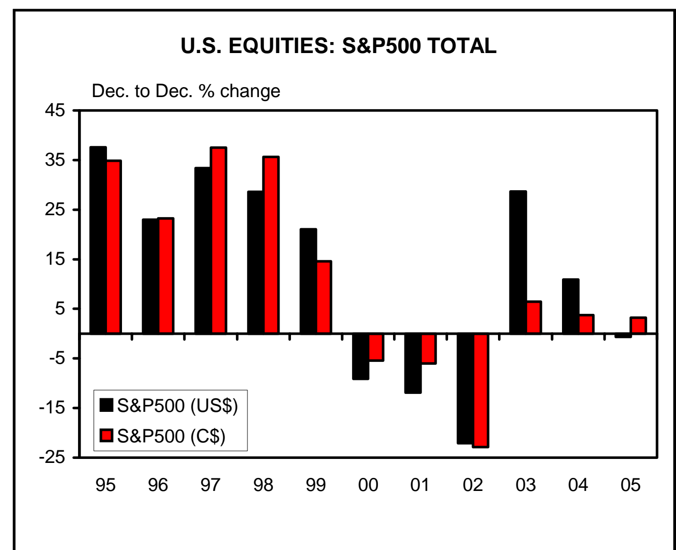
Over the past few years, Canadian investors have seen their holdings of U.S. equities perform quite poorly. To begin with, the bursting of the tech bubble produced the deep market correction in 2000-2002. Then, U.S. equities rallied strongly in 2003-2004, but the gains were virtually offset by a surge in the Canadian dollar. The loonie's advance was checked in 2005, but the major U.S. equity indexes have largely treaded water this year. Given this disappointing performance, it is not difficult to see why some investors may be hesitant to invest Stateside. And, the near-term economic outlook suggests that U.S. equities will face a challenging environment of rising short-term interest rates, continued high energy prices and slower economic growth, with the latter occurring over the course of 2006. Nevertheless, one must differentiate between short-term and long-term perspectives, and there is a strong case to recommend U.S. equities over the long haul.

U.S. equities should be part of a diversified portfolio

Investors should consider having some exposure to U.S. equities in order to achieve a well diversified portfolio. America is the world's largest economy and capital market. Many investors will probably be tired of hearing this often-repeated mantra, but that doesn't make it any less true. And, considerable diversification can be found in the industry distribution of the benchmark S&P500 U.S. stock index. For example, whereas the Canadian S&P/TSX Composite Index has a 32 per cent weighting in financials and a 25 per cent weighting in energy, the industry distribution on the S&P500 is far less concentrated.

Upside to the Canadian dollar limited

With respect to fears that future capital gains on U.S. equities could be wiped out by foreign exchange movements, it should be noted that the bulk of the appreciation



in the Canadian dollar is in the past. At around 82 U.S. cents today, the Canadian dollar appears fairly valued on the basis of relative productivity performance, labour costs and purchasing power. That doesn't mean that the Canadian dollar will be stable or that it cannot rise further. Indeed, there are legitimate concerns that the massive U.S. current account deficit could result in significant downward pressure on the U.S. dollar in the future. However, while foreign exchange rates will fluctuate, the scope for a further considerable appreciation in the Canadian dollar seems limited. Any rise in the loonie to 90 U.S. cents or higher would likely not last long, as the economic fallout would cause investors to channel funds rapidly away from Canada, leading to an eventual retreat in the currency.

Long-term fundamentals favour U.S. equities

The strongest argument in favour of U.S. equities is that they should deliver a superior performance over the long term compared to stock markets in many other industrialized countries. The reason has to do with how

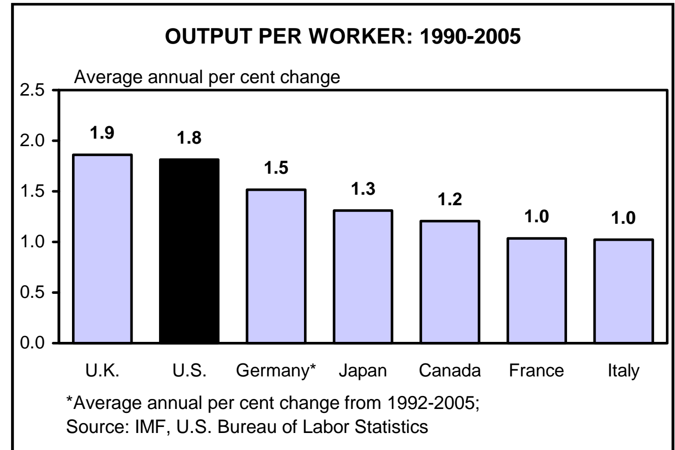
economies grow. In order to increase output, an economy must either have more workers or use them more productively. The U.S. has an edge on both fronts.

I. Population growth will be stronger

While all industrialized countries are confronted with aging populations, the slowdown in U.S. population growth will be less than that experienced in most other major developed countries over the next two decades. This is partly because America has a higher birth rate. And, if there is any scarcity of labour arising from an aging population, the perception of the U.S. as the 'land of opportunity' is likely to give America an advantage at attracting highly skilled immigrants. Consequently, the Population Reference Bureau forecasts that the population of the U.S. is expected to rise by 19 per cent by 2025, compared to 13 per cent in Canada, 7 per cent in the U.K., 6 per cent in France and contractions in Japan, Germany and Italy.

II. Productivity growth will be higher

There is also good reason to believe that the U.S. will record stronger productivity growth than most other industrialized countries. Over the past 15 years, growth in output per worker in the U.S. has outpaced that in rest of the Group of 7 (G-7), with exception of the United Kingdom. An extremely flexible economy that has adjusted rapidly to changing, and often challenging, economic circumstances facilitated the strong U.S. performance. A stellar track record on research and development, as well as the rapid implementation of commercial applications from new innovations, also contributed to the strong productivity . Looking ahead, the pace of U.S. productivity growth

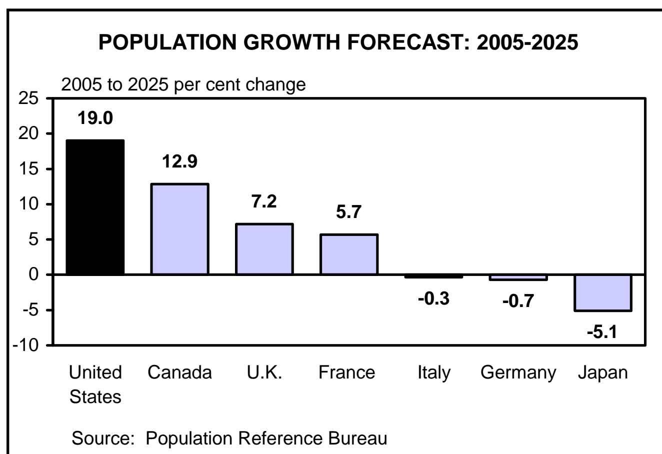


is expected to lead the G-7. And, should an aging population require a shift in production towards less labour-intensive and more capital-intensive processes, the change will likely be implemented fastest in the United States.

Faster U.S. profit growth favours U.S. equities

Higher population and productivity growth implies that the U.S. is likely to experience a faster trend rate of economic expansion than the rest of the industrialized world, which should support relatively stronger corporate profit growth. TD Economics forecasts that U.S. real GDP and U.S. corporate profits will rise at an annual pace roughly 1 percentage point faster than the G-7 average over the next two decades. That may not sound like much, but it implies a cumulative compound outperformance of 22 per cent between now and 2025. And, to the extent that equity valuations reflect long-term profits growth, the implication is clearly positive for U.S. equities. This is not really ground breaking analysis, as the S&P500 has outperformed most other developed country stock indexes over the past 20 years, delivering an average annual total return of around 12 per cent in Canadian dollars. We don't expect that performance to be matched in the future, but we do expect an average annual return of 7 to 9 per cent.

The main conclusion is that U.S. equities may be struggling at the moment and may experience a challenging environment over the short term as the U.S. economy slows, but the long-term economic fundamentals point to a superior performance over the long haul – which is likely the appropriate time horizon for most investors.



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