

## A Balanced Diet of Trade and Investment

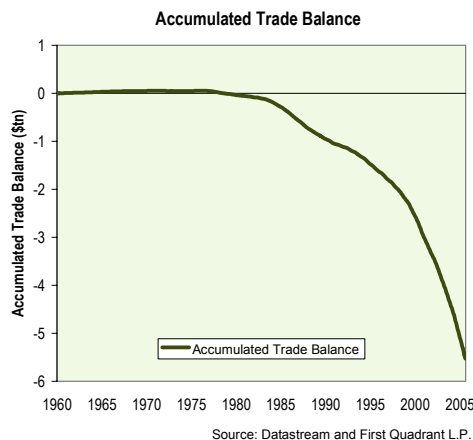
by Ghene Faulcon

Following on from the last currency monitor where we looked at the US national debt and its growth, this time we turn to a related topic. Last month we looked implicitly at the size of the budget deficit, this time we look at the trade deficit. The recent attention given to the record trade deficit and the presumed impact on future exchange rates leads us to think about the underlying mechanism and the actual impact. We further wish to examine the claim that there must be a reversal of the accumulated trade deficit at some point in the future.

We shall first look at the similarities between the trade deficit and the budget deficit. Both are at their largest values ever and have been on increasing trajectories. They are each alleged to put pressure on the dollar to weaken. How the budget deficit does so was covered in last month's currency monitor, but the argument for the trade deficit's effect on the currency might be thought of as follows:

Each time that products are imported from abroad, this results in a net financial (money and investment) flow out of the US. Thus the US trade deficit is financed through the world's investment in the US. The accumulation of this net investment position would mean that foreign entities would eventually own all financial value in the US, but before that could happen there would be fear that this net position would ever pay off. A repatriation of that accumulated value would mean a large net flow of currency out of the US and a decline in the exchange rate. An alternative method of easing the pressure would be to reverse the trade balance through a combination of increasing exports and decreasing imports, which some might argue might only be possible by a weakening of the US dollar.

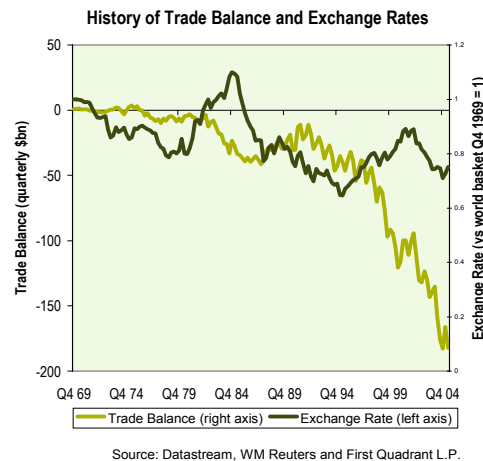
This is a perfectly reasonable explanation of how people think about the trade deficit. It however makes some assumptions; the first is that the accumulated position must tend toward zero over time. Is this notion reasonable? And more importantly does it hold true? Over the past 45 years, the accumulated international investment position of the US (as measured by the accumulated value of the trade deficit) has deteriorated by \$5.4tn<sup>1</sup>, a very substantial portion of the country's GDP (43%) and has done so in a very consistent manner, rising nearly the entire period. This would suggest that the notion of a tendency toward zero is not very reasonable at least on any feasibly investible timeframe.



To understand why this might be possible we take the analogy of a company. An investment in a company assumes some eventual reclamation of value by individual shareholders while not requiring all shareholders to reclaim value at the same time. Additional people can invest in that company without diluting the share value as long as the new investment can be as productive as the prior investment. The same is true of foreign investment in

the US, there can continue to be increases in foreign investment (continued trade deficits), as long as US growth prospects remain strong; the value added through growth outpacing the financing of the trade deficit. In this way, the financing need not ever be repaid.

The second assumption is that the exchange rate directly and strongly affects the trade balance, specifically with a weakening currency leading to a shift towards increased trade surplus or decreased trade deficit. This is a very dubious proposition considering the weakening of the exchange rate by 25%<sup>2</sup> versus a world basket during the last 35 years, during which, the trade balance has taken a decidedly strong turn from surplus toward ever increasing deficit – opposite of the direction one would predict based on the change in the exchange rate.



If we look into the composition of the trade balance, we find that trade is not really balanced at all, with imports at more than 1.5 times exports. So now a weakening of the dollar by 10 percent would, if quantities and prices remain unchanged<sup>3</sup>, would increase the trade

deficit by \$196bn. This means that price adjustments and quantity adjustments would have to overcome this hurdle to even begin to reduce the trade deficit.

The price and quantity (demand) relationship is characterized by the price elasticity of demand. Highly elastic goods respond more to changes in price than inelastic goods. Since we need the quantities to respond to price movements, we are really requiring that trade is relatively elastic with respect to the exchange rate. Not only does this not appear to be true for US trade overall, it may be even worse; imports and exports may have different elasticities.

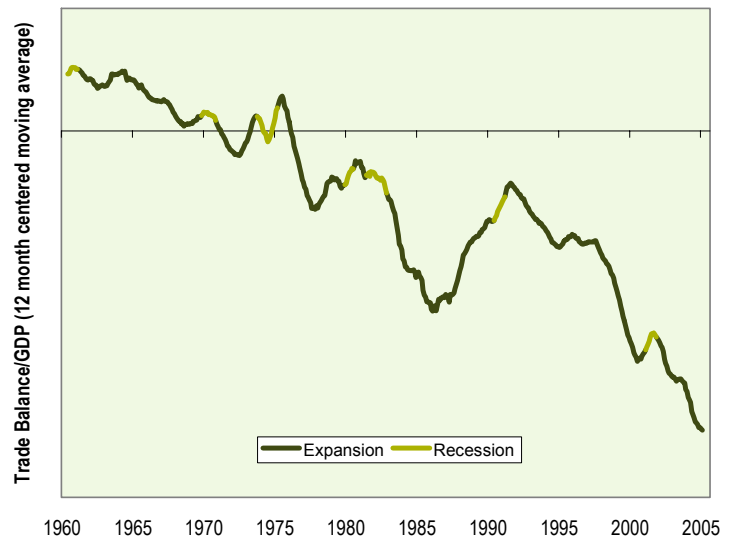
The imports from Asian countries that make up the bulk of the trade deficit are low priced items that cannot be replaced domestically at the same price. As a result the elasticity of imports may be relatively low. Of exports, a large portion is services and high cost goods, which may be available from other developed countries, potentially making them more elastic, because of the alternative sources. In a situation of elastic exports, but inelastic imports, a weakening exchange rate could actually increase the trade deficit.

Now that we are somewhat skeptical about whether exchange rate depreciation results in trade balance shifts toward increased surplus or reduced deficit, the logic of the assumed relationship between trade deficit and exchange rate now appears tenuous at best. Let's instead turn our focus back to the financial flow, which finances the trade deficit. In reality, it is here that the pressure is meant to build.

If we realize that for the accounts to balance, foreign investment in the US necessarily requires a trade deficit, just as a trade deficit necessarily requires foreign investment. We now consider the desire of foreign entities to invest in the US as a cause of the trade deficit rather than as a result of the trade deficit, though perhaps both that desire and the desire of Americans to have cheap foreign goods are contributory to the situation.

When would a foreign investor want to invest in the US? Generally, these would be the times when the growth prospects of the US are good. Investors would flee from the US when growth prospects in the US are poor. These conditions are exactly the conditions of the business cycle<sup>4</sup>; or rather they are the conditions of the prospective business cycle. Thus foreign investment should be repatriated when recession is on the horizon and foreign investment should occur when the economy is expanding. When viewed in terms of the trade balance: trade surpluses (or significant decreases in the trade deficit) occur when the US economy is in recession (or is expected to go into recession in the near future) and trade deficits occur in a booming economy. A wealth effect may also be at play; during the times that the US is prosperous, American entities have the more resources, and increase purchases. These increased purchases result in an increase in both domestic purchases and imports, thereby increasing the deficit.

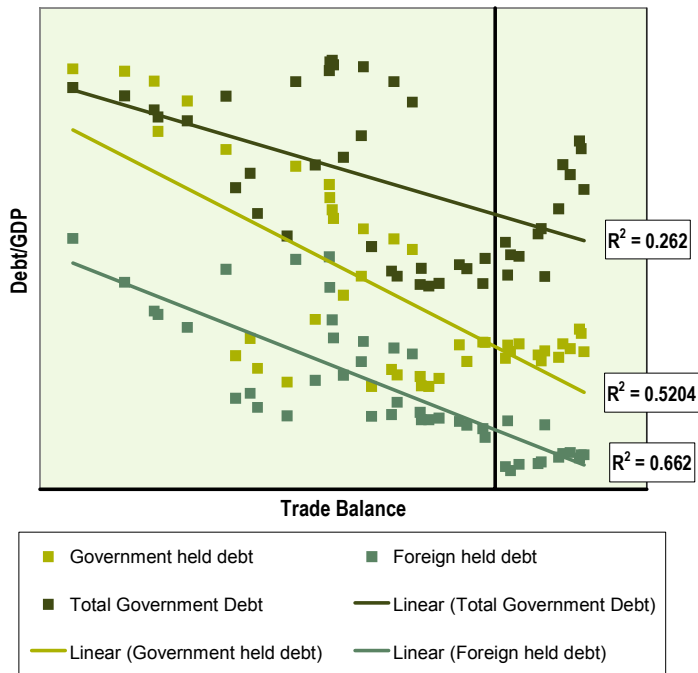
Trade Balance/GDP during recessions and expansions



Source: Datastream, NBER and First Quadrant L.P.

The government inevitably tries to stimulate the economy out of recession and economic slow downs; usually through spending increases such as during the depression, or through tax cuts as in 2001, or some blend of the two as in the Reagan era. These policies often result in budget deficits and increased debt, which brings us back to last month's topic. Under this suggested paradigm, trade deficits should occur along with budget deficits. We see this in the chart below. We should really note two things in the chart. The first is that the balance of payments assertion that the trade deficit must be financed by foreign investment is strongly supported with the foreign held debt (foreign investment) increasing as the trade balance shifts towards deficit. The second is that the times when the government is borrowing and especially borrowing against future budgets as represented by government held debt (those times when the government is trying to stimulate the economy – i.e. recessions) the trade balance is increasing.

**Debt - Trade Balance Relationship**



Source: Datastream and First Quadrant L.P.

We have re-evaluated the idea of the record US trade deficits leading to an eventual depreciation of the dollar and have difficulty finding support for its main premises. The accumulation of foreign investment does not tend toward zero over time. Decreases in the exchange rate do not lead to trade surpluses or decreased trade deficits. In stead we have found an alternative relationship that has support from the data as well as making fundamental sense. Most notably, there seems to be an identifiable relationship between the trade deficit and the business cycle in which trade deficits occur (and increase) in times of expansion and decrease (or turn to surplus) in times of recession and impending recession.

**Returns and Expectations**

Once again only two countries made changes to their monetary policies. On the first, The US Fed increased its rates by 25bp as the market expected putting rates at 4%. Norway also raised rates by 25bp to 4.25%. The ECB signaled that it would increase rates at its next meeting on December 2<sup>nd</sup>.

Cash yields increased an average of 16bp in the month with only Hong Kong (-4bp) and Japan (-1bp) breaking ranks. Singaporean rate climbed 75bp. Though no other market was able to match that, but New Zealand, Denmark, Canada and the EMU each experienced increases between 21bp and 30bp.

Average bond yields were flat over the month. The markets were however mixed. Norwegian rates increased by 28bp followed by Sweden's 10bp and Denmark's 7bp increases. The

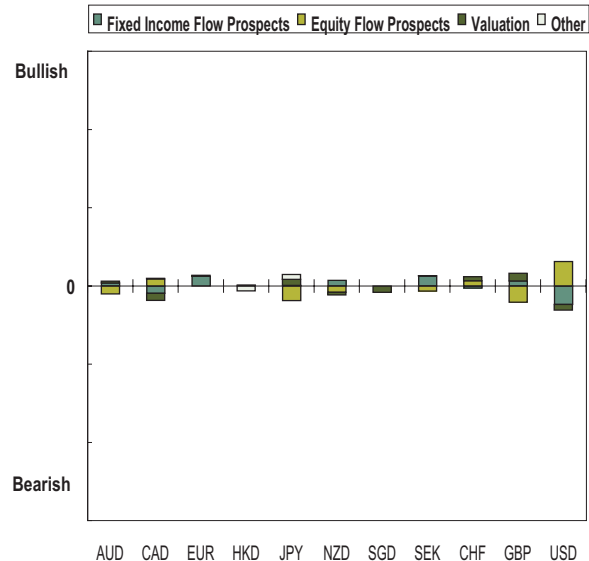
decreases in bond rates during the month were generally smaller with a maximum decrease of 12bp from the Japanese market. Australia and the UK also had 7bp yield decreases.

Equity markets bounced back in November averaging a 3.5% gain with only New Zealand (-1.0%) taking a loss. Japan continued its strong year with an increase of 7.5% in the month with the Swiss Market not too far behind, posting a 5.4% gain.

The currency markets continued to be as active this month as they were last month with the best performing currency outperforming the worst performing currency by 4.5% and the average currency moving by 1.2%

Positions did not change very much during the month. This was a result of equity flow being offset by fixed income flow prospects.

**Change in Factor Contributions to Forecast**  
31-October-2005 to 30-November-2005

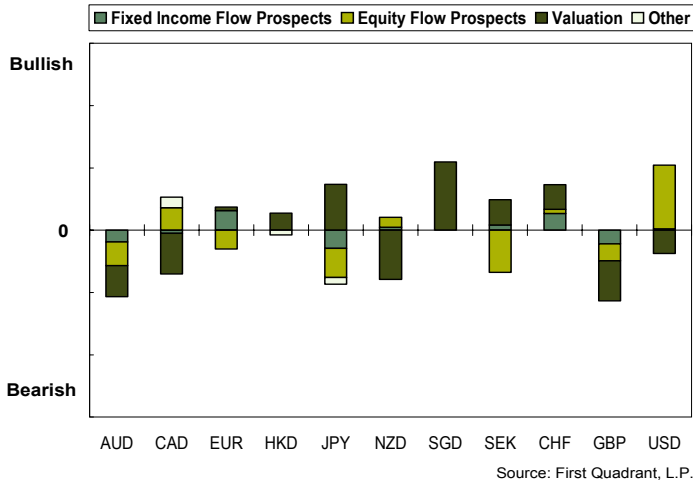


Source: First Quadrant, L.P.

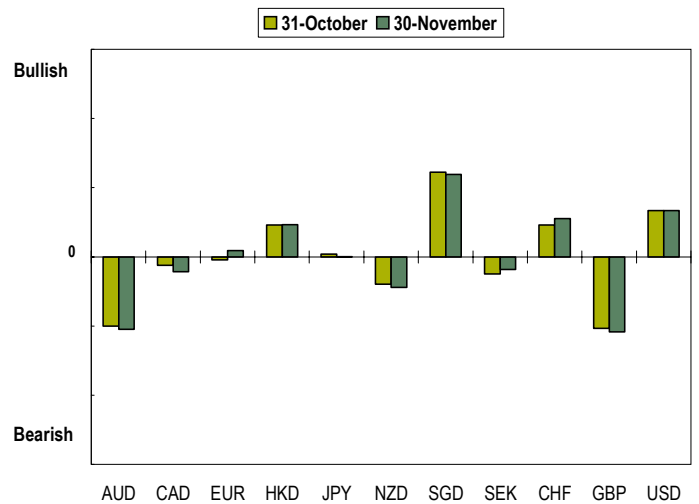
On a valuation basis, New Zealand continues to have the most overvalued currency. The British Pound and the Canadian and Australian Dollars also remain overvalued currencies. The Japanese Yen is still the most undervalued currency followed by the Swedish krona and the Swiss Franc. As for equity flows, the US is the most attractive market for equity flows while the Swedish, European, Japanese and Australian equity markets are the least attractive. A small amount of fixed income should flow out of the UK and Australia into the US and Switzerland. Overall we are positioned toward US dollar and Swiss franc strengthening and Norwegian krone, British pound and Australian Dollar weakening.

The portfolio had a slightly better than neutral month. This was primarily due to well-placed positions in the US dollar (long) and the British pound (short) while our long position in the Swiss franc and our short position in the New Zealand dollar attenuated those gains.

**Factor Contributions to Forecast**  
30-November-2005

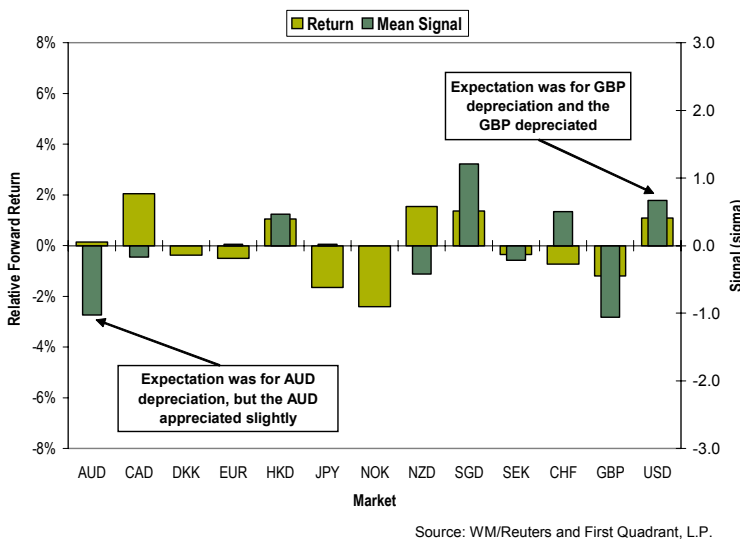


**Market Attractiveness**  
31-October-2005 to 30-November-2005



We have broken away from our neutral position in most currencies. We are significantly more bullish for the US dollar as a result of the interest rate changes during the month. The flip side of that coin is that we are a bit more bearish nearly all other currencies.

**Currency Returns and Expectations**  
November 2005



(Endnotes)

- <sup>1</sup> Data source: Datastream and First Quadrant, L.P.
- <sup>2</sup> Data source: WM Reuters and First Quadrant L.P. This calculation is based on forward returns relative to a basket of developed market currencies.
- <sup>3</sup> This assumes that quantities remain unchanged and that the prices remain the same in the currency of the point of origin of the goods and services.
- <sup>4</sup> The idea of the current account having a relationship to the business cycle can be found in "America's Record Trade Deficit, A Symbol of Economic Strength", Daniel Griswold, February 2001 which can be found on the web at: <http://www.free-trade.org/pubs/pas/tpa-012.pdf>

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