FQ FirstQuadrant

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FXMONITOR

A Flow of a Different Color...

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On October 22 2004, President Bush signed the American Jobs Creation Act of 2004 (AJCA). In among the estimated $145 billion of tax cuts is section 965 which gives corporations a 1 year 85% deduction for dividends from Controlled Foreign Corporations (CFCs). In the simplest terms, this is a tax holiday – big companies can bring back accumulated foreign profits at a maximum tax rate of 5.25% rather than the normal 35%. In this month's FX Monitor we will look at this one-time opportunity with a particular eye towards how this will affect world exchange rates, particularly the US dollar.

There are restrictions on the use of the funds that are repatriated that are intended to ensure that jobs are created as a result of the repatriations (see table below). Despite these restrictions, corporations will simply use the same accounting measures that are used by states with money from lotteries that is mandated to go to education. They will simply reallocate the money previously allocated for the allowed activities to the disallowed activities, while spending the repatriated funds on the allowed uses. However, this in no way forces an increase in the money spent on the allowed uses. Because of this ability to effectively spend the money on anything that a company wishes, the incentive to repatriate funds exists for all companies that have accumulated foreign profits.

Allowed Uses	Disallowed Uses
• Hiring and training workers	• Executive compensation
• Capital Investments	• Inter-company transactions
• R&D	• Dividends and other shareholder distributions
• Debt Repayment	• Stock redemptions
• Mergers and Acquisitions	• Portfolio investments
• Infrastructure	• Debt instruments
• Advertising	• Tax payments
• Licensing	
• Funding pension plans	

[Source: Treasury guidance on the American Jobs Creation Act]

Estimates for the total amount of foreign profits available for repatriation under this provision range from approximately $450 to $750 billion. Though this is available to repatriate, it is unlikely that it will all be brought to the Unites States. Early estimates for likely repatriation totals were around $150 to $200 billion, though the estimates have risen since the Treasury gave clarification about the allowed uses for these profits. These estimates are now closer to $300 billion and as high $500 billion. Since funds only brought back in excess of the normal repatriation are eligible for this special tax treatment, the entire amount will represent extra capital flow into the US. The announced repatriation plans support the revised estimates with more than $100 billion of already announced repatriation. Of the 20 companies with the most foreign profits available to repatriate, the 10 that have made announcements of their intent to repatriate profits have chosen to repatriate nearly the entire amount eligible for the reduced tax. Only 4 of those 20 have indicated that they are considering repatriating significantly less than the maximum.

Companies that have publicly stated that they are planning or considering repatriation ($billions)

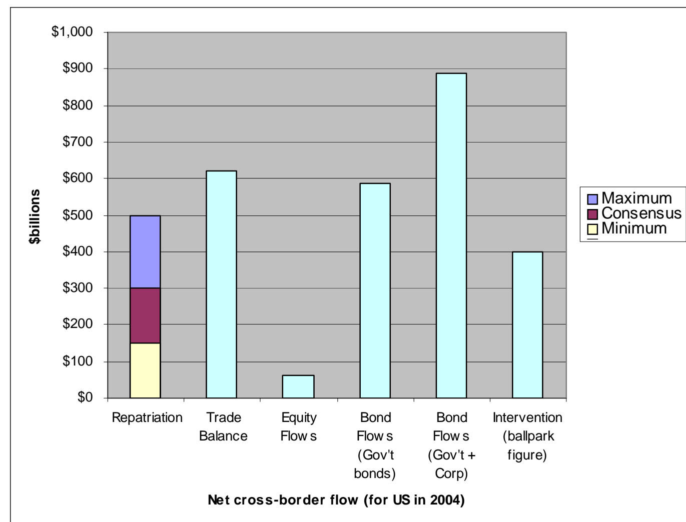
Company Name	Eligible Foreign Profit (billions)	Either planned or considering repatriation
Pfizer*	$38.00	$29.00
Exxon Mobil	$17.00	
IBM	$16.30	$8.00
Merck	$15.00	$14.00
General Electric	$15.00	$3.00
Hewlett-Packard	$14.50	$14.50
Johnson & Johnson	$12.30	$11.00
General Motors	$11.90	
Procter & Gamble	$10.70	$10.70
DuPont	$10.30	
ChevronTexaco	$10.10	
Schering-Plough	$9.40	$9.40
Bristol-Myers Squibb	$9.00	$9.00
Eli Lilly	$8.00	$8.00
Motorola	$7.60	
Pepsico	$7.50	$7.50
Altria Group	$7.10	$7.10
Intel	$6.30	$6.00
3M	$6.20	$0.80

Company Name	Eligible Foreign Profit (billions)	Either planned or considering repatriation
Coca-Cola	$6.10	$6.00
Dow Chemical	$6.00	
Wal-Mart	$5.30	
Oracle	$3.00	$3.00
Microsoft	$1.64	
Stryker	$0.99	
Dell		$4.10
Wyeth		$2.70
Mattel		$2.40
LaFarge		$1.10
Sun		$1.10
Kellogg's		$1.00
Heinz		$1.00
Boston Scientific		$1.00
Safeway		$0.73
National Semiconductor		$0.50
Colgate Palmolive		$0.50
Nvidia		$0.50
Duke Energy		$0.50
Total	$255.23	$164.13

** Both figures for Pfizer could increase to $38 billion upon further clarification of the Act as it relates to Pharmacia.*

[Source: MSN MoneyCentral website, SEC filings and press releases of the individual companies]

To really understand this we should ask if this new flow would be large in comparison to some numbers that we do care about. Since these numbers represent a net increase in repatriations, the appropriate comparisons would be to net flows[1]. There are three flows that we believe are meaningful to the currency markets: trade flows, equity flows and bond flows. We'll also include official interventions, as recently those have been in the news (see chart for comparison). These are the main sources of the net demand (or supply) for dollars. Any net flow comparison clearly shows the significance.



[Source: US Treasury TIC data and author estimate]

Estimates of the unhedged portion of accumulated foreign profits hover around $100 to $150 billion. Repatriating this money would have a direct impact on foreign exchange because of the need to convert to dollars. Hedged foreign profits will still have an effect, but to a lesser extent. The hedging horizon for these profits most likely is for several years. This timing mismatch will result in the same direct effect from the spot market transactions, but will be partially offset by the unwinding of the hedges. As much as half of the accumulated foreign profits may fall into this category. Finally, the dollar denominated profits should not have a direct effect on the exchange rate.

It seems reasonable to assume that the funds likely to be repatriated are held primarily in fixed income instruments. Previous research at First Quadrant has estimated the effect of bond flows on the exchange rate. Even with partially hedged flows, the result could mean as much as 1% to 4% to the exchange rate. This is not to say that repatriation would increase the exchange rate by 4%, just that the dollar could be 4% stronger than without repatriation.

These numbers are not spectacular; 1% to 4% over a year is noise relative to yearly market movements and as such we may never know the true effect of this year's repatriations. Without knowing more about the timing and magnitude of the repatriations and whether or not they are hedged makes forecasting the effects more like guessing.

There are however other effects that can be anticipated. The result of removing up to half a trillion dollars from foreign fixed income markets will be an increase in foreign yields along with a decrease in yields in the US as corporate debt is repaid. More importantly, removing capital from foreign markets will occur and,

depending on the reserve requirements for those foreign banks, the amount could be significantly more than the $0.5 trillion of cash moved.

Of the explicitly allowed uses, the three that stand out as the most likely to be utilized are debt repayments, acquisitions and funding pension plans because these are the easiest places to quickly use large amounts of funds. All three of these uses put the money directly back into domestic financial markets, rather than filtering into the economy to increase GDP directly as hiring employees and capital expenditure would. The result here should be an increase of capital in the markets in much the same way as the decrease in capital abroad.

Though many others write-off the potential effects of the American Jobs Creation Act as being inconsequential, there will be some direct effects, but the secondary effects may be more important. We leave you to consider the effects of the foreign monetary contraction and the domestic monetary expansion, particularly the reaction of the bond and equity markets and of central banks.

American Jobs Creation Act
http://thomas.loc.gov/cgi-bin/query/F?c108:6:./temp/~c108uHd9kx:e309030

Treasury guidance on AJCA
http://www.treas.gov/press/releases/reports/repatriationfactsheetfinal.pdf

Returns and Expectations

Central Banks were more active in March than they had been earlier in the quarter, with all developed market central banks meeting over the month, and three making changes to monetary policy. Australian, New Zealand and US central banks all raised rates (i.e. a tighter monetary policy) by 25bp, which was the second rate increase in the US for the year (the first for the other two banks). Through the first quarter of 2005, only those three banks have changed monetary policy, with all other banks on hold so far this year.

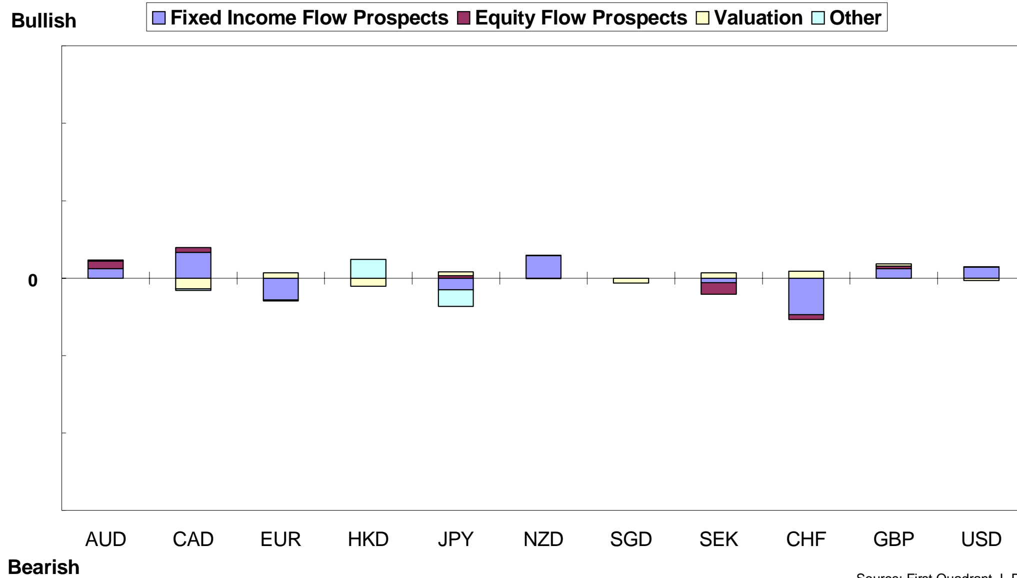
Short-term interest rates were little changed on average around the world, though both Australian and New Zealand cash yields rose strongly over the month (Australian by 12bp and New Zealand by 21bp), while most other markets saw almost no change to their cash yields.

On the long-end of the curve, the average bond yield was little changed over the month, but we saw more activity *between* markets over the month. Australian, Canadian, Norwegian, New Zealand and US bond yields all rose over the month, by 10bp, 6bp, 7bp, 8bp and 10bp, respectively. EMU, Japanese, Swedish and Swiss bond yields fell, by 6bp, 14bp, 13bp and 12bp, respectively. British yields were nearly unchanged, rising by 2bp over the month.

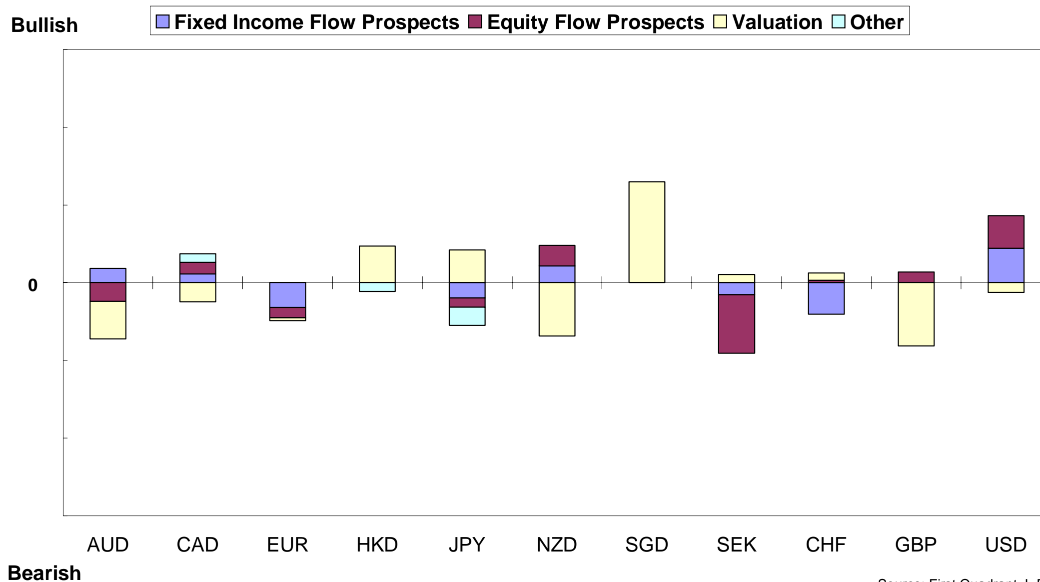
Equity markets were slightly down on average over the month, though we saw a similarly large "spread" between markets, with the best performing market (Danish) outperforming the worst performing market (New Zealand) by more than 8%!

In the currency markets, the Canadian, Hong Kong and US Dollars faired well, rising by 3.3%, 1.6% and 1.6%, respectively, versus the World currency basket. The Swedish Krona and Swiss Franc were the two worst performing currencies, falling by 1.5% and 1.2%, respectively, versus the same World currency basket. The return difference between the best performing currency (Canadian Dollar) and the worst performing currency (Swedish Krona) was 4.8%.

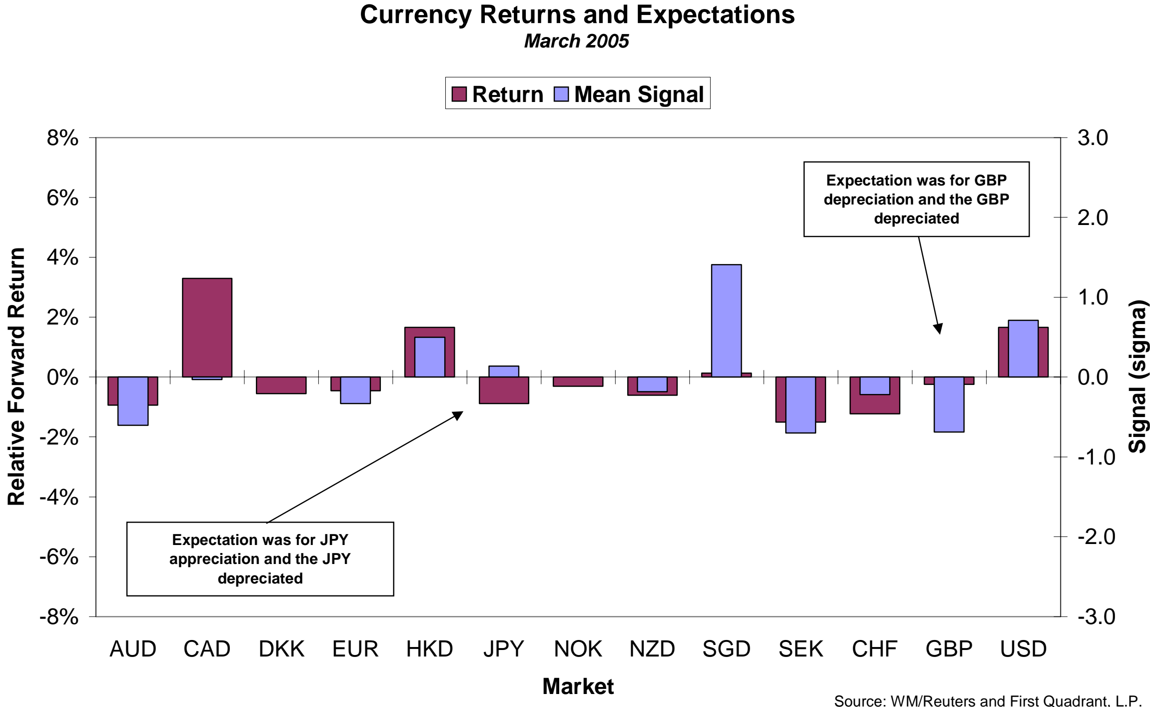
The significant relative movements in bond yields once again drove most of the changes to our signals, particularly for the Canadian Dollar and Swiss Franc. The rise in the currency-independent price of commodities (which started at the beginning of 2005 and has continued through the end of March) has shifted our forecast down modestly for the Japanese Yen.



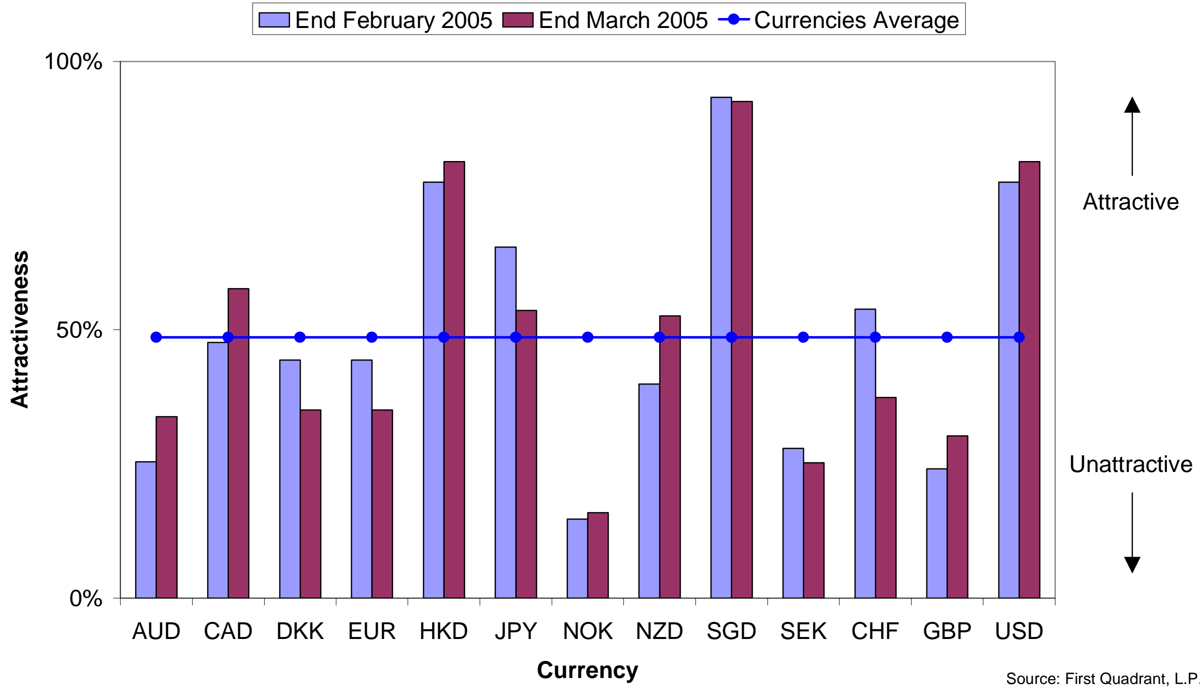
Prospective flows in both equities and bonds are contributing to our forecasts in approximately equal proportion, true in most cases on a currency-by-currency basis. Only for the Swedish Krona and Swiss Franc is only one type of prospective flow providing most of the forecast, with the poor prospects for flows into Swedish equities and Swiss bonds the primary driver in those markets. Valuation continues to play the dominant role for the Australian and New Zealand Dollars, as well as the British Pound, all of which are overvalued. The Canadian Dollar has shifted into a slightly over-valued position, while the US Dollar remains very slightly over-valued.



March was, in general, quite a good month for the forecasts, with most signals aligning with the market return. Our bullish tilt on the Japanese Yen had the only notable difficulty, though a modest one, as the Yen declined modestly.



Our forecasts have continued to evolve modestly, as we have become less bearish on the Australian Dollar, become modestly bullish on the Canadian Dollar, become more bearish Euro, become less bullish Japanese Yen, moved to neutral (from modestly bearish) on the New Zealand Dollar, moved to modestly bearish (from neutral) on the Swiss Franc, and modestly reduced our bearish position on the British Pound. We have become very slightly more bullish on the US Dollar as well.



(Endnote)

[1] *Comparisons to total flows are also meaningful, but all except intervention dwarf the repatriation estimates. Depending on the timing of the flows, there could be some short-term market effects, but those are not really of interest.*

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