Do Stocks Worry About Current (Account) Events?

"There's no trick to being a humorist when you have the whole government working for you." -- Will Rogers

Will Rogers would have felt right at home today as a financial commentator: Not only would he have numerous governments in his employ, he would be able to enlist the services of the entire Wall Street community as well. Even more so than in government, some in this crowd believe error, illogic and a near-reckless disregard of available data, if subjected to sufficient repetition and recirculation, can be elevated to an exalted state envisioned in the dreams of religious mystics and those unable to distinguish between various mushrooms.

As promised in a Columnist Conversation post last week, two questions stand before the house today, whether a weaker dollar should close the U.S. current account deficit, and whether the current account bears any relationship to the fortunes of the U.S. equity markets. The answers are "no" and "no."

A lesser question, whether a zero current account deficit or for that matter a zero budget deficit should be goals of national policy, was answered in the negative in this space in December 2003. The questions of whether the Federal Reserve should target the dollar and whether weak currencies imply weak equity markets were dismissed similarly in November 2004.

A Good Idea At The Time

Prior to the early 1970s, exchange rates were fixed either to each other, to a reserve currency or to gold. The post-World War II regime established at the Bretton Woods conference in 1994 fixed the U.S. dollar at 35 per ounce of gold; other currencies would be fixed against the dollar once they became convertible following the damage from the war. A characteristic of a fixed exchange rate system is a country in perpetual deficit eventually depletes its reserves of either gold or convertible currencies and has to limit its imports to whatever is provided by vendor financing. In such a system, periodic crises ensue, and the occasional devaluations or revaluations of currencies become market-jarring events.

Milton Friedman, among others, advocated a system of floating exchange rates wherein the exchange value of a currency would be established by the market. The concept was simple and elegant: As a country moved into deficit, the units of its currency paid to its suppliers would be worth less on world markets. Its exports would become cheaper and its imports more expensive. The opposite would be true for those countries in surplus: Their imports would become cheaper as their currency rose in purchasing power and their exports would become more expensive. Trade imbalances thus would be self-correcting.

As a matter of full disclosure, a certain student of international economics at the time was absolutely smitten by this idea. The problem with being young and stupid is you will be cured of only one of these for sure.

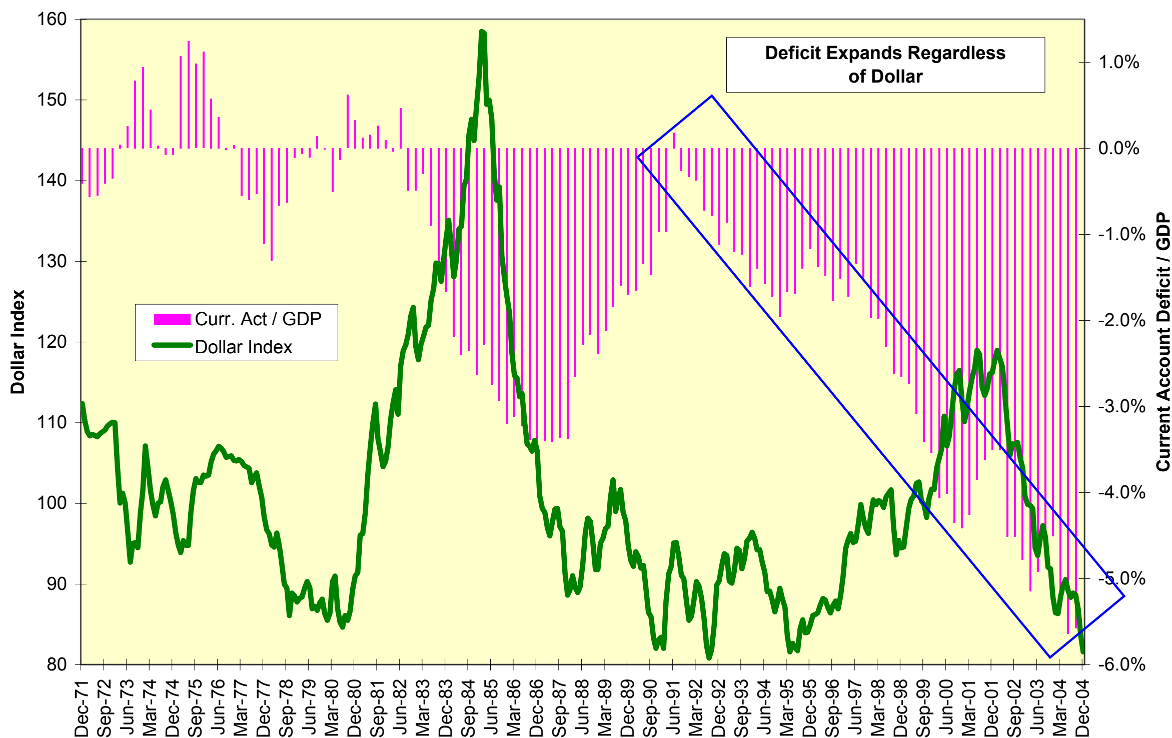
In practice, floating exchange rates have never performed this function as advertised. For one, too many goods such as petroleum and metals are priced in dollars globally; I discussed the link between the dollar and oil prices a year ago. A second reason has been the formation of currency blocs; several important exporters elected either to peg their currency to the dollar or to engage in non-stop manipulation of the exchange rate. China today is an example of the former phenomenon; Japan is an example of the latter. A third reason is the prominence of Canada and Mexico in our trade mix; we are in a free trade zone with both.

Additional important reasons for the inefficacy of exchange rates in correcting trade imbalances lie in the necessary wage and price adjustments engendered by exchange rate movements. Japanese automakers, for example, did not sit by idly as the yen strengthened. They accepted lower profit margins, improved their cost structures and shifted production to low-cost zones, such as Mexico and Brazil. Many American firms did the same; as a result, much of our trade is really intra-company transfers from one subsidiary to another. Finally, American consumers demanded and received wage adjustments to compensate for the reduced global purchasing power of the weaker dollar.

The most important reason of all, however, is the disconnection between financial flows and physical trade flows under a floating exchange rate regime; I noted this a year ago in discussing whether the euro had run out of steam to the upside. The simple fact of the matter is no physical trade whatsoever is required to support trade between two currencies.

Updating History

Let's take a look at the long-term relationship between the dollar and the current account deficit expressed as a percentage of GDP. The current account deficit includes services and income as well as merchandise trade. This deficit has been increasing nearly continuously since the first quarter of 1991 regardless of whether the dollar has weakened or strengthened. Incidentally, the dollar was as weak or even weaker during this last period of trade balance as it is today.



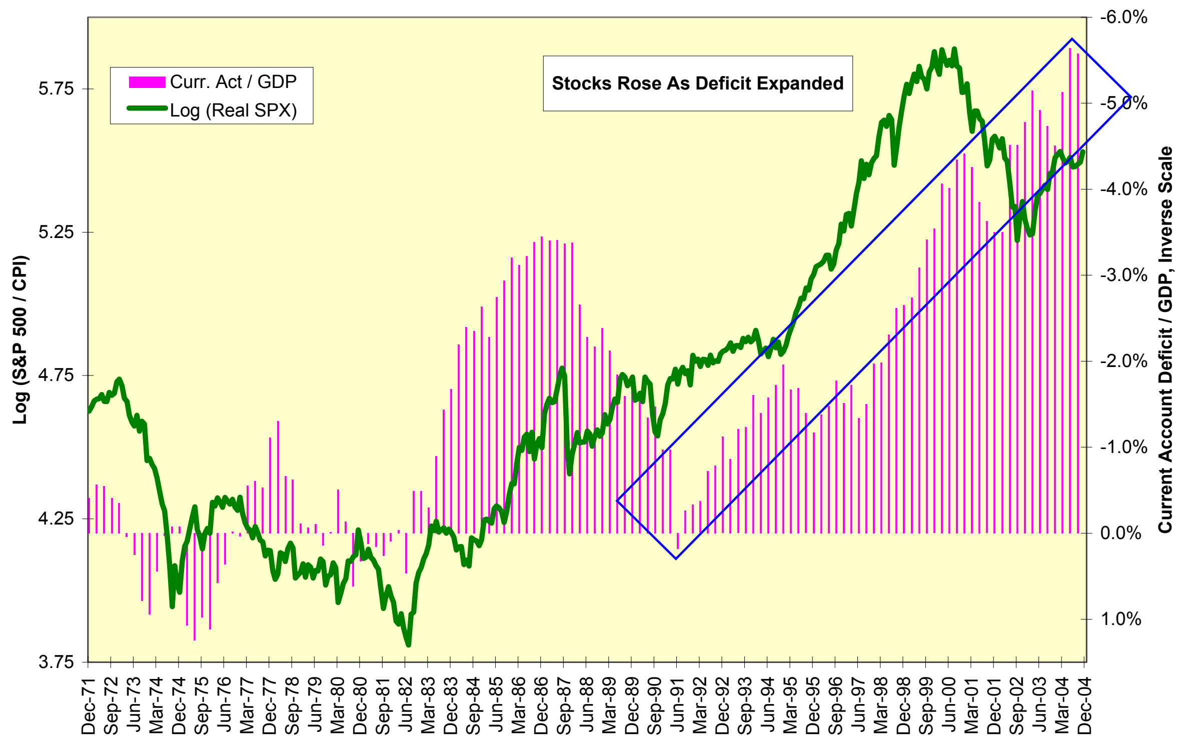
Those who clamor for a zero trade balance are invited to explain not only *how* the U.S. could close this deficit in the presence of continued weak import growth elsewhere in the world, but also *why* the U.S. should be willing to forego much cheaper imports from China. The entire premise of international economics is to focus on your comparative and competitive advantages, not to see whether you can turn out tchotzkes for Wal-Mart better than can China.

Turning To Stocks

Imports are an artifact of economic growth. As the economy strengthens, we should expect to see imports surge. One of the problems in the world today is slow growth and consumption outside of the U.S.; China, Japan and Europe are not growing to the extent their imports can expand as much as ours. ***No matter how low the dollar goes, we cannot sell to countries who lack the wherewithal to buy***.

The link between economic health as represented by the stock market and import growth in excess of export growth can be illustrated quickly and I hope convincingly. Over the past three decades the growth of the inflation-adjusted S&P 500, dividends not included, has paralleled the expansion of the current account deficit. The "real" SPX is depicted on a logarithmic scale to convey its percentage growth rate, and the current account as a percentage of GDP is depicted on an inverted scale. Those who long for a current account surplus can find them during the 1974-75 and 1980-82 recessions. These are not often recalled as happy times for stock investors.

The Current Account Deficit And Stocks



Those who insist that one day – one day! – the trade deficit and the lower dollar will in some combination be the ruin of us all have to explain why their warnings have yet to come to fruition. The parable of Chicken Little is taught to small children as a warning about each of us having only a finite store of credibility. Will Rogers, an ever-reliable font of wisdom, said it best: "Never miss a good chance to shut up."