Exporting Lower Profit Margins

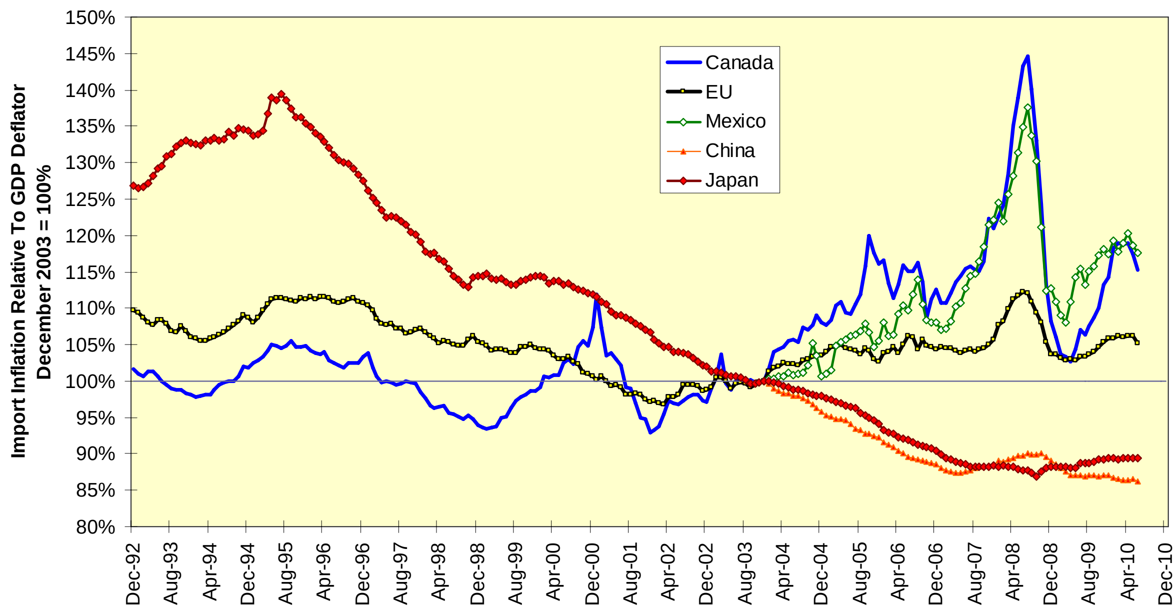
The longtime leader of the AFL-CIO, George Meany, was right out of central casting, and he had a way of getting to the heart of a problem that today's media-coached union bosses could never match. He once observed economics was the only profession where a person could acquire a lifelong reputation as an expert without ever once having been right.

Harsh? Yes, maybe, but for those of us who have watched the same mistakes repeated over and over again in areas such as the role of currencies in managing trade balances, the crusty Mr. Meany seems to have been onto something. Even today, Sens. Schumer and Graham are convinced the answers to all of our problems lie in a stronger Chinese yuan; three decades ago, their spiritual predecessors thought the same about a stronger yen.

Relative Import Inflation

Our good friends at the Bureau of Labor Statistics have been compiling import cost indices since 1992 for some key exporters to the U.S.; tellingly, indices for China and Mexico do not begin until December 2003, as if those countries were not key exporters to the U.S. before that date. If we map their performance relative to the GDP deflator compiled by the Commerce Department, some trends emerge.

Import Inflation Trends Diverge Widely



Note Japan; here the relative inflation measure has been declining since 1995 as the yen came off its all-time high. Note Canada, its export prices rose rapidly during the commodity price boom and broke rapidly soon thereafter. If the Canadian series looks an awful lot like the Canadian dollar to you, it is.

I will leave it to the BLS folks to explain why the Chinese and Mexican series look so much like the Japanese and Canadian series even though the Chinese yuan has been pegged for much of this period and the Mexican peso remained relatively stable until the 2008 financial crisis.

Finally, take a look at the series for the European Union. The euro dominates our thinking about foreign exchange movements, and the dollar-euro rate has put on a show in both directions over this era, but the relative import inflation series for European goods have gone nowhere.

Murder At The Margin

There are numerous explanations for some of these anomalies; the one that concerns investors most is the absorption of stronger currency rates by exporters. Let's take Japan, whose yen is challenging its 1995 all-time high despite enduring zero interest rates since February 1999 and quantitative easing on and off since March 2001. Firms as disparate as Suzuki and Sony are bewailing the stronger yen and their boards are wondering, no doubt, why they did not follow the lead of Honda years ago and move more production out of high-cost Japan into the high-cost U.S. Direct foreign investment is the ultimate currency hedge.

Sony, which has long used its own profit margins to absorb yen strength, is considering the limits of that strategy. If we step up to the index level – and you can trade Japan as a bloc with exchange-traded funds such as the EWJ – we can see the margin compression effect in action. For 2010 to-date, the total return on Japan in dollar term has been a loss of 1.85%, as compared loss of 6.45% for the MSCI-Barra World index in USD terms. The yen's strength accounts for this gain to the U.S. investor. What if you were a Japanese investor in Japan? There your loss would be 10.8% in yen terms, as opposed to a 5.07% loss for the World index in local currency terms.

The end result of our currency policy has been to make life miserable for the Japanese. This sort of beggar-thy-neighbor policy contributed to the Great Depression; just ask any economist.