# What Ever Happened To The Trade Deficit?

*With apologies to Neil Diamond...*

*I thought gains were only true in fairy tales / Meant for someone else but not for me*
*Stocks were out to get me / That's the way it seemed*
*Disappointment haunted all my dreams*

*But then I bought the lows, now I'm a believer / Not a trace of doubt in my mind*
*I've got gains / I'm a believer!*
*I couldn't sell them if I tried*

We just passed the 15th anniversary of the Crash of 1987, an event whose most enduring legacy was the dissolution of fear. If you go back and read the Presidential Task Force on Market Mechanisms, better known as the Brady Commission report, you will find it replete with anxiety that the 1987 implosion would lead to a deep and nasty recession. It didn't, the market made new highs by 1989, and for the next decade investors treated each and every downturn as the latest and greatest buying opportunity.

That was a great strategy until the minute it wasn't.

**Fear Strikes Out**
While the 1987 Crash occurred for several reasons, including bond yields approaching 10% and levels of equity valuation that while quaint by late 1999 - early 2000 standards were alarmingly high by historic standards. The immediate cause, however, was the release of the monthly merchandise trade balance report on Wednesday, October 14, 1987. The trade deficit was *the* number that year; I can recall financial markets nearly ceasing to trade for two days prior to its release.

The logic, such as it was, went as follows:

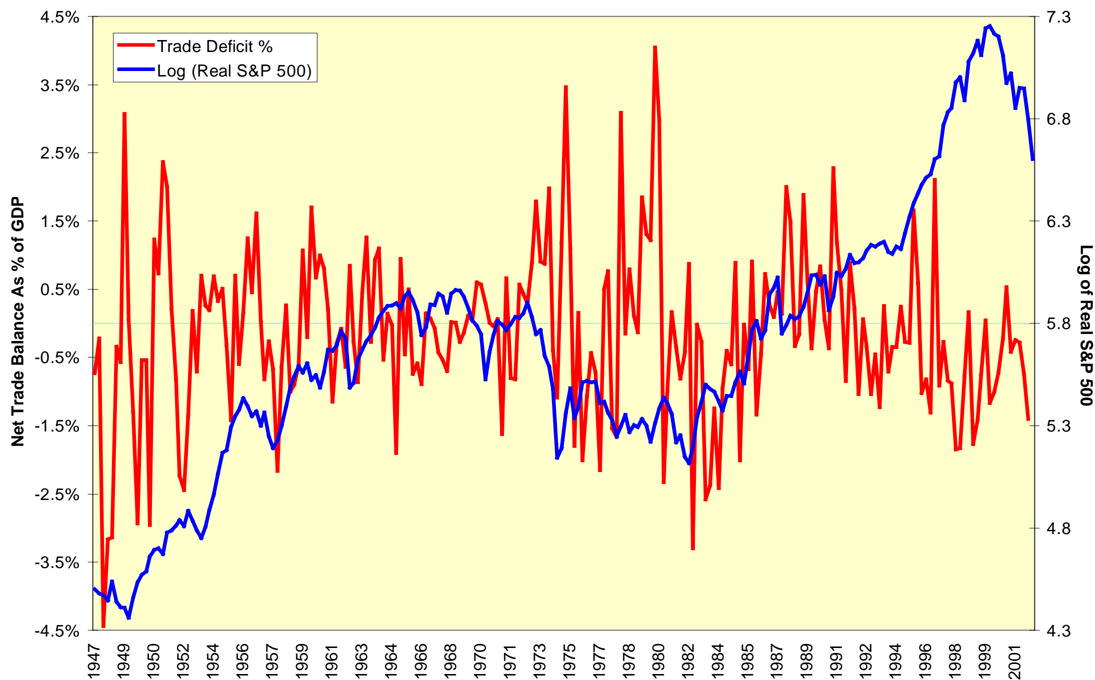
1. We had been weakening the dollar since the September 1985 Plaza Accord in an attempt to reduce our trade deficit;
2. The strategy did not work, and the dollar was falling too far and too fast;
3. The only way to support the dollar was to raise interest rates; so
4. The Fed's response to a larger trade deficit would be higher short-term rates

All of this was bad politics and worse economics. It is simple accounting identity that the merchandise trade deficit can be restated as the capital account surplus, and since when has anyone been hurt by an investment inflow? We were consuming the Japanese cars, cameras and VCRs, and they were consuming our Treasury bonds, and is there any doubt in your mind who got the better end of that deal?

**A Permanent State of Affairs**
The U.S. has not had a single month of a merchandise trade surplus since April 1976. This stands as a testament to how much foreign investors want to send their capital here and are willing to forego consuming the fruits of their labors - those very same cars and cameras we are buying are ones they are not - for the privilege.

Trade involves services as well as goods, and this particular datum often is ignored. The U.S. is a large exporter of services, a category that includes non-U.S. subscribers to RealMoney. Services often have a very high value-added component, and are less subject to global competition than are goods. After all, it is very hard to demonstrate that an autoworker in Detroit is intrinsically more productive than his counterparts elsewhere, but it is easy to demonstrate that the engineers who designed the state-of-the-art facilities in any industry are adding value on a global scale.

If we net goods and services together, as we should, we find an interesting relationship between trade and equities in the postwar era.



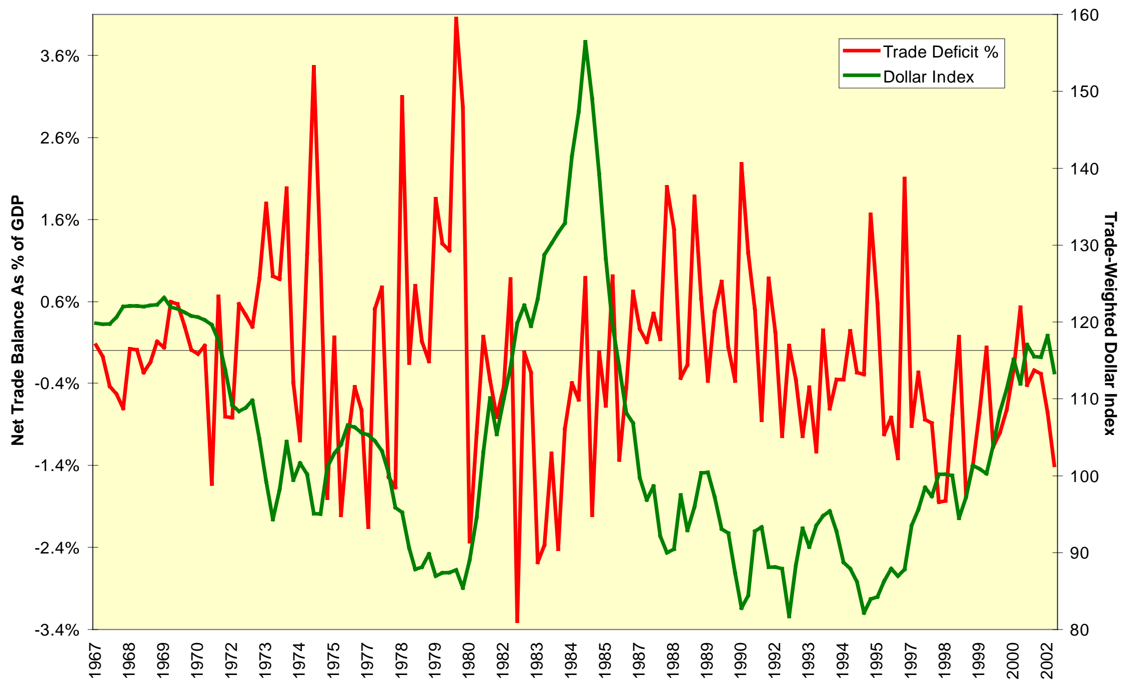

In real dollar terms, the S&P 500 has gone through two long-term bull markets since 1947, those of 1949-1966 and 1982-2000. Two bear phases, those of 1966-1982 and the present unpleasantness are visible as well. The initial phases of both bull markets saw some fairly substantial net trade deficits, often more than 2.5% of GDP. In fairness, the first bull market saw some substantial net exports as well; this was to be expected given the exigencies of the Cold War and the rebuilding requirements of much of Europe.

The relationship reversed during the 1970s, however, as the U.S. ran a series of very large next export quarters in the midst of a prolonged bear market in real dollar terms. Our economic weakness damped down imports, and the unattractiveness of U.S. capital markets discouraged foreign investors.

By the time of the late 1990s surge in stocks, a global phenomenon as well as an American one, net trade balances were more consistently negative for reasons just the opposite of those mentioned above. Everyone wanted a piece of the American economic bonanza, and U.S. economic growth sucked in imports from the rest of the world, especially from those countries devastated by the 1997-1998 Asian financial crisis.

**Where Do We Go Now?**
As the Monty Python troupe used to proclaim, "Now for something completely different." It has been taken as gospel by many that a trade deficit weakens the currency, and vice-versa. In fact, this was Milton Friedman's logic when he argued that floating currencies would have a self-correcting effect on trade balances. However, the data since 1967 indicates the complete opposite.

**The Effects Of Trade On The Dollar**




The dollar's strongest phase, which occurred as Nobel Laureate Robert Mundell would have predicted during the Reagan tax cut era, occurred while the U.S. was running very large net trade deficits. The opposite was seen during both the 1970s and early 1990s, a combination of a weakening dollar with a net positive trade balance. Much of the late 1990s strength in the dollar was attributable to the mechanics of involved in creating the euro, but even this strength occurred in the face of a negative trade balance.

Given the slowdown in the U.S. economy and the unattractiveness of our capital markets at present - O.K., everyone's market is bad at the moment - we should expect a movement back toward a net positive trade balance, and a weakening dollar.

In such an environment, the government securities of non-U.S. issuers ought to do well, and the stocks of export-dependent U.S. multinationals ought to outperform those of import-dependent domestic firms.