This week we look at the links between the US trade deficit, the low savings rate in the US, home prices, and interest rates, all in an effort to answer the question: “Do trade deficits matter?” I think I will offer a few practical, if simple, insights to the matter.

At the end of last year, I did a series of e-letters on the debate over dinner in London between Bill Bonner and Charles and Louis-Vincent Gave. Both had just published a book. Bill’s book, Empire of Debt (which is still doing well) states that the US trade deficit, coupled with massive government and consumer debt, is going to drive the dollar to its knees and end up with the US in a soft depression. You can chalk it safely in the doom and gloom column.

Then Charles and Louis-Vincent Gave, along with colleague Anatole Kaletsky answered in their book, Our Brave New World, that trade deficits do not in fact matter at all. It is different this time. They make a persuasive argument that the US trade deficit can last forever and that the deficit is in fact a sign of US strength, not weakness.

To the surprise to none of my long-term readers, I found myself in the muddle-through middle, saying that deficits do indeed matter; the US trade imbalance cannot be sustained, but that it will go on for quite some time.

Looking back on those articles, I am not persuaded I made my case as well as I should, so I want to revisit it this week. This has been occasioned by an essay by Anatole Kaletsky, which was part of a debate between himself and Stephen Roach (of Morgan Stanley).

Do Imbalances Matter?

I am going to reproduce a longish part of the essay, as a starting point for the letter. As I often remind readers, it is important to read smart people (and Anatole is quite smart) with whom you disagree. If you cannot figure out why they are wrong, then you need to change your opinions. I’ll let you be the judge. Let’s jump right to his essay, entitled “Do Imbalances Matter?” (I should note that Louis-Vincent Gave will be at my Strategic Investment Conference next week, so I expect to get a rebuttal, which I will report back to you.)
“This is one point which almost all economists and policymaking institutions – the Fed, the IMF, the OECD – all absolutely agree on: even if the US deficits were perfectly harmless or even desirable, they would soon have to be narrowed, because borrowing $800 billion a year is simply unsustainable. What I now want to tell you is that all these distinguished experts are exactly wrong.

“I cannot be sure whether the present US deficits are a good or a bad thing; but on their sustainability there is absolutely no doubt. Deficits of US$800bn are perfectly sustainable, not just for many more years and decades but, if necessary, forever. This is a matter of simple and irrefutable arithmetic.

“A deficit of $800 billion is a very large number, so we have to put it into some kind of perspective. The standard approach is to compare it with GDP. So we say that America’s $800 billion deficit is roughly 7% of its $12 trillion GDP – and this sounds pretty scary because anyone can quickly calculate that 15 years of borrowing at this rate would add up to 100% of GDP. In other words, after 15 years of such deficits, the whole American economy would be in hock. Or would it?

“I’m afraid the answer is a very firm no. The reason is that GDP is not the right factor for scaling the deficits on current account. I know that all economists use it, the IMF uses it, as does the OECD – but the fact that everyone does something, does not necessarily make it right. So let me explain why comparing deficits to GDP is simply wrong.

“We’ve established that the US current account deficit is a mirror image of a capital inflow, or to put it more emotively, that US trade deficits reflect a country living beyond its means by borrowing from foreigners and selling off national assets. Let’s be even more insulting: America is selling $800 billion worth of family silver every year to finance its shop-a-holic addiction (Buffett’s share-cropper society). Eventually this rake’s progress will surely lead to national bankruptcy, but just when? To see how long the present rate of borrowing can continue, we should compare the $800 billion America raises each year from pawnbrokers and loan sharks with the total amount of family silver it has left to mortgage, sell or pawn. You might think that this wealth is roughly equal to America’s national income of $12 trillion, but you would be completely wrong.”

“The US is one of the few countries in the world which publishes a detailed balance sheet of national wealth, produced quarterly in the Fed’s flow of funds statistics. From this we find that the total assets belonging to the US private sector, net of all government and borrowing, both domestic and foreign, is not $12 trillion but $52 trillion. Gross assets (before netting out household debts and the $2 trillion owed to foreigners) are $64 billion. This figure consists of tangible wealth (mostly housing) worth $26 trillion, equity in quoted companies worth $15 trillion, other financial corporate assets (such as bonds and deposits which also represent part of the net worth of the business sector) of roughly $9 trillion, plus $15 trillion of “other” assets, much of it represented by the value of national infrastructure plus the net worth of private non-quoted businesses.
“Offset against these $64 trillion gross assets are gross liabilities of $12 trillion, three-quarters of which are accounted by mortgage debts (incidentally, the assets and liabilities of the corporate sectors and the US government are cancelled out in these calculations, since the net value of companies ultimately belongs to their shareholders in the household sector, while the financial liabilities of the US government are equal to the government assets held by US households and the overseas sector). If we accept this official estimate of America’s wealth, then our perspective on the current account deficit is completely changed. (And the reasonableness of the Fed figures is suggested by a back of the envelope calculation: Suppose there are roughly 100m households in America and the average house price is roughly $200,000. Then the total gross value of the US housing stock is around $20 trillion, which is very close to the official figure of $19.8 trillion).

“As such, instead of saying that the deficit is 7% of GDP or national income, we should say it is roughly 1.2% of US assets. Instead of describing America’s net foreign debt of $2.5 trillion as a scary 20% of national income, we can more meaningfully express it as 4% of national net worth. Moreover, America’s $52 trillion net worth is not a static figure. Both net and gross wealth in America has been growing by a steady 5-6% in nominal terms every year since 1955.

“This means US net worth is growing by roughly $3 trillion each year, while it borrows $800 billion from the rest of the world. So to finance its consumption binge, the US is not exactly scraping together the last of its family silver and sentimental heirlooms; rather it is selling (or more precisely mortgaging) about one-quarter of the annual growth in its net worth.
“Now let us put America’s supposed national profligacy into the context of a corporate business. Suppose you were analyzing a company with a turnover of $11 billion, a net worth of $54 billion and $2.5 billion of net debt. And suppose that its shareholders’ funds were growing steadily by $3 billion each year. This company comes to you and says that it wants to increase its leverage by borrowing $800m a year. What would you do? You might ask the management whether it had good projects in which to deploy this extra cash. You might ask whether the borrowing program would increase or reduce its long-term RoE. You might wonder whether the company should be even more aggressively or more conservatively managed. But one thing you would not dream of asking is whether this company was about to go bankrupt – remember it is borrowing $800m on the basis of $54 billion net equity and an annual increase of $3 billion in net worth!

“You might, however, note that by adding $800m each year to a debt, which begins at only $2.5 billion, the company will be steadily increasing its debt to equity ratio. Given that this debt-equity ratio starts at only 4%, this would hardly be a worry; but you might, out of pure curiosity, wonder how many years (or decades) the company could keep up this rate of borrowing before the debt-equity ratio started to draw attention from Moody’s and S&P. To do this, you would run a spreadsheet which analyzed what would happen to the various financial ratios if the initial rate of borrowing continued for many years ahead.

“This is exactly what we can do for the US. Let us start with a debt to asset ratio of 4% and let both GDP and gross wealth grow at a steady 6% per annum. Let us assume that the current account deficit begins at $800 billion and then, far from returning to balance, keeps getting bigger at the same rate as GDP growth (i.e. 6% per annum). The results are summarized in the chart below. The scale on the left is trillions of dollars – the initial foreign debt is $2.5 trillion, GDP is $11 trillion, US net wealth is $54 trillion, and time is shown in years from the starting point. The red line at the bottom shows the ratio of foreign debt to net assets:
“What we find is that the US could afford to borrow $800 billion – and continue borrowing this amount, plus increases of 6% annually – forever without its foreign debt to asset ratio ever exceeding 26%. In the first few decades of this foreign borrowing program, the debt to asset ratio would rise gradually from an initial 10%, to 13% after 10 years, 19% after 20 years, and 22% after 30 years. After that the growth in the debt-equity ratio would gradually tail off, until it stabilized at around 25% after 40 years. By that time, US net foreign debt would be over $100 trillion and the current account deficit would be $8 trillion a year.

“These astronomical numbers may sound utterly impossible, but all they really tell us about is the magic of compound interest, rather than unsustainable profligacy. By 2045, when on present trends the US foreign debt would reach $100 trillion, the net wealth of the US private sector would be nearly $500 trillion – and the total wealth of the global economy from which the US would be borrowing would be five to eight times as large.

“In other words, even if we assumed that the US deficit, instead of stabilizing or contracting sometime in the future, continued to grow forever at a rate of 6%, there would still be easily enough global wealth to finance this deficit without any problems. The cumulative assets which America would have to sell or mortgage to finance such an ever-expanding deficit would still represent no more than a modest proportion of the country’s total net worth.”

All Assets Are Not the Same

Anatole is right. As long as foreigners are willing to take any old US asset, we have more than enough to sell them as far as the eye can see. But I think that is framing the question in the wrong manner.

The question should be: “Do we have enough assets of the preferred type that satisfy the needs of the current lenders?” And that answer is different.

I became bearish on the dollar in early 2002 (good, if lucky, timing!) partially as a result of a series of e-letters I did on the nature of the US account deficit. At that time, we had large (almost 4% as compared to today’s 7%) deficits, but the dollar was only getting stronger, and not weaker as classical economics would argue.

The answer was that up until that point, foreign investors, mainly European, were buying US companies and equities in rather large amounts, more than enough to offset our trade balances. But the data was showing that private foreign demand for US assets was beginning to wane. Where would the necessary cash to maintain the dollar come from?

To make me even more bearish, there were several very well-researched studies which showed that no country had ever run a deficit of more than 5% without at least a
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30% drop in the value of its currency. I looked at this as a good time to turn bearish on the dollar and as a side result bullish on gold and commodities. (I view gold as a neutral currency.)

The dollar has indeed dropped, but mostly against the euro and the Canadian dollar. We now know that foreign central banks, mostly Asian, decided to make up the difference that private investors were willing to place into dollars. It became a sort of competitive currency devaluation, as each country bought US dollars in order to keep its own currency from rising against the countries with which they felt they were competing.

What these foreign central banks and investors want today is US government-backed bonds. The reality is they are never going to be interested in buying US homes, real estate, stocks, or corporate bonds. So it is not the total assets of the US that are important. It is the amount of government bonds. So, let’s look at those first.

How much have they bought? You can go to http://www.treas.gov/tic/mfh.txt and see the government statistics. Japan has $673 billion, China is at $265 billion, the United Kingdom is at $250 billion, and those powerful centers of commerce, the Caribbean banking centers, own $94 billion (mostly as proxy for governments, hedge funds, and private investors). It is not all Asia after that. Among other interesting items, OPEC owns $85 billion, Taiwan $72 billion, Korea $69 billion, Germany $65 billion, and Canada $58 billion.

You can go to www.publicdebt.treas.gov and get the official debt statistics. You will find US government debt (to the penny!) as of today is $8,357,988,734,259.29. The Bureau of the Public Debt divides the national debt into two main categories: debt held by the public, and intragovernmental holdings. Intragovernmental debt includes money for government trust funds such as pension plans and the debt for social security. Overall, intragovernmental holdings account for over about $3.5 trillion as of May 2006.

The remaining $4.8 trillion or so has been purchased by the public, including foreign entities. This largely comes from the issuance of US Treasury securities. It is common for individual Americans and businesses to buy bonds and other securities, though much of the debt is now held overseas. As of February 2006, foreign holdings of Treasury debt were $2.232 trillion, which was 46.5% of the total debt held by the public. Foreign central banks owned 64% of the federal debt held by foreign residents; private investors owned nearly all the rest (this figure from the Analytical Perspectives of the 2006 U.S. Budget, page 257).

And that is the official total. It is likely understated. As Brad Setser says: “The US consumer seems to have opted out of any rebalancing. Higher oil prices? No reason not to keep buying more of everything else too … The only rebalancing I see is in the set of folks financing the US… In 2005, by my calculations (which have a higher total for official financing than the formal data, as I think the formal data understates official inflows significantly), private investors provided about 1/2 the net financing the US
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needed, and central banks the other 1/2. Each chipped in about $400b.”

(www.rgemonitor.com)

Today, the US trade deficit came in at a surprisingly “low” $62 billion in March, the smallest deficit in seven months. It was a 5.5% improvement from February’s $65.6 billion deficit, which in turn had fallen from the all-time high of $68.6 billion set in January.

That is still around $750 billion. That means that to finance that debt foreign sources must come up with that amount. Since the bulk of that source is foreign central banks, that means they are going to want to buy bonds.

But their demand for US bonds is growing faster than the growth in the supply, even given the massive debt the Bush administration with Republican congressional collusion is allowing to accumulate. Thus, we arrive at the downward pressure on interest rates and Greenspan’s conundrum.

When the Music Stops

Now, we can probably add GNMA bonds into the mix that foreign central banks are willing to buy, although they have somewhat more risk. But the point is that there is a finite supply of bonds that foreign central banks want to buy. And while that supply of mortgage bonds was growing rapidly during the housing boom, that is not the case today. Kevin Harrington, the head of research for Clarium Capital Management, writes [emphasis mine]:

“All housing data that could be considered leading already foreshadow a marked decline. Pending home sales, new home sales volumes and prices, and inventories of unsold homes all show marked weakness. Even if forecasts of sideways price action prove correct, such forecasts say nothing about the volume of transactions that will occur at such prices. A sharp decline in transaction volume results in a prepayment speed shock and an enormous decline in the net supply of MBS and Agency issuances. That reduction will have profound effects on the bond market, even if house price declines are mild. A linear regression analysis on the Mortgage Bankers Association purchase applications data vs. the Federal Reserve Flow of Funds series on net mortgage debt creation suggest that Q1 2006 net mortgage debt creation is running below $850 billion per year, as opposed to the $1.15 trillion net creation rate of 2H 2005. Even if the decline becomes no more severe than this (and there are many reasons to think it will), such a shift approaches a loss of net mortgage supply to the banking system and bond markets roughly equal to the size of the US annual federal deficit.”

This is confirmed anecdotally by the note this week that “… Ameriquest, one of the nation’s leading mortgage lenders, closed 229 branches and laid off 3800 employees. Households are paying more in mortgage interest than they have for the last quarter century – 15.8%. It appears that they have reached a limit. Mortgage applications are declining. Unsold inventories of houses are increasing. The bubble in America’s property
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market is over. At last, it looks as if prices are becoming a barrier to buyers.”
www.dailyreckoning.com

Thus, we see the limits. Mortgage debt is slowing. I actually think the US
government deficits will go down over time. So, the rise in the total supply of bonds
available for foreign investment will soon be lower than the demand. Of course, we do
have a ready supply already on hand. Admittedly, it is in the high trillions of dollars and
can allow the game to go on for quite some time, but unless foreign central banks decide
they want something besides US bonds, which is doubtful, the music must stop when
they have bought all our bonds (to make a rather absurd point). But the reality is that US
citizens and agencies and retirees also want some of those bonds. So then the music stops
long before foreign central banks buy all our bonds.

The question is “How long?” and the answer is that no one knows. While the G7
and the IMF call for a “rebalancing,” which is code for allowing the dollar to drop, Japan
has rejected that call, as have other Asian countries. The dollar is falling, and will
continue to do so over time, but it is going to be slower and controlled.

No one has an interest in seeing the US dollar become too weak too fast, least of
all the Asian countries which need our consumption patterns to hold until they can
develop their own consumer markets.

The Surprising Rise of US Savings

But foreign central banks will soon have help, and from a surprising source – one
they will not be all that happy about. I think the US consumer is going to start saving
again before the end of the year. It will admittedly be a slow start, but I think it is
inevitable.

Why have net US savings dropped to almost zero? Because stock market and
housing wealth has risen so much. Consumers feel comfortable spending as long as their
total net worth is rising. Retirees, who are by definition net spenders, feel comfortable
spending even more if their net worth is rising.

When will the US stock market take a break? No one knows the exact date, but it
is difficult to believe the stock market will keep growing at the levels it has in the past
few years, for reasons I documented last week. The housing market seems poised to slow
down. The “wealth effect” from those markets is going to go away and the US consumer
is going to revert to a more traditional savings pattern. Count on it.

I can hear the scoffing from the audience. You can go ahead and mock me now,
but I suggest holding off for a few years. When I suggested that the Canadian dollar
would go to parity four years ago, I remember the laughs, and many of them from
Canadians. I mentioned that to a group of very large bond traders this week at Casgrain &
Compagnie in Montreal. (Casgrain is the largest private bond house in Canada, and Pierre
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Casgrain is the consummate host.) I not only got no laughs when I predicted parity, I also got the comment that it will get even stronger.

So, back to the original question. Trade deficits do matter. There is a limit to how far the deficit can go, and that limit is less than the total of US government-backed bonds. Before that point, either central banks will start buying other assets (US stocks and corporate bonds), which is unlikely in my opinion, or the dollar will have dropped enough to lower the trade deficit. I think the latter is the far more likely outcome.

A lower dollar will (hopefully) happen gradually over time. A higher US savings rate will happen gradually. Foreign consumer spending will happen gradually. The whole period will be one of Muddle Through. But Anatole and GaveKal do have one major point: large trade deficits can go on for a lot longer than classical economists think.

Let’s end with a provocative quote from one of the smartest economists in America, Martin Feldstein, writing in the May, 2006 edition of *Foreign Affairs*. After noting that a rise in US consumer savings would have negative effects upon foreign countries who need the US consumer to continue his profligate ways, he writes:

“The coming rise in the U.S. savings rate could temporarily cause a serious problem for the U.S. economy as well. As consumer spending falls, GDP and employment will also decline. This decline will last until net exports increase by an equal amount. If markets function well, the higher savings rate will quickly put downward pressure on real interest rates, causing the dollar to become more competitive [i.e., fall – JFM] – until the rise in exports and the decline in imports return total GDP to its full employment level. However, there is the danger of a time lag between when the savings rate rises and when the U.S. trade deficit declines. Such a lag would cause a slowdown in the growth of output and employment, potentially leading to a recession.

“This downturn would be exacerbated if foreign governments restricted imports from the United States or prevented the natural adjustment of the dollar exchange rate. The political response in the United States could easily be the imposition of protectionist policies, including tariffs and quotas in imports.

“Foreign governments would thus do well to anticipate the coming rise in the U.S. savings rate. By permitting more exchange rate adjustment, foreign governments could mitigate the adverse cyclical effects in the United States of a higher U.S. savings rate. Because it takes time for trade flows to respond to exchange rate adjustments, it would be best to allow exchange rates to adjust before the U.S savings rate rises. Equally important, the United States’ trading partners must find ways to increase their domestic demand in order to maintain their output and employment even as exports to the United States decline. A failure to achieve both types of adjustments could lead to a wave of protectionist policies that would be in nobody’s interest.”

*La Jolla, Mavericks, and Mother’s Day*
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This week was tiring but very stimulating. My heartfelt appreciation to Tony Boeckh for inviting me to speak at his Club X conference. He was a wonderful host and a true gentleman. It was one of the more thought-provoking conferences I have ever been to.

It is Mother’s Day this Sunday, and I am still lucky enough to have my Mother with me. She is 88, bionic (two new knees and two hip replacements) and as sharp as ever. My siblings have arranged for a picnic at our local Fort Worth Arboretum, which is lovely at this time of year. I am looking forward to it.

I leave Wednesday for La Jolla and my annual Strategic Investment Conference co-hosted by Altegris Investments. All my international partners are coming in as well. We will have Martin Barnes, Richard Russell, Louis-Vincent Gave (who will take me to task for this week’s letter, I am sure), and Art Laffer, as well as a number of hedge fund managers. It will be great to see old friends and make new ones. As an aside, how many money managers do you know who invite their clients and prospective clients to spend two days together?

If you would like to find out more about the world of alternative investments from my point of view, and you are an accredited investor (basically $1,000,000 or more of net worth) I invite you to go to www.accreditedinvestor.ws and sign up to get more information. (In this regard, I am president of and a registered representative of Millennium Wave Securities, LLC, member NASD. Please see the risk disclosures at the end of the letter.)

Tomorrow night is the third game of the second-round play-offs between the Dallas Mavericks and the San Antonio Spurs. Evidently, we found some kind of magic last game and crushed the world champion Spurs to gain home court advantage. We will see if it can continue. I love the intensity of the crowd during the later play-off rounds. There is just so much energy. I have my front-row tickets and will be there for the tip-off. I just hope we can get into the Finals for the first time. We will see.

Have a great week. Here’s a tip of the hat to Mothers everywhere.

Your hoping to see an NBA Finals in Dallas analyst,

John Mauldin

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