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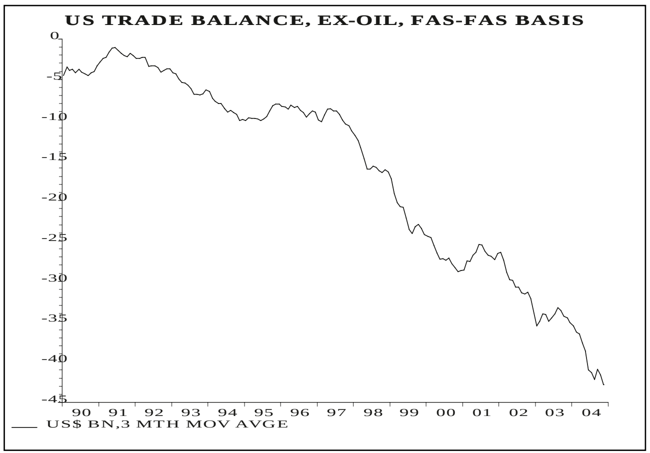
STOCK MARKET WOBBLES AND TRADE DEFICITS

Stock markets have been under pressure so far this year, and November's record trade shortfall shows just how far the US$ may have to fall in 2005 to procure even a modest improvement in the deficit. That raises the spectre of a further acceleration in goods inflation, forcing the Fed to continue pushing rates up. Import prices outside of oil rose again in December, and with China's economy showing few signs of slowing, the risks to raw material costs remain on the upside. But stock markets are also suffering from a significant slowdown in corporate profits. The easy gains procured during the early stages of the economic recovery could prove difficult to replicate this year. Double-digit growth in earnings may only be possible if companies intensify their cost cutting, implying real disposable incomes are unlikely to accelerate. And with short rates climbing and credit growth turning down, it is not difficult to see why consumer spending might slow later this year. This in turn could put equity markets under further pressure, since valuations remain well out of line with most underlying measures of profitability. Total stock market capitalisation has risen 288.9% since the bull market began in earnest in January 1995, compared with a more modest 70.0% rise in the national account measure of pre-tax profits. All this suggests longer-dated Treasuries will continue to outperform, with 10-year yields falling over the course of this year and eventually testing the lows of 2003.



New Year, New Hopes

Hopes were high at the turn of the Year that the three-year downtrend in the US$ would finally start to narrow the US trade deficit. The sense of optimism did not last long. The November trade report was poor in nearly every respect. An 'unexpected' jump in the oil deficit to US$17.8bn did not help. But the ex-oil numbers hit a record high too, climbing to US$45.1bn. After showing tentative signs of stabilising over the late summer, the underlying trend is deteriorating again (see chart). None of this should come as a surprise. The modest levelling out in the ex-oil deficit had reflected a slowdown in US consumer demand, itself a response to the rise in long-term rates witnessed earlier in the year. Since then spending has rebounded swiftly. Given the time lags involved, there is every reason to believe the trade numbers can only get worse over the coming months. President Bush is promising to tighten up on some areas of public spending in the next budget settlement. However, it is not just a yawning federal deficit that has spawned record trade numbers. The persistent drop in the personal sector savings ratio has also played its part in driving the external deficit up.

The most troubling aspect of the trade report was the drop in exports. A fall of 3.8% m/m means that the volume numbers have contracted by 1.9% over the past six months. This data can be quite volatile and in mitigation, it should be stressed the ISM survey suggests export demand is picking up. Indeed, looking at the volume numbers over the last three months paints a rather different perspective. Despite the November fall, the 3m/3m annualised rate was a very respectable 11.5%. Similarly, the import numbers look quite favourable, with volumes actually slowing to 0.8% on a comparable basis. But the ex-oil numbers show that the differential is much smaller, with exports up 7.2% and imports climbing 6.6% on the corresponding basis. All this merely underlines the difficulty of securing even a modest reduction in the deficit during 2005. While the volume numbers may have 'improved', the deficit has carried on deteriorating, since the level of imports remains so much higher than exports. A sustained reversal in the deficit is going to require a far bigger fall in real imports relative to real exports.

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Looking at the breakdown of the trade numbers suggests there are plenty of reasons why that is not going to happen. The continuing loss of market share by domestic auto manufacturers highlights some of the structural competitive issues behind the poor trade numbers of recent years. The deficit in autos reached a record US$139.9bn during the year to November. But the US is now also a net importer in areas where habitually it has tended to run a surplus, including captial goods and food. The deficit on "computers and peripherals" is rising too. In addition, the shortfall on consumer goods has hit a record US$266.6bn in the past year. That is not entirely surprising, given the extraordinary rise in the imbalance with China, which hit another all-time high in November. In seasonally adjusted terms, the bi-lateral deficit rose to US$16.0bn, well above the previous record of US$14.5bn set in June. Geographically, there were few regions where the deficit is showing any sign of stabilising. The deterioration was widespread across all regions.

The recent numbers certainly validate the Fed's worst fears of a significant rise in the current account shortfall during 2005. Even if the goods and services deficit fell back to October's level of US$56.0bn next month, the current account could easily have topped 6.2% of GDP in Q4 last year. But the Fed's concern was predicated on the risk posed by rising short-term rates, which could significantly impair the net investment income balance. An estimated 58.9% of external debt held by the US has a maturity of five years and less, while 28.6% has a maturity of two years and below (see commentary of December 1st). Only 18.7% of the debt has a maturity of ten years or more. Furthermore, doubts over the treatment of net retained earnings suggest that the true current account deficit could easily be 1.4% of GDP higher than that suggested by the headline figures.

The high dependency on short-term financing constitutes a policy dilemma. The current account is deteriorating anyway, pushing the US$ down and sending import costs significantly higher. The obvious response is to tighten more aggressively, and yet, this threatens to push the deficit up even further in the short term at least. There is no easy way out. The numbers will get a whole lot worse before the current account even stabilises, let alone falls to sustainable levels. In the meantime, the risk of a further spike in import prices, pushing goods inflation higher, remains significant. The danger is compounded by China's unwillingness to contemplate any currency revaluation. The record one-day cash drain from the banking system last week is a clear statement of intent by the authorities in Beijing: the peg is here to stay. China's boom will roll on, possibly pushing raw material prices higher and certainly putting the US$ under downward pressure against the floaters, notably the yen and the euro, but increasingly against other Asian currencies too.

Interestingly, last week's inflation data was not all 'bad' since the core PPI was only up 0.1% m/m. In a sense, this underlines the dangers of extrapolating the acceleration in pipeline pressures too far. The jump in crude material (notwithstanding last month's drop), intermediate and import prices all look worrying at face value. But the pick-up in inflation is largely an external shock, and not a reflection of domestically generated price pressures *per se*. With airline fares starting to fall again, for example, this week’s CPI report may show that core service sector inflation remained close to the recent lows in December. Nevertheless, any attempt to tighten will run the risk of a sharper than anticipated downturn in the second half of this year, especially as the labour market data continues to disappoint. Against this backdrop, it is not difficult to see why the stock market has made a poor start to the year.