

Market Commentary

Worry du jour

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The state of the U.S. economy is reflected in thousands of different economic statistics, most of which are continually changing. However investors have a tendency to over simplify things and thus become fixated on one or two at a time. Recently two numbers, which are in many ways interrelated, have captured the attention of investors: the relative value of the U.S. dollar to the Euro and the price of oil.

It is important in looking at these issues to understand a few basic facts about subjects which can be quite arcane, and are frequently the source of inflammatory statements by market strategists whose track records are mixed at best.

The decline of the dollar relative to other nations' currencies can be attributed to a number of factors including the unattractiveness of US investments and bonds to foreigners and the trade deficit. Without making political judgements, most economists agree that the low savings rate and the budget deficit caused by increased defense spending, tax cuts, and rapidly escalating entitlement costs (primarily Medicare) do not encourage others to invest in the US. Budget deficits are assumed to be inflationary because the government figuratively prints more money to pay for the deficits (actually in the form of issuing more Treasury debt).

The trade deficit is the imbalance between what the U.S. spends on foreign goods including oil (imports) and the amount those outside spend on our goods (exports). There are numerous causes of the trade deficit. Perhaps the major factor is the strength of the U.S. economy relative to those of many of our trading partners (our economy is stronger – not a bad thing- and thus we consume more of their goods). Another is that Americans save less than other countries. Additionally several Asian countries (most notably China) have tied the value of their currencies to the U.S. dollar, resulting in their currencies being overvalued which makes their exports cheaper and more attractive to Americans.

The price of oil is not just related to factors of supply and demand. It is also related to geopolitical factors and fear. Much of the world's oil reserves are located in the most politically volatile and unstable areas (the Middle East, Venezuela, and Russia). Thus when there is unrest in those areas it produces fears that oil exports will be reduced or shut down entirely and this causes the price to rise further.

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However those fears have a tendency to be transitory as we saw during the last quarter when oil fell from the mid-50's per barrel to the mid-40's in very short order.

Why does the dollar decline in value as a result of the deficits? The primary economic reason is concern about inflation and economic imbalances caused by the trade and budget deficits and higher oil prices.

Should this be of concern to investors? Maybe yes and maybe no. As long as dollars accumulated as a result of trade surpluses are recycled into purchases of U.S. stocks and Treasury securities (which finance the budget deficit), it becomes a zero sum game. The dollars go out and the dollars come back in. There is only a problem if foreign investors with U.S. dollars decide to stop investing in the U.S. stock market because of concerns about currency losses on their investments. The demand for stocks will fall and thus perhaps their prices. If they have similar concerns about currency losses on their investments in U.S. Treasury securities the demand for those will fall and interest rates will have to rise in order to compensate investors for the weaker dollar. Generally higher interest rates are assumed to be bad for stocks because they make safer fixed income investments more attractive than the uncertain returns from stocks. Thus investors worry that rising oil prices combined with larger trade and budget deficits will eventually cause a decline in the stock market and interest rates to go up, both of which will have additional negative economic consequences.

This is all very theoretical, because, despite the rise in the trade deficit and oil prices and the decline in the dollar, money continues to pour into our securities. In fact the fourth quarter of 2004 (when the dollar fell and oil rose) produced the best performance by the stock market in the entire year and accounts for practically all of the market's gain this year.

The jury is still out on whether this will change. What is clear, however, is that drawing conclusions about either the economy or the investment markets based on one or two isolated numbers viewed over short periods of time can produce very misleading conclusions and ill-advised investment decisions.

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