Mesirow Financial

THEMES on the Economy

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Trading Places

A Closer Look at the U.S. Trade Deficit

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An Equalizer

In theory, the trade balance is supposed to be an equalizer for the economy:

- Narrowing when economic conditions in the U.S. deteriorate; and,
- Widening when economic conditions in the U.S. improve.

There is no steadfast limit to the size of the deficit relative to the overall economy. Historically, however, countries like the U.S. that have consistently run large deficits have paid a high price for their indebtedness, namely a collapse in the value of their currencies, which caused run away inflation and deep recessions. Hence, the worry over the current U.S. trade deficit, which failed to narrow when it should have during the recession of 2001. It is now at a historic high. The gap between U.S. exports and imports widened to $801.7 billion in the third quarter of 2006 and ate up a record-breaking 6% of GDP.

There are signs, however, that the rate of deterioration in the U.S. trade deficit slowed in 2006, with preliminary data suggesting that the trade deficit actually narrowed at the end of the year. Indeed, if current trends hold, the improvement in the trade deficit could add almost a full percent to real GDP growth in the fourth quarter of 2006. The question for the outlook is whether or not those trends can be sustained.

This report takes a closer look at the outlook for the U.S. trade balance, why it is likely to narrow in 2007 and whether that improvement in trade will be enough to silence the cries for more protectionist policies. China has become a particularly large target now that it has surpassed Mexico as our second largest trading partner.

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Not Our Fault?

There are many reasons for the size of the U.S. trade deficit:

- Rising oil prices pushed up the cost of imports faster than we could cut consumption in recent years.
- Until recently, many of our trading partners in both the developed and developing world relied more on external demand (exports to us) than internal demand to drive economic growth. This made foreign economies overly dependent on the U.S. for their economic performance and inhibited their ability to buy our exports.
- The U.S. dollar is a reserve currency, which has put an artificial floor on the extent to which the dollar can depreciate.
- Productivity growth abroad picked up, which slowed the pass through of dollar depreciation into import prices much like it muted inflation in the U.S. Indeed, higher productivity provided an offset on profit margins, which allowed foreign companies to absorb the shock of a weaker dollar without raising prices.

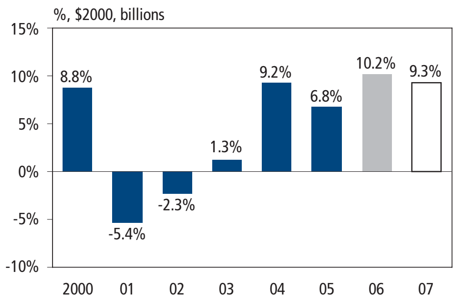
Soft Start Sets Stage for a Stronger Second Half

Real GDP is forecast to rise at a 3.1% rate in the fourth quarter, a full percent ahead of the third quarter. Lower oil prices more than offset the drag created by housing to keep consumer spending afloat. There is some evidence that labor markets also continued to firm and wages accelerated. The data on December payrolls, however, was somewhat distorted (buoyed) by unseasonably warm winter weather. The brightest spot was trade, which improved fairly substantially on the heels of stronger growth abroad and a sharp drop in oil imports.

Prospects for the first quarter are not as good, with consumers no longer getting the extra boost created by lower energy prices and unseasonably warm weather. Economic conditions are expected to improve during the balance of the year, however, as the negatives associated with housing and the restructuring in the auto sector abate, business investment will pick up and the trade deficit will improve. On net, real GDP growth is forecast to slip back into the low 2% range in the first quarter, and then move back above 3% for the balance of the year.

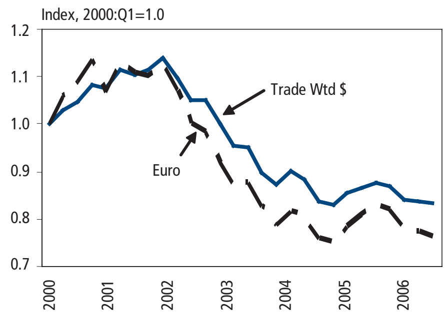
Fed is Pleased with Itself. Vice Chairman Kohn all but declared victory in the Fed's battle to slow the economy and temper inflation this week. As any good central banker, however, he was quick to acknowledge Murphy's Law which states that if something can go wrong, it likely will. On net, expect the Fed to remain on hold much of the year and not resume tightening until after the economy reaccelerates late in 2007.

Chart 1
Exports Are Picking Up



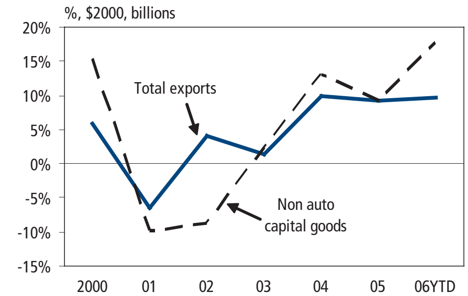
Source: Haver Analytics/Mesirow Financial

Chart 2
Euro Drives Dollar Decline



Source: Federal Reserve Board/Haver Analytics/Mesirow Financial

Chart 3
Capital Goods Drive Export Growth



YTD = Year-to-date average
Source: Haver Analytics

- Many developing and some developed economies deliberately manipulate the value of their currency to limit the impact that shifts in the dollar have on the pricing of goods sent to the U.S. Hence, the continued flow of cheap goods coming in from China.
- For better or worse, the U.S. has the highest propensity to consume of any country in the world, which makes us a natural debtor nation as our largess allows us to systemically import more than we export.

Exports Pick Up

Chart 1 shows the recent pick up in export growth. Everything from the building of infrastructure in the developing world to the need to repair and rebuild the neglected infrastructure of the likes of Japan and Germany is working in our favor.

Add to that the persistent depreciation of the dollar, particularly against the euro in recent years, and it is little surprise that non-auto capital goods are driving the rise in exports. (*See Charts 2 and 3.*)

China has also begun to show signs of coming into its own as an export partner, edging out the United Kingdom as our fourth largest export buyer in recent years. Capital goods dominate exports to China. There are signs, however, that Chinese consumers are maturing. Vehicle sales surged in China last year, with every producer from GM to Rolls Royce (yes, Rolls Royce) trying to cash in on the gains. Why is this important? GM sold more vehicles abroad than at home for the second year running in 2006, which means that its future will be more dependent in how it succeeds abroad than at home.

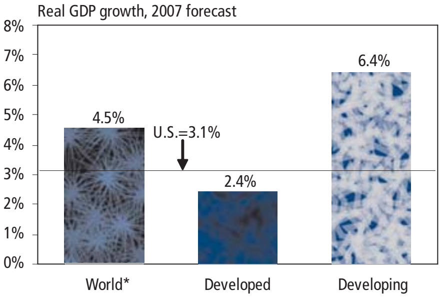
Prospects are good that those trends will continue in 2007. World growth is expected to remain significantly stronger than growth in the U.S., with growth in the developing world continuing to grow at several multiples of that in the developed or "industrialized" economies (*see chart 4*):

- Canada, our largest trading partner, is probably one of our weakest markets because of the role that the Detroit-based auto makers play in cross-border trade. The only good news is that downsizing in the auto industry is occurring on both sides of the border, which means that much of the loss we are likely to experience in exports will be at least partially offset by a slowdown in imports.
- Western Europe remains on good footing, despite some tightening of monetary policy and a hike in Germany's value added tax (VAT) at the start of the year.
- Japan is not expected to do as well as it did in 2006, but will keep its head above water in 2007, which is better than it did during much of the 1990s. Indeed, Japan's biggest hurdle is no longer its dependence on government spending and exports. Instead, it must figure out how to increase female participation in the labor force and boost productivity growth of its existing workers to stem the slowdown associated with a rapidly aging (retiring) population.
- Growth across the developing world is expected to remain relatively robust. The Americas are expected to slow somewhat with the recent drop in commodity prices, but remain in the black. Growth in Brazil could actually accelerate in response to easier monetary policy. China and India are expected to moderate slightly. The central bank of China, however, has yet to prove its ability to reign-in run away growth. Bank lending in China accelerated last year despite efforts by the authorities to tighten credit standards.

Add to that the lags on the dollar and the effect that recent dollar moves are likely to have on our competitiveness in Europe, and exports are sure to remain strong in 2007. Work done at Mesirow Financial suggests that it takes almost two years for firms to reprice their contracts and unwind currency hedges, which means that the bulk of the lift to exports from the dollar's recent descent is still ahead of us.

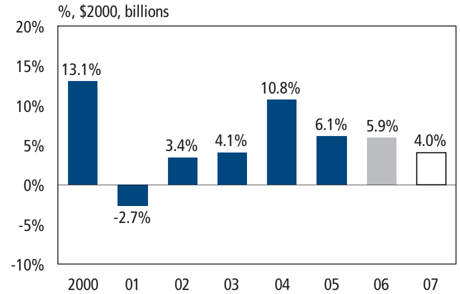
On net, exports are forecast to rise 9.3% in 2007 after nipping above 10% in 2006. Shipments of equipment exports are expected to remain in double-digit territory. Boeing reported a record-winning 1,044 new airplane orders in 2006, which would put it ahead of Europe's Airbus in orders for the first time since 2000. Indeed, the dollar has depreciated so sharply against the euro that many New York retailers were joking that Madison Avenue had become a flea market for Europeans seeking to get designer goods at Wal-Mart prices during the recent holiday shopping season.

Chart 4
World Growth Holds Up



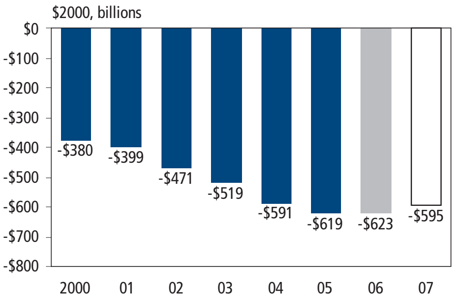
* Weighted for purchasing power parity

Chart 5
Import Growth Moderates



Source: Haver Analytics/Mesirow Financial

Chart 6
The Trade Deficit Narrows



Source: Haver Analytics/Mesirow Financial

Risks. One could argue that many of the risks to export growth have faded over the last year: much of the downsizing in the auto industry has already occurred, which suggests that the impact of the intra-industry trade with Canada should dissipate over the course of the year; the most recent Blue Chip consensus for the Eurozone, which accounts for the lion's share of Western Europe, was revised up; and Chavez appears to have shifted his sights more towards ruining his own economy rather than those of his neighbors in Latin America with a move to nationalize Venezuela's telecom and electricity industries and remove the independence of its central bank. Separately, developing nations, most notably China, are likely to perform better than currently forecast in 2007.

Imports Slow

Chart 5 shows how import growth has tailed off in recent years. A slowdown in intra-industry trade between the U.S and Canada is at least one of the culprits. Unusually warm winter weather and a drop in oil price is another reason. Oil imports in both October and November receded fairly dramatically from the highs we saw last summer.

However, the primary reason for slowed imports is a slowdown in domestic demand. Imports slowed as spending in the U.S. slowed. The slowdown in the housing-based spending was particularly pronounced, which meant a fairly substantial slowdown in imports of high-end appliances. Autos and parts also took a hit as the Detroit-based automakers curtailed their production.

Those trends are expected to continue in 2007 as growth in the U.S. slows relative to 2006 and our trading partners continue to rely more upon internal than external demand to keep their factories humming.

Imports from Europe are expected to be particularly slow given the persistence and magnitude of the movement in the dollar relative to the euro. So far, however, the pass through of dollar-based shifts to prices in the U.S. has been remarkably limited.

On net, imports are expected to rise a meager 4.2% in 2007, more than 2% behind the already slowing pace of 2006. Imports of big-ticket consumer durables are expected to be particularly weak given the slowdown we have seen in both housing and autos.

Risks. China's inability (unwillingness) to let its currency measurably appreciate in the months to come could keep the price of imports artificially low. This would not only keep the flow of imports into the U.S. artificially high, but would also further fuel the rage of protectionists who have already picked China as their favorite target.

The worst case scenario would be the resurrection of tariffs against China, which would not only stem the flow of imports, but also work to destabilize growth in the developing economies as it cuts off a burgeoning source of export growth. Japan has grown particularly dependent on China to fuel export growth in recent years.

Separately, additional declines in the price of oil could stimulate consumer spending in the U.S., which would offset the drag that falling oil prices are currently having on imports.

The Bottom Line

On net, the trade deficit is forecast to narrow for the first time since 1995 in 2007, and will finally play the role that it was intended to play—keeping our factories humming even as consumer spending moderates. (*See Chart 6.*)

However, the question remains whether those improvements will be enough to temper the rise in both isolationist and protectionist sentiment. At least some of the Democrats elected during mid-term elections used anti-trade rhetoric to gain an edge over their Republican counterparts.

The good news is that political gridlock will likely dominate the next two years, which should stop lawmakers in Washington from passing more protectionist policies. Indeed, it appears that both parties have more to gain by delaying major changes in legislation and instead saving the tough issues to shape 2008 party platforms.

A greater threat is perhaps China's own inability to stem growth and overheat. The multinationals of the developed world are at the greatest risk of a subsequent correction in China's economy, as they have placed the biggest bets on growth in China's burgeoning middle class. The bulk of that risk, however, probably lies in the outlook for 2008 and beyond.

Mesirow Financial Economic Forecast (Numbers as of January 10, 2007)

	2006	2007	2008	2006:3	2006:4	2007:1	2007:2	2007:3	2007:4	2008:1
National Outlook										
Chain-Weighted GDP	3.4	2.8	3.0	2.0	3.1	2.4	3.5	3.4	3.1	3.2
Personal Consumption	3.2	3.4	3.0	2.8	4.4	3.2	3.3	3.2	3.0	3.1
Business Fixed Investment	7.5	6.1	5.4	10.0	1.1	7.9	6.5	6.5	5.9	5.4
Residential Investment	-4.4	-13.2	0	-18.7	-21.4	-16.5	-7.3	-2.6	0.5	0.9
Inventory Investment (billion $)	46	39	49	55	33	33	36.2	39	48	50
Net Exports (billion $)	-622.5	-595.2	-584.4	-628.8	-600.5	-604.5	-593.6	-587.5	-595.2	-591.0
Exports	10.2	9.3	8.3	9.4	5.1	11.7	11.6	9.5	8.4	8.1
Imports	5.9	4.0	5.6	7.1	-3.8	7.9	4.7	4.8	7.9	5.3
Government Expenditures	2.2	2.2	1.2	1.7	5.3	1.7	1.6	1.3	1.7	1.2
Federal	2.3	2.2	-0.2	1.3	10.3	1.0	0.8	0.4	0.1	-0.6
State and Local	2.1	2.2	2.1	1.9	2.5	2.1	2.0	1.8	2.6	2.2
Final Sales	3.1	2.8	3.1	1.9	3.3	2.5	3.4	3.3	2.9	3.2
Inflation										
GDP Deflator	2.9	2.0	2.0	1.9	1.4	2.3	1.7	1.9	1.9	2.3
CPI	3.2	1.4	2.1	2.9	-2.4	1.8	1.6	2.5	2.1	2.0
Special Indicators										
Corporate Profits*	17.4	7.1	4.4	30.6	17.4	4.8	5.7	3.9	7.1	8.0
Disposable Personal Income	2.7	3.7	3.3	4.1	5.7	4.3	3.1	3.2	3.2	3.8
Housing Starts (millions of units)	1.81	1.49	1.47	1.71	1.53	1.51	1.48	1.48	1.48	1.47
Civilian Unemployment Rate	4.6	4.6	4.8	4.7	4.5	4.5	4.6	4.7	4.7	4.7
Employment	1.6	1.0	0.9	1.3	1.3	0.7	0.6	1.2	1.0	1.0
Vehicle Sales (millions of units)										
Automobile Sales	7.8	7.7	7.7	7.7	7.7	7.6	7.6	7.7	7.7	7.8
Domestic	5.3	5.2	5.3	5.3	5.1	5.1	5.2	5.3	5.3	5.4
Imports	2.5	2.4	2.3	2.4	2.5	2.5	2.4	2.4	2.4	2.4
Lt. Trucks	8.8	8.5	8.6	8.7	8.7	8.6	8.5	8.4	8.5	8.5
Domestic	7.4	7.2	7.3	7.4	7.2	7.2	7.1	7.1	7.2	7.2
Imports	1.4	1.4	1.3	1.3	1.5	1.4	1.4	1.3	1.3	1.3
Combined Auto/Lt. Truck	16.6	16.2	16.3	16.4	16.4	16.2	16.1	16.1	16.2	16.3
Heavy Truck Sales	0.6	0.4	0.4	0.5	0.6	0.5	0.4	0.4	0.3	0.4
Total Vehicles	17.1	16.5	16.7	16.9	16.9	16.7	16.5	16.5	16.5	16.7
Interest Rates/Yields										
Federal Funds	5	5 1/4	5 1/2	5 1/4	5 1/4	5 1/4	5 1/4	5 1/4	5 1/4	5 1/2
10-Year Treasury Note	4 3/4	4 7/8	5 1/8	4 7/8	4 5/8	4 5/8	4 7/8	5	5 1/8	5 1/8
Prime Rate	8	8 1/4	8 1/2	8 1/4	8 1/4	8 1/4	8 1/4	8 1/4	8 1/4	8 1/2
Corporate Bond AAA	5 5/8	5 3/4	6 1/8	5 5/8	5 3/8	5 3/8	5 3/4	5 7/8	6	6 1/8
Exchange Rates										
Yen/Dollar	116	117	116	116	118	118	117	117	116	116
Dollar/Euro	1.25	1.29	1.28	1.27	1.29	1.30	1.29	1.28	1.27	1.27

A=Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation.
**Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2004, GDP was $10,756 billion in chain-weighted dollars.*

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