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## Dealing with the Trade Deficit

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by Peter Boyle

Since the early 1980's, the U.S. has steadily purchased more foreign goods and services than it has sold to the rest of the world. Last year, the trade deficit soared to a record \$489.4 billion. As a result, the U.S. has been borrowing record amounts from foreign investors and banks. What's wrong with purchasing inexpensive apparel manufactured in Singapore or consumer electronics imported from China? Doesn't everybody benefit? U.S. consumers certainly do. Offshore production aids corporate America's profit margins as well as the stock market. Inflation is kept in check; so well, in fact, that Federal Reserve Chairman Greenspan is currently as concerned about the risk of deflation as that of inflation. Foreign economies are benefiting from improved growth rates. It may be argued that the only group not benefiting is displaced U.S. workers.

So why are some economists so nervous about this deficit? Our Economics 101 textbooks say that in a completely open world economy, the current trade imbalance corrects itself. As excess dollars accumulate overseas, foreigners sell their surplus, which drives down the price of the dollar. A lower-valued dollar makes American goods cheaper to foreigners and foreign goods more expensive for Americans. Foreigners buy more American goods and Americans buy fewer foreign goods, bringing the trade imbalance back toward equilibrium.

Since we have moved further away from

equilibrium, are our textbooks wrong? Theoretically no, but in practice the theory is too simplistic. Both world demand for dollars and foreign government policies have enlarged the U.S. trade deficit. Demand for the dollar remains extremely high. Despite our recent downturn, the U.S. has been the most consistent engine of world economic growth. Our consumers have been a source of demand for foreign goods, and our currency a welcome investment by foreigners. We continue to be the beneficiaries of low-cost, high-quality goods produced abroad and, in exchange, foreigners obtain better investments than they could at home, especially our highly liquid U.S. government securities that meet their need for safety, long-maturity and yield—a very symbiotic relationship.

The dollar is the world's reserve currency. Oil is denominated in U.S. dollars, so net oil importers will likely hold larger than normal dollar reserves as a hedge against currency movements. While Europe is making progress installing the Euro as a second reserve currency, the U.S. dollar continues to occupy a privileged position.

The second factor influencing our trade deficit is foreign government policies. China, whose deficit with the U.S. is growing faster than any other, artificially "pegs," or locks, its currency to the U.S. dollar. While, theoretically, trade imbalances should be brought back into

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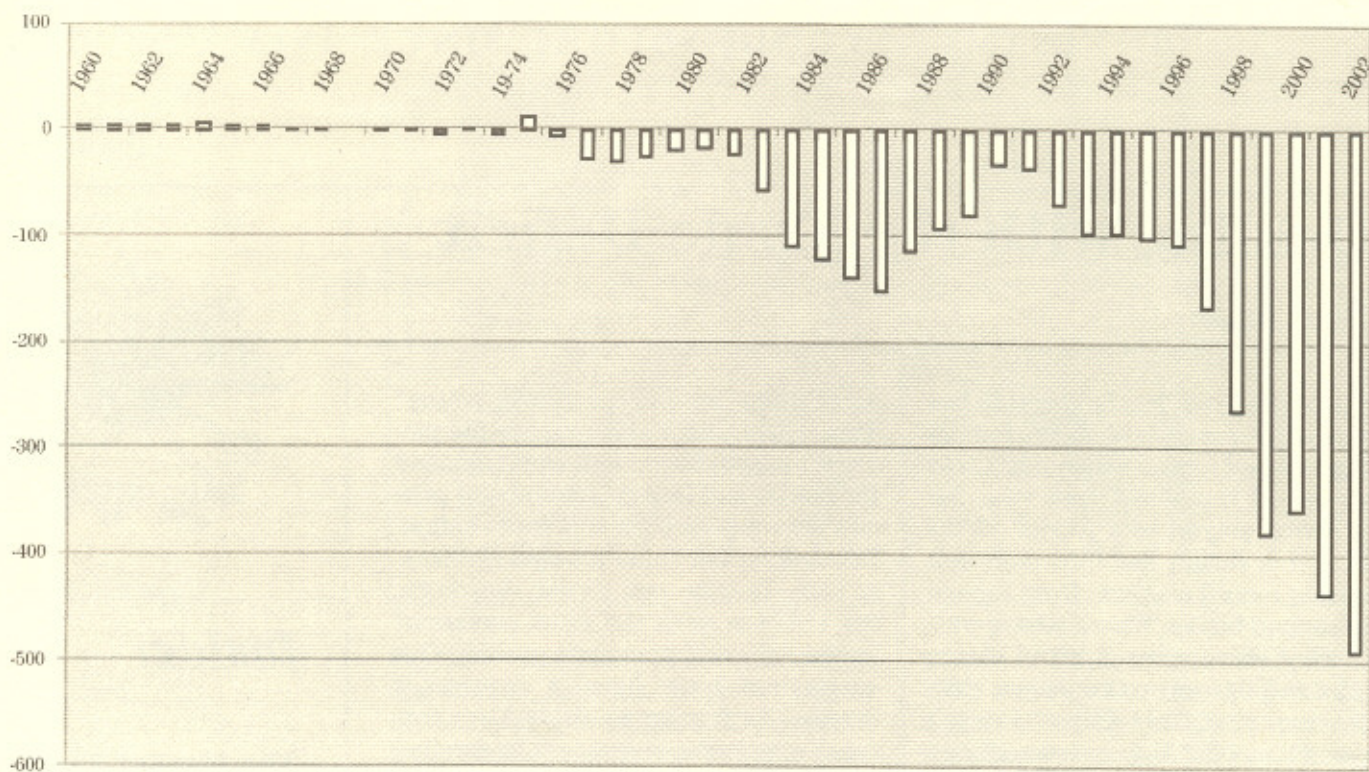
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### U.S. Trade Deficit (1960-2003)



line by the changing prices of currencies, in China this is not allowed to happen. As a result, the trade deficit continues to grow. In contrast, Japan buys U.S. dollars to support its value and maintain the yen's competitive position. Competitiveness is Japan's first priority and profitability is allowed to suffer. It is partly for this reason that prices of Toyotas have not risen despite a 22% rise in value of the yen against the dollar over the last two years (hedging may also be a factor).

Economists are concerned that we cannot maintain this imbalance indefinitely and, more importantly, that some event might abruptly change the status quo. It may be due to erosion in the privileged position of the dollar, or a policy change from one of our trading partners. If either of these occur, the value of the dollar will likely decline further, forcing foreign investors to reconsider their commitment to dollar investments. Domestically, import prices would rise, thereby increasing inflation prospects, which would force the Fed to reconsider its low-interest-rate policy. Not a wonderful scenario for the U.S. economy.

We believe such a scenario unlikely. As is true of most symbiotic relationships, neither party really benefits from rocking the boat. The U.S. needs foreign capital, but our trading partners need our consumers as well. For

now, at least, there is simply no other economy with consumers capable of replacing our collective buying power. Secondly, there is little threat to the dollar's reserve currency position, which ensures a healthy level of demand.

Progress is already being made on the trade deficit itself. This year, many of our top trading partners in Asia will grow at least as fast as or faster than they did in 2003. Unfortunately, our level of import growth will likely surpass any progress made on the export front. U.S. manufacturers witnessed their competitive position erode with a nearly 40% increase in the value of the trade-weighted dollar between 1995 and 2002. In response, they cut costs and ultimately outsourced production overseas in order to survive. Our exporters will be aided significantly by the recent 22% retracement in the dollar's value since its recent highs in 2001, but in manufacturing, change is not immediate. The trade deficit and U.S. jobs will recover slowly.

We cannot be complacent. Instead, we should promote policies that address some of the structural sources of our trade deficit. According to *U.S. News & World Report* (5/26/03), "perhaps the problem isn't too many goods but

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# The Market Shuffle

by David Andrew

As we closed out the first quarter of 2004, most major stock indexes (Dow Jones Industrial Average, Standard & Poor's 500, and Nasdaq Composite) were mixed compared to year-end. While the S & P was up 1.3% in the first quarter, both the Dow and Nasdaq were slightly lower. This marked the first down quarter for those indexes following three consecutive strong up quarters. While no one enjoys seeing stock indexes fall, these events should be expected and are actually quite normal. This is especially true after the significant gains since March of last year.

Frequently, stock prices follow a quarterly pattern of three to four steps forward and one to two steps backward (please refer to chart below). When viewed over a longer period of time however, most stock prices move in a path similar to the company's revenues, earnings and cash flow. It is for this reason that we spend considerable time and effort monitoring the financial results and valuation of our portfolio holdings. We continue to believe that the financial outlook for our companies remains positive.

There are many factors which contribute to this overall positive outlook. We believe the current rate of profit growth will largely be maintained over the course of 2004. The likely continuation of the Federal Reserve Board's low-interest-rate policies (the lowest since 1958), a high level of government spending in a presidential election year and rising real estate values across much of the country (which has a positive influence on consumer spending) all argue for average Gross Domestic Product (GDP) growth of 4% or better throughout the balance of the year. Additionally, the ongoing uneven gains in the job market are likely to keep the Fed from raising interest rates until late this year. The persistence of low interest rates should help maintain high levels of housing demand as well as give the stock market a lift.

Against this overall positive outlook for our companies are several

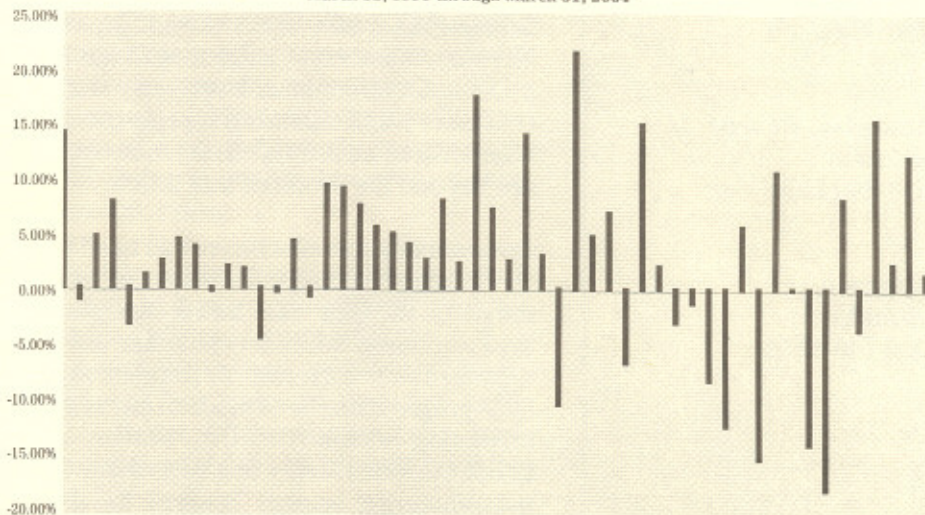
external factors worth watching. Although earnings are forecasted to continue climbing, the year-over-year comparisons will get tougher in the second half this year and in 2005. This could result in some earnings disappointments. Another factor is the high cost of oil, which recently reached \$38 a barrel. We have not seen oil prices this high since 1990. Should the price of oil continue to increase, forcing gasoline prices to reach \$3 a gallon, many companies and consumers would feel the pinch. Also, geopolitical fears and the threat of continued global terrorism are unpredictable and unlikely to subside soon.

All of these concerns caused stock prices to weaken late in the first quarter. Since the market had not experienced a 5% decline in a year, this was probably a natural reaction. As first quarter earnings are released, we expect results to be positive but stock prices to react in a more moderate fashion. Our expectations are for a return to more normal performance this year. In short, we believe the market will continue its usual shuffle for at least the near future.

At press time, the March employment statistics were announced indicating stronger than expected job growth. While it is premature to comment on the sustainability of the numbers, we will keep you abreast of the market impact in future newsletters. ↵

***"While no one enjoys seeing stock indexes fall, these events should be expected and are actually quite normal."***

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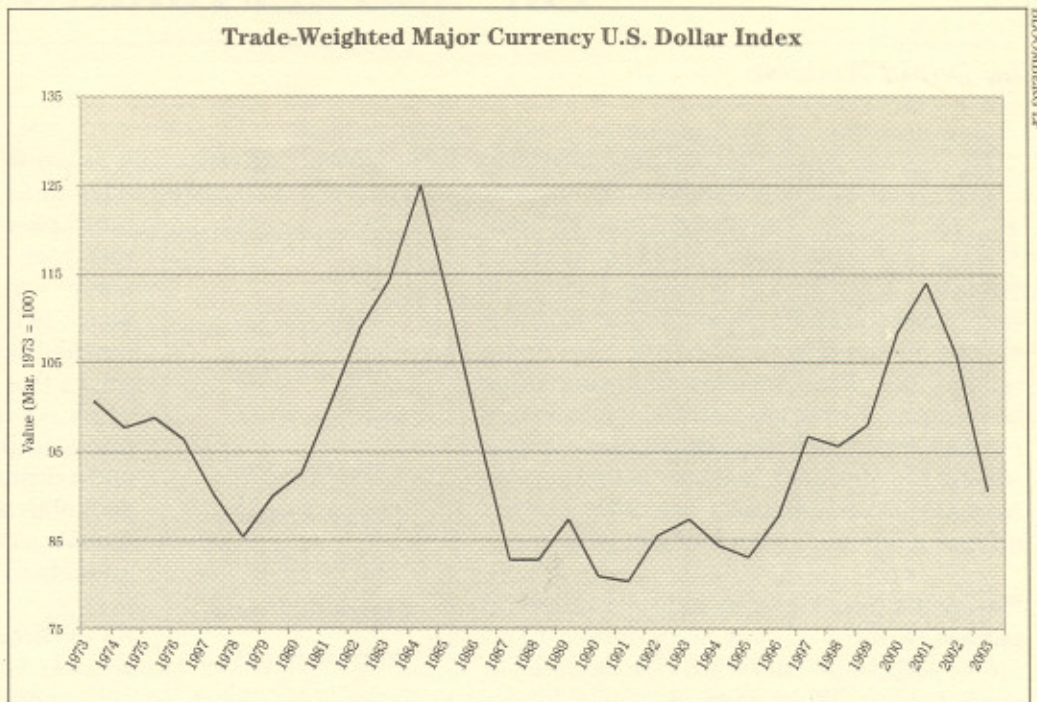
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too few consumers—concentrated in one country, America... Might we not, as the world's buyer of first and last resort, use a little of our muscle to push those who sell to us to raise their wages [creating a consumer base], unpeg their currencies, and develop their home market." We missed a real opportunity when China joined the World Trade Organization. If China would allow the yuan to appreciate even slightly, exports to that country could rise. According to *Business Week* (3/1/04), China's share of U.S. exports is only 4%, but their purchases jumped 28% last year and accounted for 20% of our overall export increase. We acknowledge that China is a Communist command economy with economic faults including a pegged currency. These additional issues, however, are beyond the scope of this article.

Domestically, manufacturers still need to be vigilant regarding innovation and productivity so they can better compete internationally. While so much has been written about increases in productivity, little progress has been made in the manufacturing sector. The U.S. Bureau of Labor Statistics states that half of the 86 manufacturing sectors tracked by the government had annual productivity

growth of 2% or less between 1995 and 2001; one-third less than 1% annually. As noted earlier, the U.S. dollar appreciated significantly between 1995 and 2001, possibly contributing to the under investment in some manufacturing sectors.

What makes little sense at this point is protectionism. Nothing would trigger the rapid decline in the value of the dollar more quickly and unleash the resultant economic damage than a rapid increase in measures to restrict free trade. In the short term, the U.S. economy might benefit from stronger domestic production. Ultimately, inflation and trade retaliation may be the longer term consequences. One has only to look to the 1930's to see the tremendous damage a vicious cycle of protectionism can produce.

So while economists are correctly raising some concerns about our trade deficit, its existence is certainly understandable and should be expected given the historical strength of the U.S. economy. As a longer term priority, our policies should work towards fostering overseas consumption and domestic manufacturing innovation, while resisting increasing calls for protectionism. ↵