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Continued Strong U.S. Trade Performance

*Based on a January 2014
client bulletin.

- **Trade likely a meaningful support for U.S. profits and growth in 2014**
- **Unfortunate flip-side: Emerging market economies are being squeezed, gradually undermining stability**

January's Census international trade release showed that the U.S. merchandise trade balance improved in November to near its narrowest deficit in three years. November trade data reflect a continuation of a strong, multifaceted trend of improvement in U.S. international trade performance. Unlike most of the past three decades, when the U.S. trade gap widened except during recessions, the trade gap has narrowed during the past two years of the current expansion (chart 1). Thus, in contrast to the previous two recoveries when trade was an increasing drag on profits, in the current recovery trade is becoming a decreasing drag, thus providing meaningful support to the profits trend. The narrowing of the U.S. trade deficit is likely to continue in 2014, barring a serious weakening of the global economy. However, continued improvement in U.S. trade is likely to exert further pressure on emerging market (EM) economies, which are

already struggling with weakening growth, overcapacity, worsening current account balances, and consequently pressure on capital inflows and their currencies.

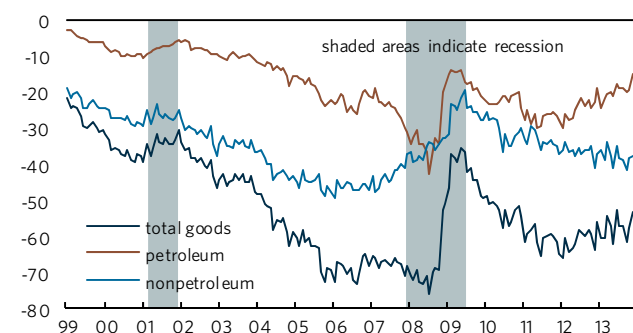
Based on the November release, we estimate that the merchandise trade deficit narrowed to 4% of GDP in the fourth quarter of 2013, continuing a contraction that began in the second quarter of 2012 (chart 2). The contrast with the previous two expansions is stark:

- 1990s expansion: Goods trade deficit widened from 1.1% of GDP in Q2 1991 to 4.6% in Q4 2000
- 2000s expansion: Deficit widened from 3.8% of GDP in Q4 2001 to 6.4% in Q4 2005
- Current expansion: Deficit initially widened from 3.2% in Q2 2009 to 5% in Q2 2011, then stabilized, and has been narrowing since 2012

Thus, changes in the trade deficit have added to profits over the past two years (about a percentage point of GDP), when in past cycles it subtracted from profits.

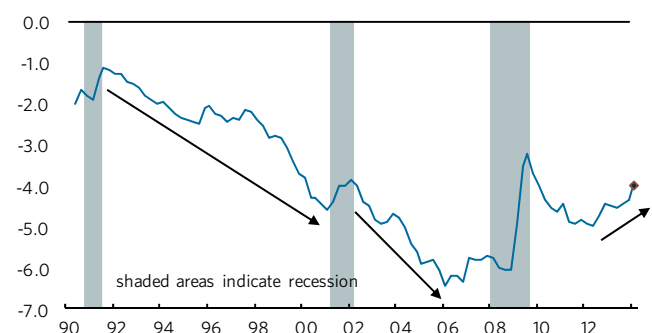
Trade Gap Narrowed Over Past Two Years CHART 1

Census: U.S. Merchandise Trade Balances by Type of Good
\$ billions, seasonally adjusted, monthly rate



Goods Trade Balance On Upward Trend CHART 2

BEA: Goods Trade Balance as % of GDP
seasonally adjusted, Q4 2013 estimated



The improvement in the U.S. trade balance is all the more remarkable given that it has occurred amid a decelerating global economy while the U.S. economy more or less maintained its pace of growth. This positive development in U.S. international trade reflects multiple factors we have written about before, including:

- Increased domestic production of oil and natural gas
- Manufacturers' cost advantages from cheap domestic natural gas relative to global prices
- Growing world appetite for U.S. agricultural products
- A secular shift of manufacturing back to the United States due to the shrinking importance of direct labor costs, greater security for intellectual capital, and proximity to final markets

However, the dark side of the U.S. trade development is that it aggravates emerging markets' troubled economic situation. As we have written, emerging markets excluding China have experienced a dramatic worsening in their trade balances over the past two years, thanks primarily to Europe's burgeoning

trade surplus but also to the shrinking U.S. trade gap. Unless EMs can improve their trade balance and reduce their dependence on foreign capital flows over the next several quarters, they will become increasingly vulnerable to adverse developments in international financial markets, including rising U.S. yields. Yet, EMs have limited scope to improve their trade balance given that 1) the U.S. trade balance is likely to keep narrowing, 2) the European recovery will at best be sluggish and, consequently, its trade surplus is unlikely to narrow substantially, and 3) China is seeking to increase net exports as it deals with domestic economic problems.

Looking ahead, we expect the U.S. trade deficit to continue to narrow as long as *the global economy holds up reasonably well*. Such a development will likely strain EM economies, leaving them ill-equipped to deal with rising U.S. yields, any other adverse international financial shocks, and their own retrenchments in private fixed investment. On the other hand, a stronger U.S. trade balance will help keep U.S. domestic profits solid over the next few quarters.



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