# Partner Talk®

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## Trade

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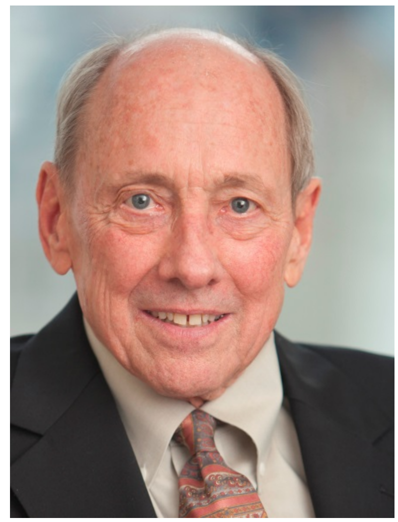

Asset management is equal parts art and science. It's also constantly evolving. Done correctly, managers continually weigh new variables and the latest information. Here at PMA, we keep our eyes on a wide range of data sets as we look to generate solid returns while also living up to the "prudent" part of our name. Recently, we've had our eyes trained very carefully on both US trade and current account numbers and the policies driving them, in part because of inconsistencies in those policies, but more importantly to inform our assessment of risk across portfolios.

Let's begin with what's been in the news: the growing US trade war with China. President Trump has demanded that China reduce its $187 billion trade surplus with the US by $100 billion. The US trade deficit with China is one of the most visible parts of the iceberg composed of all our financial interactions with other countries. Perhaps that is the reason it has captured President Trump's attention.

Of greater interest to economists, however, is the **current account**: the sum of the surpluses and deficits of the goods account (for example, automobiles), the service account (for example, travel and financial services), the income account (foreign income earned by US entities less US income earned by foreigners), and transfers (for example, US foreign aid grants for developing countries and remittances from citizens working abroad).

To cite some numbers for 2017, the US current account with all foreign countries showed a deficit of $466 billion dollars, made up of a goods deficit of $811 billion, a service surplus of $242 billion, an income surplus of $217 billion, and transfer deficit of $115 billion. The goods and service accounts are frequently added together for a combined deficit of $569 billion, termed the trade deficit.

The current account is important as it mirrors the capital transactions of the US with foreigners. A negative current account tells us that the US is on balance borrowing abroad or selling assets to finance its domestic activities. Ask an economist whether a negative current account is good for a country, and that economist is likely to reply: “It depends.” The determining factor is mainly how the country deploys it borrowings.

While all eyes currently seem fixed on China, there are interesting and unprecedented domestic policies that could temper the impact of a decrease in the US trade deficit with China. Even if China were to reduce its trade surplus with the US by $100 billion, the US deficit in its current account for 2018 may well be greater than that of 2017 due to the increases in the government deficit from tax reductions and increased federal expenditures.

To see why this is so, we shall relate the current account to net US savings. Recall that the current account is a measure of what the US borrows and lends to foreign countries as well as the purchase and sale of assets and thus equals net US Savings. Mathematically,

Current Account = Net US Savings = US Total Savings – US Total Investment

This is a mathematical identity and must hold by definition, much like 2 plus 2 equals 4. It is not a theory, such as a reduction in marginal tax rates will pay for themselves through increased domestic income. A theory can be rejected; an identity cannot.

To provide some intuition to this identity, consider a household. The household has income and outlays for consumption. When its income exceeds its outlays for consumption, its net savings, which is the same as the current account in international transactions, is positive, and the household is accumulating assets in its balance sheet, which in international accounting is called the capital account. When a household consumes more than its income, its “current account” is negative and it must borrow or sell assets to finance its “trade deficit.”

Since, unlike a household, there are many players in the US economy, international accounting breaks net savings into US total savings less US total investment.

The recent tax reductions and the increased government spending mandated by the current budget resolution are likely to decrease US total savings, and by substantial amounts. According to the Congressional Budget Office, the government deficit of $665 billion in 2017 will balloon to $804 billion in 2018 and to $981 billion in 2019 and will continue to increase for the foreseeable future.

These big increases in the deficit will decrease government savings, and it is unlikely that the public will increase their savings by a sufficient amount as an offset. If US total investment remains the same or drops just a little, the US net savings, or its mirror image the current account, which now shows a deficit of $466 billion, will balloon along with the increase in the government deficit.

Many have viewed the prospective increase in the deficit as a stimulus to the economy at a time when the economy is doing just fine. Traditional economics calls for stimulus only when the economy is doing poorly -- not well. What is not usually recognized is that this stimulus affects our capital flows from foreign countries.

These atypical policies have us entering uncharted waters. We at PMA will continue to maintain a proper lookout. Know that we are constantly evaluating possible rebalancing of our client portfolios as the seas change and as we venture forth.