

Something to Think About



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This morning, the Bureau of Economic Analysis (BEA) announced its second take on 4th Quarter 2014 economic growth. After previously announcing a 2.6% number, it seems the BEA's best guess this time is it grew at a 2.2% clip. What's 0.4% among friends?

When you break down the data, several things become readily apparent: 1) military expenditures fell through the floor, and; 2) the private sector appears to be in reasonably healthy shape, and; 3) our net export situation is deteriorating.

The last point, perhaps, bears the most attention. Why? Well, our military expenditures are going to start to go up as we get more embroiled in the Middle East. The question isn't whether we will have to ship more troops and equipment to Iraq; the question is: just how much more will we have to ship? As such, I fully anticipated military expenditures won't continue to fall at an annualized 12.4% rate, as it did last quarter.

As for the private sector, personal consumption expenditures grew 4.2%, annualized, and private fixed investment was up 5.1%. Obviously, both of these are solid numbers. So, no problem here.

The trade picture is decidedly less attractive. It seems our exports grew at a 3.2% clip, which isn't too bad. However, our imports surged 10.1%, which is kind of alarming, particularly since crude oil prices fell like a rock at the end of last year. By the time the sun set on 2014, the deterioration in our trade balance shaved 0.23% off the Gross Domestic Product (GDP) equation. This represented roughly a \$70 billion increase in our trade deficit.

How did this happen? Well, through no real fault of our own, the US dollar rallied like nobody's business last year. The DXY index on the Bloomberg, a measure of dollar strength relative to other major trading currencies, ended the year at 90.269. This was a 12.8% increase over 2013, and the highest year-end value since 2005.

The best part? Our currency has continued to rally thus far this year, and the DXY index is at 95.132 as I type here this morning. So what? Well, a strong US dollar makes imports less expensive, and makes US exports more expensive in the foreign markets.

As a result, a strong dollar is great for US consumers, and horrible for US exporters. Therefore, it isn't too surprising to see consumer expenditures surge 4.2% as our trade balance deteriorates. Folks are gobbling up the cheaper, foreign made stuff.

In a perfect world, currency values would be self-correcting. The more dollars we export overseas, the more valuable foreign currencies become here (good old supply & demand). As they appreciate, read go up in price, imports become less attractive for US consumers, and US producers gain an advantage.

This is the reason why export driven economies, like Japan (traditionally) and China, seemingly go out of their way to deflate their currencies: to keep their exports cheap in larger consumer driven economies like the US and the UK. Shoot, it isn't just the Asians, as just about every country in the world will occasionally try to devalue their currency, at least temporarily, in order to give a spark to domestic production.

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Unless the trade deficit shrinks, the combination of the trade deficit and the interest and dividend payments to foreigners will grow ever more rapidly.
Martin Feldstein

Something to Think About Cont.

Look at the US. Our overnight lending target between banks is about as low as you can go (0.25%), and the Fed has created \$3-4 trillion of money, basically, out of thin air. Better put, it has created the potential for \$3-4 trillion in new money. The only thing that remains is for banks to lend it on out.

So, in a nutshell: 1) the US ran an estimated \$540 billion trade deficit in 2014, 2) interest rates in the United States are extremely low, and; 3) the Fed has created close to \$4 trillion in reserves in the banking system. In so many ways, over the last several odd years, we have flooded the world with our currency. We have done everything we can to devalue it save running the printing presses day and night.

...and yet the thing continues to rally, and our trade deficit continues to grow. How now brown cow?

Let me put it this way, the last time the US dollar was this strong, relatively speaking, the overnight lending target was 4.25%; the Fed's balance sheet was about 20% its current size, and the US has imported around \$5.253 trillion more stuff than it has exported since 12/31/2015.

A stronger currency shouldn't be, and wouldn't be but for: 1) we have more guns than everyone else, and; 2) everyone else is more screwed up than we are, or must be.

So, what happens to our trade deficit IF the Federal Reserve starts getting aggressive in tightening monetary policy? Okay...okay...the Fed isn't supposed to worry such things, as it is technically, or at least directly, outside of its dual mandate. But, still; what would happen, particularly since it has started to go back up even with everything the Fed and the US consumer have done to flatten the dollar?

I will tell what: any meaningful interest rate increases from this point will cause the US dollar to rally even more, and the trade deficit will explode from roughly \$540 billion in 2014 to, well, choose your number because the Europeans and the Japanese sure aren't going to fight a stronger US dollar. Heavens, higher US interest rates would be great for their dollar holdings, their exporters, and their companies with a significant US presence. Further, with moderate inflation overseas, at best, they, foreign economies and central banks, can keep their currencies as weak as they want for as long as they want.

Meanwhile, the remaining blue-collar middle class in the United States will get shellacked.

Have you ever seen the Canadian TV show "How It's Made" on the Science or Discovery channels? If you have, you have probably noticed a somewhat common thread in the manufacturing process, particularly for common consumer goods or mass produced anything. Do you know what that is? That is right, the relatively few human producers involved in the actual production process. The worst part? I would be willing to bet a plug nickel most of those factories could be even more automated if there was enough economic incentive.

Shoot, I imagine there are plenty of plants which could be fully robotic/automated on the production and packaging line. In short, the semi to unskilled labor is fungible, at best, and flat out redundant more often than not. So much so, I would imagine there are any number of folks in manufacturing who are barely hanging onto their jobs, and don't even know it.

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Something to Think About Cont.

Consider the numbers: there were 13.243 million production workers in the United States in 1965. This represented a healthy 21.2% of all payroll jobs. In 1985, the numbers were 12.55 million and 12.7% respectively. 20 years later, in 2005, they were 10.11 million and 7.5%. At the end of 2014, sadly enough, there were 8.664 million production workers in the US economy, which made up 6.2% of the payroll workforce.

Since 1965, we have had 9 different Presidents, and any number of changes to monetary policy. We have had economic expansions and contractions. Companies, products, services, and industries have come and gone. In so many ways, the US economy looks incredibly different today than it did 50 years ago. The one constant, if you can call change constant, has been our willingness to adapt to new technologies and imports, which help to make domestic workers obsolete.

Please read the following excerpt from a January 20, 2015 *Wall Street Journal* article by James R. Hagerty:

“After more than a decade of weakness, the dollar began surging in mid-2014 against the euro and many other currencies. That is making U.S.-made products pricier in other countries and imports cheaper in the U.S.—a combination that is likely to expand the already gaping U.S. trade deficit.....

Here in Freeport, on the fringes of the Pittsburgh metro area, Oberg Industries is striving to hang onto its small share of the global economy. The family-owned company, with 750 employees and annual sales of about \$130 million, makes metal parts for a host of products, including oil-production equipment and door locks.

Oberg is moving out of some markets where competition is based mainly on price. For instance, the company recently sold a plant in Mexico where it made doorknobs, competing with Asian manufacturers. Oberg is putting more focus on highly regulated markets, such as parts for medical devices and aircraft. Because quality standards are higher, there is less import competition, said Rich Bartek, Oberg’s chief operating officer.

Oberg recently bought another robot to help sort out parts as they emerge from a stamping machine. It also has invested in new computer-controlled cutting machines that are easier to program and run. One operator can handle four of these machines. “In the old days, it was one operator, one machine,” Mr. Bartek said.”

I admit, this is so much Chicken Little worrywart stuff. Still, you don’t need to do much more than drive through an old mill town to find out what happens when production is moved elsewhere and jobs are lost. The whole societal fabric gets torn, and this becomes incredibly expensive, in so many ways.

Make no bones about it: after peaking in 1978, production jobs in the US have been moving in one direction, down. This downward trend has really picked up steam since the late 1990s, specifically 1997. The Chinese? Perhaps, but, according to the World Bank, in 1997, the value of US manufactures was \$1.349 trillion. In 2012, the number was \$1.967 trillion. That works out to be 45.8% growth. Inflation from 12/31/1997—12/31/2012 was 42.9%.

So, if nothing else, US manufacturing has kept pace with inflation since the late 1990s. However, the production worker workforce has fallen about 33% since 1997. How then is US manufacturing basically flat, when adjusted for inflation, with about one-third fewer workers? China? That doesn’t answer the question, at all. No, the answer would have to be, there is no other explanation, increased use of technology.....just like that last paragraph in the excerpt from the WSJ suggests: “One operator can handle four of these machines. In the old days, it was one operator, one machine.”

Guess what? If the Federal Reserve decides to look at spreadsheets, as opposed to reality, and starts raising interest rates while the rest of the world is cutting theirs (heck, even into negative territory a la Denmark), that number ain’t going to be four machines per worker, it will be five or more.

In the end, the Fed will do what it feels it has to do. However, the global economy and technology have changed how we live our lives and conduct business. So, it would be wise for the Fed governors to go down all possible “rabbit holes” before tightening credit. This just happens to be one of them, but I fear it is a rather large one.

Have a great weekend.