SOME US MONEY FLOWS: RIDING THE WAVES
(c) Leo Haviland, 646-295-8385 August 8, 2013

"Let's go surfin' now
Everybody's learning how". "Surfin' Safari", by The Beach Boys
****

OVERVIEW AND CONCLUSION

Armies of advisors assert the rationality and goodness of owning ("investing" in) allegedly high quality United States arenas, especially over the "long run". These include financial fields such as interest rate instruments and stocks as well as so-called real world assets such as commercial real estate. In recent years, and notably since the advent of the worldwide economic crisis, foreigners have purchased a substantial share of the deluge of United States Treasury debt. Monitoring the net buying and selling tides of foreign participants in UST and other American securities playgrounds offers insight into interest rate, US dollar, and stock marketplace trends. Analysis of overseas direct investment levels and patterns in America, as well as the nation's current account history and prospects, can intertwine with and influence these perspectives.

Statistics from the Treasury Department on foreign buying and selling of US securities presently extend only through May 2013. Yet reduced net foreign acquisition (official and private sources combined) of UST notes and bonds confirms the trend of higher UST rates over the past year (use the 10 year note as a benchmark). Moreover, as overseas UST holders actually have been net UST sellers on average over the first five months of calendar 2013, this warns of higher UST yields on the horizon. Although UST yield trends depend on numerous factors, including federal fiscal trends, the Federal Reserve hints that it will reduce its gigantic UST buying (money printing) in the relatively near future. And doesn't the Fed's two percent long term inflation target and its higher Federal Funds rate forecast for the long run portend higher rates?

In addition, the substantial net foreign buying of US corporate notes during the glorious 2005-2007 Goldilocks Era has dried up. All else equal, this stance toward corporate debt helps to push yields higher in this sector. Foreigners obviously are not the only sailors in the US corporate debt ocean. Yet their paltry net purchases- several years display net selling- of American corporate debt is consistent with the recent decline in their appetite for UST. Consequently, further interest rate increases in both UST and corporate debt probably loom ahead.

The United States has enjoyed a fairly robust economic recovery since around the time of the major low in the S+P 500 around 667 on 3/6/09. Yet despite this, foreign direct investment in America not only has not matched the highs of 2000 and 2008, it shows signs of ebbing, particularly in first quarter 2013 (the most recent data point).

This recent dive in net foreign direct investment is roughly consistent with the slide in net foreign buying of UST notes and bonds and American corporate debt. Looking forward, this combination suggests that higher US interest rates and a weaker US dollar are on the horizon. Does net foreign direct investment data offer warning flags for equity voyages? Recall that highs and subsequent declines in foreign direct investment roughly paralleled pinnacles and falls in the US stock marketplace in first quarter 2000 and October 2007/May 2008. Suppose American interest rates keep climbing, or that the US dollar drops significantly (or both) and that US corporate earnings do not grow much if at all.

Anyway, a survey of net foreign buying that includes not only long term debt but also stocks shows a significant slide over the first five months of calendar 2013 relative to the past several years. Five months obviously is a fairly brief period. Yet this slowing net acquisition, when interpreted alongside the decline in foreign net direct investment, hints that America "in general" is becoming relatively less desirable to foreigners from the economic standpoint than it used to be. Admittedly this conclusion is contrary to much rhetoric flowing through marketplaces and media.

These rather recent US securities and direct investment patterns, because they float alongside the long run bear trend (relatively weak) for the broad real trade-weighted dollar as well as the continued probability of US current account deficits, signal that the trade-weighted dollar generally will remain feeble and probably will decline.

FOREIGN PURCHASES OF UNITED STATES SECURITIES

"Well, dark clouds are rollin' in
Man, I'm standin' out in the rain….
Yeah, flood water keep a rollin'
Man, it's about to drive poor me insane". "Texas Flood", performed by Stevie Ray Vaughan and Double Trouble (L. Davis and J. Scott, songwriters)

****

The following table summarizes US Treasury International Capital System ("TIC" data, 7/16/13; next release 8/15/13) for net foreign purchases (and net sales) of US securities. Lookouts should scan these statistics in regard to future financial marketplace trends.

These securities include three types of debt obligations (UST notes and bonds- though not Treasury bills, long term agency bonds, and corporate bonds) as well as equities. The overseas net total includes and combines official and unofficial accounts. The numbers are monthly averages in billions of dollars (rounded); the minus sign represents net selling. Even if a given overall calendar year displayed net buying, one or more individual months may have had net selling. The 2013 average runs through May, the most recent month in the data series. The "Grand Total" column adds net purchases of equities to the net buying (selling) within the debt securities category (UST, agencies, and corporates).

	Debt Securities			GRAND TOTAL: Debt Securities
	UST notes and bonds	**Agency**	**Corporate**	**Plus Equities**
2005	28.2	18.3	31.0	84.3
2006	16.3	23.9	**42.6**	**95.3**
2007	16.5	18.2	32.8	83.8
2008	26.2	-3.2	7.8	34.6
2009	**44.9**	-.9	-3.4	53.2
2010	**58.6**	9.0	-1.1	**75.7**
2011	36.0	6.7	-3.8	41.1
2012	33.8	11.0	-2.1	51.3
2013	**-.6**	5.7	2.4	**10.3**

****

Survey trends regarding the grand total of debt plus securities column. In the wonderful 2005-07 span of the Goldilocks Era of 2005-07, foreign demand for overall US debt and equity securities soared. The monthly average for calendar 2003 stood around $60.0bb, with 2002 at $45.6bb and 2000 around $38.2bb. However, the total withered sharply from about $95.3bb per month in calendar 2006 to $34.6bb in 2008. Although foreign net purchases of debt and equity combined ascended sharply to 2010's $75.7bb per month, this still did not match the Goldilocks heights. Moreover, average monthly net acquisitions since then have collapsed significantly, reaching a paltry $10.3bb average monthly rate for calendar 2013 through May.

What about 2013's individual months? Since January 2013's net foreign buying of American stocks and bonds of about $48.9bb, demand has shrunk dramatically. February 2012 net overseas purchases were about $12.3bb. In fact, the overseas community emerged as net liquidators in each of the most recent three months of statistics. They were net sellers of .9bb in March 2013, about $9.0bb in April 2013, and a slight net seller ($6mm) in May 2013.

Many observers take significant foreign net acquisition of UST for granted. However, such net buying is not inevitable. Marketplace watchers should stress the monthly average net sales (yes, net sales) of about .6bb in UST notes and bonds in calendar 2013 thus far. Despite talk of progress on the US federal deficit for the near term, that gap remains fairly substantial. In any case, the projected long run deficit looms large. Given the importance in recent years of foreign sources in absorbing the UST inundation resulting from the federal deficit deluge, and given the mediocre (or negative, depending on the section of the yield curve) real returns offered in recent history via UST, this net overseas UST selling underlines the current pressure for US interest rate increases. April 2013 saw substantial net liquidation of UST ($38.3bb). In some calendar 2013 months, there has been notable foreign official UST selling (as in March and April 2013), not just from private sources.

Remark also upon the dramatic tumble in acquisitions of US corporate debt securities by foreigners. From the lofty crest of 2006's net monthly average purchase total of $42.6bb, net acquisitions evaporated. The overseas crew became net sellers from 2009 through 2012. Net buying in 2013 averages a meager $2.4bb per month. The hunt for yield in recent years, despite much Wall Street and media talk, does not look terribly fervent in respect to the foreign dealings in the overall US corporate pond. As this sustained lack of foreign buying over the past several years in this corporate realm now coincides with the recent (particularly 2013) slump in foreign demand for UST, it points to the likelihood of higher US interest rates in general. And so all else equal, to the extent the Fed reduces (tapers) its current quantitative easing scheme for UST, the greater is the likelihood of further US rate hikes. The yield highs in the UST 10 year achieved around 2.75 percent (7/8/13 and 8/2/13) probably will be broken.

****

Perhaps in the past several months there has been less of a rush by foreigners to acquire or hold UST due to a reduction of "flight to quality" concerns. Many observers worry somewhat less these days about an international economic crash. The Eurozone, despite its ongoing troubles, has not broken to bits. However, reduced net buying (or net selling) of UST also may reflect a view that that UST are of lower quality than previously believed, at least when they offer mediocre real yields.

In any event, UST 10 year yields soared from 5/1/13's 1.61 percent interim bottom. Around the end of May 2013, they ranged from about 2.00 to 2.20pc. The low in early June was about 2.00pc, and yields leaped upward from that point, clearly staying above the 2.20pc level. A recent

low is 7/17/13's 2.46pc. This UST yield pattern probably hints at limited net buying or even net selling of UST and other debt securities since end May 2013.

US corporate debt of course is diverse from both the issuer and quality perspectives. Take a snapshot of Moody's Baa grade corporate bonds, all industries (Federal Reserve Board, H.15; the Fed says the Moody's Baa index contains bonds with an average maturity of 30 years and a minimum maturity of 20 years). From lows (monthly average) of 4.59pc in April 2013 and 4.73pc in May 2013, they climbed to 5.19pc in June and 5.32pc in July. The 8/5/13 daily level was 5.37pc. This yield pattern for this corporate sector is consistent with that in UST and likewise indicates that foreigners probably have been net sellers (or at best small net buyers) of American corporate debt.

****

Foreigners were net sellers of US stocks in February 2013 (about $2.0 billion) and May 2013 (about $8.6bb). Although these are not huge sums in the context of the US equity arena, they indicate that foreign ownership interest in holding US assets is not guaranteed. It also suggests that the majority of the buying enthusiasm in calendar 2013 for American stocks derived from Americans (enhanced by American corporate share buyback programs).

****

"Major Foreign Holders of Treasury Securities" data (this also includes Treasury bills; TIC statistics) parallels this viewpoint on the UST foreign ownership trend and the related yield outlook. It shows a drop in total holdings from a recent peak of about $5.72 trillion in March 2013 to $5.68tr in May 2013 (compare these with nominal US GDP in first half 2013 over $16.5tr annualized). Foreign official holdings have remained about unchanged recently. As of May 2013, foreign official holdings of about $4.10 trillion represented about 72.2pc of the grand total, with net little arithmetic change from March 2013's $4.09tr and February 2013's 4.10tr heights. However, private holdings declined about $53.5bb to about $1.58tr from March to May 2013.

****

Of course many intertwining factors influence overall supply/demand for US debt securities and American stocks. These include not only global and American economic growth levels and trends, US (and other) interest rate levels and travels, policies of the Federal Reserve (including quantitative easing) and other central banks, the "free supply" and net new amounts of US securities being offered, and dollar trends.

For example, focus on the US federal deficit size and related potential debt issuance. According to the Congressional Budget Office ("Updated Budget Projections: Fiscal Years 2013 to 2023", Table 1, 5/14/13), the federal fiscal deficit falls from 2012's nearly $1.1 trillion (seven percent of nominal GDP) to $642bb in 2013 (4.0pc of GDP), $560bb in 2014 (3.4pc), and $378bb in 2015 (2.1pc deficit versus nominal GDP). So if new supply of UST declines, net buying by foreigners of UST may diminish somewhat relative to the big federal deficit years. Where are the surpluses? After 2015, the deficit total and as a percentage of GDP gradually increases.

Moreover, despite these relatively sunny near term deficit prospects, the long run deficit problem remains unsolved. And the Fed probably will taper and eventually eliminate its current UST buying program.

Also, will owners of US securities, especially foreigners, be pleased by continued US deficit debates? Will the US government run out of operating money at the beginning of October 2013 (unless legislators approve a stopgap continuing resolution)? In November, the debt ceiling

situation will force Congress to confront the debt ceiling issue. See the NYTimes (8/2/13, pp A1, 12), which headlines “G.O.P. Rifts Lead Congress to Spending Impasse”. The article states: “Congress on Thursday hit a seemingly intractable impasse on government spending, increasing the prospects of a government shutdown in the fall and adding new urgency to fiscal negotiations between the White House and a bloc of Senate Republicans.”

****

Keep in mind US state and local fiscal deficits and watch municipal bond rates. Also, many corporations have pension fund shortfalls.

****

The longer the Fed represses short term (and other) interest rates via its determination to keep the Federal Funds level on the floor, the greater the chance of broad real trade-weighted dollar depreciation.

FOREIGN DIRECT INVESTMENT

Not all buying of American assets is in debt and equity securities. Statistics on foreign direct investment in the United States provides a further viewpoint regarding the attractiveness of America to foreigners. This information comes from the US Bureau of Economic Analysis website (US International Transactions Accounts, Table 1, US International Transactions, line 64; 6/14/13 release).

Over the long run from 1960 to the present, every calendar year manifests net buying. In recent decades, worldwide nominal GDP growth and globalization arguably helped to boost totals from the much lower nominal levels of a few decades ago. The average of FDI/nominal GDP (1960-2012) is about seven-tenths of one pc, with 1992-2012’s average just over 1.3pc.

****

Foreign direct investment (FDI) rose from $367 million and a mere three hundredths of one percent of US nominal GDP in 1971 (the low FDI percentage of the 1960-present period; GDP in 1971 $1.17 trillion) to $58.5 billion in 1987, or about 1.2 percent of $4.9tr GDP. FDI kept flowing in, reaching $68.3bb in 1989 (also 1.2pc GDP). It then melted to about $19.8bb in 1992, or only three-tenths of one pc of GDP.

FDI spouted to a new to its all-time record high to date of $321.3 billion for calendar 2000 ($289.4bb in 1999). The FDI in 2000 likewise achieved its all-time record versus nominal GDP since 1960, reaching 3.12pc of 2000’s nominal GDP around $10.3tr. FDI eroded to $63.8bb in 2003 (2002 was $84.4bb), or just under six-tenths of one pc of GDP. The S+P 500 peaked 3/24/00 at 1553, making its final lows at 769 on 10/10/02 and 789 on 3/12/03.

Net foreign direct investment in America then bubbled up substantially, reaching $243.2bb in 2006 (1.8pc of GDP), $221.2bb in 2007 (1.5pc of GDP), with a tidal wave of $310.1bb in 2008 (2.1pc of GDP). Recall the S+P 500’s major high on 10/11/07 at 1576, with a final top in 2008 at 1440 (5/19/08). AS the global economic crisis accelerated, FDI stumbled down to $150.4bb in 2009, or just over 1.0pc of GDP. The S+P 500 sank, hitting bottom on 3/6/09 at 667.

What has been the recent trend for FDI? FDI streamed in during 2010 and 2011, but at much lower levels than the 2000 and 2008 elevations. It was about $205.9bb in 2010, or almost 1.4pc of

nominal GDP; the $230.2bb in 2011 was just under 1.5pc of GDP. Calendar 2012 FDI tumbled to $166.4bb, or about 1.0pc of GDP over $16.2 trillion.

First quarter 2013 FDI fell further, reaching merely $22.8 billion; or a mere $91.3bb annualized. That FDI total for full year 2013 would be the lowest since 2002 and 2003. Relative to first quarter nominal GDP of about $16.5tr, $91.3bb is only six-tenths of one percent. FDI might accelerate relative to its first quarter 2013 depth. Yet the most recent four quarters of FDI through 1Q13 (2Q12 through 1Q13) total $153.5bb, and this still falls steeply from the 2011 height.

****

Recall that the highs of calendar 2000 and 2008 in foreign direct investment in the United States roughly mirrored the time of US stock marketplace peaks. Similarly, the 2003 bottom in the S+P 500 coincided with the 2003's FDI depth. So did the 2009 FDI total with the 2009 S+P low.

Marketplace history is not marketplace destiny. And the history from 2000 to date represents a relatively brief time for purposes of creating a generalized rule. Moreover, US stocks respond to numerous variables, including the widespread American devotion to investment in them. Foreign money, though important to American stock levels and trends, is not as important as domestic money. In any event, to what extent has this rough parallel between US equities in general and foreign direct investment continued?

This relative close though rough relationship (parallel) between the major highs and lows in US equities from 2000 through 2009 with FDI apparently has not persisted recently. The 2012 FDI total and the 1Q13 annualized amount fall substantially from 2011's height, yet the S+P has skyrocketed to over 1700 (8/2/13 high 1710).

Perhaps foreign direct investment will show significant increases from 1Q13 levels. But perhaps this will not occur, especially given the recent evidence of diminished net overseas purchases of US securities discussed above.

So in the current and future marketplace context, arguably the significant FDI slump since calendar 2011 (assuming no big jump in FDI from the calendar 2012/1Q13 levels) may be a leading indicator of a decline in the S+P 500. In any case, the slowdown in FDI since 2011- and particularly 1Q13's depressed amount (assuming such a mediocre quantity persists)- hints that in a rising US interest rate environment that it will become increasingly difficult for US stocks to make new highs unless further big (net) new waves of US cash venture into those equities.

THE US CURRENT ACCOUNT DEFICIT

The United States has a long-running current account deficit. It probably will continue to have one for quite some time. The International Monetary Fund's "World Economic Outlook" (April 2013, "Statistical Appendix", Table A10; April WEO database), forecasts US current account deficits of around $474bb in 2013 (2012 was $475bb), $517bb in 2014, $559bb in 2015, $620bb in 2016, $682bb in 2017, and $739bb in 2018. As a percent of US nominal GDP, 2012's deficit was 3.0pc. It will be 2.9pc in 2013, 3.0pc in 2014, 3.1pc in 2015, 3.3pc in 2016, 3.4pc in 2017, and 3.5pc in 2018. Compare 2006's deficit of $801 billion, which was a hefty 6.0pc of GDP.

The IMF's Article IV Consultation with the US (7/26/13) updated current account information for several of these years. However, this did not alter the April 2013 WEO much. The US's 2012 deficit was $440bb (somewhat lower than the WEO, and consistent with the Bureau of Economic

Analysis's 6/14/13 release), but 2013's prediction is $476bb (the BEA's 1Q13 total is about $106bb), with 2014's $541bb. As a percentage of nominal GDP, 2012's deficit is 2.8pc, with 2.9pc in 2013, and 3.2pc in 2014. The Article IV outlook provided no data for subsequent years.)

****

The broad real trade-weighted dollar (TWD) remains relatively weak from the historical perspective. July 2013's 85.6 TWD level (monthly average) is about that of June 2012's 86.3. Although these levels manifest a modest dollar rally from July 2011's record depth around 80.5, they lurk far underneath March 2009's 96.9 and February 2002's 112.8. A weak US dollar can be explained in various ways by choosing between and evaluating a diverse assortment of variables.

Suppose America continues to run at least a modest current account deficit, as captains such as the International Monetary Fund forecast it will. Maybe the US will never sail into a crisis related to its sustained current account deficit. But it might. Perhaps America can solve this current account deficit problem by buying less overseas goods and services, or selling more US ones to foreigners. Perhaps to eventually attract sufficient foreign (overseas) money to help reduce or eliminate the current account deficit (run a surplus), America over the long run may have to raise interest rates further, depreciate the dollar, or both.

****

This essay is furnished on an "as is" basis. Leo Haviland does not warrant the accuracy or correctness of this essay or the information contained therein. Leo Haviland makes no warranty, express or implied, as to the use of any information contained in this essay in connection with the trading of equities, interest rates, currencies, or commodities, or for any other use. Leo Haviland makes no express or implied warranties and expressly disclaims all warranties of merchantability or fitness for a particular purpose. In no event shall Leo Haviland be liable for any direct, indirect, special, incidental, or consequential damages (including but not limited to trading losses or lost profits) arising out of or related to the accuracy or correctness of this essay or the information contained therein, whether based on contract, warranty, tort, or any other legal theory.

All content copyright © 2013 Leo Haviland. All Rights Reserved.