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TARGET MAINTAINS ITS STANCE:
THE U.S. ECONOMY IS GOING, NOWHERE !

In the second quarter of this year, ended June 30, 2003, the **U**nited **S**tates (US) dollar depreciated by about 5 percent, on a trade-weighted, quarterly average basis, against other major *'hard'* currencies.

And it continues to lose ground – to the delight of many US industrialists, no doubt, and to the consternation of the central banks of the major trading partners of the US.

For the second-largest economy of the world, the US is the principal marketplace for its goods and services; and, its currency, the Japanese yen, is being stung, especially hard of late, causing exporters of the country to contract Saint Vitus' Dance.

Last Friday, while emergency teams in the US were battling the devastating effects of Hurricane Isabel, the value of the US dollar was falling, rapidly, against the Japanese yen.

The Bank of Japan, the Central Bank of the country, had to step in, in order to try to put a financial finger in the leaking dyke, which saw one US dollar fall to 114.70 yen, at one point.

But even with The Bank of Japan, buying up US dollars on international, foreign-exchange markets, it did little to stem the tide of speculators.

By the close of the day, the US dollar was standing at a 30-month low against the Japanese yen, at about 115.30.

In that one day, last Friday, depending on the time of day, the Japanese yen had appreciated against the US dollar by not less than one percent and not more than 2 percent.

For many Japanese exporters, it meant an erosion of their profit margins, which, in many cases, is very tight, in any event.

The immediate effects of a stronger Japanese yen vis-à-vis the US dollar is to make Japanese-manufactured products and services more expensive to the US consumer.

And US consumers are very cost-conscious, these days, following 2 years of difficult economic times.

According to The **B**ureau of **E**conomic **A**nalysis (BEA) of the US Government, its statistics for the second quarter, ended June 30, 2003, indicated that foreign investment is picking up in the US – very rapidly:

> *'Net recorded financial inflows – net acquisitions by foreign residents of assets in the United States less net acquisitions by US residents of assets abroad – were $*(US)*148.60 billion in the second quarter, up from $*(US)*140.70 billion in the first* (quarter). *Financial inflows for foreign-owned assets in the United States strengthened more than financial outflows for US-owned assets abroad ...'.*

It makes sense for non-US institutions/investors, with cash in their pockets, to pick up US-based assets at a discount to *'yesterday's'* costs due to the depreciation of the US dollar on the world stage.

Regardless of the economics of the US, making a *'turn'* is the only consideration of the speculator, in any part of the world, be he the individual investor or the multinational conglomerate.

It is quite likely that the US dollar will continue to lose ground against the currencies of its major trading partners and, at the same time, further inroads will be made into the US by international investors, who will be picking up what they consider to be cheapies.

The BEA, in giving a snapshot of the US economy, said, last week, among other things:

> *' **Current Account***
>
> *'The US Current Account Deficit – the combined balances on trade in goods and services, income, and net unilateral current transfers – was virtually unchanged at $*(US)*138.70 billion (preliminary) in the second quarter of 2003. An increase in the deficit on goods was offset by increases in the surpluses on income and on services and a decrease in net outflows for unilateral current transfers.*
>
> ***'Goods and Services***
>
> *The deficit on goods and services increased to $*(US)*123.40 billion in the second quarter from $*(US)*121.6 billion in the first (quarter).*
>
> *'**Goods***
>
> *'The deficit on goods increased to* $(US)*138 billion in the second quarter from $*(US)*136 billion in the first* (quarter). *Goods exports increased to $*(US)*174 billion from $*(US)*173.30 billion. Small increases in industrial supplies and materials and in consumer goods were partly offset by a small decrease in capital goods. Goods imports increased to $(*US)*312 billion from $*(US)*309.40 billion. An increase in non-petroleum products more than offset a decrease in petroleum and petroleum products. The increase in non-petroleum products was largely accounted for by increases in capital goods and in automotive vehicles, parts, and engines.*
>
> ***'Services***
>
> *'The surplus on services increased to $*(US)*14.60 billion in the second quarter from $*(US)*14.40 billion in the first* (quarter). *Services receipts were virtually unchanged at $*(US)*74 billion. A decrease in travel was almost entirely offset by increases in all other services categories combined. Services payments decreased to $*(US)*59.40 billion from $*(US)*59.60 billion. Decreases in travel and in passenger fares were mostly offset by increases in all other services categories combined.*
>
> ***'Income***
>
> *'The surplus on income increased to $*(US)*1.70 billion in the second quarter from $*(US)*0.20 billion in the first* (quarter).
>
> ***'Investment income***
>
> *'Income receipts on US-owned assets abroad increased slightly to $*(US)*62.20 billion from $*(US)*62.10 billion. An increase in direct investment receipts more than offset decreases in "other" private receipts (which consists of interest and dividends) and in US Government receipts. Income payments on foreign-owned assets in the United States decreased to $*(US)*59.20 billion from $*(US) *60.50 billion. Decreases in "other" private payments (which consists of interest and*

dividends) and in US Government payments more than offset an increase in direct investment payments …

'***<u>Foreign-Owned Assets in the United States</u>***

'Foreign-owned assets in the United States increased $(US)*255.30 billion in the second quarter, compared with an increase of $(*US)*242 billion in the first* (quarter). *US liabilities to foreigners reported by US banks increased $*(US)*33.20 billion in the second quarter, following an increase of* $(US)*16.70 billion in the first* (quarter). *Net foreign purchases of US securities other than US Treasury securities were* $(US)*86.50 billion in the second quarter, up from $*(US)*55.60 billion in the first* (quarter). *Transactions in US stocks shifted to net foreign purchases of $*(US)*20.60 billion from net foreign sales of $*(US)*2.60 billion. Net foreign purchases of US corporate bonds increased to $*(US)*67.20 billion from $*(US)*60.40 billion, and net foreign sales of Federally sponsored agency bonds decreased to $*(US)*1.30 billion from $*(US)*2.20 billion. Net foreign purchases of US Treasury securities were $*(US)*61.10 billion in the second quarter, up from $*(US)*14.60 billion in the first* (quarter).

'Net financial inflows for foreign direct investment in the United States were $(US)*12.10 billion in the second quarter, down from $*(US)*34.40 billion in the first (quarter). The decrease was more than accounted for by a large decrease in net equity capital inflows. Reinvested earnings also declined. In contrast, inter-company debt shifted to net inflows from net outflows.*

*'Foreign official assets in the United States increased $(*US)*57.60 billion in the second quarter, following an increase of $*(US)*41 billion in the first* (quarter).'

The above speaks for itself: **TARGET** need not comment on its implications.

<u>Inflation</u>

As was stated by the US Federal Reserve Board, last Tuesday (Washington time) '… *the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level. The* (Federal Open Market) *Committee judges that, on balance, the risk of inflation, becoming undesirably low, remains the predominant concern for the foreseeable future…*'.

What The Fed did not state, however, was how it reached that determination.

Dr Alan Greenspan, the Chairman of the US Federal Reserve Board, knows only too well that gains in productivity in the US should keep the damper on inflation.

There is a distinct and inevitable correlation between the rate of inflation and the rate of productivity.

Over the past few years, there has been increased productivity in the US, for one reason or another, thus keeping inflation in check.

But that does not, necessarily, mean that the US economy is out of the woods, as US President George W. Bush would have the world believe.

Disregarding the requirement for producing more bullets, tanks and fighter aircraft to do battle with the enemies of the US, it is clear that US factories are not rehiring, in any great numbers, as was painfully obvious by the number of people, making claims for Initial Unemployment benefits, during the past fortnight. (Please see last Wednesday's TARGET Intelligence Report, Volume V, Number 177)

The growth of US productivity in the second quarter of this Fiscal Year rose from about 5.70 percent to about 6.80 percent, a gain of about 19 percentile points.

It surprised some people – especially the US President, who made political mileage out of the statistics – but there is a reasonable explanation for it.

As **TARGET** has stated, many times in the past, since the year 2000, US factories have been cutting back, both on production and manpower.

They, really, had no choice in the matter.

Today, therefore, the gains that have been made, from the much-lower base to that of pre-2000, look impressive.

Indeed, they are impressive, from a purely relative standpoint, Year-on-Year, Quarter-on-Quarter.

But to the US worker, these statistics means little.

The only people and organisations that can make capital out of such statistics are those people, running for political office, or those organisations that would like to bad-mouth the existing, US Government Administration for their own political gain.

When management is faced with a situation of continual dwindling sales of products, there is an in-built reluctance to pare existing staff levels until the last minute.

Conversely, management is just as reluctant to rehire staff when there is a seeming surge in consumer activity for its products.

That would appear to be the situation, today.

TARGET notes – and it is very surprising to this medium that more people did not pick up on it – that last week's missive from the US Federal Reserve Board stated, inter alia, that there was a great deal of uncertainty about the final half of this year and what it would bring, as far as the US economy was concerned.

The Fed's prognostications were:

> *'…The evidence accumulated over the inter-meeting period confirms that spending is firming, although the labour market has been weakening. Business pricing power and increases in core consumer prices remain muted…*
>
> *'The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal…*
>
> *'In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period …'.*

Interest rates, as far as The Fed sees the situation, cannot be raised from the present, 45-year low, due to prospects that the US Central Bank could well cripple America's golden cow and cause more stagnation in the economy of the world's only superpower.

Another factor, of which insufficient publicity has been given in order for the man-in-the-street to have a better grasp of the present situation, is that inflation in the US, today, stands at a 44-year low.

Any material increase in interest rates in the US, it may well be feared by certain Governors of The Fed, could lead to deflation, which could be disastrous for the economy.

If deflation should become prevalent in the US, then, that means that consumer spending has started to dry up, even more, and, most likely, it would continue to flag.

When deflation sets in, consumers, thinking that tomorrow's prices will be lower than today's, determine to wait … and wait … and wait.

Production stagnates as a natural result.

US manufacturers cannot raise prices because supply far exceeds demand; and, this is coupled with intransigent consumer resistance to making any new major purchases.

It follows that investment in new infrastructure is put on hold – by all.

It follows, also, that more workers are given pink slips – one by one.

In the motor-vehicle industry of the US, in spite of zero-financing packages, introduced a couple of years ago, and in spite of offering numerous other incentives to prospective US consumers, the Big Three – Ford, General Motors and DaimlerChrysler – cannot move stocks, sufficiently.

At the same time, international competition has been cutting into the traditional markets of the Big Three.

The reason for this is due to the better quality of the products of the competition, compared with the (US) home-grown product.

The label, *'Made in America'*, no matter what US President George W. Bush maintains, is not the mark of quality, any more, especially with regard to much of the production of the Big Three.

To many economists, deflation is considered a bigger problem than inflation, the latter-mentioned, containable by applications of the interest-rate weapon, while deflation may only be abated when demand is seen to outstrip supply.

In an economy, caught up in a deflationary spiral, no matter how low may be the interest rate of the day, consumers will not budge, resisting the temptation to make new purchases.

<u>The Family Budget</u>

The so-called US economic recovery will be hamstrung by the lack of wherewithal on the family front.

For many US households, there is, still, that existing debt that must be whittled down.

Until that problem can be tackled, adequately, there will be considerable reluctance to make new financial commitments of any materiality.

There is, also, the matter of the chief bread-winner, keeping her/his job, which is not a guarantee in this day and age.

Household spending, for the most part, will be curtailed, to be sure, with only necessities, being considered at this juncture.

For those families that have been fortunate enough to see a profit from investments in stocks and shares, over the past few months, while memories of 2000 may be short in the heat of the moment for some, to the majority, one is likely to hear the refrain: *'Remember the Alamo!'*

Household wealth is, to a great extent, one of the *'fuels'* of the US economy.

However, according to the statistics, presently available from various organisations of the US Government, household wealth is little changed from where it was a couple of years ago.

Household wealth hit its highest spot in about March 2000, from where it has declined, steadily.

The deterioration in household wealth coincided with the pricking of the US, stock-market bubble.

Holdings in equities by US households declined by about 30 percent in 2001 and by about 50 percent by the third quarter of 2002.

Household wealth is not rising, very quickly, these days, also.

Hence, there is a dire shortage of *'fuel'* to power the US economic recovery.

At an annualised rate, household wealth has appreciated by about one percent per annum since 2000.

If one compares that statistic with the situation, which existed in the recession, which took hold in the final quarter of 1989 and lasted until the final quarter of 1992, one sees that household wealth rose by about 12.70 percent on average, during those 27 months.

The deterioration of household wealth, due to falling prices on equity markets, has extracted a terrible toll on investors in the US; and, it has reduced net household assets, considerably.

One notes that workers are holding onto jobs longer than before: They are not opting to take retirement until their inability to continue in their present positions makes it a requirement to leave the workforce.

Mortgage borrowing has been increasing of late, also, because households need more money as the situation in the family has become more difficult.

Over the past 12 years, mortgage liabilities have increased by about 30 percent, according to the latest statistics, recorded by The Bureau of Economic Analysis.

In fact, since the last quarter of 2000, household liabilities have risen by about 24 percent, on average.

The $US200 that the Bush Administration gifted to many Americans will do little to assist the economy; or, to ameliorate the situation for many households.

Consumer spending will continue to be curtailed because there is insufficient growth in household wealth.

It is as simple as that.

The requirement to attain certain goals – retirement, a home, free of debt, a college education for the children, etc – will mean that households will cut back on the spending habits of the past in order to try to guarantee the goals of the future.

But the future is opaque.

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