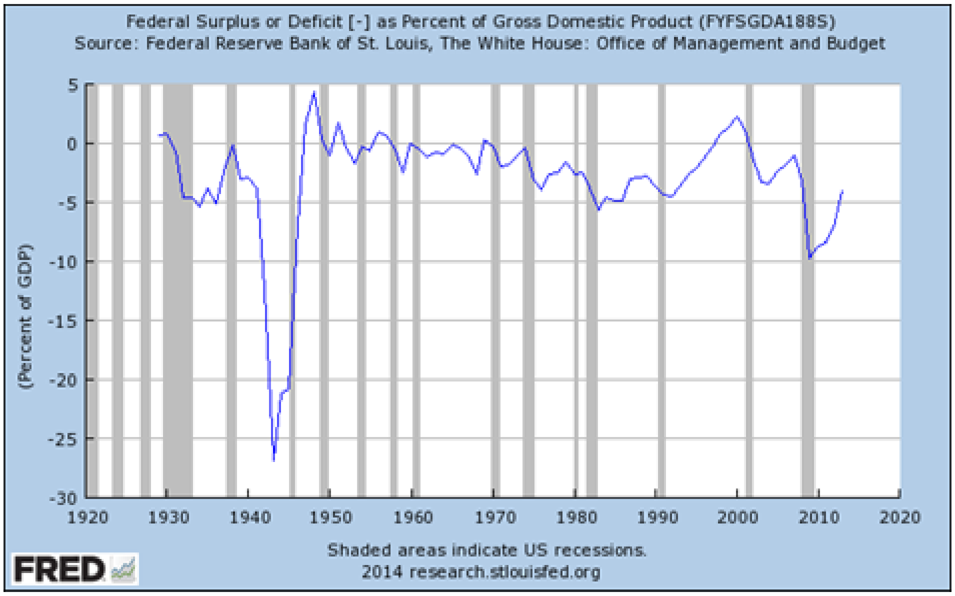
A Glimmer of Hope: Twin Deficits on the Mind

Amidst, and in spite of, the rampant political turmoil over the past few years, a glimmer of hope has appeared in the surprising turnarounds of both the budget and trade deficits of the United States. Affectionately known as the "twin deficits," these measures reflect our country's long-standing propensities to outspend our federal tax revenues and import more than we export to our trading partners. While the drivers behind each deficit are unique in their own right, the improvements in both the budget deficit and trade deficit represent a significant positive departure from their recent trajectories and are worthy of some extra attention. In this month's MAInsights, we will offer our views on the catalysts for these turnarounds, their sustainability, and the implications for investors.

The U.S. Budget Deficit

In the post-World War II era, there have been just twelve years where the federal government's revenues have exceeded their expenditures. Thus, the default budget position has been one of deficit, with the economy's cyclicality determining how large (in recession) or small (in expansion) the deficit would be. The 2008 financial crisis led to a collapse in tax revenues and surge in federal spending that combined to widen the deficit to nearly $1.5 trillion annually or 10% of U.S. GDP - its worst level since the wartime spending of the early 1940's. But since then, the economic recovery, rising stock market, higher tax rates and cuts to government spending, have all contributed to a sharp narrowing of the deficit back to $561B, or just 3.5% of GDP. As shown in the chart below, compared to our long history of budget imbalances, this level of deficit appears more "normal" and manageable.

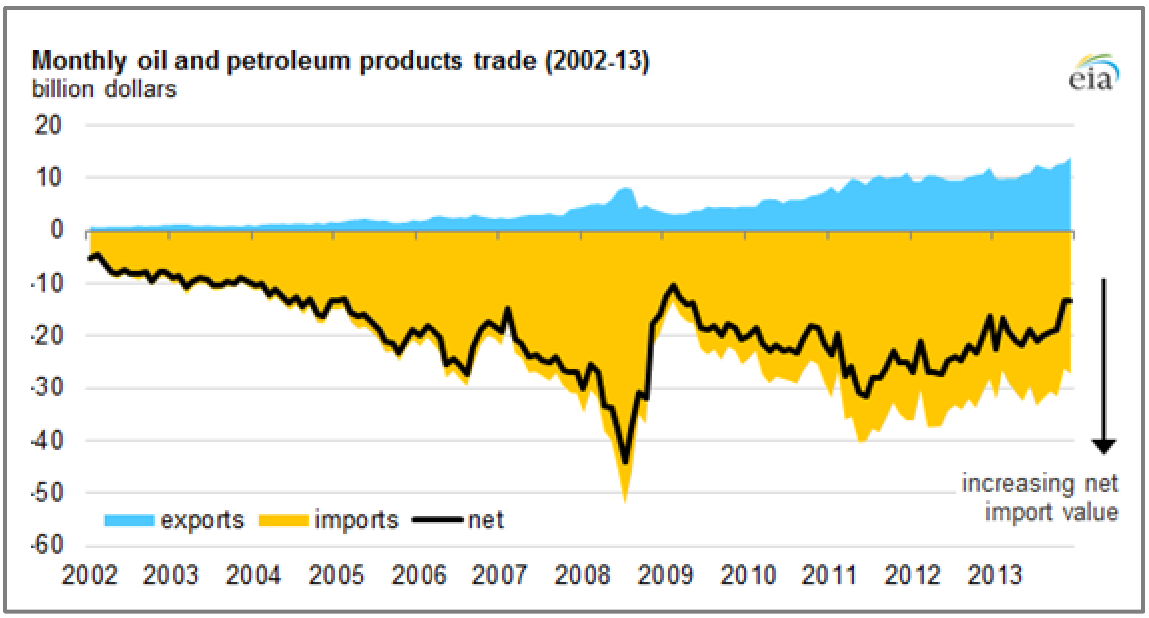


Source: Federal Reserve Economic Data, St. Louis Fed

As long as the economy continues to recover, we would expect the deficit to remain at these manageable levels. Whether we actually get back to a budget surplus still remains to be seen, but regardless, the improvement in our federal budget situation has positive implications for U.S. government bonds, due to our improved credit profile, as well as U.S. equities, as it reduces the political headline risk associated with high deficits. Of course, the long-term budget picture still looks bleak absent major entitlement reform, but for the foreseeable future, markets should enjoy less of a headwind from immediate deficit concerns.

The U.S. Trade Deficit

Much like our history of budget deficits, the default position of the U.S. trade balance has also been one of deficit. But unlike the negative implications of a large budget deficit, widening trade deficits in the U.S. have historically been associated with an improving economy, as rising imports have been driven by increased demand for global goods. In that light, it is more eye opening to see that the trade deficit has narrowed by $20 billion since 2012 in the midst of an economic recovery. Rather than this raising a red flag, however, we believe it reveals the fruits of a very bullish trend in the U.S. economy – the booming production of crude oil and natural gas from U.S. shale reserves. As we have discussed in previous commentaries, the energy renaissance of the United States is one of the major bright spots for our economy. Previously untapped shale formations are now being harvested with new technologies, causing a surge in the U.S. supply of oil and natural gas and the potential for energy independence, a huge export opportunity in liquefied natural gas, and a rebirth of U.S. manufacturing. To give some perspective on the sharp increase in production, the 243 million barrels of crude oil produced in the U.S. last December was a remarkable 40% increase over December 2010 levels and nearly 60% increase over December 2005 levels. If this trend continues, as we expect, the EIA forecasts the United States will overtake Russia and Saudi Arabia as the world's top oil producer by 2015. Who would have predicted that ten years ago? As shown in the chart below, this production surge has caused less demand for imports of crude oil into the U.S. and a strong ramp up in exports of petroleum products to other countries. With the oil and petroleum products trade representing the largest swing factor in our country's trade balance, this phenomenon has been the leading driver behind the decline in net important into the United States.



Source: U.S. Energy Information Administration

While the oil trade has experienced the most immediate reversal, we believe the greater driver of exports over the next 5-10 years will be the bourgeoning opportunity in natural gas. With natural gas selling for an average of $16 in Japan and $11 in Europe, the U.S. has begun to invest billions of dollars in the infrastructure necessary to ship our $4 has to these global markets. To date, there have now been six natural gas liquefaction plants approved by regulators to be constructed in the U.S. and used to freeze natural gas into a liquid, transportable form. At MAI, we have found pipeline MLPS to be the most compelling way to invest in the infrastructure growth required to support these new energy markets. Beyond the direct trade of natural gas, the impact of low U.S. gas prices has also begun to attract more manufacturing back to the states. Multinational companies such as General Electric, Siemens, Boeing, Dow Chemical and Apple have all begun to "onshore" production partly due to the low cost of natural gas, which could be the tipping point of a longer-term trend that supports further export growth, a stronger trade balance, and also improved economic activity.

The surprise improvements in the "twin deficits" of the United States offer positive reinforcements to our moderately constructive views for the U.S. markets in 2014 and beyond. And in both cases, we are reminded that new hope often comes from where you least expect it.