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Overseas investing makes sense



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There's an old cartoon that shows a U.S. map, with tugboats towing away several states. The caption goes something like this: "The trade deficit? Oh, that's just for economists to talk about. It doesn't mean anything."

Twenty years later, economists are still talking about the trade deficit, which encompasses interest payments on debt and earnings on overseas investments as well as goods and services. To many, the trade deficit is a useful economic indicator and provides insight to the direction of foreign exchange rates, interest rates and even world economic growth. It hit a record \$666 billion in 2004, almost 26 percent larger than the \$531 billion imbalance the United States racked up in 2003, and could soon amount to 6 percent of the U.S. gross domestic product (GDP). Many economists consider trade deficits above 4 percent of GDP dangerously high.

To pay for the trade deficit, we need to borrow money overseas, and that debt must be repaid at some point.

"We're already paying interest on that debt, about 2 percent of GDP, and that debt will continue to be a drag on our economic growth," notes Weller.

The trade deficit is calculated by stacking up the value of all cars, electronic gadgets, tourism, and payments for banking services, among others, that enter the country against those that leave. These days, it's mostly goods coming in and money going out.

According to the commerce department, on a release on July 13, the trade and balance declined to 55.3 billion in May. This was an improvement of 2.7 percent from April. The belief is this will be temporary due to the high price of oil and high oil imports. The deficit with China rose to 15.8 million, the highest since last

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November. This was pushed along by a surge in imports of Chinese clothing and textile in the first 5 months of this year. Chinese clothing and textile shipments are up 53.6 percent from the same period in 2004.

But the picture is complex, showing a range of sometimes-counterintuitive effects.

The trade deficit largely reflects a hunger for imports. The healthier the U.S. economy becomes, the more U.S. consumers spend on goods from Japan, South Korea, and the eurozone.

When the value of the dollar falls – which it has been by almost 30 percent against the euro during the past two years – imports become more expensive because a dollar buys less. At least for now, Americans are still buying foreign goods. Many economists believe the dollar must drop much further for the trade gap to narrow.

Major exporters to the United States would rather see the dollar rise, not fall. A stronger dollar could mean even more U.S. sales. And foreign investors, including central banks, hold lots of dollar-denominated stocks and bonds as well as greenbacks themselves. A rising dollar makes those holdings worth more.

So what does this mean to you as an investor?

Today's situation represents a global imbalance, one that ultimately will correct itself. If the ballooning trade deficit shakes the confidence of foreign investors, they could begin to look for other places to park their cash, the dollar could drop further, and interest rates might have to rise more rapidly to lure investors. This does not bode well for the stock market.

During the last several years, while the dollar has weakened tremendously, we have made a lot of money for investors in international bond funds. They've been a terrific addition to client's portfolios. However, that reverse course, when the dollar started to strengthen back in February. We reduced our holdings in the international bond. We do want to keep an exposure to this important asset class.

However, if the government makes promised cuts in its other deficit – the federal budget – the demand for investment could ease, thus reducing pressure on interest rates. Whether the dollar remains strong or continues to weaken, the global nature of markets may make it wise to have some investment dollars in international investments.

One of the best ways to invest in the overseas is through mutual funds. One way to think of a mutual fund is to see it as a large bucket. As an investor you are putting cash into the bucket. Based on the objectives of the fund the fund manger decides what stocks or bonds to buy with the cash in the bucket. If the purchased securities go up in value the bucket is worth more money. Interest, dividends, and/or capital

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gains on the securities are paid out to the shareholders of the fund on a regular basis—typically on a monthly basis for income funds and annually for growth funds.

Open-end mutual funds are the most common types of mutual fund. When you purchase shares of the open-end mutual fund the fund company issues additional shares equal to the value of the money you have invested. Open-end mutual funds are constantly purchasing and redeeming mutual fund shares. To determine the value of an open-end mutual fund the fund companies simply take all the cash and securities at the end of the day and divide it by the number of shares outstanding. That provides the net asset value at the day's close.

Closed-end mutual funds, on the other hand, issue a fixed number of shares when they go public. These funds are typically traded on one of the stock exchanges. The value is set by market conditions and they can trade at a discount or premium to the net asset value. These funds would be purchased through your broker or financial advisor the same way you would buy stock.

Exchange traded funds are another way to invest. You can buy into the ETF during the market day and know exactly the price that you're going to get. The expenses on ETFs are also very low, and it's a great way to pick up an individual sector or a particular region.

While foreign investing does involve political and currency risk, it also provides a way to take advantage of economic cycles on a global level.

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