Twin deficits: trade and budget

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Trade's one of the topics that's getting a lot of interest today, a lot of press coverage. I think we have to put it in perspective.

Trade is getting a lot of attention today in the press, because of the confrontation between the U.S. and some of our trading partners. And one of the thoughts is, well, the U.S. is really not that vulnerable to downturn in trade and that exports are only about 10% of our GDP. So we don't export a lot of what we make, so therefore, we're not dependent upon exports. But we don't, buy the country, we buy the companies.

And if you look at the S&P 500, close to half of S&P sales come from abroad, because it's not just what we export, it's also what we make overseas. So in fact, global growth and trade are very important to stocks, to U.S. stocks, to the S&P 500 and therefore, has a greater impact on investing than it does on the economy overall.

So one of the concerns is the trade deficit, which simply means we export less than we import. But we also have a budget deficit, which isn't getting as much attention as trade, but getting a definition of budget deficit, we spend more than we take in as a country…as a government…through taxes.

And there's something called the "twin deficit hypothesis," It sort of says, if you're going to have one, you're going to have the other. The fact is, if we have a budget deficit, we need to borrow. And if we don't save enough to buy bonds that the government issues here at home in the U.S., then we're going to sell our bonds to foreign investors. In fact, 40% of U.S. debt is held overseas. So we need those overseas investors to buy our bonds. And the way they get the funds to buy our bonds is, we buy their goods.

If the budget deficit persists, the government's going to have to issue bonds and they're going to have to be sold. And so we're going to continue to be dependent upon overseas buyers of our bonds. Forty percent of U.S. debt is held overseas, about a quarter of that debt is owned by China or Hong Kong. So a quarter of 40%...10% of our debt is owned by China.

We need China to buy our debt. It's why the trade confrontation also has implications on the budget deficit. What if this trade issue gets more hostile and what if China was to not buy our bonds? That would obviously…could push rates up. The issue of the trade deficit and the budget deficit are really intertwined. So the risk here is trade deficit, budget deficit, you probably can't solve one without solving the other.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

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