



Strong July retail sales, a wider trade gap, and weaker than expected University of Michigan sentiment readings have not much changed the currently robust forecast for third quarter US GDP growth. The FOMC raised interest rates as expected by 25 bps to 3.5% with no change in the accompanying text, much to the market's chagrin. In the meantime, the yield curve remains remarkably flat, and market participants still cannot explain low long US yields.

Trade and the US Dollar

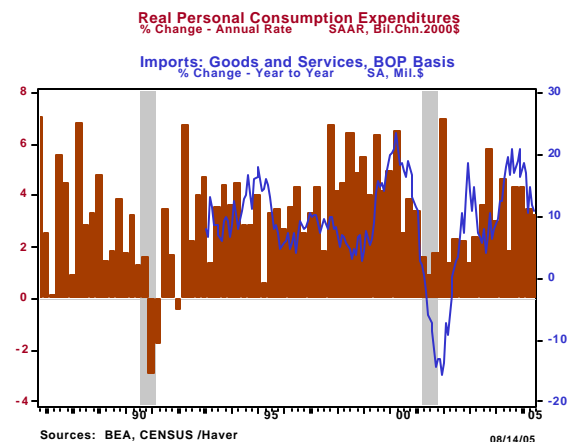
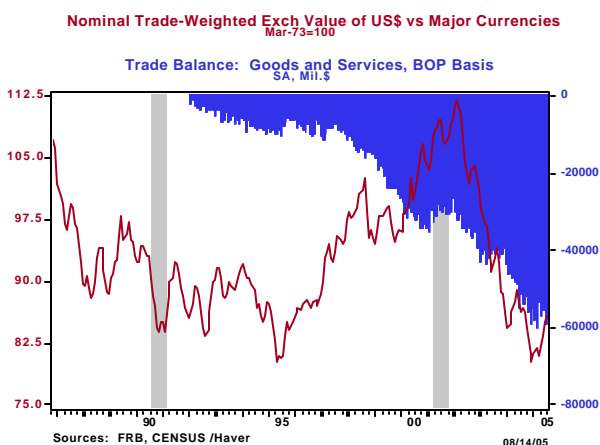
The US June trade deficit was slightly wider than anticipated at \$58.8 billion. Assumed in the second quarter GDP accounts was a deficit of \$57.5 billion. The announcement came amid recent US dollar weakness in the aftermath of the yuan revaluation, sparking concerns that the dollar would have to weaken again to produce further trade balance improvement. The second quarter combined US trade deficit is running at \$171.1 billion vs. \$171.8 billion in Q1, a marked improvement from the steady deterioration in the trade balance over the course of 2004. Was the

sharp dollar sell-off in 2004 responsible for this year's trade balance stability? In part. Export growth is strong due to the combination of strong foreign economies and some weakness in the currency. More important seems to be the slowdown in US import growth. While US consumer spending remains relatively robust, the improvement in the trade deficit this year is in large part due to a slowdown in import growth. Current sales seem to have been driven from existing inventories.

Speculation that the dollar needs to continue to weaken for ongoing improvement in the trade balance seems largely overblown. The US dollar is unlikely to experience the renaissance in strength of the 1995–2000 period. More likely it will remain range-bound between 80 and 90 on a trade-weighted basis for the foreseeable future. With any luck, the US trade deficit has stabilized for 2005 — 2006 will be a brand new game. At the end of last year, most players in the currency market

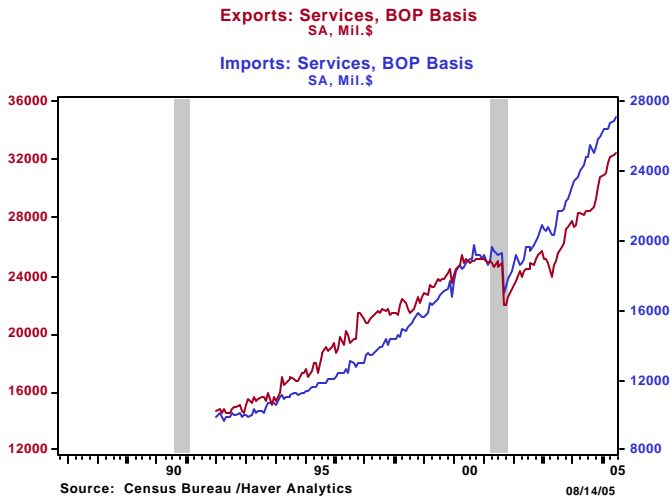
thought the dollar would continue to fall, breaking through the old 1995 lows in order to spark trade deficit improvement. This was a costly bet made by some of the most savvy financiers and traders. Instead, in an issue written at the end of 2004, we suggested that the US dollar would improve, as it was already dangerously close to its 1995 lows.

The belief that the structural trade deficit the United States is now experiencing could be cured with foreign currency changes is pure folly. *An often overlooked idea is that the heart of the structural US trade deficit lies in the belief that globalization is the cure to global poverty.* The more trade that takes place between countries, the better off both of



those countries are. Take the United States and China for example: Both are beneficiaries of more trade. But many people — especially US workers whose jobs are displaced by cheaper workers abroad — don't see it that way. On the other hand, many US leaders (particularly our Treasury secretary) do, as do many heads of multinational corporations. This concept needs to be understood and embraced by the financial media as well as US citizens. The public is tired of the same old rhetoric coming from the economic community: "The dollar must weaken to improve the US trade deficit" and "A weaker dollar is the result of US ills such as over-indebtedness." The fact remains that US citizens are benefiting from an abundance of cheap foreign-made goods, while

US exports of goods and services are booming. The benefits need to be expressed more often.



As the US economy has transitioned to services and moved further away from manufactured goods, skeptics claim that a mature economy cannot thrive with such a small portion of its total output dedicated to manufacturing. The fact remains that an ever-larger portion of our output is services, and an ever-growing portion of US exports is services (see the chart at left). Note the rapid acceleration in the growth of US service exports in just the last five years. This is yet another sign that more global trade benefits all the players, as US expertise in these areas is brought to bear on lesser-developed nations anxious to grow. As we've mentioned on numerous occasions in the recent past, the global pie of goods and services production is not fixed. It has long been an economic assumption that what one nation gains in trade another loses. The reality is that the global pie is infinite (with the constraint of available raw materials and

the impact of global warming considered, of course), and all players are capable of achieving a higher standard of living.

The more we are accustomed to talking and thinking this way, the more everyone will benefit from the ideas and innovations developed in a peacetime environment. The Internet was positioned as a source of that activity through global community building. Despite the terrorist activity that grabs daily headlines, the Internet is still quietly working its magic to make more information available and more solutions possible.

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