JAMESSON ASSOCIATES

Winter Newsletter December 2003

Recent Economic Events

As the little kid in the Mazda commercial says, "zoom, zoom, zoom." The American economy exploded with growth in the third quarter as both tax cuts/rebates and the tag-end of the mortgage refinance boom boosted consumers' spendable income. Inflation remained muted and employment started to show signs of stabilizing. Early fourth quarter indications suggest the baton is being handed over from the consumer to business.

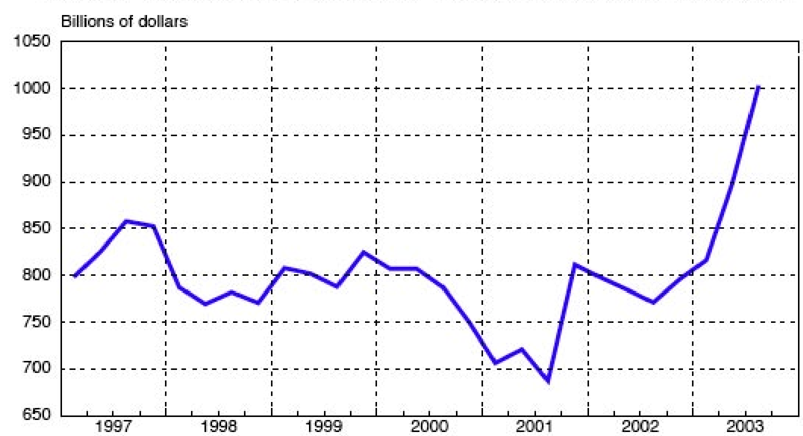
GDP advanced by a stellar 8.2% in the third quarter. All of the major categories of the economy were contributors. The real stars were personal consumption (4.6% or a bit over half the total growth) and business investment (2.6% or about one-third of the total). Net exports (0.8%) were positive for only the second time this century. Let's look at why each of these categories was such a solid performer.

Personal consumption was on steroids during the quarter. Tax cuts and rebate checks combined with a final surge of funds from mortgage refinancing boosted spendable income by over $100 billion, and in true American fashion, most of the extra income was spent.

Recent statistics on retail sales were somewhat weaker in October, but November showed a solid .9% gain. The early returns on Christmas sales are mixed. It appears to be a product-driven season so far.

Businesses finally started to invest in the future during the third quarter. It's not surprising that they loosened the purse strings. Profits have been fantastic. The recent figures show a new all-time high when adjusting for inventory and depreciation on a proper basis. (See chart.) We may also be seeing a change in psychology. Most of the indices of business confidence are posting large gains.

CORPORATE PROFITS WITH IVA AND CCADJ



Source: Bureau of Economic Analysis.

Exports are showing signs of life. They were up by 7.1% over a year ago October. The weaker dollar is a major contributing factor. It has fallen by about 25% from its peak in early 2002 and is down roughly 15% this year.

All of the economic statistics suggest that the Federal Reserve is succeeding in its attempt

(continued on page 2)

Recent Economic Events (continued)

to reflate the economy. However, the inflation statistics that count (PPI and CPI) have yet to join the party. The total PPI for November unexpectedly fell by .3%, and core producer prices were down .1%. On an annual basis, core producer prices are up only .5%. Consumer prices are also well behaved. November figures showed declines in both the overall price index (.2%) and in the core (.1%). The latter being the first drop in 21 years. On a year-over-year basis consumer prices are up 1.8% with the core a well-behaved 1.1% (best since 1966).

...the employment picture has moved from negative to neutral

With the sharp revisions in employment figures for August and September and solid albeit insufficient jobs created in October and November, the employment picture has moved from negative to neutral. Average job creation over the last four months has been 82,000 while the unemployment rate is now below 6%.

As Dr. Pangloss might argue, we appear to be in the "best of all worlds" economically. The economy is showing good signs of growth. Consumer-driven stimulus is poised to be replaced by a more confident business community and inflation is under control. The last piece of the puzzle, employment, is showing signs of stabilizing. If we can get solid growth in that area, we can truly celebrate the New Year. Zoom, zoom, zoom, indeed.❖

Commentary

Greenspan Dream:

Growth builds steadily while inflation remains low. Job creation picks up, moving the country to full employment in 2005. Mr. Greenspan declares his job done and retires at the perfect moment.

Bush Dream:

Economy recovers steadily allowing President to point to tax cuts as the cause. Iraq resolves itself peacefully. Reelection is a cakewalk, setting the table for more tax cuts and the assault on Syria, North Korea, and Iran.

Democrat Dream:

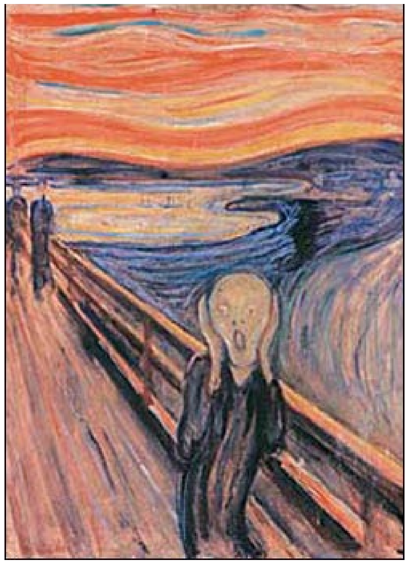
They wake up in 2000 and find 538 more votes in Florida.

(continued on page 3)

Commentary (continued)

Greenspan Nightmare:

Economic growth stalls due to financial market pressure driving intermediate and long rates up even while the Fed holds the overnight rate at 1%. No ammunition is left as the economy heads into another recession, laboring under record debt levels.



Bush Nightmare:

Jobs continue to leave for overseas locales, and the public realizes how irresponsible government spending has become under full control of Republicans. The bums are voted out. Taxes are raised, especially on special business interests, bringing on fiscal sanity before it is too late.

Democrat Nightmare:

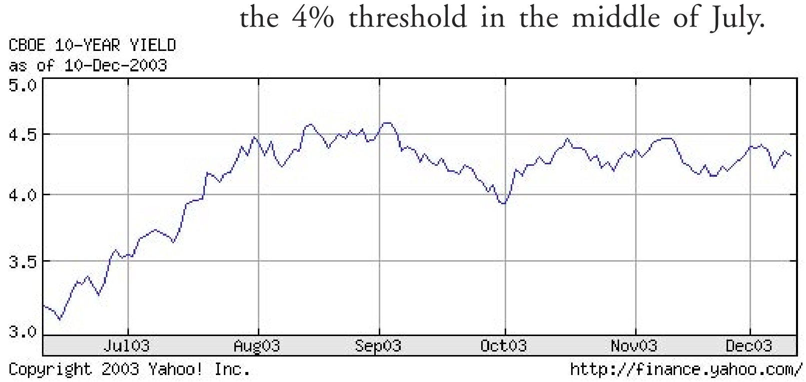
See Bush Nightmare. Democrats are elected to resolve the deficit issues but get no credit for doing so. Jeb Bush is elected in 2008.❖

Market View

The Dow has once again closed above 10,000, Saddam Hussein is in custody, and economic statistics are showing a much more positive picture. How come I don't believe the rally? It could be my contrary nature. Historically, it has been a poor time to jump in when everyone else has been positive, and the still high valuation level is a warning sign. The dividend yield on the S & P 500 is a low 1.6% while its P/E is a lofty 27x. These levels are more normally associated with a top in the market than a bottom. However, it's tough to fight the tape.

Right now, momentum is a powerful force pushing the stock market to new highs. Market breadth and the steady, rather than explosive, increase in prices are supportive of additional gains. More speculative stocks (technology especially) are due for a correction, but the more staid dividend-paying companies are fairly valued.

Interest rates have been in a trading range for quite a while. The ten-year Treasury has been basically bounded by 4% on the low side and 4.5% on the upside since it crossed the 4% threshold in the middle of July.



This range has held through the mortgage market hedging meltdown, the bounce-

Market View (continued)

consistently improving economic statistics for the last three months. The range has also withstood increased Federal budget deficits (Iraq, Medicare, etc.) and a stubbornly high current account deficit (over $2 billion per business day).

I believe that there are two positive factors that account for the bond market's performance in the face of plenty of negatives. The first and most important is the Federal Reserve. With the Federal Funds rate anchored at 1% for the time being, it is hard for market participants to refrain from the carry trade. When you are assured you can borrow cheaply to fund term purchases, there is a bid for bonds always at hand. The second factor is the continued lack of inflation. Real interest rates for term securities are very attractive versus historical averages.

The calculation on investing today has to do with the timing of a move by the Federal Reserve to normalize the Federal Funds rate and a consideration of how high inflation goes in the next cycle.

Here's what I think. The Fed will be on hold through the election in 2004 unless it looks like President Bush is likely to win a landslide. If the political story is settled by summertime, the Fed will have room to nudge up rates if necessary. If not, we will wait until 2005. In any event, the market is going to try to jump ahead of the Fed. There will be upward pressure on rates over the next year, but the story is that the pressure will be less than anticipated. I differ from the consensus in how I answer the following question: Will the Federal Funds rate or the ten-year Treasury rate be closer to 3% at the end of 2004? I say the latter; the market says the former.

The core of my forecast is that the Federal Reserve will be successful in holding any acceleration in inflation to about 2%. Admittedly, that is well above the present rate, but it is low by historical standards. That should be more supportive of bond prices than many presently believe.

Somewhat paradoxically, the biggest pressure on rates in 2004 is likely to be on the short to intermediate term market. This is because the market will back up these rates more aggressively. However, even if they do, the roll down the curve will act as an insulator. Three-year investments presently seem to have the best risk/reward relationship that I see. I would not chase the market (we are in a trading range), but would buy this maturity on weakness.❖

Editor's Note

I'm sending out an all points appeal. I have lost my warranty papers, and parts are breaking down. If anyone knows where you can get service on a fifty-year old body, please contact the editor.

Michael Jamesson
Jamesson Associates
Scottsville, NY
(585) 889-8090
Mjamesson@aol.com