JAMESSON ASSOCIATES

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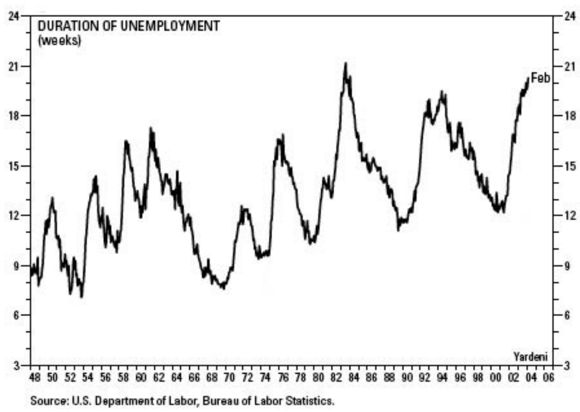
Recent Economic Events

From economists to media pundits to the man on the street, the question everyone is asking is, “Where are the jobs?” Overall economic growth continued its solid pace in the fourth quarter of 2003 and appears to have good momentum in early 2004. Inflation has remained well-behaved, perhaps too well-behaved. And yet, employment has only barely budged.

Decelerating from its unsustainable 8.1% growth in the third quarter, GDP increased by a healthy 4.1% in the last quarter of 2003. Key contributing factors were decent consumer spending and a very strong performance by business capital expenditures. The latter were up at a 10%-plus annual rate. Early 2004 brought more good news. Industrial production increased by .7% in February, extending the good performance from the last half of 2003. In fact, this eight-month period shows the best growth in industrial production that the American economy has enjoyed since the last half of 1999.



Other measures of economic health have been positive as well. Retail sales have held up nicely allowing for the normal volatility we see around year-end. Although both car sales and housing sales are down from their peak levels, they remain quite strong. The former continue to register north of 16 million units on an annual basis while the January seasonally adjusted annualized sales of both existing and new homes exceeded the full-year 2003 totals.

Inflation shows no signs of acceleration. The increase in prices during from January 2003 to January 2004 as measured by the Personal Consumption Expenditure index was 1.5% and excluding food and energy was only .8%. Remember, these are annual, not monthly, increases. The CPI increased by .5% in January, bringing its annual increase to 1.9% and to 1.1% on a core basis. In fact, except for the stubbornly high price of oil and the rest of the energy complex, the majority of consumers are enjoying the slowest rate of price increases in their lifetimes.

Would that they were enjoying a similar situation with employment. The recently released employment report for February was another disappointment. Reflecting only 21,000 jobs created and the 43rd consecutive month of manufacturing job losses, the report did little to dispel the disquiet of job-seekers. The report followed equally disappointing reports covering December and January. The average monthly job gain indicated by these three reports is only 42,000, well below the 150,000 to 250,000 per month increase needed to absorb natural growth in the labor force and provide employment for the unemployed, under-employed, and discouraged workers. According to the Department of Labor, this more comprehensive measure of labor slack is near 10% of the workforce. Furthermore, the average duration of unemployment is higher

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Recent Economic Events (continued)

than it has been at any other time since the end of World War II except for the double recessions of the early 1980's.

We are faced with an economy that appears to be delivering the goods based on traditional economic statistics. It would be hard to argue that, by those measures, the situation is anything but good. But when we look at the mood of the public and their very real concern over jobs, a different picture emerges. Until that concern is resolved, we will have to consider this recovery a work in progress with all of the risks of failure that such a characterization implies. ❖

Commentary

Alan Greenspan's true colors are showing. The acolyte of loony libertarian philosopher Ayn Rand had the audacity to recently suggest to Congress that Social Security benefits should be cut because the federal deficit was too large. Not to everyone, mind you, said the 78-year old Chairman, only to those workers expecting to collect benefits five or more years from now. His target for cuts: Baby Boomers. In the same testimony, Mr. Greenspan contended that we had better make the Bush tax cuts permanent, and furthermore, that Americans should be taking out ARMs instead of fixed rate mortgages.

These remarks are so bizarre and self-contradictory as to call into question Mr. Greenspan's grasp of reality. But assuming that he is serious, the Social Security remarks represent one of the most egregious bait-and-switches in my memory.

In the early 1980's, Ronald Reagan tapped Mr. Greenspan to head a commission on Social Security. His proposals were reasonable. Social Security at the time was a pay-as-you-go program with taxes collected roughly equal to benefits paid. The commission recommended raising Social Security taxes to build up an excess of funds while Baby Boomers were working so that come 2010 and beyond when they began to retire, there would be a cushion of assets to pay the benefits. In fact, so well did this work that the annual Social Security surplus is now in excess of $150 billion and is expected to grow to over $250 billion by 2009.

Although Social Security is a political hot potato with truly non-partisan analysis somewhat hard to find, the official projections suggest that the system is fundamentally sound and should be able to meet its benefit needs at least through 2075. To suggest that Social Security benefits need to be reduced now to pay for income tax cuts must be viewed as politics rather than economics. This is especially so for the very man who proposed the long-term fix of higher taxes to protect benefits twenty years ago. He knows or should know better.

I believe that Mr. Greenspan is looking toward the history books. My read is that he may achieve a prominent entry — the worst Chairman in the history of the Federal Reserve. His Johnny One-Note approach of flooding the system with liquidity every time (but only after) there is a problem in the financial markets (not the real economy) has had real consequences.

There were four major easings in monetary policy during the first 16 years of the Chairman's tenure. Taking over in August 1987, Mr. Greenspan was raising rates until the

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Commentary (continued)

crash in October, when he reversed course and eased. Beginning in 1990, in the wake of bank failures driven by bad loans on overextended commercial real estate, the Fed cut rates from over 8% to 3%. The Russian debt default and the demise of Long-term Capital Management in 1998 prompted another rate reduction, and the plunging stock markets of 2000 led to the most recent round of easing. This was extended by the additional ease instituted in the aftermath of September 11th. Only the 1990 example could possibly be classified as reacting to an economic slowdown, and that would be dependent on a close reading of contemporary news stories. Having lived through the banking troubles of the time, I am convinced that Mr. Greenspan was trying desperately to hold the banking system together rather than boost GDP.

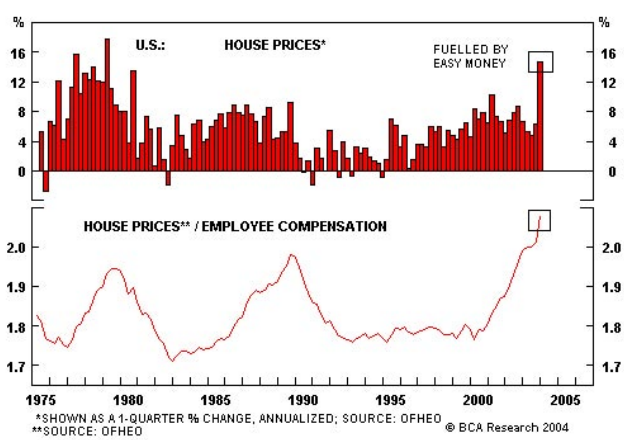
Had the Fed let the market clear in 1998 or addressed the dot.com bubble while it was building rather than after it burst, we would be in a much sounder position today. This is the same mistake committed in 1929 by Roy Young, Mr. Greenspan's chief competitor for worst Fed Chairman.

Is it any wonder that we now find ourselves with the Federal Funds rate at 1% and the country deeply in debt? When Mr. Greenspan took over the Fed in 1987, the debt to GDP ratio was roughly 2x. Now it is 3x. His "solution" in every case has been the one normally used to ridicule liberals, "throw money at the problem."

Regardless of whether the economy picks up sufficiently to bail us out of our current situation, there has been lasting damage done to the finances of the country because of the Federal Reserve's "pile on the debt and don't worry about the bubble until later" approach under Alan Greenspan. For this and for his plainly political breach of trust on Social Security, he deserves to retire sooner rather than later. I hope someone in Congress is courageous enough to raise this during reconfirmation hearings this summer. ❖

Market View

As I expected, the stock market continued to rise in early 2004 due to the momentum of the gains in 2003. More recently, its gains became more labored and a correction has begun. The bond market has shown more relative strength, breaking its multi-month trading range with a move to the 3.75% area on the ten-year Treasury. The real market story, however, is what is happening in the housing market and a very special commodity: oil.



Driven by the lowest mortgage rates in most homeowners' lifetimes, housing prices have appreciated relative to pretty much everything over the past few years. Much of the stimulus that the Federal Reserve has directed toward the economy is

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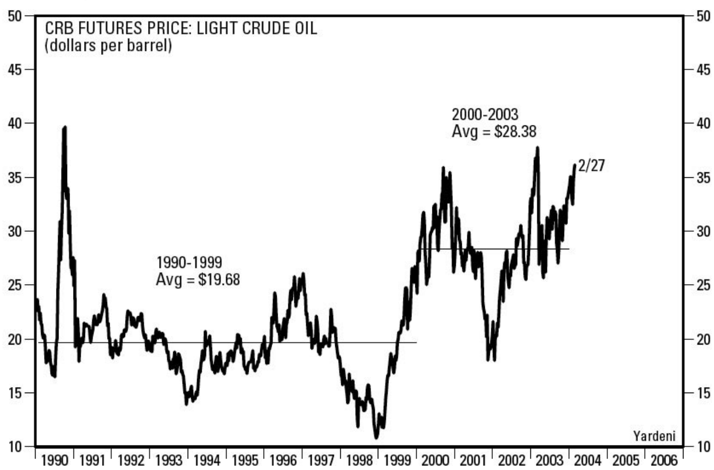
Market View (continued)

ending up in the housing market rather than in the expansion of goods, services, and employment. Note that the price of housing relative to employee compensation has reached and exceeded the levels achieved during previous housing bubbles in the inflationary 1970's and the boom time 1980's. After both episodes, housing prices either declined or simply fell far behind general inflation until values were more reasonable versus income. You obviously can't fall too far behind a 1% inflation rate without experiencing price declines.



* Nearby contract, closing price.
Source: Standard & Poor's Comstock.

It is interesting to note that oil prices have risen to the $30 per barrel price during Mr. Bush's term after spending Mr. Clinton's at an average of $20. However, there is more than manipulation going on here. I believe that another place where overly accommodative monetary and fiscal stimulus is leaking out of the system is into China. As we stimulate the American consumer with low rates and easy credit, he buys more things from the low-cost producer. With booming demand for goods in China, the consumption of all commodities has increased, and the price of those with the least elasticity of production in the short term increased the most.

The overall stock market is topping out. I believe we have seen the highs for the year. However, good yielding oil stocks offer some upside. The bond market is clearly in a bubble, but given the history of the Fed in letting bubbles go, there is probably more time in the game. Aggressive investors can choose long bonds for a market play; more conservative players should stick to three to five-year items with call protection. Ride the curve for fun and profit. How to play the real estate bubble? The most radical approach would be to sell your house and rent. Few would be willing to go this far. An alternative would be to identify those who benefit from increased housing prices and get ready to short the stocks at the first sign of a reversal in the direction of interest rates. Prime candidates would include mortgage lenders, mortgage insurers, and home builders.❖

Editor's Note

A recent article in the Wall Street Journal about the online lender E-Loan was an eye-opener for me. The company allows customers to choose between having loans processed in the United States or out-sourced to India. The domestic option takes two or three days longer. Given the choice, customers chose India 86% of the time. In the immortal words of one of the 20th century's greatest philosophers, Walt Kelly's Pogo,

"We have met the enemy, and he is us."

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