Jamesson Associates

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Recent Economic Events

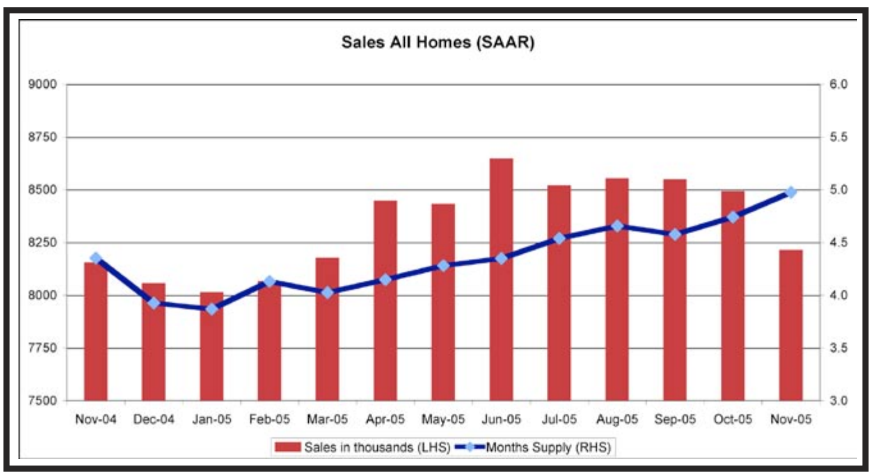
The American economy continues to grow solidly with little inflation, and employment finally appears to be keeping pace. But before we conclude that we have entered economic nirvana, we need to consider recent developments in the housing market.

Real GDP advanced a healthy 4.1% in the third quarter of 2005, its tenth consecutive quarter of growth in excess of 3%. This is a very solid performance and bodes well for the near future on momentum grounds.

Inflation has remained well behaved. The CPI fell by the largest monthly amount since 1949 in November as energy costs that had been driven up by the hurricanes in the fall returned to earth. The actual figure was (0.6%) which brought the annual rate down to 3.5%. It topped out in this cycle at 4.7%. Even more important, the core rate, which excludes food and energy, registered a benign 0.2%, leaving the annual increase at 2.1%. It is likely that continued moderation in energy costs and Christmas sale discounts will deliver another good report for December.

Employment, the recovery's poor relation, now seems to have gained some traction. December job growth was a disappointing 108,000, but that came in the wake of sharp upward revisions to earlier months. Now that the hurricane distortions are behind us, we can focus on whether employment momentum continues. The good news here is an unemployment rate below 5%, and an up-tick in wages that should help support future income and spending.

It's a good thing too, because one of the major props to the past performance of the economy is showing some signs of stress. The great American housing machine is starting to slow. We can see this on a number of fronts. First, the most recent statistics on housing sales were uniformly weak. Existing home sales fell in November and are now below the one-year ago rate. More ominously, existing homes for sale continued to increase, and the median price fell $3,000 to $215,000. New home sales were even weaker, falling 11.3% in November. The unsold inventory of new homes is at an all-time high. It goes without saying that a slowdown in housing activity and price appreciation has potentially significant implications.



Historically, the economic statistics show stability in growth and low core inflation. But the underpinnings of this stability appear destined to change. Positive momentum (continued on page 2)

Recent Economic Events (continued)

in GDP is more and more dependent on businesses continuing to hire and workers' abilities to generate increased income. Support from the housing boom can no longer be assumed, as it has transformed from a sellers' to buyers' market. From this point forward, the economy will have to perform based on fundamentals rather than wealth-based stimuli. ❖

Commentary

The shape of the yield curve is one of the most contentious current topics facing the markets. The facts are not in dispute, but the lessons drawn are.

First, the facts. The historical record shows that each of the past six recessions in the United States has been preceded by a yield curve inversion. This inversion being defined as the three-month Treasury yield exceeding the ten-year Treasury yield. However, it is also true that the 1966 inversion did not immediately (within a year or so) lead to a recession, and that the two recessions in the late 1950s were not preceded by inversions. Furthermore, 1998 saw a near inversion similar to that in the two late 1950s examples that did not lead to a recession. Note on the chart from UBS how close we are to an inversion now.

A more rigorous statistical analysis suggests that the likelihood of a recession increases in an exponential fashion as the yield curve first gets near to and then inverts. Current odds suggest a roughly 25% to 30% chance of a recession within a year.

Any reasonable person looking at this evidence would have to conclude that the chances of a recession in the next year have increased, perhaps to the point where recession is more likely than not. And yet, any number of well-respected analysts are making the, "This time it's different." argument.

How is it that otherwise sensible observers can make this contention? I would categorize the skepticism as falling into two camps — self-serving political analysis and self-serving economics professionalism.

The main proponent of the former camp is my old nemesis, Alan Greenspan. As the Chairman winds down his term, he is looking forward to his legacy. He and his retinue of sycophants are making the case that the predictive power of the yield curve has diminished due to more transparency in policymaking and the demise of inflation. In effect, Mr. Greenspan is patting himself on the back, contending that the Fed has been so masterful in driving down inflation, limiting volatility in the economy, and convincing investors that stability is a permanent feature of the markets that they are no longer pricing in as much risk in long term rates. Voilá, "I'm just a victim of my own success."

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Then we have the professional economists who need to make things complicated so that regular investors will value their analysis. They need to find another set of reasons to predict the course of the economy to justify their existence. The main line of argument here is "special circumstances." Either we find that long-term interest rates are too low because of huge capital flows into the US; real interest rates matter, not the yield curve; or it's all due to the pending retirement of the Baby Boomers, who are looking to lock in long-term fixed income returns.

I might point out that the last inversion was also supposed to be due to "special circumstances." In 2000, economists contended the inversion did not matter because it was due to the shortage of Treasuries due to the ongoing budget surpluses. A recession came nevertheless.

Now, who is better at allocating capital: an economist, a government bureaucrat, or Mr. Market? If you choose either of the first two, then you can disregard the shape of the yield curve. Pick your reason from the long list offered. If you chose door number three, you need to pay attention to the possible inversion, and plan for at least a slowdown in the economy, if not an outright recession.

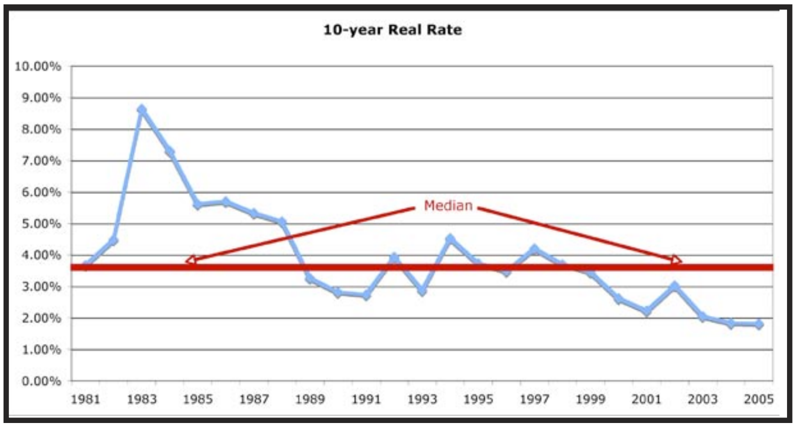
In these times of faith-based analysis, I will continue to focus on the facts, sticking with evolution, not creationism, and the odds of a slowdown if the curve inverts rather than enlightened bureaucrats or "special circumstances." I expect 2% or less GDP growth by year-end if the curve inverts. If not, stay tuned. ❖

Market View

A rising tide lifts all boats. Were I to have simply repeated this simple sentence over and over, I would have done much better in predicting financial market returns. Virtually all investments have done quite well recently. Commodities, led by energy and precious metals, are either at mulit-decade or all-time highs. Stocks continue to trade at elevated P/E multiples, and bonds have refused to buckle under an unremitting tightening cycle from the Federal Reserve. And real estate? We are seeing record prices around the world. The driving theme in all of this is that the liquidity being generated by the global economy is finding its way into asset purchases rather than bidding up the prices of goods and services.

I see three main reasons. First, the entry of China and India into the global economy has added billions of people to the mix. They have impacted the marginal stock of labor to the point where prices for labor inputs (goods and services) are being held down or pushed lower. At the same time, the savings rate in these countries is much higher than that in the countries whose labor they are replacing in the industrialized world. Hence, more of annual production is appearing as savings which need to be invested. Second, record borrowing by the United States paradoxically creates liquidity. The democratization of credit has added many more buyers to the equation. Note that this borrowing initially bids up the price of an asset like a house. This tends to raise the value of all houses and encourage some owners to tap their equity for purchases. It's no coincidence that money supply growth has been highly correlated with mortgage lending. Finally, the ubiquitous implementation of new technology has boosted productivity to a higher growth path. This also keeps downward pressure on goods and services while boosting the return on and value of invested capital. (continued on page 4)

According to Yardeni.com, non-gold international reserves are up close to 125% over the last five years. I would contend that it will be quite difficult to see lower prices for any asset that generates value as long as liquidity is growing at these kinds of rates.



A low real interest rate will ultimately do two things. First, it will drive existing asset values up to the point where returns are similar across asset classes. Second, it will consign future returns to similarly low levels. It's a great process while it is occurring, but is not much fun after it is done.

Theory tells us that all asset markets should have values determined by the real interest rate available as an alternative. All assets that can generate returns (real or financial) should ultimately be priced on this rate. And price appreciation should begin with the most liquid market and progress to the least liquid. That's not a bad description of what we have seen over the last decade.

What do I gather from this? First of all, and in contrast to my previous beliefs, I do not see a bubble in any particular area. I see a wide variety of assets being priced to a new marginal real rate. This means a <u>bubble in all areas or no bubble at all</u>. Second, there is no real place to hide. Cash is a possibility, but if as I believe, the Fed will be easing a year from now, the respite is only temporary. I am afraid we are in a low return world with no alternatives but to stay invested.

Pessimists will argue that the real rate needs to return to the 4% or so area and that all assets will decline. Optimists will argue that freer markets create more capital to seek and drive down returns. The risk is not an economic slowdown, but rather a slowdown in liquidity creation or a reversal of productivity growth that allows goods and services to capture the liquidity created. For now, I count myself in the optimist camp, expecting low but positive returns to all asset classes. My favorites continue to be gold, energy, and dividend paying stocks. Fixed income choices should focus on the three-year range. ❖

Editor's Note

Time is marching inexorably forward, a point brought home with a vengeance in the last two weeks. Apparently, I am a freak of nature because I have one eye that sees up close while the other handles long distance. I never had any depth perception, but I could usually get along quite well. Recently, I concluded that I could not really see well at a distance of 10 to 20 feet. So, I went in for a test, and they figured out the prescription. Not only will I be getting glasses, but they will be bifocals. The thing that ticks me off is that I think there is a better way. During the exam, they asked me to read an eye chart with my left eye, and it was only a guess that had me identify the "E" in the first line. Then, they placed a black circle with pinholes in it over my eye, and I was able to identify lines all the way down to 20-20. Now, why should I pay hundreds of dollars for glasses when all I need is a black patch with pinholes?

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