# Jameson Associates

September 2006 Newsletter

## Recent Economic Events

The Federal Reserve made a bet in August (doubled up in September) that the economy would slow, dragging down inflation, even without further increases in the Federal Funds rate. It appears they are on a winning streak. Virtually all measures of economic activity in the United States are less robust today than they were at the beginning of the summer. Furthermore, after an early summer increase in inflation, the most recent statistics hint at moderation.

Following the first quarter snap-back in economic growth from hurricane-related issues late last year, GDP slowed to a below-trend 2.6% in the second quarter. Key components in the slowdown were moderating consumer consumption, weaker business investment growth, and an unexpected decline in residential investment. Note that this decline preceded the even weaker monthly statistics that have been released in August and September. There have been few statistics on the production side that would suggest that the weakness in the second quarter was reversed in the third. Capacity utilization has receded from its high point during this cycle. The index of leading indicators declined in August for the second month in a row and for the fifth month out of eight this year. New orders for durable goods have fallen two months running. The optimism exhibited by business owners earlier in the year has evaporated, led by a plunge in confidence on the part of homebuilders.

Job creation has slowed as well. In August, 128,000 jobs were created, just equaling the average for the last three months. This is down over 20% from the 165,000 monthly jobs created on average during 2005. Other measures of labor market health also appear to be softening. New claims for unemployment insurance have stayed stubbornly above 300,000 per week, and the unemployment rate has stopped declining.

There is some good news to report, however. Inflation seems to be turning downward. Headline inflation, which is heavily influenced by energy prices, has moderated from its mid-summer pace. The annual increase in the headline CPI is now 3.8% down from a peak of 4.7%. Even though core CPI is up a worrisome 2.8% on an annual basis, the future suggests moderation here as well. Core PPI is up only .9% over the last year, (continued on page 2)

## Recent Economic Events (continued)

signaling that pressures in the pipeline are easing. Housing costs, which have been driven higher by comparable rental costs, have moderated, and the price of automobiles is adjusting downward as car companies scramble to clear bloated inventories of gas-guzzling SUV's.

The $64,000 question is whether the slowdown will turn into a recession. The odds today suggest we will dodge the bullet on this, but there is one big caveat — housing. America has benefited greatly over the past few years from an almost unprecedented increase in housing values. This has allowed homeowners to skimp on savings while watching their wealth increase. It is estimated that over $600 billion was extracted from home equity in 2005. Now that housing prices are falling (both new and existing homes show prices down from a year ago), it appears that this prop to spending will fall away.

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The chart showing builder confidence in the housing market reflects the free-fall we have seen over the last few months in this measure. It captures the 17% drop in new home sales coupled with a 19% increase in inventory. The existing home figures are just as grim, down 13% on sales and up 38% on inventory. It doesn't take much to paint a scary scenario on this sector of the economy.

Let's keep in mind that housing, although important, represents just 6% of the total economy. So even if it drops by 50%, we can hold out hope that the rest of the economy can keep growth going. The next few months will tell whether or not the Fed stopped soon enough to avoid a recession or if it went too far as it did the last time in 2000. ❖

## Commentary

Why is it that with unemployment below 5%, inflation below 4%, and the Dow Jones within spitting distance of a new all-time high, a two to one ratio of Americans believes the country is on the wrong versus the right track? Are Americans blind to prosperity or is there a disconnect between the aggregate economic statistics and economic reality?

Here are some things to consider. The recovery which began in 2001 has shown far more anemic income growth than the average of the previous four recoveries. Morgan Stanley estimates that the income shortfall is $600 billion. That number bears a striking similarity to the home equity extraction that took place in 2005. Also consider that the national minimum wage is stuck at $5.15, having been last raised in 1996. At that time, the average CEO was making about 300 times the amount a minimum wage worker earned. Now the ratio is over 800 times. Inflation-adjusted median household income has increased by less than 7% in the last fifteen years while households in the top 5% saw growth of 21%.

Wealth has increased in the United States, but the gains have been poorly distributed. The wealthiest 1% of Americans held wealth equal to 131 times of the median in 1983 while in 2004 (last data available) the ratio was 190 times. It appears that the rich are getting richer. Could it be that the economic statistics are heavily skewed by the success of the top quartile while the rest of the country feels it has been left behind?

These statistics are the result of many factors, but it is legitimate to ask about those that can be countered versus those that cannot. Globalization has been a big contributor to the divergence in economic outcomes. As modern production techniques travel around the world and the cost of communications and (continued on page 3)

## Commentary (continued)

transportation decline, the key variable in the production equation becomes labor. It is no wonder that manufacturing jobs have left the United States at a rapid pace through both expansion and recession. It is simply cheaper to produce many goods with a high labor component overseas. We can stand around like King Canute, trying to order back the tide, but this will prove ineffective at best.

Global labor arbitrage has begun its assault on service employment as well. Call centers were early conversions, but now the trend has extended to paralegals (September 18, 2006 *Business Week*). The benefits of globalization are obvious as well — less expensive goods for Americans to buy, helping to hold down inflation.

The jury is out on whether globalization helps or hurts the country in total. What isn't in dispute is that workers who had performed low or unskilled labor in the US were left behind. Those further up the income ladder benefited from lower priced goods if they stayed employed, but not so much if they lost or worried about losing their job. The rich benefited the most. But this doesn't explain everything,

Government has been an active helpmate to the more affluent in skewing the rewards of economic growth. Let's check the level of taxes over that period of time.

| Type of Federal Tax | 1990 | 2005 |
|---|---|---|
| Social Security/Medicare | 7.65% | 7.65% |
| Income (top rate) | 28% | 35% |
| Capital Gains | 28% | 15% |
| Dividend Income | 28% | 15% |

It appears that taxes on income for the vast majority of working Americans have either held steady (FICA) or risen while rates on investment income has declined by close to 50%. It is hard to believe that these changes have not exacerbated the income and wealth skew we have witnessed over the last fifteen years.

Say you and your family are primarily dependent on wage and salary income, barely staying above even as you feed, house, and educate your kids and prepare for your retirement. You are disadvantaged versus those who benefit from earnings on existing wealth, whether capital gains or dividends. The final nail in the coffin, so to speak, would be a repeal of the estate tax, allowing wealth to escape taxes for another generation or more.

The facts are in. Wealth is beating income both because of global change and because the tax system is helping out. Two options are available. Rise up and overthrow the oppressive capitalists. Quietly increase savings and join the over-class. To borrow a phrase, "We report, you decide." ❖

## Market View

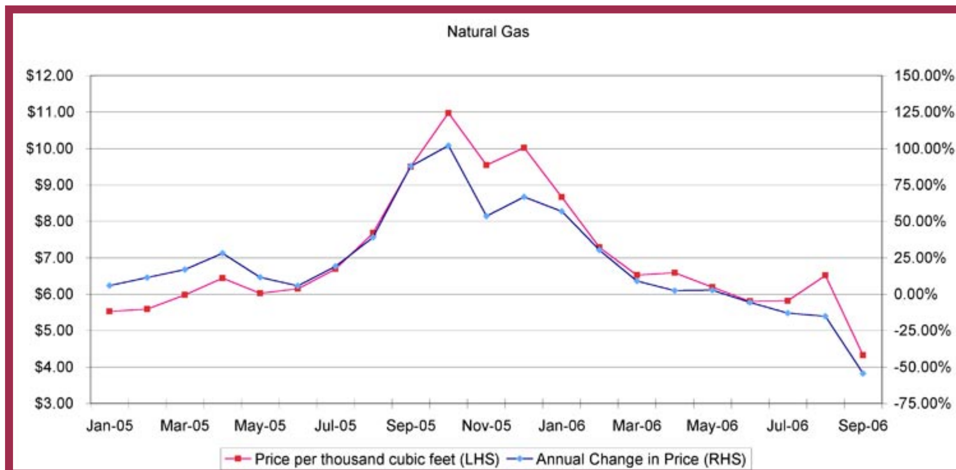
The economy is in late cycle expansion or early recession/slowdown. The best relative performance is provided by commodities in the former and bonds in the latter. Both classes driven by the timing of the peak in inflation. The types of stocks that do well at these times are defensive in character with good income attributes (large cap US companies selling consumer non-durables).

Real estate is not a good choice at this point in the economic cycle.

Since commodities have corrected, and corrected violently, I would judge that the markets are telling us that we are past the late expansion blow-off. Furthermore, the stresses and strains of early recession/slowdown are (continued on page 4)

## Market View (continued)

starting to hit the financial pages. And as we always find, leverage is a handmaiden to the train wreck. The hedge fund, Amaranth, is our current poster child. These worthies managed to pry over $9 billion from "investors" to pursue a multi-strategy approach to a wide range of investments. Turns out what they really were pursuing was highly-leveraged, illiquid bets on that most volatile of commodities — natural gas. They lost. And they lost big — around $6 billion.




In the Greenspan era, this would be the signal to buy. Whenever a big crack-up occurred Uncle Al would dump gobs of money into the system to protect investors. Time will tell whether Ben Bernanke inherited the same MO. However, it is a safe bet that the Fed will be reluctant to tighten further if stories of more hedge fund collapses hit the papers.

A more benign monetary environment is good for bonds if it does not engender inflation (I don't think it will.). Ultimately, it will help stocks as well, but for now, the chance of an elephant rush to the risky asset exit suggests staying with defensive names.

Commodities are in a multi-year bull market, but it appears that the correction phase is upon us. Better to wait until the Fed has clearly switched to easing before re-entering this market.

Cash has been a winner for the last few years. It will relinquish its crown soon. Put reserves to work. For the most cautious, choose maturities of two to five years. Those with a higher tolerance for volatility could look to buy ten-year maturities on weakness over the next few months. ❖

## Editor's Note

*I am officially clueless. In the innumerable laptop battery recalls that have been announced, I found that one of my computers qualified. I dutifully registered for a replacement online, and it came in about three or four days along with instructions on how to return the old battery for proper disposal. This involved contacting an overnight delivery service to schedule the pickup. As you might imagine, the timing was not at my convenience — they would be at my office between 1 PM and 5 PM the next day. I stayed tethered to my desk all afternoon waiting for the pickup, but around 5:20 PM, I gave up and called. The lady in customer service checked her computer and politely told me that they had picked it up at 4:45 PM. Who would be right, customer service on the other side of the globe or me only one floor removed from where I had placed the package? When I went downstairs to check, it was they. So much for local hands-on knowledge.*

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