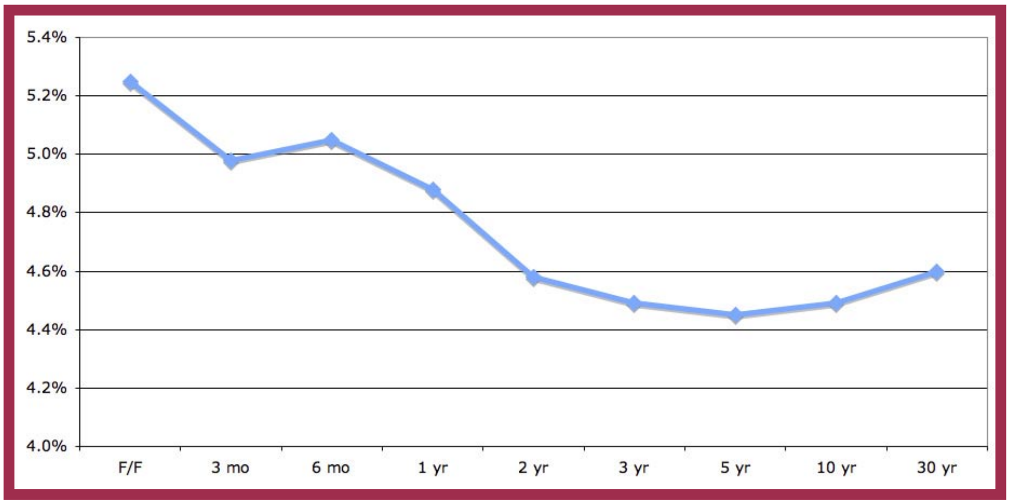
Jamesson Associates

December 2006 Newsletter

Recent Economic Events

Socrates opined, “A wise man knows that he doesn’t know.” I believe wise men looking at the current economic situation would do well to keep this in mind because uncertainty has been increasing. GDP has slowed, dragged down by a rapidly weakening housing market, but employment gains have remained healthy and have been consistently revised upward. Inflation seems to have peaked, but oil prices are once again on the rise. And finally, the market and the Federal Reserve have come to decidedly different conclusions, as reflected in the shape of the yield curve.



Real GDP grew by a below-potential 2.2% in the third quarter. This continues a serial slowdown from 5.6% in the first quarter and 2.6% in the second. A key factor in the weakening is the reversal of fortune in the housing market. While residential construction dropped over 11% in the second quarter, it was falling at an annual rate of 18% in the third. Since then, the statistics on housing have been uneven but generally negative. In fact, sales of new homes and existing homes are down 25% and 11.5% respectively from a year ago even as homes for sale have jumped by over 30% in the last year. Prices have followed suit: existing home prices were 3.5% lower than last year in October, the largest decline ever recorded on an annual basis.

Offsetting this dreary news is the strength we see in employment. Not only is unemployment running at 4.5% (near the cycle low), but the Labor Department has made a habit of revising historical job figures upward. Seems as though they found an extra 800,000 jobs in the March 2005 to March 2006 period.

October headline consumer prices fell by .5%, pulling down the year-over-year rate to only 1.3%. The core rate fell as well, bringing the annual change down to 2.7%. Overall producer prices are actually lower than they were one year ago, and even the core PPI is up a non-threatening .6%.

With this benign inflation picture, you would expect that the Federal Reserve would be making easing noises. You would be wrong. In fact, a series of speeches by Fed officials since mid-November has tried to scare the market into concern over inflation. Traders are not buying it. No Treasury rate is in excess of Federal Funds — the closest be-

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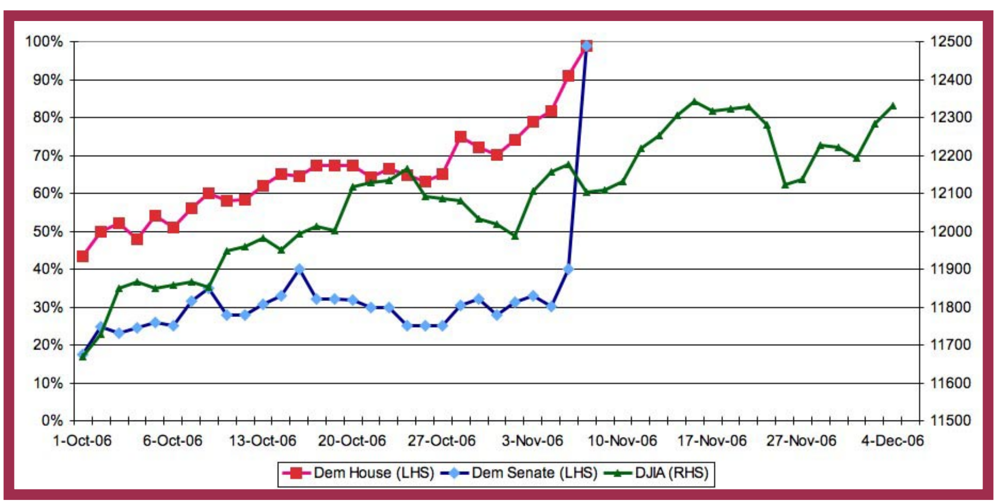
ing six-month rates at 5.04%. The Federal Funds futures market now expects the next move to be a reduction regardless of what the Fed says.

The current economic environment is uncertain. Based on history, it is unlikely that we are poised for strong growth, so the uncertainty revolves around whether we simply face a period of positive, albeit below-trend, growth or an outright recession. Since all readers of this missive are wise, and we know that we don't know, let's sit back and enjoy the holidays instead of trying to pick sides in this economic dispute. ❖

Commentary

The chart which graces this section of the newsletter presents three separate trends. Two indicate prices from the Iowa Electronic Markets on expectations for Democratic control of each house of Congress. The last one shows the Dow Jones Industrial Average. In early October, the chances of Democrats capturing the House rose above 50%. They exceeded two-thirds by early November. However, until the evening of election day, the Senate was not expected to change hands. The stock market tracked Democratic prospects in the House and then jumped to new all-time highs in the wake of the Congressional sweep. Although not on the graph, the ten-year Treasury is basically unchanged from early October.



What are we to make of this? Are investors closet liberals? Do Americans really believe Democrats are more responsible officeholders than Republicans? I think not. I believe the markets are reflecting an expectation that checks and balances will be restored to a government that has essentially been one-party rule for the last six years.

There is a wide variety of opinion on the value of divided government, and to be honest, the small number of historical examples limits our ability to make statistically valid conclusions. With that said, I think that most would agree that the reason we have two political parties in this country is that there are differences of opinion in the voting public as to the best course of action on any number of important issues. When one side gains monopoly power, the extremes of that party pull policy beyond the edges of the mainstream. Eventually, the flaws of pure ideology are exposed in market reversals. With one party watching the other, compromises are necessary, leading to more measured policy choices. This allows the basic strength of the underlying economy to shine through.

Although there are some well-publicized Democratic initiatives like increasing the minimum wage, encouraging the government to negotiate for lower drug prices, and steps toward universal health care (sure to be vetoed), I see these issues as small potatoes in the context of (continued on page 3)

Commentary (continued)

a $13 trillion economy. Far more important is a pending change in budget rules and the possibility of discussing entitlement reform.

The Democrats have indicated that they will reinstitute Pay-go rules on the Federal Budget. This is great news. Under Mr. Bush not only have revenues dropped from about 20.5% of GDP to about 17.5%, but expenditures have jumped from about 18.5% to 21%. This latter growth is faster than anything since LBJ's Great Society coupled with the Vietnam War. It is likely that investors are focusing on a return to fiscal sanity as the real reason for increased market values.

There is also a wild card. Although privatization of Social Security is dead, there is a not insignificant chance of some compromise on entitlements. The desires of potential Presidential candidates in 2008 may offer a real opportunity. One thing is certain, it can't get any worse than what we've seen under the do-nothing Republican rule.

Being a skeptic, I would suggest we reserve judgment on the coming golden age. However, I agree with the early market returns. Divided government is much better than the mess we have seen since 2000. Even if all that happens is one side stymies the other, we are better off. And as a long-shot possibility, we may see some real progress on the big issue of Baby Boomer entitlements. ❖

Market View

Over thirty years ago, I wrote a senior thesis exploring the implications of zero population growth in the context of continued gains in productivity. In other words, what happens when production overwhelms consumption and excess savings pile up? Globalization and market activity over the past few years bear a startling resemblance to my now long-forgotten theoretical musings. My solution to the dilemma then was a redoubled effort to explore outer space (thus using up the extra production by shooting it into the wild blue yonder). In a true "life imitating art" story, just this week NASA announced plans to put a permanent base on the moon.

> *...the excess savings story is alive and well.*

Back here on earth, I believe the continued world wide low-interest regime, along with many stock markets (US, India, etc.) hitting all-time highs, suggests that the excess savings story is alive and well.

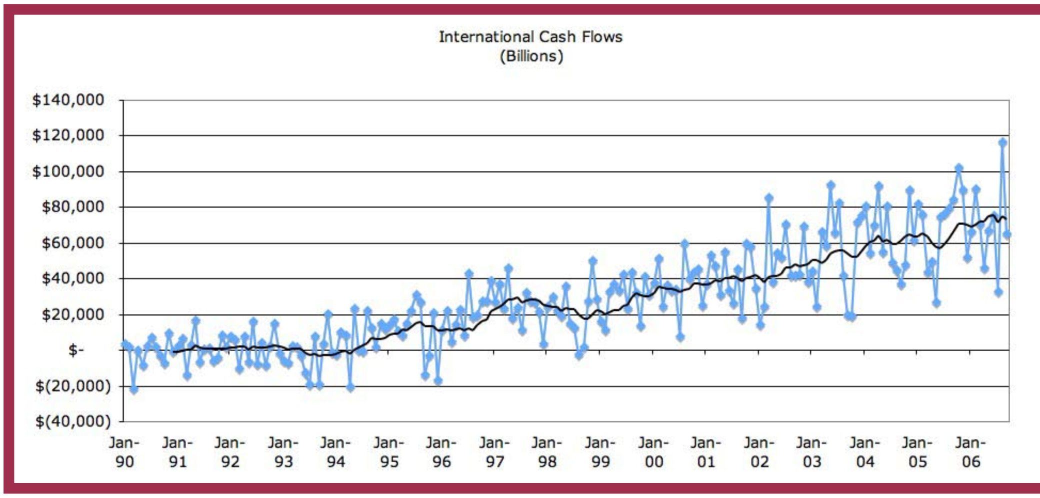
As you can see from the accompanying chart, international cash flows into the United States continue to build. Although volatile on a month-to-month basis, the twelve-month moving average is now roughly $65 billion, an amount equal to our monthly trade deficit. This is as we would expect because everything does have to balance. However, the key point is that far from spending their increased income, countries that send products to the United States in return for dollars turn around and invest those dollars. As long as this transfer of wealth from us to them is returned by bidding up the value of our assets, it is likely that interest rates will stay relatively low and stock valuations relatively high.

Note that this argument is basically a "rising tide lifts all boats" approach. Too much money chasing too few goods and services is what we know as inflation. Too much (continued on page 4)

Market View (continued)

money chasing too few investment opportunities is what we know as a bull market.

Before everyone rushes to buy, I have two caveats. All markets go through corrections even if their underlying direction is upward to new levels of valuation. Second, it is not inconceivable that these trends could change due to new developments. Secular trends are powerful and long-lasting, but they are not infinite in duration.



For now, I would be careful but opportunistic in the stock market. Even though we may be nearing a slowdown in profit growth, I believe the interest rate environment offers the possibility of expanded P/E multiples. Interest rates are clearly expecting an economic slowing and ease by the Fed. I think this is a good bet, but the chances of huge drops from the present levels are modest. I would target maturities in the two to five year range. Commodities have gone through a correction and appear to be ready to resume rising. Here, however, I would continue to keep my powder dry until the Fed has actually signaled they are in an easing mode. ❖

Editor's Note

I was recently asked by a client to present my views on the economy (both short and long-term) to an audience of their customers. Needless to say, my ego became fully engaged as I worked on perfecting the presentation. Although content was important, two other factors take precedence in these situations — humorous stories consistent with the points made and an acceptable appearance for credibility. Hours of searching and practice secured the former, but imagine my chagrin when I arrived in town to find my freshly laundered button-down shirt was missing a collar button. I could either wear a wrong colored shirt or learn to sew. I chose the latter and managed to secure a spare button on the shirt with only two problems. The first try missed the proper location by about ½ inch; the second ended with the button upside-down. Fortunately, my handiwork held, and I was far enough from the audience that the button surface was not visible. Please note: I don't darn socks.

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