Winter 2007

Jamesson Associates

Recent Economic Events • • •

Historical statistics suggest a healthy American economy despite mounting troubles in the housing market. Overall growth has remained solid and employment is growing. Core inflation is moderating. But higher prices for food and energy may finally stop the consumer. A key offset: our shrinking trade deficit.

The US economy has turned in six months of real growth in excess of potential. The third quarter was recently revised to a very strong 4.9% rate. The key drivers of this performance were exports (up 18.9%) and non-residential investment (up 9.4%). These positives were large enough to offset another horrible quarter for residential investment (down 19.7%) and somewhat weaker consumer spending (up 2.7%). Note, however, that consumer spending was up, reflecting continued employment gains and some movement on wages.

Employment growth has continued, albeit at a somewhat slower pace than that of the past few years. The American economy created 94,000 jobs in November, down from 170,000 in October, but much better than the anemic 44,000 gain in September. The past three months' average of a bit over 100,000 compares to roughly double that in 2005-6. Nevertheless, the unemployment rate held steady at 4.7%. Most of the strength in the job market is coming from the service sector of the economy, as manufacturing, and now construction, are weak. Compensation is growing, which allows consumers to maintain their spending habits in the face of weakening housing conditions.

Embedded in the third quarter reports was an increase in productivity (up 6.3%) which is a large factor in holding down inflation and in creating real gains for workers. Both consumer and producer prices are staying well-behaved at the core level. But, when food and energy are included, inflation is much higher than we would like. The divergence in October consumer prices between core (2.1% y-o-y) and headline (3.5% y-o-y) is as large as it has been in recent memory. How the consumer reacts to this increased "tax" on spendable income from higher food and energy prices will help determine how well the economy does in the next few months. Currently, the mood is gloomy.

Potentially offsetting consumer headwinds are the growth prospects for the global economy. The US is poised for a slowdown but, global growth appears solid. This is reinforced by the continued strength in industrial commodities and in the solid improvement in the US balance of trade. The most recent figures available show the monthly deficit is down by about $10 billion from its peak even as our monthly oil bill climbed to $26 billion.

It is likely that the economy will slow, but signs do not point to a recession unless the sub-prime contagion spreads well beyond its current victims.

Commentary • • •

The battle has been joined. The positions are hardening as both the right and the left proffer their views on the events of the day. Of what issue do I speak? Iraq? The 2008 Presidential primaries? Health care? No, no, and no. The issue is the intertwined one of housing and financial turmoil.

We all know the core narrative to this point. Irresponsible borrowers/lenders piled debt on homeowners leading to housing purchases beyond affordability. The loans were packaged up and sold to/retained by "sophisticated" investors reaching for yield and assured by rating agencies that dross was gold. Mass illusion swept all in its wake. Then, housing prices stopped rising and dropped as did the value of the loans backing many of the new financial instruments. It now is/isn't the job of the government to address the situation.

Problem is, there is plenty wrong with this story. First of all, many, if not most, of the loans made over the past two or three years to homeowners were made based on sound principles. Delinquencies have increased, but even sub-prime delinquencies are only in the range of 15% or so. Of course, this is a high figure, but it belies the belief that all sub-prime borrowers were unqualified. In fact, according to the Mortgage Bankers Association, foreclosure statistics have increased even faster for prime than for sub-prime borrowers (see table).

Foreclosures	September 2006	September 2007	% Increase
Prime Fixed	.13%	.22%	69%
Prime ARM	.30%	1.02%	240%
Sub-prime Fixed	.97%	1.38%	42%
Sub-prime ARM	2.19%	4.72%	115%

Note that for both prime and sub-prime groups, the increase in foreclosures was three times as great in ARMs as it was in fixed-rate loans. This leads one to think that structure (and the fees inherent) are a big part of the problem. The same situation obtains on the investor side of the equation. Not all investment bank CEOs have lost their jobs over the losses. Some investors stayed away from the mess, and now have funds to take advantage.

Moralists and do-gooders have been quite selective in their remedies for the situation. The moralists argue for those with losses to take their medicine in order to "purge the system of excess." The do-gooders want a comprehensive solution so as not to "throw the baby out with the bathwater."

However, the right generally feels that the free market is good for the "irresponsible" borrower but that the Fed should intervene to promote "orderly financial markets." The left wants to create an "orderly housing market" while suggesting that "irresponsible" investors be left to their own devices. As Arsenio Hall used to say, "Hmmmm."

The reality of the situation is that the US built up a housing bubble both because borrowers and their enablers took on too much debt and because the resulting loans were magically transformed into high-grade paper for purchase by investors. If either the housing or the financial markets completely freeze up, the pain will be shared by the irresponsible and the innocent alike. However, letting everyone off the hook risks an even bigger calamity once this crisis passes. I don't envy the Federal Reserve or the Bush Administration/Congress in their decisions.

What is obvious to me is that any solution has to be much bigger than what's currently on the table. In the financial markets, the boneheaded 25 basis point let's see how things go approach has not worked.(See chart.)

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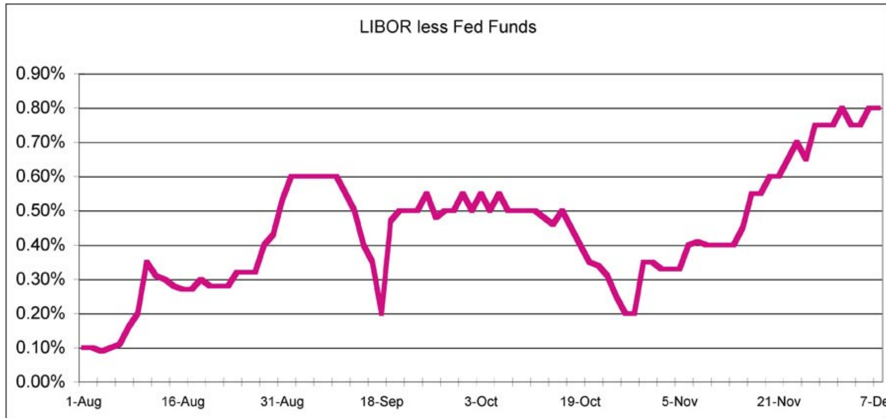
Commentary (continued) • • •



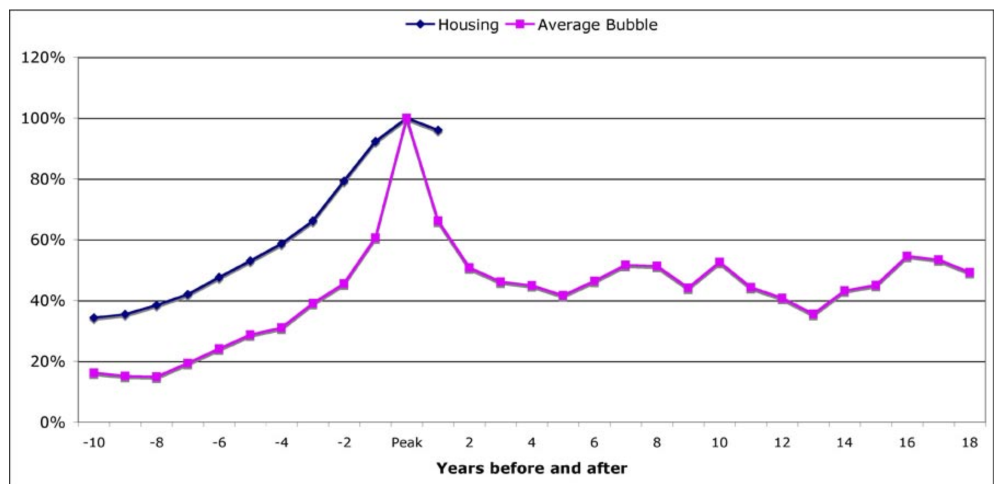
The current Treasury plan looks like a good first step for existing loans, but we need to make sure that the mortgage market provides funds for new qualified buyers on reasonable terms.

For housing prices, there is no solution short of increasing household income by 25% or more. In the short term, the best we can hope for is a restructuring. Whether loan payments are frozen at teaser rates or loans are rewritten at lower values, eventually the price of the house must adjust to the real market. The magnitude of the issue (up to 2 million foreclosures over the next two years) means that we need an overall solution rather than one that goes loan by loan.

One of the lessons that we should all learn from this debacle is that an unfettered free market only worked on the way up. With ideologues in power and things looking good, the markets are king, and it is very hard for responsibility to be given the weight it should. But when systemic problems come to the surface, everyone is looking for intervention. Much better for government to exercise oversight responsibility well before the crisis strikes (a quaint notion of the pre-Greenspan Fed). That keeps costs lower and allows the system to right itself without government intervention is not needed because the losers are far fewer in number and innocents are not swept along.

Market View • • •

One of the most asked questions today is, "How far will the housing market fall?" To try to answer this question, I went back in time (not literally of course) to look at bubbles from previous eras. I focused on three bubble peaks — the US stock market in 1929, gold in 1984, and Japanese stocks in 1989. A chart averaging each of these markets based on a price of 100 at the peak appears at the right. It begins ten years before the peak and runs to



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Market View (continued) • • •

18 years after (the maximum period since the Japanese top). I also included the current housing market on which prices peaked in 2006.

Note that the period from ten to roughly two years before the peak shows appreciation at a near steady rate. Then, prices seem to move up exponentially. Furthermore, after an initial fall, prices tend to recover but to levels well below the peak, even 18 years later. Finally, the distance from peak to stabilization level seems to return prices to where they were pre-bubble before the price went exponential.

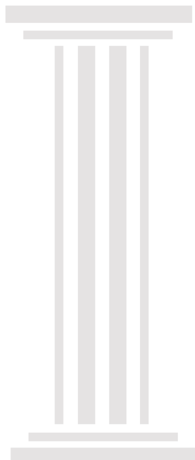
> ...this suggests that housing prices have further to fall...

If there is a common architecture of bubbles, this suggests that housing prices have further to fall, perhaps another 15%. That would bring them back to where they were in 2004. In addition, we are likely to experience an extended period of time where prices do not resume an uptrend. Although I hesitate to suggest that it will take 18 years, that would not be the first time housing prices in the US were lower for a two-decade period. From the mid-1920s to the early 1940s, housing prices generally fell.

Reflating the system is the time-honored way out of this box. If the currency is debased enough, the nominal price of homes can be held up. But too much liquidity has a side effect that cannot be contained. Other items will rise in price at the same time, and a wise investor will look to those fundamentally stronger areas.

Hard assets represent the best choice. Commodities of all sorts and companies and countries well positioned to provide commodities still look like winners. Gold continues to be my number one choice. Equities, both domestic and international, should also be repriced higher based on a sea of liquidity. Long-term bond prices must fall (higher rates) if I am right. The flight-to-quality in Treasury securities will be reversed if confidence returns to the system. Then, the Federal Reserve will be back to worrying about inflation, and rates will begin to rise. If you do choose fixed income, stay with high quality and keep maturities inside of three years.

Editor's Note • • •



In keeping with my ideas about increased globalization, I felt it was time to get a new passport. My previous one was twenty-five years old. After a too long wait, it arrived, but I was not really ready for the final version. The passport photo has very strict criteria, including not showing teeth or an overt smile. As you can see, I met and easily exceeded these requirements. My concern: given my normal demeanor compared to the passport photo, will they let me back into the country or lock me up? If you were a border guard, would you take a chance?

Passport

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Reality