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Jamesson Associates

Recent Economic Events . . .

November employment news reinforced the third quarter GDP report, suggesting the recession has ended. This does not mean that all of our economic travails are over, or that there will not be more bank failures (128 and counting year-to-date) and economic bumps in the road. The recovery thus far appears to be centered in the financial markets rather than on Main Street. Nevertheless, there are encouraging signs in spending and production suggesting that the worst has passed. Furthermore, inflation has remained under control.

In the month of November, the American economy lost the fewest jobs since the recession began in late 2007, only 11,000. This helped to reduce the unemployment rate from 10.2% in October to a still-too-high 10% in November. Almost as important, the average workweek in the economy increased from 33 hours to 33.2 hours. This may not seem like much, but when you consider that almost 140 million Americans have jobs, the 12-minute increase in hours worked means that someone was earning money for another 28 million hours per week in November versus the previous month. That is mathematically similar to holding the workweek constant while adding about 850,000 new jobs. There are still over 15 million unemployed Americans and an additional 12 million who are under-employed or so discouraged that they have dropped out, but this is the first report in a long time that has a hopeful cast to it.

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Third quarter GDP growth foreshadowed the gain in hours worked. The US economy grew by 2.8%, driven by exports and government spending along with a boost from the "Cash for Clunkers" program. Note that 2.8% growth is somewhat less than America's long-term average of around 3.5%, however. Unless growth exceeds this bogey, it will be hard to whittle down the unemployment rate. The math goes like this. If the labor force is growing about 1% per year based on demographics, and productivity is advancing by 2.5% or so, growth of 3.5% will simply hold unemployment steady. It is only the growth above this level that can help to reduce the army of the unemployed.

While hardly robust, both car and housing sales have bounced off their low points. November vehicle sales moved up to 10.9 million annualized (early 2009 levels were closer to 9 million). Existing housing sales rose smartly, exceeding 5 million for the first time since mid-2007.

During the third quarter, productivity jumped by 8.1%. This pushed down unit labor costs and helped support the benign inflation environment we now enjoy. Headline CPI was up .3% in October, bringing the annual change to -.2%. Core inflation, excluding food and energy, posted a .2% gain in October and an annual change of 1.7%. All of these figures help the Federal Reserve sleep well at night.

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Recent Economic Events (continued) • • •

The economy has turned the corner from recession to recovery. As long as something else does not interfere, we should continue to move forward. However, the deleveraging process will act as a ball and chain on the recovery, forcing a "show me" attitude on the part of economic actors. While financial markets have already responded to this environment, the rest of the economy has not yet really caught fire.

This raises an important consideration. While almost all recoveries start with financial market anticipation and then proceed to real economic growth, the recent recession has been more severe in both length and depth than the others we have experienced since the Great Depression. We are simply not used to this kind of decline, and it is having its impact on America's psyche.

The divide between Wall Street and Main Street has become a canyon. Populists from both the left and the right are suggesting remedies. The results of such a politically charged environment are impossible to predict. To paraphrase Yogi Berra, this added political uncertainty makes economic forecasting difficult, especially if it's about the future.

Commentary • • •

What's so great about an independent Federal Reserve? Has the average American benefited? Why should monetary policy be decided in secret while all other important government policies are subject to transparency and vigorous debate? Where is the oversight and responsibility?

The Federal Reserve was created almost 100 years ago to act as the guardian of the financial system — the lender of last resort. In its first quarter century, it presided over the Panic of 1919, the boom and bust of the Roaring Twenties, and the Great Depression. The latter was exacerbated by wrongheaded monetary policy. The next 25 years or so brought post-war prosperity as much due to America's economic preeminence, the modified gold standard established at Bretton Woods, and responsible fiscal policy as to Fed action. Then came Vietnam and the Great Society, which ultimately led President Nixon to suspend gold convertibility and to the inflationary 1970s and 1980s. Throughout this period, the Fed was led by the pipe-smoking political hack Arthur Burns and the clearly incompetent G. William Miller. Not until President Carter appointed Paul Volcker was monetary policy restored to sanity. Then we had the non-pipe-smoking political hack Alan Greenspan. Ben Bernanke, the current Fed Chairman, was a key engineer of the recent financial meltdown and bailout of Wall Street. This litany is hardly a confidence-building one, arguing that the political system should keep hands off. One might even contend that holding the executive branch of government directly responsible would be a big improvement.

The Federal Reserve has been captured by the wealthy Wall Street crowd and is subservient to their interests rather than those of the financial (continued on page 3)

Commentary (continued) • • •

system in general or the American public. While this might have been acceptable in the past or if performance had been exemplary, it is no longer so.

It is time to cast off the dogma of independence; it has not worked. Congress is making good progress with current reform legislation. It now appears that oversight by the GAO will make its way from the House to the Senate. Mr. Bernanke's reappointment is also not a slam dunk. I say good. It's about time some consequences for this mess were assessed.

I pose three questions:

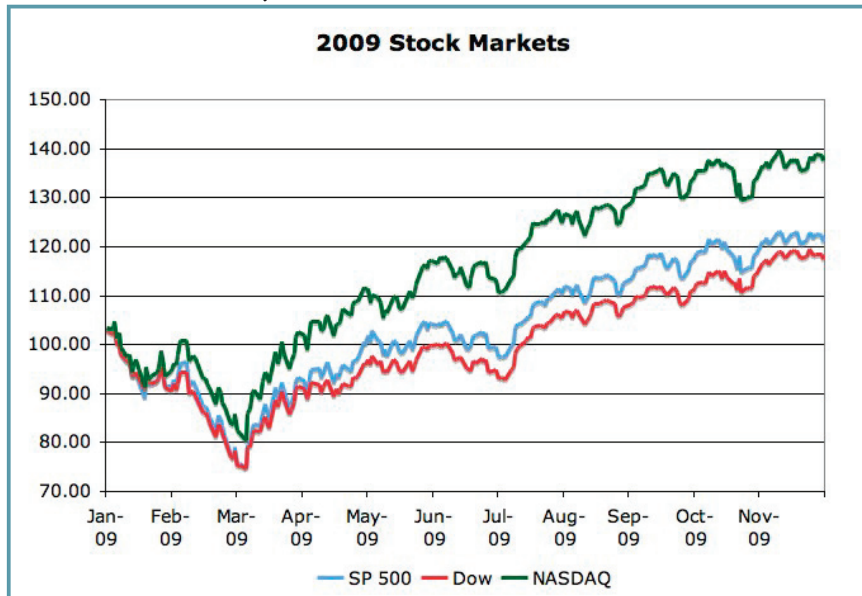
- Should the Fed become a direct responsibility of the Administration?
- Should Mr. Bernanke be confirmed for another term as Chairman?
- Should Fed responsibilities be limited to executing monetary policy rather than mixed together with regulatory authority?

My answers: Yes, no, yes.

Market View • • •

The stock market has finally realized that George Bush is no longer President and has advanced by almost 20% to almost 40% this year, depending on which index you chose. This performance has outrun the earnings of the underlying companies and any reasonable assessment of the overall economy's health.

In this advance, both Zeno (change is illusion) and religious fundamentalists (truth is absolute) have been proven wrong. The world did change — from terrible to just bad. Investors sensed the transition and put money to work in the most powerful rally in over 70 years, disregarding the "fact" that things were still not ideal.



The expansion in Price/Earnings Ratios has been the result of easy credit and plenty of liquidity. These same factors have restored most bond market spreads to more normal levels and have kept Treasury rates down to boot. The sea of dollars has had a predictable impact on foreign exchange values, boosting commodity prices in the bargain.

We are now at an inflection point. Riding the liquidity tiger in risk assets is becoming a more dangerous game. In fact, market complacency as measured by the Volatility Index (VIX) is signaling that the financial crisis is over. This is a red flag. At the same time, it is hard to ignore the fact that there is plenty of cash in the system and returns for holding it are close to zero. What options make the most sense as we travel through the transition from recession to recovery to expansion?

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Market View (continued) • • •

First of all, commodities have outrun fundamentals and are due for a correction. The dollar is likely to recover some lost ground as well. I would avoid adding new funds to gold or energy positions unless and until there is a decent correction. I expect gold to hold the $1000 per ounce level, so if it backs up to something near that point, new positions make sense.

Longer-term fixed income options are a fool's game. Government manipulation is set to reverse as both the Treasury and the Federal Reserve change course. The former is in the process of extending the maturity of its debt which had shortened dramatically this year based on huge issuances of Treasury Bills. At the same time, the Federal Reserve is ending its purchases of longer-term MBS. This combination, along with an expected restoration of positive inflation figures, will be deadly to long-term bond holdings. Anything beyond seven years should be avoided. On the other hand, if you are contemplating refinancing your mortgage, now is the time to move.

If you need fixed income in your portfolio and cannot stomach money market rates near zero, there is value in items up to three years or so. Focus on high-quality corporate or municipal issues or, alternatively, US Agencies with calls.

Since I no longer believe that a rising tide will lift all boats, equity choices must be much more earnings-driven. Although emerging markets have been the top performers this year and are likely to be so over the next decade, I suspect that they are in for a correction just like commodities. Look for a 10% to 15% pull-back to add to those positions. Domestically, financial stocks are the most extended, as investors apparently believe all the shoes have dropped. I don't think so. The value in the market is in those stocks that can generate earnings growth in spite of a sluggish recovery. Of course, companies with well-covered dividends generating a decent yield are always a great place to hide while we wait for a higher level of economic clarity.

Editor's Note • • •

I will not soon forget my 56th birthday. On the Saturday after Thanksgiving, Susan and I headed to Boston to drop our son off for a fencing tournament. We managed to navigate both the NYS Thruway and the Mass Pike at high speed and in bumper-to-bumper traffic, arriving within a mile of my son's hotel when, at 6 PM, the car died. This is not the ideal time to conk out — no shops were open to fix the car until Monday. Imagine my fear as we stalled on N. Harvard Street no more than a mile or two from Fenway Park. This is the heart of enemy territory for a YYF (Yalie Yankee Fan). Fortunately, there were no identifying stickers on the car, and I was able to keep my mouth shut when the AAA tow-truck driver arrived sporting both a Red Sox hoodie and baseball cap. After declining his offer to tow us back to Scottsville (some 400 miles at $3 per mile), we settled on a local repair shop. Catching a cab to our hotel, we had a nice dinner, delayed only a half hour from our original reservation. We ended up renting a car the next day. Informed on Monday that the car needed a new fuel pump, we arranged a return trip to pick it up later that week. While I would hardly recommend our journey as an on-purpose trip, we were able to see the Berkshires, eat in a great Cajun restaurant in Springfield, MA, and experience genuinely helpful people at every point of the ordeal. All in all, I may revise my view of Red Sox fans. Harvard: a higher hurdle.

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