Jamesson Associates

12.2012 Newsletter

Recent Economic Events

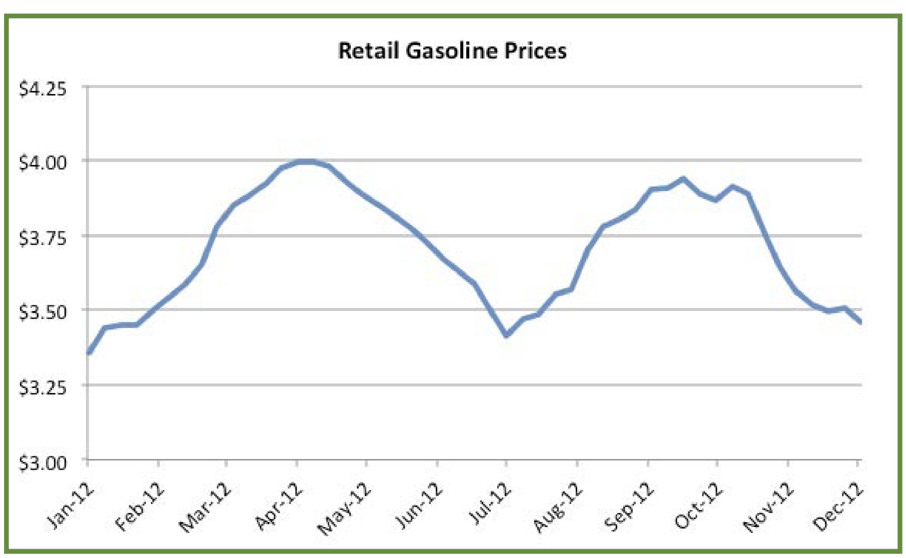
The American economy finally generated some positive thrust in the third quarter on the strength of a healing housing market and better employment figures. Even the price of gasoline has retreated from its summer high. The generally upbeat figures helped boost consumer confidence and may well have played a part in President Obama's re-election. But just when we could have expected to build on the good news, Superstorm Sandy slammed into the eastern seaboard and fiscal cliff-itis infected Washington. This means more than normal noise in the economic statistics. Nevertheless, we need to look at what we have.

GDP advanced by a better-than-expected 2.7% in the third quarter. Consumer spending on goods and services (1%) and on housing (.3%) accounted for almost half of the gain. The rest of the growth was about 50-50 between inventories and government spending. Note the former is a timing issue, and the latter was probably due to defense spending accelerated to avoid the sequester of funds come 2013. Both these sources of strength are temporary. The biggest disappointment in the report was the decline in investment by businesses. Without this support, the economy will not only labor in the short term, it will be held back over the long term because our productive capital stock will erode.

Rising housing prices are a major factor in consumers' more optimistic view of the economy. On a national basis, we have strung together eight months of gains, and prices are up about 6% from a year ago. Not only that, but new home starts and sales of all homes have jumped by double digits from 2011. Forward-looking measures, such as distressed properties on the market and housing affordability, are also at their best levels in years. It appears that the housing recovery is real and will be a plus for the economy, rather than a headwind.

The momentum seemed to be building, and then, Sandy made landfall. Car sales were knocked down to 14.3 million annualized in October, but they recovered to 15.5 million in November (highest since before the recession). Retail sales excluding autos were down .3%. New claims for unemployment insurance jumped to 480,000 in the wake of the storm, but are now back to their pre-storm level of 370,000. The November jobs report showed a gain of only 146,000 while previous months were revised downward. The hope is that retail sales and employment will quickly recover their previous strength, as have car sales and new claims.

After twice flirting with $4.00 a gallon earlier in the year, gasoline prices began to fall in mid-October and have continued to recede since. While pundits have pooh-poohed the idea that increased domestic oil production (highest level since 1998) has anything to do with gasoline prices, I am not so sure. (continued on page 2)



Recent Economic Events (continued)

Even though energy markets are global, I believe the extra domestic crude is helping to keep the cost of filling up down. A few more dollars left over after the trip to the gas station has to help consumer psychology.

While the election was settled relatively decisively, the so-called "fiscal cliff" has served to heighten partisan rhetoric in Washington. The resulting uncertainty has frozen business expansion plans and will likely add to volatility over the remainder of the year and into 2013. While volatility provides opportunity for market participants, it is not good for the economy and can result in a real loss in activity.

Given the hurdles the economy has overcome in the last few years to finally emerge with momentum, it is disappointing that Mother Nature (Sandy) and human nature (Washington politics) have teamed up to create another obstacle. Let's hope Nietzsche was correct in saying, "What doesn't kill you, makes you stronger."

Commentary

In the recently renovated Ford Theater in Washington, DC, a new play entitled, "Fiscal Cliff" opens for a limited engagement, only through year-end. It stars Morgan Freeman as President O and George Hamilton as Speaker B. All other characters are played by themselves.

Act One

The curtain comes up on a practically bare stage. In the center are two lawn signs — Clinton/Gore and Dole/Kemp.

Enter stage left President O and stage right Speaker B. Both men take one last drag on their cigarettes, stub them out, and make tentative moves to meet in the center of the stage.

From the far right balcony, a shot rings out, directed at the Speaker, not the President. After missing his target, Grover jumps onto the stage, yells out, "Death to the taxers," and heads offstage in search of a bathtub.

From the left edge of the stage, Nancy in a bright red dress walks over to the President and warns him, "Don't sell out your base, remember what I did for you on health care." Before exiting, she puts a finger in the Speaker's chest and snarls, "I'll have your job in two years."

Two motley groups enter. From stage left, a disheveled number of mostly young (with a few gray-haired escapees from the 60s) carrying OWS signs begins chanting, "Two plus two equals five, entitlements forever." They quickly pitch a tent, renounce soap, and set up a Twitter feed.

From stage right, a somewhat better groomed group sporting white hair, white shirts, and white skin, begin a counter chant, ""Two plus two equals five, tax cuts for all." They unfurl their Tea Party banner and placards denouncing government involvement in Medicare.

The cacophony on stage escalates, with each side trying to outshout the other. Nothing intelligent or intelligible can be heard. The President and the Speaker use the opportunity to exit together through a door at the back of the stage. As they do, the theater goes dark, and the noise subsides.

Illuminated above the stage, a Fox News crawl reports, "President refuses Republican compromise on taxes and spending." Just underneath, a MSNBC crawl reads, "Republicans refuse President's overture on spending and taxes."

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Commentary (continued)

Act Two

As the lights come up, two groups are milling about on stage. Each is dressed in distinctive colors with the red hat group on the right and the blue hatters on the left. Police have set up barriers on both sides to make sure the two groups don't communicate.

A paperboy shouts, "Newspapers, newspapers, *Wall Street Journal* and *New York Times*." The reds scream, "*Wall Street Journal*" while the blues scream, "*New York Times*." A few members of each group ask for both. They are de-hatted and expelled.

The President and the Speaker re-enter from the door they exited earlier and try to walk between the groups, but they are grabbed and pulled toward the barricades. Finally, clinging to each other, they jump off the front of the stage and out of sight.

The set opens to reveal a blue 1966 Ford Thunderbird convertible. Thelma and Louise are seated in the front. Before driving themselves off the stage, they proclaim, "Here's how you go off a cliff!"

Surviving playgoers were split on whether the production was a comedy or a tragedy.

Market View

Recent commentaries by two respected money managers — Bill Gross of PIMCO and Jeremy Grantham of GMO — suggest that the United States had better get used to much lower rates of growth than have obtained over much of our history. Mr. Gross reiterated his belief in the "New Normal" of 2% growth while Mr. Grantham suggested that we could easily slow down to zero growth by 2050, although we might enjoy a rate near 1.5% for a while.

The New Normal argument is predicated on the end of the Debt Super-Cycle and the resulting deleveraging of the economy. Instead of using debt to bolster spending and drive the economy forward, the need to pay down debt will erode spending power and result in slower growth. In addition, the extra jolt we got from the fall of the Soviet Union and the integration of China into the world economy was a one-time event that is now mostly complete. The third supporting fact Mr. Gross highlights is one I have worried about for a number of years. Technology is now racing ahead so quickly that it is eliminating jobs faster than new opportunities are being created. Finally, dovetailing with the GMO analysis, Mr. Gross observes that we are all getting older.

The demographic argument is dual-edged. Not only is consumer spending likely to slow as average age increases (note the weak demand growth in Japan over the last two decades), but fewer young people means the labor force will grow more slowly. Mr. Grantham posits that overall growth equals the combination of increased hours worked and the productivity of those hours. While the US had labor force growth over 1.5% when the Baby Boomers and their children entered the labor force and women increased participation rates, we are now below .5% and falling. Figures for other developed economies are even worse, with the labor force in the OECD now shrinking.

What about productivity? Shouldn't we be seeing the gains of improved technology? Turns out that we have a problem there. Net capital *(continued on page 4)*

Market View (continued)

investment is down to about zero in the US, following a long-term pattern. Since virtually all additions to capital for production occur in the manufacturing sphere, the shift away from manufacturing to services creates a structural headwind for productivity. GMO sees productivity growth in the overall US economy slowing to 1% from over 2% prior to 1981.

Now, let's look at the other side of the investment argument. It contends that the Fed has created too much money and used it to support profligate government spending. Unless we get our fiscal house in order, we will either drown in debt and default, or the value of the money used to support the process will become worthless through inflation.

Quick thought experiment: say the Fed decides to boost the overnight interest rate from its present .25% level to 3.25% in January. That would almost double the Prime rate. What impact would that have on the economy and longer-term interest rates? I suggest that after the initial shock, investors would become concerned over an economic slowdown and rush *into* longer-term Treasuries, not *out of* them. Far from financial repression from low rates, I believe the Fed's ongoing quantitative easing is actually keeping rates higher than the market wants them because of the fear it will kindle inflation. The natural overnight rate today should be negative, and longer rates probably have more downside.

If 1.5% to 2% growth is the future, we need to reduce our expectations regarding investment returns. Bond rates may be low, but they reflect both slower long-term growth and the potential shock risk from Europe, the fiscal cliff, or whatever. Heightened demand for safety has chased dollars into banks, high quality bonds, and mattresses. History suggests this theme will persist and intensify until some event (inherently unpredictable) changes the psychology of investors. Until then, we need to bet on the trend.

I come down on the side of structural headwinds in the economy and a higher likelihood of deflation than inflation. What to buy? High-quality, dividend-paying stocks, preferably with global reach. Municipal bonds with good credit support. Agricultural commodities which will benefit from increased standards of living in emerging nations. I think oil and gold are topping out and that the combination of technology (oil) and deflationary pressure (gold) will keep them in check.

Editor's Note

The older we get, the more difficult it is to break out of routine. So in the spirit of exploring the new, Susan and I decided to traverse the Finger Lakes Cheese trail instead of our normal wine trek. On a crisp fall day in early October, we began our journey at a dairy farm between Seneca and Cayuga Lakes, where we not only tasted a variety of fresh and aged cheeses, but also picked up a map of what was officially the Cheese and Ale Trail. This settled it: I would stick with beer, not wine. The theme worked well on our next two stops, a brewery and a goat farm, but our fourth stop stymied me. The brewery/winery was housed in an old Presbyterian church which itself seemed to be tempting fate. I knew we were in trouble when we got close enough to hear Sinatra singing over the converted altar, now a tasting bar. Frankie doesn't do beer. Sure enough, the proprietor said the brewery was an idea in progress; the winery was up and running. So was my fate predestined as I drank alcohol in a Calvinist space? Apparently not, as I am here to tell the tale on the 79th anniversary of the repeal of Prohibition (12/5/33).

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