Jamesson Associates

12.2014 Newsletter

Recent Economic Events

Jobs
jump.
GDP gains.
Housing holds.
Petroleum plummets.
Auto sales advance smartly.
Quantitative easing quits entirely.
US dollar up dramatically.
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The last three months have seen the tone of economic statistics change to one consistent with a happy holiday theme. New jobs created in the month of November registered 321,000, keeping both a 10-month string of 200,000-plus gains and a record-long 57-month (if you exclude the census hiring and firing in 2010) run of positive job growth intact. 2014 is on pace to deliver the strongest annual job growth this century. Even wages seemed to accelerate in November, although the year-over-year increase is still mired at a lethargic 2.1%.

Strong third-quarter GDP growth of 3.9% extended the second quarter's above-trend gain. This time, key drivers included consumer expenditures, business investment, and net exports. Inventories pulled back, suggesting that replenishment could help the current quarter. The unfortunate fact is that even with this growth, annual growth slowed down, as last year's third quarter was even stronger.

Perhaps the biggest story since our last publication is the cascading drop in oil prices. Both global and domestic oil prices have fallen by $45-55/barrel from their 2014 highs. Although this is great news for all of us who use oil in its many forms, it may have a more measured impact on the overall American economy. Why? Because the US fracking boom is the most important factor in the collapse of oil prices. The market has become flooded with petroleum which the global economy cannot currently use.

Two facts should serve to temper our optimism. First, virtually all of the high-paying net job growth and the lion's share of business investment during the recovery is due to oil and gas expansion in shale country. Lower prices are likely to inhibit growth in the industry, sapping both consumer income and business investment. And since a ton of money was lent to drillers on the assumption of $100 oil, there could be some credit indigestion as well. Second, to the extent that production of alternatives to OPEC and Russian oil (fracked oil, solar, wind, etc.) is curtailed because of lower prices, the next price spike could be even more severe. For now, we should enjoy our good fortune.

The Federal Reserve concluded the bond-buying program that had been designed to pump liquidity

(continued on page 2)

Recent Economic Events (continued)

into the markets, boost financial asset prices, and cause trickle-down economic growth. Asset prices certainly increased — the stock market is near all-time highs — but the promised trickle-down growth was conspicuous by its absence.

Back in the real economy, car sales have been buoyant, topping 17 million annualized in November. Some of the strength in car sales has been due to lower credit standards, increased leasing, and longer-term loans, which have all lessened the need for real income on the part of buyers. Over in the housing market, where lenders have actually become responsible in underwriting mortgages, there has been no such return to pre-recession home sales levels. Houses at the low end of the market, typically bought by first-time home buyers, are not selling as well as are higher-end residences. In fact, the percentage of first-time home buyers is at a thirty-year low, suggesting that even higher priced homes will face headwinds as the food chain suffers.

Finally, as we commented in the fall newsletter, the dollar is benefiting greatly from the relative strength of the American economy. The Japanese Yen is kissing a seven-year low at about 120 to the dollar and the Euro is down below $1.25. It appears that the demise of the dollar as the world's reserve currency has been greatly exaggerated.

Dare I say that it is time to consider the American economy as a glass half full? The weight of evidence is clearly tilting in that direction. Let's hope this is real and not just the eggnog talking.

Commentary

It's time to give credit where credit is due. After enduring blame for all of America's shortcomings in his first six years, President Obama should bask in the glory of an improving economy, record equity prices, and a string of foreign policy successes.

Things were really a mess on Election Day 2008; how else to explain the landslide victory of a Muslim, Kenyan, socialist over a war hero? And this doesn't even take into account that Joe Biden would be only one heartbeat from the Oval Office. But by sticking it to Wall Street in the GM bailout and ramming a stimulus package through Congress over Republican objections, the economy stabilized. Since then, progress has been painfully slow — average GDP growth of only 2% to 2.5%. But progress there has been, and US growth has easily outpaced the rest of the developed world.

While hysterical deficit worrywarts have brayed about irresponsibility, it turns out that the Federal Government under Mr. Obama's stewardship now accounts for only about 20% of GDP, a figure below even the lowest expenditure level of Ronald Reagan's presidency. Perhaps we should herald a new "Morning in America"?

> Federal Government ... now accounts for only about 20% of GDP

Foreign policy, more analogous to Inspector Clouseau than Chancellor Bismarck, and driven by the sophomoric, "don't do stupid stuff" credo, has been ridiculed across the political spectrum. Maybe judgments were premature. Sure, the Libyan "lead from behind" strategy seemed silly, but there are no American troops on the ground there. While Mr. Obama let Vladimir Putin spearhead the removal of Syrian chemical weapons, the US took the lead in actually destroying them. And in Ukraine, what appears to be a Russian success is anything but. Recall that Ukraine under a Russian puppet was a unified state which offered a buffer between NATO and the Russian heartland. A smaller Ukraine out *(continued on page 3)*

Commentary (continued)

from under Kremlin domination offers Putin no such comfort. Limited US involvement in the battle against the Islamic State has brought in local players and turned back the advance of those murderous fanatics.

And in his most brilliant long-game action, President Obama refused to approve the Keystone pipeline when oil prices were high. This forced American drillers to frack their way to an oil glut as Canadian tar sands oil stayed land-locked. The collapse in oil prices is the greatest US foreign policy success story in a very long time. It is pressuring Russia (now likely to go into recession and rethink its military options), Iran (facing increased domestic fiscal pressures which may yet result in a nuclear deal), and Venezuela (perhaps on the brink of a counter-revolution reversing Hugo Chávez's leftward lurch).

President Obama realized something that is very hard for people to put into practice. The United States is a superpower pretty much regardless of what else happens. Russia is not; China is not; and Iran is certainly not. Robert E. Lee was a better general than was Ulysses S. Grant, but Grant won because he understood that the North had the upper hand in men and material. He simply overwhelmed the South. This is exactly what Mr. Obama has done. Using America's deep strength, limited commitments have generated far more benefit than the muscular policy of the neocons.

Back on the home front, the President has taken a page out of George W. Bush's book. After losing the election to Al Gore, President Bush claimed a mandate and plowed ahead, cutting taxes for the wealthy and eventually invading and occupying Iraq. Mr. Obama, after the Democratic wipeout this year, has decided to act unilaterally on immigration. Just like Obamacare, this will rile up the Republican base in opposition, but serve to boost the US economy. The former has helped drive healthcare inflation down to a multi-year low, while the latter promises to bring millions out of the shadows of the economy and more fully use their talents.

Don't take my word for it. President Obama has already rebounded from his nadir of sub-40 approval to the low 40s on average; some surveys indicate a move to the high 40s. The combination of low oil prices, a strengthening economy, and overseas success should propel the President's ratings even higher.

Note: all facts in this commentary have been checked using the stringent process pioneered by Fox News.

Market View

Poor Janet Yellen. She and her colleagues on the Federal Reserve Open Market Committee will be the subject of a titanic tug of war between the forces of growth and those of deflation. Now that Quantitative Easing has ceased, the Fed will focus on raising the ultra-low Federal Funds rate. Recent positive economic statistics regarding job and GDP growth strengthen the hawks' argument. The collapsing price of oil and general deflationary pressures (see Europe and Japan) are fodder for the doves.

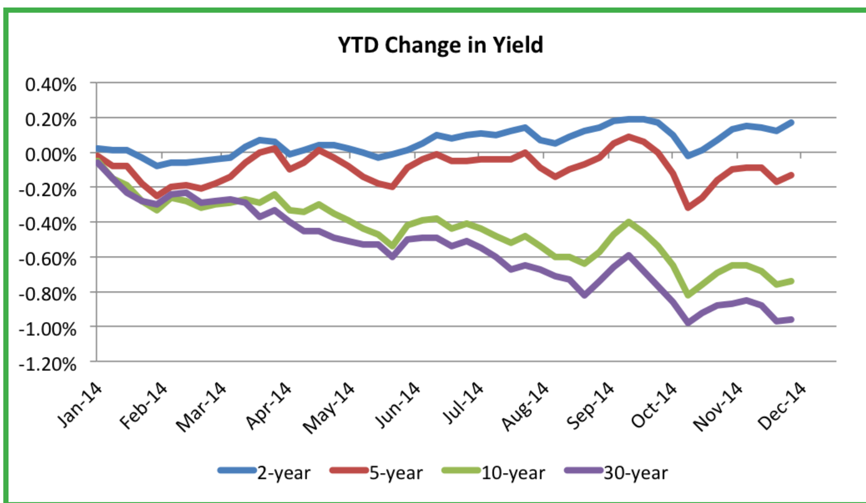
I am not sure whether the tussle is relevant. Recent market activity has raised a troubling trend in my mind. Note the contrast between the changes in Treasury yields this year depending on whether you look at short-term or long-term rates (chart on page 4).

Short-term rates are telling us that the Fed will tighten in 2015, while longer rates are suggesting that tightening will be limited by the risk of deflation and recession.

(continued on page 4)

MARKET VIEW (CONTINUED)

Recent history argues that the Fed should be very careful not to push the Federal Funds rate too high. In fact, were the Federal Funds rate to exceed the 10-year rate, the chances of a recession skyrocket. Each of the last three recessions was preceded by similar curve inversions. And if I know this, both the Fed and the markets know it.



Consequently, I would stay away from investments in the two to three-year range. Invest shorter (variable rate options seem best) or longer (five years or so to roll down the curve). Municipals still offer the best value if you can use the tax benefit.

The stock market remains both overvalued and reasonably priced versus alternatives. With everything expensive because of low interest rates, future return expectations need to be reeled in. That said, solid dividend-paying stocks instead of the hype of the day should form the basis of your portfolio.

Oil has taken an epic tumble since its summer highs, but gold has not. Recently, an ounce of gold could buy about 20 barrels of oil. The long-term average is, depending on your time frame, near 15 or near 10. That leaves a lot of air under the gold price or some real potential for the oil bounce back trade. Because it's always dangerous to try to catch a falling knife, I would scale into oil or oil stocks instead of trying to pick the bottom. The rest of the commodity space is too dependent on global growth winning out over deflation.

EDITOR'S NOTE

This past weekend, Susan and I attended a holiday ball, our annual opportunity to get dressed to the nines. I grabbed my tuxedo from the closet and began the rather involved process of putting it and all the extra paraphernalia on. Much to my chagrin, while my waistline had increased, the pants had not expanded in concert. An evening of forced grins and shallow breathing ensued. However, being an American to the core, I wondered whether this bout of adversity could launch a new technology. After all, did the caveman's wife complain about tough antelope meat? No, she invented fire. Did the Egyptian pyramid builders whine about unhappy workers? No, they invented beer. My idea could be just as revolutionary — pants that expand to meet the needs of evolving waistlines. However, the key change is not just elastic waistbands, but rather a transfer of material from the length of the pants to the waist, taking into account that as we get rounder we also get shorter. This could be as transforming as the smartphone. In fact, I have already chosen the name: Smarty Pants™. I expect to crowdfund when the prototype is perfected.

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