Jamesson Associates

03.2015 NEWSLETTER

RECENT ECONOMIC EVENTS

Jobs, jobs, jobs. The American economy is on a job creating roll. However, the excellent employment numbers don't seem to be translating into the kind of wage gains that would boost retail sales or GDP to a higher level of growth. The strong dollar is starting to impact the nation's trade balance as more expensive exports are facing headwinds in a softer global economy. Fortunately, this same stronger dollar is holding down prices, keeping a lid on both inflation and interest rates.

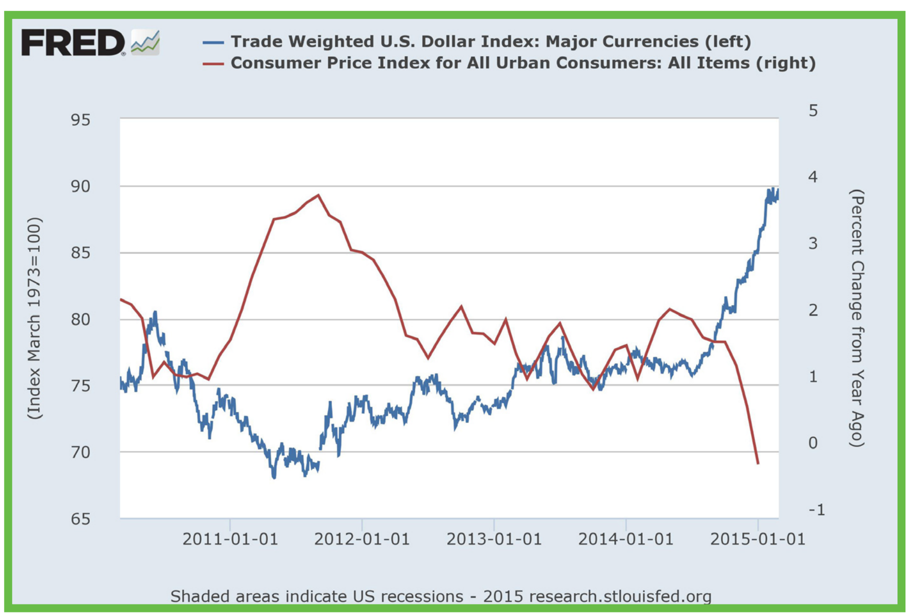
2014 was the best year for employment this century, and the pace has hardly slowed in 2015. The most recent BLS release reported that in February jobs increased by 295,000, while the unemployment rate dropped to a post-recession low of 5.5%. This is the 13th month in a row of over 200,000 jobs created, the longest streak since the mid-1990s.

You would think that, with so many folks getting jobs, wages would begin to accelerate. However, after a nice gain in January (perhaps due to a number of states raising the minimum wage), the annual rate of wage gain has again fallen back to 2%. There may be some temporary forces in play. The plunge in the price of oil has reversed the strong growth in oil field jobs, many of which were extremely high-paying. However, the bottom line is that the forces of globalization and technological advance continue to sap the bargaining power of labor.

Speaking of lower oil prices, many thought that the decline in gasoline prices would allow consumers to shift the dollars that had been going into the tank to other purchases. Didn't happen. Ever since gasoline prices began their epic fall in late summer, retail sales have slowed or outright fallen. It appears that many who benefited from lower gas prices were so close to the margin that any dollars they saved flowed into debt repayment or rebuilding rainy-day funds. Now, with gas prices on the rise again, there is concern we may never see the gasoline dividend.

Without an extra push from consumers, GDP cannot seem to accelerate from the 2% to 2.5% annual growth rate that has prevailed since the recovery began in 2009. Fourth-quarter GDP was revised down to 2.2%, with punk housing and export weakness some of the major culprits. A quick look around the globe reveals few countries building economic momentum. This, coupled with a US dollar that has broken out of its long-term downtrend, suggests that the US cannot depend on foreign demand to take up any slack.

The good news regarding the strong dollar is that it has been instrumental in keeping the price of imported goods down, helping to broaden the slowdown in



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Recent Economic Events (Cont.)

inflation that has been primarily due to energy prices. While annual wage growth has been stuck at 2%, the inflation print for January showed a decline in prices from one year ago. They were .1% lower than they were in January 2014. This means that even modest wage gains will produce real buying power.

I wish I could report that the solid job creation that we have experienced over the last year or so has translated into increased wages and an accelerating GDP. I cannot. I'm hoping our story is Odysseus's return to patient Penelope at Ithaca, not Vladimir and Estragon's unfulfilled wait for Godot.

Commentary

The Copernican Revolution, Non-Euclidian Geometry, Quantum Physics, Negative Interest Rates.

In his classic work, *The Nature of Scientific Revolutions*, Thomas Kuhn contended that facts are made to fit with existing theory until the point that the anomalies become pervasive. Then, after some false starts and heated arguments, a new theory is born. A more cynical view of the process states that old theories die off when their supporters die out.

In any case, the broad-based arrival of negative interest rates turned the world upside down for those who believe in standard economic theories. Until a few years ago, the idea of negative interest rates was dismissed as theoretically impossible. No one would willingly pay a storage fee for money; they would simply hold cash. The rare and fleeting examples of negative rates could be dismissed as special one-off cases. This is no longer possible given the trillions of dollars worth of holdings in negative territory in Europe and Japan.

Setting aside theory for now, what is driving investors to accept negative rates? There are many possible answers. One is that investors around the world are looking for safety and liquidity after the traumatic events of the financial meltdown. Another is that deflation makes it rational to pay a storage fee, as the money received will be more valuable than that originally invested. Still another is that money is simply a good which is subject to the laws of supply and demand like any other.

I think all of these ideas have merit, but want to focus on another aspect. What came first, the chicken or the egg? Did Central Banks validate the private market migration to negative rates, or were they responsible for driving private market rates into negative territory?

Most would argue the latter, but the advent of negative rates further out the curve (and most recently even with corporate issues) suggests to me that validation, rather than agency, is involved. I arrived at this conclusion using two lines of thought. First, negative interest rates have been quite common in the (continued on page 3)

COMMENTARY (CONT.)

inflation-bond market. For example, five-year Treasury Inflation Protection Securities (TIPS) have had yields below zero for an extended period of time. These bonds pay the holder a return which is the combination of the coupon and the annual rate of CPI inflation. Since the recent headline print on the CPI was negative .1% and most forecasters expect it to stay negative for the next month or two, this means negative yields have even arrived on our shores. This isn't because of Federal Reserve action; it's entirely due to pressures in the private market.

The second reason I believe that investors, not governments, are the prime movers has to do with the obvious question of why those being charged for storing the money don't just withdraw it. The typical answer I hear is that there is too much to turn it all to cash. Perhaps so, but banks are the primary holders of the funds held at central banks. Why don't they reduce their liabilities which support these assets and effectively reduce their costs? I believe the simple answer is that there is no way to reduce the private deposit base because there is too much idle money sloshing around the global system.

The world of interest rates (and economic theories about them) has been turned on its head. Sooner or later someone more clever than I will stitch together a theory to explain all of this. In the meantime, I will focus on the facts. What if the Fed has not been holding rates down with its ZIRP, but rather holding them up? Remember that until the financial meltdown, the Fed had never paid interest on reserves. What would happen if they stopped doing so? I suspect that the trillions of dollars held at the Fed would not budge. Only if you believe the banks would start a massive withdrawal program can you conclude that the Fed is responsible for the low rates we see. Interesting question on what will happen when they try to raise rates later this year.

MARKET VIEW

Pick a number between zero and one hundred. For any that you have chosen, there is a government bond someplace in the developed world trading at that level in basis points. You chose 49: five-year Spanish notes; 68: two-year US Treasuries. How about 19: ten-year German bonds. Limbo, limbo, how low can they go? Well, actually they can go below zero, where they reside for Switzerland all the way out to ten years.

I have not listed these rates to cause despair among those who have saved and are seeking a decent return. I have listed them to show that low rates in the US are not an isolated example. In such a world, there are really only two choices: 1) Go to cash, wait and hope rates increase. 2) Find relative value and hope rates don't increase by much.

Hope isn't a strategy, so I think looking at the risk/reward of the situation is the correct course of action.

The stock market recently hit an all-time high, but although it is trading above its long-term Price/Earnings Ratio, it is not so high as to cause a nosebleed. It is more than likely that future returns will be muted because of the stretched valuations. But on a relative value basis, stocks offer extra spreads versus fixed-rate alternatives. Equities have an ace up their sleeve: the boom in stock buybacks. Because of the dearth of good real investment options, companies find that the demand for money is well below the supply (in other words, interest rates are quite low). This means that corporations can borrow money to repurchase stock and use financial engineering to increase earnings. Some might argue that this is artificial, but it has proven effective in generating returns for the stocks involved. It is a far better use of funds than a CEO's white elephant ego project. Look for companies returning dollars to stockholders whether by dividends or by stock repurchases.

(continued on page 4)

Market View (cont.)

With interest rates as low as they are, it is hard to recommend fixed income investments. I certainly wouldn't advise one to purchase bonds at a negative yield with the hope that appreciating currency will create a profit. What I would do is use the volatility of interest rates to pick an entry or exit point. Since my Winter newsletter, the ten-year Treasury yield has yo-yoed from about 2.35% to 1.65% and back up to 2.25%. The dollar price difference from high to low is six points. Note that is about three years worth of interest. In today's fixed income market, I believe that value resides in the three to five-year range on taxable investments and seven to ten-year on municipals. However, I would buy on weakness and not be afraid to sell on strength.

> "financial engineering … is a far better use of funds than a CEO's white elephant ego project"

Oil has proven to be entirely unpredictable. Over the short term, this is to be expected. However, the intermediate trend may be easier to discern. Fracking is a game-changer. Not only can wells now be drilled in a matter of days, the costs of doing so have dropped sharply. Plus, while some fields are not currently economically viable, neither the oil nor the expertise has gone anywhere. Couple this with leveraged drillers liquidating their assets at reduced prices and industry slack taking out the cost premium of both equipment and labor, and it's not hard to envision an overall lower cost structure going forward. This suggests selling on strength is a better bet than trying to catch the bottom.

Assets of all types have increased in value to the point where future returns are likely to be below historical averages. In such an environment, the best approach for a long-term investor is to lower expectations and seek relative value. Keeping powder dry to benefit from a market meltdown is always difficult, not because a market decline will not happen, but because normal human behavior when markets are crashing is to hide under the desk, not boldly purchase. If you didn't sell in late 2008 or early 2009, but added to your portfolio at that time, you may be the unique individual who can pull off market timing. Otherwise, like the rest of us mortals, you have to take what the market offers.

Editor's Note

Silly me: I thought that Mardi Gras in New Orleans was a one-day event. Wrong! It goes on for weeks. And for first-timers, pacing is of critical importance. This becomes obvious after the first few parades. Starting with shorter versions, some more party than parade, they become much more elaborate. By the time the final weekend is in swing, simple beads and plastic cups transform into beads with medallions, doubloons, purses, shoes, and even coconuts. The crowds wave and implore the Krewes (those riding on the floats) while the Krewes look for the most deserving. It's more like high school than most would admit. Blessed with but two above-average physical talents: not spilling alcohol even while moving and catching whatever comes my way, my true calling was revealed. I captured string after string of beads. These and the other very valuable items I snared shared a common provenance: China, that most Catholic of countries. Laissez les bons temps roulez!

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