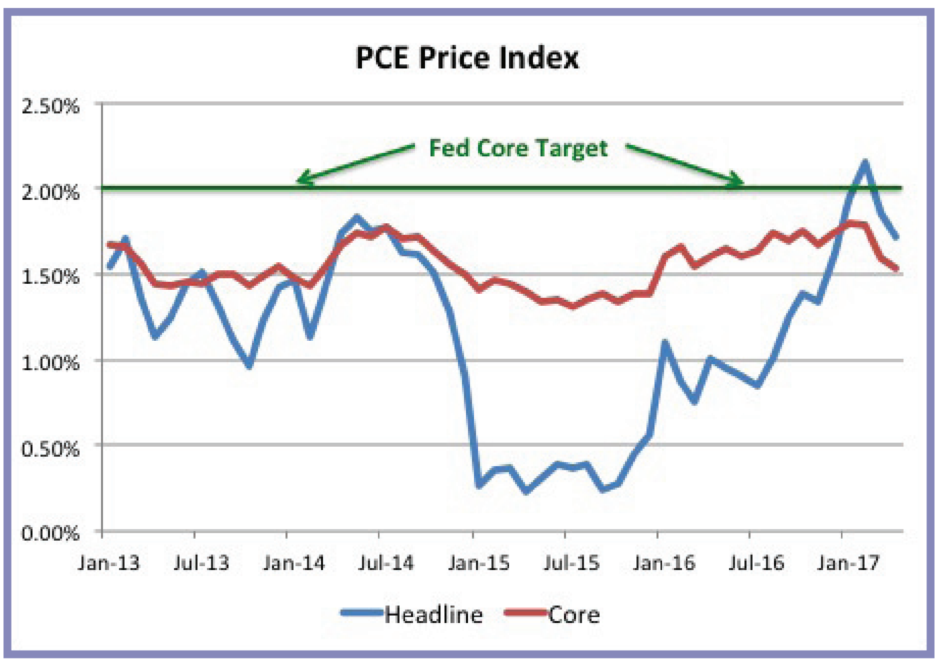
JAMESSON ASSOCIATES

SUMMER 2017

QUARTERLY NEWSLETTER

Recent Economic Events

First-quarter growth in the US economy was quite disappointing, driven downward by weak consumer purchases. Elevated consumer confidence surveys did not translate into strong consumer spending; maybe the weakening employment figures were responsible. The most surprising news of early 2017 was the collapse of inflation indices and expectations. Current economic signals are more consistent with an economy towards the end of an expansion than they are with an imminent acceleration, which begs the question as to the Federal Reserve's course of action. A flattening yield curve suggests Ms. Yellen has already twisted the monetary screws tight enough.



The American economy slowed during the first quarter, producing real GDP growth of only 1.2%. The biggest culprit in the numbers: consumer spending, up only .6% during the quarter. It appears that, eight years into the recovery, the consumer is wearing out. Auto sales, which had shown real strength last fall, have shifted into reverse, having fallen short of expectations every month this year. Contributing factors include credit tightening by lenders and satiation of pent-up demand. Major manufacturers have resorted to large price discounts only to see sales continue to founder, and in a real twist, Ford fired its CEO before announcing production worker reductions.

Job gains slowed dramatically since my last newsletter. The three-month average through May fell to about 120,000, only two-thirds the 2016 pace. A key area of weakness was retail, which has shed jobs in four of the last five months. This is destined to continue, as reports of store closings are practically a weekly occurrence. Wages are up only 2.5% from a year ago notwithstanding an unemployment rate of 4.3%.

The good news is that inflation is advancing even slower than wages. The Consumer Price Index actually fell in the month of March and bounced back less than expected in April. This left the annual headline rate at 2.2%, while the core rate, which excludes food and energy, was up by 1.9%. The Federal Reserve likes to zero in on the PCE Index, which showed even less price pressure: up by 1.7% with a core rate of only 1.5%. These indices suggest that, rather than heading upward, inflation has already hit its peak for the cycle. Perhaps the Federal Reserve can declare victory on this front and exit the battlefield. Unfortunately, they appear to be trapped into another rate increase by obsolete theories and misguided rhetoric.

The flattening yield curve is further evidence that the Federal Reserve may have tightened enough already. Just before the Fed began the upward rate push in

Recent Economic Events (cont.)

December 2015, the ten-year Treasury was yielding about 2.25% and overnight rates .25%, for a spread of 2%. Today, the ten-year yields 2.15%, while the overnight rate is 1.00% (spread of 1.15%). If expectations of another hike in mid-June come true, the spread will fall below 1%. This clearly suggests that the market doesn't support the Fed's actions.

Signs that we are close to the end of the expansion include its length (closing in on eight years), three months straight of falling housing starts, Federal tax collections coming short of expectations, and loan contraction in the banking system.

A cold hard look at economic statistics would suggest that Ms. Yellen and company should step back from the tightening cycle, but politics and previous statements on normalization have put them in a box of their own making. Let's hope that the next move on rates doesn't turn out to be the straw that broke the camel's back.

Commentary

Markets have traveled from normal to "new normal" and now seem to be heading to abnormal. The economic and financial landscape bears little resemblance to Ronald Reagan's or Bill Clinton's America. One might ask, "How abnormal are things?"

If the market really believes that the Fed will raise the overnight rate two more times this year and two or three times in 2018, why is the two-year Treasury yielding only 1.30%?

If OPEC is maintaining supply discipline, why is oil languishing below $50?

If fiscal stimulus and tax reform are in shambles, why is the stock market at all-time highs with a long-term P/E ratio higher than at any time save market peaks in 1929 and 2000?

If American is exceptional, why is Donald Trump President?

These are questions that defy logical explanation. However, logic and facts don't appear to be in great supply at present. The breakdown in civil discourse has been encouraged by the President, but it preceded his tenure and has been building for a long time. Partisan emotions are bubbling over. The consistent anecdotal undermining of institutions over the past few decades has taken its toll. Mistakes are taken as conspiracies. There is no one remaining who is viewed as an impartial arbiter. Facts are casually dismissed by ideologues on both sides of the barricades.

> FACTS ARE CASUALLY DISMISSED BY IDEOLOGUES ON BOTHSIDES OF THE BARRICADES

The implications for our economy, the financial markets, and dare I say, for our country could not be more dire. If facts are considered nothing but dressed-up opinion, consensus and civil interaction become impossible.

The administration seems to be channeling George Orwell's Big Brother in asserting that anything President Trump says is true even when it is an obvious lie. No one believed that FBI Director Comey was fired because he botched the Clinton e-mail investigation, but the apogee of the fact-free zone around 1600 Pennsylvania Avenue was the defense of "covfefe". Sean Spicer contended that it was a secret word that only White House insiders were privy to. If so, the tin foil order alone will break the Federal budget.

Commentary (cont.)

Let's not let the Left off the hook. There seems to be a belief among progressives that the President should be impeached and removed from office due to his statements. Evidence of wrongdoing is apparently not a prerequisite. Impeachment without evidence would cause incalculable damage to our Republic; it would unleash all of the partisan demons of mob rule. And then we have the nonsense of attacking speakers on college campuses who don't hew to a politically correct line. Whatever happened to the college experience being a time to broaden one's mind?

The plain, simple fact of the matter is that democracy depends on civil discourse and compromise. Given that a diverse people will have equally diverse views, the only way to live together is to negotiate and find a middle ground.

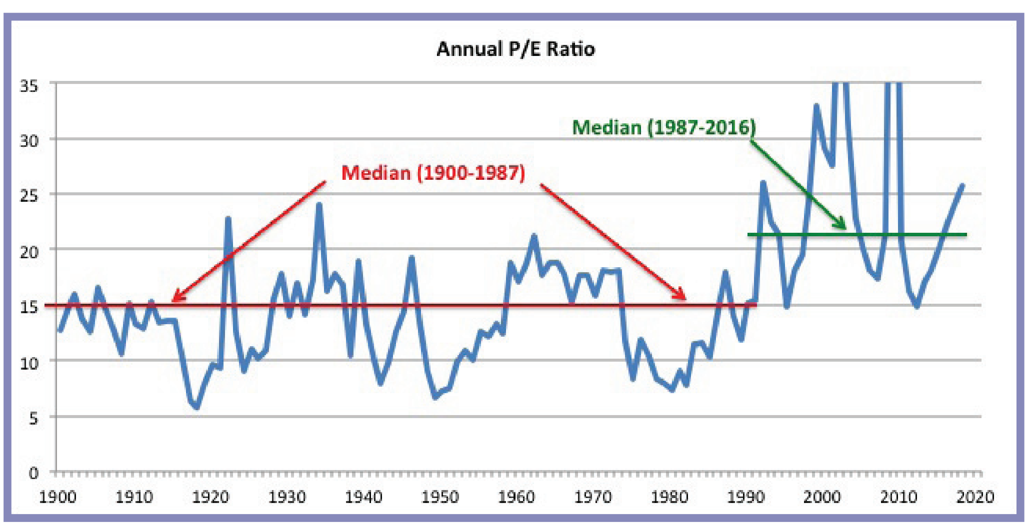
Because I am an inveterate optimist, I continue to hope for a break in the partisan war. Perhaps I am naïve, but I see the possibility of the President becoming increasingly irrelevant and Congress doing its job. Unlikely? Maybe, but who would have believed Mr. Trump would be where he is today as recently as eight months ago? Abnormal times demand abnormal solutions.

Market View

Mean reversion is a time-honored approach to investing in financial assets. The idea is to buy/sell assets that are under/over-valued based on historical averages and hold on until the averages reassert themselves.

The history of Price/Earnings Ratios had been one of mean reversion for most of the 20th Century. But the relationship broke down in the late 1980s. As you can see on the chart showing the P/E of the S & P 500 from 1900 up to today, the ratio meandered up and down around 15x until about 1989 but has used that level as a minimum since then.

So, will we revert to the long-term average, will a new mean take over, or will current levels prove only a stopping point to even higher valuations? Let's travel back in time to find some answers.



Older readers may remember what occurred in late 1987, but for the youngsters on the distribution list, I will recount the events. Alan Greenspan took over as Chairman of the Federal Reserve in August 1987 and raised the Federal Funds rate in the following month, continuing a process that had begun under his predecessor, Paul Volcker, about a year earlier. Then, the Reagan administration in the person of James Baker got into a policy dispute with Germany on Friday, October 16, 1987. On the following

Market View (cont.)

Monday, the stock market took its biggest one-day loss in history, dropping 22%. The rest of that week was mega-volatile as stocks rose and fell by huge amounts. To stanch the bloodletting, Mr. Greenspan loosened credit and lowered interest rates. By late 1987, calm had returned to the markets and a lesson had been learned. Thus was born the Greenspan Put, carried forward by both Ben Bernanke and Janet Yellen. When financial markets are in chaos, the Fed will pump in liquidity. It's no wonder that valuations have separated from their historical anchor around 15x P/E and have moved to a median of 21x.

> AS LONG AS GOLDILOCKS RULES — LOW INTEREST RATES AND SLOW BUT POSITIVE GROWTH — THE MARKET CAN HOLD ITS OWN

Modern developed economies run on credit. Without it, growth would be much slower, but the volume of debt has an impact as well. Once debt hits certain levels, the need to service it can hold back the economy. I believe that what we have seen is the positive impact of debt on the economy and valuation levels from the pre-Greenspan to the post-Greenspan period. While I always hesitate to say that this time is different, I think that it is.

We have entered a different valuation environment, but are pushing even its heightened limits. After all, the market is trading around 25x earnings, not 21x. However, as long as Goldilocks rules — low interest rates and slow but positive growth — the market can hold its own. Note that if the porridge is either too cold (recession) or too hot (inflationary spike), the bears will be coming home.

I am presently more worried about a slowdown than an acceleration in the economy. That means interest rates and stock prices have a downward bias. Hold on to core equity investments, but look to prune more speculative positions, and don't be afraid to take some profits. Cash holdings now yield a bit more than zero, so the pain of waiting for better pricing levels is not as acute as it has been over the past few years.

Editor's Note

While President Trump pulled out of the Paris Climate Agreement due to his doubts over global warming, anyone who looks out their window knows otherwise. Susan and I saw this firsthand on a trip north from Memphis through Missouri and on to Indiana. Our travels through the "Show Me" state showed plenty of overflowing creeks and rivers spilling into flooded fields. We spied a farmhouse and barn completely surrounded by water, and I don't think they were in the tilapia business. Closer to home, Lake Ontario and the St. Lawrence River have topped piers and put seasonal boating businesses at risk. I wish I had a witty remark about this subject, but I don't. About all I can say is, "when I was younger….." As a glimpse at my younger self, check out my look when I was a real banker. (The three-piece suit is the tipoff.) I can assure you that everyone had a beard in the late 1970s because it was much colder then.

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