JAMESSON ASSOCIATES

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QUARTERLY NEWSLETTER

Recent Economic Events

The government shutdown delayed or distorted many of the key economic reports covering late 2018 and early 2019. However, based on the statistics that we do have, a picture of a slowing economy is coming into focus. There is no definitive way to determine whether the domestic slowdown has been impacted by the global weakness or the other way around. The record US trade deficit argues for the former, suggesting more softness is on the way. While some may conclude that the Federal Reserve reversed course because of the stock market's December swoon, the underlying reason was a weaker set of economic statistics.

GDP continued to downshift in the fourth quarter, rising by 2.6% — a serial drop from 3.4% and 4.2% in the preceding two quarters. About the only factor helping to produce this gain was consumption spending and that was down from the previous two quarters as well. Retail sales took a real header in December (-1.6%), leaving the starting point for the new year below the fourth quarter average. The weak rebound in January (.2%) is no cause for comfort. Car sales in February were nothing to write home about either, creating a headwind for the entire first quarter. And then, there is that trade deficit that the President keeps complaining about. Well, he certainly has plenty of fodder, as he now presides over the largest merchandise trade deficit in US history. The easy-to-win trade war has proved more of a challenge than he originally thought.

While some of the increase in the trade deficit has to do with the tit-for-tat tariffs, the bigger reason is that the global economy is slowing down, led by both European weakness and retrenchment in emerging nations. The US will have a hard time accelerating while the rest of the global economy slows.

No set of statistics was more impacted by the shutdown than the job figures. Strong job increases in December (224,000) and January (311,000) were undermined by a very weak 20,000 job gain in February. On top of the second worst performance since 2010, the average work week fell by one-tenth of an hour as well. While this doesn't sound like a lot, it is the equivalent of almost 16 million fewer hours worked per week during the month. Figuring a 35-hour workweek and four weeks to the month, this would be equal to over 400,000 full-time jobs. We will have to see whether next month's revisions create the first job loss month in almost a decade.

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Other labor market statistics suggest a mixed picture as well. New claims for unemployment insurance are clearly up from their nadir even though their absolute levels are still low, and actual job cuts have continued to rise. On the plus side, the unemployment rate fell back below 4% after having increased in December and January, and it finally appears that wages have good upward momentum. They gained .4% in February, bringing the year-over-year gain to a post-recovery high of 3.4%.

Potential alternative drivers of the economy are pretty weak. Housing remains in the doldrums notwithstanding a big gain in housing starts in January. It was a bounce from the truly dreadful December figure which had been held back by wildfires in California and bitter cold up north.

Recent Economic Events (continued)

Unfortunately, all housing statistics that count are off their highs of the cycle.

Lower tax rates initially helped corporations boost earnings and buy back stock. However, recent developments have suggested that the benefits are dissipating and that profit margins are in retreat. This doesn't bode well for a pick-up in corporate investment.

I am afraid that the Federal Reserve's more dovish stance is less related to the December stock market tumble (worst performance since the Depression) than it is to the spate of weaker economic releases. After all, January's market performance was the strongest start to the year since 1987, and February finished in the black as well. If stocks were all that mattered, the Fed would now be talking about resuming the tightening cycle. However, they are not. In fact, the recent pronouncements may be even more dovish than those near the turn of the year.

The Fed rate pause and their intimations of stopping balance sheet reduction are the right things to do. The lagged effect of monetary restraint from 2017 and 2018 is now impacting the economy. Fiscal ammunition has already been spent, and monetary dry powder is modest at best. The American economy will have to stabilize and head upward on its own, or we will find that a recession has arrived a lot sooner than we expected.

Commentary

Modern Monetary Theory (MMT) is under attack from both establishment economists and Republican politicians/pundits. That was enough for me to be favorably disposed to the idea even before I knew what it was. A little digging provided me with the outlines of the theory, which has both empirical and narrative appeal. In fact, it appears to be far sounder than the discredited supply-side hokum peddled by ideologues from the right. (I subscribe to Bob Dole's quip on the idea, "The good news is that a busload of supply-side economists drove off a cliff; the bad news is that there was one empty seat.")

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As I understand it, MMT's most important assertions have to do with government spending and its interaction with the employment and inflation. A key tenet of the theory is that a government cannot default on its debt if the debt is denominated in the government's own currency. This leads to the idea that deficits don't matter. As caricatured by opponents, this contention is dismissed as "monetization of debt" which can only result in ruin. Those critics sarcastically suggest, "Why not just print money and make everything free?" However, the criticism forgets the other part of the equation. MMT contends that the key variable is not the government deficit but rather the rate of unemployment and inflation. Too much government spending will cause prices to rise as the public loses faith in the currency. Too little spending produces higher unemployment and economic slack.

By freeing the government from an obsession with the deficit and debt, it puts the primary economy ahead of the financial one. If inflation were to accelerate, MMT calls for higher taxes to slow the economy and hence price increases. Note that this approach presumes that government spending has much more power to boost the economy than does an equal amount of lower taxes. The contrast between this idea and that of supply-side theories could not be more stark. The latter argues that lowering taxes will boost

Commentary (continued)

the economy, creating enough extra revenues to replace those lost to lower taxes. This idea has failed empirically at least three times (Reagan, Bush II, and Trump). Only in the 1980s did the economy respond materially to the tax cuts, and even then, the government deficit ballooned.

So, at its heart, MMT says regulate the supply/demand for money through government spending and taxation. A deficit or a surplus is the consequence, not the driving factor. If we view the world through this lens, we realize that there is a demand for dollars that has to be met for the economy to operate properly.

Let's consider some empirical evidence from a few areas where we might expect problems with the theory — Japanese government stimulus, US trade imbalances, and the Quantitative Easing engineered by the Fed during the slower-than-desired recovery.

Japan has been operating in an environment that mimics MMT theory for an extended period of time — government spending creating huge deficits for years. The government debt level is 200% of GDP, but inflation has remained quiescent. The economy is hardly booming, but adjusted for the population, it is doing well.

Contrary to the President's protestations, running a trade deficit is a great deal for America. We send money overseas, and we get back goods. If we were sending more dollars out than the world wanted, the currency would be shunned and/or devalued. It is holding up quite well. Maybe drug smugglers and illegal arms merchants account for the demand, but I suspect that the overall supply/demand needs of the global economy are more pertinent.

Finally, let's examine Quantitative Easing from both the traditional and MMT perspective. The mainstream expected that the impact of QE would be a big jump in inflation, while MMT theory indicated that the economic slack as indicated by high unemployment and a significant output gap would limit price increases.

Looks like three for three for MMT. I am not sure that I fully subscribe to MMT, as I am concerned about lags in the impact of spending and taxing initiatives. However, to dismiss its insights speaks more of ideology than it does analysis.

Market View

It is becoming increasingly likely that the secular bull market in bonds which began in the 1980s has not ended. I make this contention due to the fact that the top of the last upswing in the 10-year Treasury yields was over 5% while this cycle's top was 3.25%. A quick look at the table to the right confirms that we have seen lower highs and lower lows in each cycle since 1980. The next key level in 10-year Treasury rates is whether the low point experienced in 2016 will be breached on the downside during the next recession. I suspect it will be.

Ten-year Treasury Rates (Monthly averages)

Date	High	Date	Low
September 1981	15.32%	April 1983	10.40%
June 1984	13.56%	July 1987	7.08%
October 1987	9.52%	October 1983	5.33%
November 1994	7.96%	December 1998	4.65%
January 2000	6.66%	June 2003	3.33%
June 2006	5.11%	July 2016	1.50%
October 2018	3.15%		

Market View (continued)

However, we don't need to predict a recession arriving before Easter to gain some comfort in buying fixed-income bonds at present. History suggests that term interest rates can fall as much as 1% or so from the peak to the start of the recession. We are currently 60 basis points below the high print.

My recommendation is to buy high-quality bonds in the five to seven-year maturity range on any back-up in rates. Money market rates are currently quite attractive, but if the Fed begins to lower rates, they tend to move fast. This means that the benefits of safety will tend to melt away quickly in the next cycle.

Stocks have been on a rollercoaster ride since I last wrote: a plunge into Christmas Eve followed by a strong rally since. However, the recent gains have been driven by a complete about-face by the Federal Reserve rather than improved earnings. In fact, earnings estimates have eroded, and the tailwind of a lower corporate tax rate is now last year's news. In the short run, the stock market can move upward even in the face of poor earnings if better liquidity raises valuation multiples. However, in the long run, earnings matter, and elevated valuations tend to come back to earth.

The stock market has done well in the late stages of an expansion, but the situation is much different once a recession looms. While bonds continue to rally as the slowdown morphs into an outright contraction, stocks suffer steep declines until the economy bottoms out. The risk/reward on stocks at present is not attractive. Selling rallies has been a sound strategy since I first recommended building cash reserves last fall. It remains viable today.

Commodities are one of the hardest investments to predict in the current environment. The oil market has been transformed in the last few years by fracking. It no longer is subject to long lead times on ramping up or closing down production; it acts a lot more like manufacturing because of the low relative cost of adding new production and the short active life of wells. Agricultural products are far more subject to the politics of trade than they ever have been. Ditto for industrial metals. While the approach to economic slowdown has typically resulted in supply constraints and a blow-off in prices, I hesitate to recommend any commodities today.

Editor's Note

Mardi Gras 2019 is in the books. Unbeknownst to most, in New Orleans, the parades are not limited to just one day. In fact, the celebration begins on Epiphany (January 6th) and continues with increasing parade frequency up until the finale on Mardi Gras (March 5th this year). Susan and I were able to experience our third Fat Tuesday with some guests who visited us for their first. A Mardi Gras parade is essentially a huge party with floats, bands, dancing groups, and throws. The throws run the gamut from plastic beads, to stuffed animals, lighted doodads, and signature throws like decorated purses, shoes, coconuts, and even toilet plungers. It's quite a spectacle to see the crowds plead with the folks on the floats for what in most cases is disposable plastic junk. It becomes a competitive game to see who can collect the most. Fortunately, I am immune to the siren's call.

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