JAMESSON ASSOCIATES

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QUARTERLY NEWSLETTER

Recent Economic Events

The tug of war between consumers and business continues apace. Will the former win, reversing the current economic slowdown and justifying the Federal Reserve's characterization of the rate cuts as a mid-cycle adjustment, or will the latter prevail, sending the US into recession? There is support for both contestants. GDP growth, whether on a quarterly or an annual basis, is hardly robust, but it is holding near the economy's potential. Employment and wage gains have been enough to keep income growth ahead of still-low inflation. This has contributed to strong consumer confidence, which has translated into spending strength. Company decisionmakers see the world differently. Their inability to raise prices, along with trade and policy uncertainty, has sapped confidence. Plus, profit margins and dollar profits are down from the tax-cut boosted 2018 levels. As a result, a wait-and-see attitude has taken hold, causing business investment to plunge and job postings to roll over.

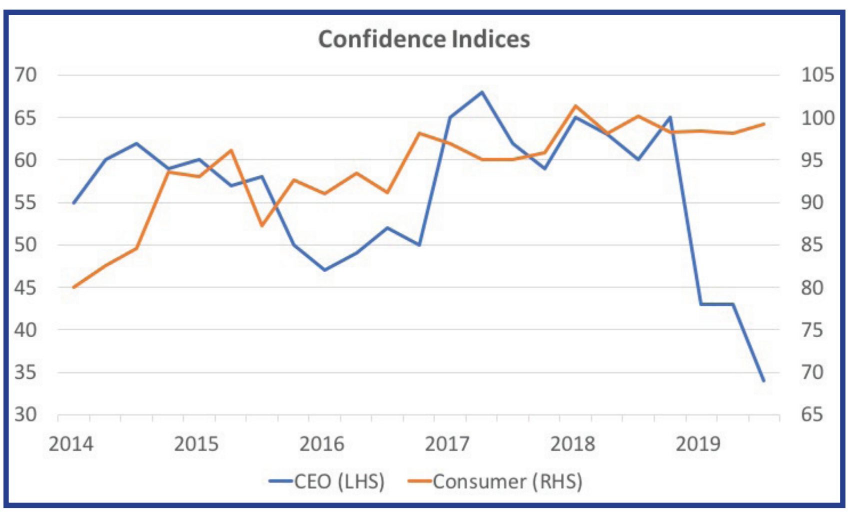
Third-quarter annualized GDP growth was revised upward to 2.1% from its originally reported 1.9% level. The key difference: inventories. This suggests that the revision was more technical than real and that there could easily be payback in the current quarter. Compared to one year ago, GDP advanced only 2.1%, less than both the pre-tax cut 2017 level of 2.4% and 2018's 2.9%. For whatever it's worth, GDP under President Trump is growing at roughly the same pace as under President Obama, suggesting that broad trends matter a lot more than the occupant of 1600 Pennsylvania Avenue. Nevertheless, growth is growth.

The ongoing advance in jobs created is a key positive for performance. In the month of November, the US economy added 266,000 jobs, well over expectations. The unemployment rate dropped back to 3.5%, matching its low point for the cycle. Wages regained some mojo as revisions to October and gains in November boosted the annual gain to 3.1%.

Although retail sales fell in September, they bounced back in October. Early indications from Black Friday and Cyber Monday point to buoyant holiday shopping. Both housing and auto sales seem to be responding to lower interest rates.

Inflation has not been a concern for the typical household. The PCE price index is up only 1.3% over the last year, while the core index excluding food and energy has advanced 1.6%. The CPI is up a little more, with the core posting a 2.3% increase and the headline figure registering 1.8%. Note none of these measures exceeds the gains in wages.

A solid job market coupled with low inflation and attractive financing rates is a recipe for enhanced consumer confidence. In fact, the consumer confidence indices remain at elevated levels even in the face of day-to-day headlines which are troubling. I guess it really is "the economy stupid".



Let's look at the economic picture from the perspective of the business community. Here we find a much different view. Low inflation for consumers means an inability to raise prices for business. The

Recent Economic Events *(continued)*

competitive landscape is brutal. More and more shopping is heading online where scale becomes paramount. Small businesses are finding it hard to keep up. Not only do we find falling employment by companies with fewer than 20 employees, but even worse, new business creation is lower today than it was a year ago. I hardly have to state that without the entrepreneurial spirit, America loses what makes it special.

While bigger companies seem to be the winners in this battle, they have their own issues. The sugar high from the 2017 tax cuts is old news. Trade uncertainty coupled with worries over potential policy reversals after the 2020 election have caused a sharp decline in CEO confidence (lowest level since the bottom of the last recession in early 2009). Human nature being what it is, there is little wonder at the decline in business investment.

So, who do we bet on: consumers or business? The Fed, the stock market, and the spirit of the holidays argue for the former. Who am I to disagree?

Commentary

There's something in the air and it ain't reverence for one's elders. Protesters in Hong Kong have been on the streets for months. Beijing is reluctant to crack down even as they have set up "re-education" camps for Uighurs in western China. Bolivians turned out in force to protest the "irregularities" in the election for president, causing said president, Evo Morales, to flee to asylum in Mexico. Anti-government crowds in Iran were met by lethal force which itself engendered the most widespread and destructive protests since the Iranian revolution in 1979. France is in the throes of a nationwide strike protesting pension reforms (read: reductions).

While the causes of the various protests and the reactions of government authorities are diverse, it is hard not to conclude that the world today much different that it was. Common threads include a reaction against elites, whether on the left or the right, and demands for immediate change. Populism is the flavor of the day. Historically, the passions of the people have blown over relatively quickly. This time they have persisted.

There is no better example than Hong Kong. What began with a sit-in protesting an extradition law on March 15th has morphed into mass marches, airport shutdowns, and violent clashes between activists and police. The most dramatic aspect of the situation occurred on November 24th in the election for local district councils. Results showed record voter turnout and a resounding repudiation of pro-Beijing candidates. Tourism has collapsed, and Hong Kong is now in recession. However, the protests continue, suggesting that the populace believes there is something more important than the economy. There has been a sea change in the self-identification of younger Hong Kongers, broaching the previously unthinkable idea of seceding from China. When control freaks are confronted with chaos, it's an open question as to what comes next.

> POPULISM IS THE FLAVOR OF THE DAY

We can't exclude the United States from these trends and may very well find their source here. The Tea Party burst on the scene in America about a decade ago in a reaction against taxation. In fact, its name originally stood for "Taxed Enough Already". We might quibble about how much was a true uprising and how much was originally produced by puppeteers, but it is hard to argue with its viral appeal. Opposition to taxes and the encroachment of government were heartfelt beliefs of the movement. They made their presence known in elections, moving the Republican party to the right and setting up a populist wing in contrast to the business wing of the party.

Fast forward a few years and the culmination of the populist revolt on the right was a major factor in President Trump's election victory. Key election promises echoed with the movement's goals, although actual governance initiatives are much more consistent with the standard playbook of the traditional Republican party.

Commentary *(continued)*

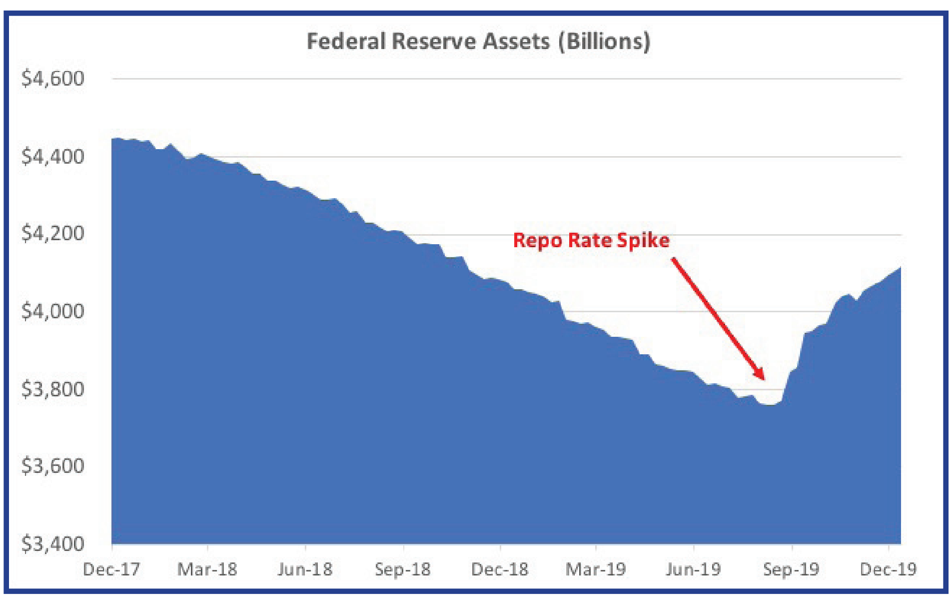
Not to be outdone, the Democrats have moved to embrace a left-wing populism. Its beginnings were signaled by Bernie Sanders' surprising strength in the 2016 primaries. This continued to some degree in 2018 with upset victories by Alexandria Ocasio-Cortez in New York and Ayanna Pressley in Boston. Admittedly, these Congressional districts are not typical, but then again, Tea Party Representatives generally hailed from very Republican districts.

Current candidates for the Democratic nomination for President have taken up the themes of the leftist populists. While not all are in favor of Medicare for All or the New Green Deal, there is broad support for moving in that direction.

Populism is ascendant in much of the world today. Driven by frustration with the failure of Baby Boomer elites, millennials are rebelling against incrementalism. It takes the form of protests in more authoritarian societies and as polarization in Western democracies. I have no idea where all this will lead, but I firmly believe that the politics of populism will be with us for the next decade or more.

Market View

Although the Federal Reserve denies that it has restarted Quantitative Easing (QE), it has clearly done so in all but name. In the wake of upheaval in the short-term money markets in mid-September, the Fed reversed course and began to rebuild its balance sheet. It has employed both overnight and term repurchase agreements to add liquidity to the market and has committed to purchasing $60 billion of Treasury Bills monthly at least into the second quarter 2020.



As I write, the balance sheet additions since mid-September have offset almost half the reduction we saw from Quantitative Tightening (QT). That program ran through the end of August this year, so it didn't take long for the T to transform into an E. It's not a stretch to assume the entire impact of QT will be reversed before we turn the clocks ahead next Spring. Also note that the pace of the Federal Reserve's balance sheet expansion is running about $100 billion per month since it resumed, a rate that essentially gobbles up the supply of Federal debt caused by the largest non-recessionary Federal Deficit in history.

What's going on and how can we invest to take advantage? I count two important takeaways from the Fed's blunders over the last year. One, raising Federal Funds beyond 2% or so is off the table. Two, resuming QT is verboten. The conclusion is not that the Fed will necessarily continue to reduce rates, but rather that they will not be raising them for a very long time. In fact, Chairman Powell admitted this in his recent comments stating, "So I think we would need to see a really significant move up in inflation that's persistent before we would consider raising rates to address inflation concerns." (My emphasis.)

It doesn't take a genius to read this statement and conclude that rates are going to stay low and that the risk is that they fall further. Is that enough to keep the

Market View *(continued)*

economy on an even keel, or will the stimulus from monetary ease simply boost the financial markets? The history of previous QE episodes suggests that the real economy will see little benefit. However, when the Fed added to its balance sheet in the past, the stock market rose, as did longer-term interest rates. Providing liquidity encouraged investors to add to their risk profile, figuring that the Fed had their back.

Today, we are much further along in the economic expansion than we were when QE was implemented previously. There is a lot less slack and arguably more potential cracks in the system. And of course, there is a wild card today that was not in play when QE was last used. Tariff Man could be true to his name and ratchet up levies on all sorts of imports, likely crashing the economy. Alternatively, he could fold his cards, declare a done deal which accomplished his goals, and move on to the next tweet. Anyone's guess.

However, readers don't pay the big bucks for this newsletter to get wishy-washy advice. A clear prediction is expected. The stock market has risen this year in the face of falling earnings precisely because of the largesse of the Federal Reserve. As long as this continues and the President recognizes his self-interest (which is the one constant in his actions) by not escalating the trade wars any further, the stock market should hold its level and make some headway into the springtime. However, this is not the time to add to equity positions or to reduce quality in your holdings. Easing out of some positions on strength makes sense as well. For now, cash is a reasonable alternative.

High-quality bonds should appreciate nicely if the trade war escalates and there is a renewed flight to safety. On the other hand, if a trade deal is signed, it is likely to be only a truce, not a comprehensive peace treaty. A knee-jerk reaction to higher rates if the US and China agree on phase one, will represent a buying opportunity. After all, a roll-back in tariffs will help send prices for imports back down which according to Jay Powell keeps the Fed in its low-rate regime.

In any event, I see little chance of an acceleration in the global economy boosting commodity prices. The supply of most goods is ample to meet demand. This goes for industrial goods, energy, and foodstuffs. In fact, it appears that OPEC will institute another production cut-back to hold prices at current levels in the face of lethargic demand. We are clearly late cycle but trying to call the turn in markets reminds me of Keynes' observation, "the markets can stay irrational longer than you can stay solvent."

Editor's Note

Planes, Trains, and Automobiles is one of the most hilarious holiday-themed movies of all time. Steve Martin and John Candy experienced diverted planes, broken down trains, and burning automobiles in their attempts to get to Chicago for Thanksgiving. While our trip to Spain was not as challenging as the movie, it did feature a medley of transportation options. Finding that it cost over twice as much to fly from Rochester to Barcelona as it did from New York, we opted to take Amtrak's Empire Service to the City instead. (Anyone who pines for microwaved cheeseburgers should book soon.) Even with a hotel and meals, we saved money. From Barcelona, we motored south to Valencia and then through the mountains by rental car. Our travels were generally uneventful, but as usual we had the rental for only a day or so before it lost paint on the bumper and side panel. I have found that parking anywhere in Spain will do that. Not to worry, the return rental agent paid no mind to the damage. Our trip back to the US involved a stay at the refurbished TWA Hotel at JFK. Here I "enjoyed" a cocktail with an ice cube in the shape of a DC-3. Well worth the $15 cost. Turns out you can buy a real one for only $150,000, or 10,000 drinks. (Had I been a teetotaler since I became legal, I could probably have swung it.)

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