JAMESSON ASSOCIATES

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QUARTERLY NEWSLETTER

Recent Economic Events

Originally intending to send out this newsletter in early March, a printer malfunction pushed publication later than normal. Furthermore, the COVID-19 contagion has clearly reduced the value of a pre-virus rundown of economic statistics.

Even though it can be considered old news, there is some value in looking at the data as a starting point for forecasting. In that regard, fourth quarter GDP was solid although impacted by some one-time factors. Headline employment also ended 2019 on a positive note which has carried forward this year. Inflation continues to be MIA. Consumers appeared to be far more confident than business leaders. Nowhere is this idea stronger than in the contrast between strong residential construction and weak business investment. Low rates have been a real fillip to the former while apparently having little impact on the latter. Unfortunately, recent reads on consumer confidence and retail sales are more foreboding.

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The US economy advanced by 2.1% as measured by real GDP in the fourth quarter. The full year increase was a bit higher at 2.3%. However, when we look into the details of the gain, we see that net exports accounted for about one-third of the increase. The math of GDP calculates net exports as exports minus imports. Note that this is the way it works even if imports far exceed exports, as they have for many years. In the fourth quarter, there was a collapse in imports as the trade truce with China was signed. Prior to that, importers had accelerated their activity to obtain products in anticipation of tariffs. Part, but only part, of the import decline was offset by smaller inventories. Eliminating these factors to concentrate on what is known as final domestic sales reveals that fourth quarter growth was a far more modest 1.5%.

Job growth around the turn of the year exceeded expectations. December saw an increase of 184,000, while January and February both posted advances of 273,000. The most recent reported unemployment rate was a low 3.5%, and new claims for unemployment remain mired in the low 200,000's. The buoyancy of the job market is somewhat belied by the easing of wage gains (currently running 3.0% ahead of last year versus the recovery peak of 3.5%) and the reversal in posted job openings (now down from a year ago). Consumers, sensing a possible jobs slowdown, delivered anemic retail sales gains during the holiday season and took a further step back in February with a drop of 0.5% from January. Consumer confidence also was hit in early March. This may mean the last pillar of the economy is teetering.

The Federal Reserve's preferred price index, the PCE, was quite subdued in the month of January. It rose only 0.1% on both the full index and the core which excludes food and energy costs. From one year ago, the headline index was up 1.7% while the core index advanced by 1.6%. Note both are well below the Fed's target of 2%. Furthermore, a recent analysis by the Federal Reserve made the case that the price indices have been overstated by as much as 0.2% per year since the turn of the century because of the advent of the internet as a source of information. The market may agree with this sentiment, as its expectation of inflation has tumbled to less that 1.0% based on the difference between TIPS and regular Treasuries.

Recent Economic Events (continued)

You would expect that the low level of inflation which has led to falling interest rates would be enough to encourage businesses to borrow and expand. You would be wrong. Business investment has contracted for three quarters in a row, and the uncertainty created by the coronavirus is likely to keep the streak going. On a far more positive note, low mortgage rates have ignited the housing market. Both existing and new home sales are up sharply as are housing starts. Some of this reflects the unusually warm weather we experienced in January, but there is no denying the multi-month improvement in residential investment. And it is residential investment that goes into the GDP calculations, suggesting that the economy has at least one area of strength.

A lack of up-to-date statistics leaves us in the dark on current economic activity. Traditional statistics paint a picture of an economy that is growing at a slow pace while creating jobs but not inflation. However, the specter of a global pandemic has not yet been fully reflected in the economic data, although it has crashed the stock market party, driven Treasury rates to all-time lows, and forced the Fed to adopt crisis era strategies (low rates and aggressive liquidity provisions). If the markets prove accurate, at least a short recession is likely. If, however, markets have overreacted, we may escape. I don't even want to think of what happens if they have underestimated the threat.

Commentary

The coronavirus is a perfect example of a collision between third-world practices and beliefs and first-world mobility. It further shows the dangers of censorship in an increasingly connected global community.

The Chinese Communist party managed to completely bungle the initial outbreak of the disease in Hubei province. As best as we can tell, the virus jumped from live animals at the "wet market" in Wuhan and then spread while the authorities were suppressing the alarms raised by local doctors. Once the death toll had risen high enough, the state imposed draconian lockdowns and quarantines. As I write, it appears that the situation in China has stabilized, but I am not ready to trust the numbers yet. Plus, we don't know what may happen when people start moving and returning to their workplaces.

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Eating wild animals and/or wild animal parts is part of a superstitious rural culture that has not changed anywhere nearly as fast as the Chinese economy has. Dangerous practices which previously had only local impact are now transmitted through an extremely mobile population. It is no surprise that the outbreak originated in China, as did the Bubonic Plague in the Middle Ages, and more recently, SARS and the swine fever that killed half of all the pigs in China.

It is becoming increasingly obvious that China, as presently constituted, is a threat to world stability. If not for their military claims on the South China Sea or for their massive investments in the Belt and Road Initiative, then for their backwards approach to public health and authoritarian impulses.

So, the question at this point is whether China will change, and if it does, can it change without violence? Hong Kong represents one avenue to change. The democracy movement there has stymied the mainland's desires. It would be a good thing for the Western world to voice solidarity with Hong Kongers.

Commentary (continued)

But that is not enough. Rather than follow the present administration's obsequiousness towards dictators, the United States should reestablish good relations with those countries which can reasonably be expected to push back against Chinese expansion. In a coordinated fashion, democracies must call out the Chinese for the disease they have unleashed on the world. Blame rather than praise should be our message. We need to help Japan and South Korea reduce their tensions. The deteriorating relationship with the Philippines needs to be reversed. ASEAN must become a more robust ally of America.

I realize that this may not be possible if Donald Trump is reelected. So be it. Elect someone who can put the interests of the country (and democracies around the world) ahead of their own. No one knows how deadly COVID-19 will be. But if China doesn't change its practices, there will be another disease made possible by ignorance and superstition which is transmitted to others while the propaganda regime contends that nothing is amiss.

Market View

The action over the past six months or so has proved to me that markets are far more subject to swings in sentiment than they are to changes in fundamentals. Oh, and we can't discount the impact of central bank liquidity either. The stock market, driven by Federal Reserve rate cuts and QE-lite hit all-time highs from October through February, disregarding signs of economic slowdown and the initial reports of coronavirus contagion. Then, from mid-February on, it suffered the quickest shift from bull market to bear market ever although the decline was punctuated by thousand point plus rallies. Who knows what additional volatility will transpire?

What we do know is that a careful analytical approach to stock picking had been cast to the wind as greed and then fear invaded the minds of investors. It is never a good idea to run with the crowd either in the final blow-off top of a market or in the cascade to lower prices. Emotion is a driving force in the market, but it can easily undo years of patient investing.

Markets are famously good at sorting out probabilities within well-defined limits. They are not good at reacting to uncertainty. When well-defined limits dissolve, markets can easily lead one astray. In the case of COVID-19, we simply don't know enough to make a rational decision. The disease, now a global pandemic, is upending normal daily life for billions of people and causing worldwide economic distress. However, eventually the spread of the disease will ease, and medical science will develop treatments and a vaccine. What we don't know is when. If we knew the probabilities and the timing, we could make a judgement on selling, holding, or jumping in to buy the dip. But we don't.

My view is based on the following foundation:

- The stock market had been overvalued for at least the last year. It was ripe for a catalyst to trigger a correction. A final bottom awaits a plateauing of new coronavirus cases.
- Stocks should be bought for dividends, not for potential appreciation, the corollary being that price declines are not fatal, but dividend suspension is.
- Interest rates have been declining for four decades in the United States with lower highs and lower lows along the way. This doesn't guarantee negative rates, but it highly suggests approaching zero.
- Monetary policy has become impotent regarding the real economy and looks like it is losing its mojo in financial markets.

Market View (continued)

If you own high-quality dividend-paying stocks, it is best to hold them. Virtually all dividend-paying stocks yield more than fixed-income alternatives. More speculative holdings call for taking profits on any rally. If you have been targeting stocks for purchase, but the market outran your price point, now is the time to review your research and identify the price you would be comfortable with even if the market continues to fall.

In bond-land, it pays to be very selective. Low-quality or junk bonds will not take kindly to a recession. I would liquidate those holdings. Investment grade corporate bonds will be torn between lower Treasury rates and potential credit hiccups. I see those as a coinflip. If you already own them, hold on but don't add to the position. High-quality municipal bonds have not participated in the race to lower rates. They may have some value here, especially if you are in a higher tax bracket.

Even though they have rallied significantly, Treasury notes and bonds have value in these very uncertain times. The huge demand for safety and the global savings glut will keep Treasury rates capped. That means that the path of least resistance is downward on rates and upward on prices. In today's environment I would look to both straight Treasuries and to TIPS. The latter have the highest effective yield available.

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Gold has done quite well and is likely to continue to appreciate. However, it doesn't pay any return and is a play on the length and severity of the contagion. Not sure I want to bet on Armageddon, even if there are locusts in Africa.

Other commodities are like gold without the safe haven appeal. That goes for oil as well. I would stay away until we get some clarity on the severity of the drop in demand.

Editor's Note

For us, 2020 has not been the Year of the Rat, but rather the Year of the Parade. The new year was less than twelve hours old when we were braving freezing weather in Philadelphia to watch the Mummer's Parade. Even for veterans of Mardi Gras, the spectacle was a treat. The marchers (aka Brigades) were dressed in colorful costumes and performed music and dances as they worked their way along what proved to be an eight-mile stretch of the city. Progress was more stop-and-go than steady and after an hour or so, we made a retreat to our hotel to warm up. Fortified, we returned for a second helping of pageant. In order to make a proper comparison, we attended a number of parades here in New Orleans in the week leading up to Mardi Gras. Our vantage point is well Uptown where the feel is far more family-oriented than what you may find in the French Quarter. My judge's card gives the nod to New Orleans for floats and throws (plastic beads mostly) to Philadelphia for costumes and variety and a tie for satire and beer bellies.

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