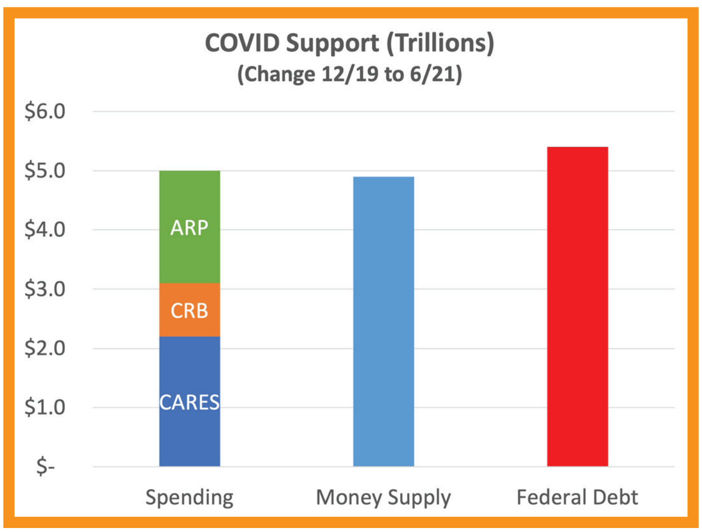
JAMESSON ASSOCIATES

FALL 2021

QUARTERLY NEWSLETTER

Recent Economic Events

The American economy reached an important milestone in the second quarter with GDP topping its pre-pandemic peak. The hope is that it is onward and upward from here into a vigorous expansion, but there are some storm clouds on the horizon. While production has recovered, employment remains well below where it was in February 2020, and there is a sneaking suspicion that the recovery, so dependent on government support, is less robust than it appears. Damaged supply chains have caused price spikes for key goods, and service prices, cut sharply a year ago, are returning to pre-pandemic levels. Both factors boost inflation indices. How quickly all this settles down will determine whether the Federal Reserve wins or loses its bet on transitory pricing pressures.



Real GDP continued its accelerating pace in the second quarter by jumping 6.6%. Led by consumer spending (up 11.9%), the economy has now topped its late 2019 level. Business investment was another notable plus, while inventories and net trade subtracted from the total. The reason that the latter two turned negative has to do with the strength of consumer demand, as businesses couldn't get enough new domestic product to meet their needs. Consequently, they drew down inventories and turned to foreign suppliers. Rebuilding inventories will provide some ongoing support to the economy, although personal consumption spending is destined to pull back in the face of expiring government support.

In unprecedented fashion, personal income actually rose during the recession as three separate government programs put dollars in the hands of American consumers ($1,200, $600, $1,400, respectively). Furthermore, businesses got a boost from Paycheck Protection Program loans ($800 billion) while folks who lost their jobs received enhanced unemployment benefits ($600 and then $300). All this largesse is now in the rearview mirror. Unfortunately, the debt that was issued to pay for the programs remains with us at an all-time high of over $28 trillion. This will represent a challenge to growth, as some future revenues will need to be devoted to debt service.

The resurgence of COVID due to the Delta variant is another headwind for the economy. Already we are seeing reduced restaurant seatings, hotel occupancy, and airline bookings. The knock-on effect of this was evident in the much slower job growth posted in August. Instead of the expected gain of 725,000, businesses added only 235,000. The biggest shortfalls were in leisure service industries, which had been growing nicely in previous months. On the plus side, the unemployment rate fell to 5.2% and wages jumped 0.6%, pushing the annual gain to 4.3%.

While the gain in wages is impressive, it appears to be mostly eaten up by price increases for goods and services. The CPI jumped by 5.4% over the year ending in July while the core rate excluding food and energy was up by 4.3%. However, both of the

Recent Economic Events (continued)

monthly increases were smaller than what we saw in the spring, suggesting that some price spikes are behind us. This is apparent in areas where supply was negatively impacted while demand remained strong, like lumber, copper, and other building materials. As those prices vaulted upward, some buyers pulled back and some suppliers ramped up. This is the promise of capitalism: prices help to balance supply and demand as self-interest comes into play.

The Federal Reserve is closely watching economic trends as they try to navigate the unsettled nature of our current situation. Their goals remain unchanged: full employment and controlled price increases. Neither is yet at hand because while GDP has regained its pre-pandemic level, employment is still about 5% short. Inflation is clearly running hot at present, but it is slowing and potentially will settle down to a level that the Fed can live with. Fingers crossed, the upheaval of the last 18 months is beginning to heal.

Commentary

I think it is time to consider the coming artificial intelligence revolution.

Computers and human beings deal with problems using different approaches. Computers, as their name implies, run through zillions of computations per second, comparing possible outcomes and then choosing the best one. Human beings, on the other hand, use pattern recognition to analogize the problem, trying to find a similar situation as a guide. Both approaches have their pluses and minuses

I hesitate to call what computers do “intelligence”, as they are not aware of their actions. However, the results have become quite impressive. My numerous spelling errors are mostly corrected by the time I get to the end of the line. Face recognition on the iPhone is close to instantaneous, both to unlock it and to pay for my groceries. The ubiquity of AI on the internet is hard to avoid, whether it’s Google figuring out what you are searching for before you are finished typing or Amazon sending special deals for anything from kitchen gadgets to books. However, before we get too far ahead of ourselves, let’s remember the Tesla car crashes and the frequent mislabeling of pictures, especially of minorities.

While we can all spot instances of artificial intelligence, finding examples of human intelligence over the last few years has been more of a challenge. Partisan polarization has seeped into all of our lives, substituting ideological dogma for reasoned discussion and analysis. Even the most straightforward facts seem susceptible to controversy. I have no interest in further fueling these battles. Instead, I hope to point to a possible future which leverages artificial intelligence in a way that moves us forward.

Perhaps I’m a naïve techno-optimist, but I see great promise in using artificial intelligence tools. In fact, an important factor distinguishing humans from our primate cousins is not the ability to use tools (many animals do this), but rather the ability to make tools. The distinction between a hammer, a riding lawn mower, and adaptive speed control is one of degree, not kind.

There would be real value in using AI to translate conversations in real time. Instead of trying to fumble through with high-school Spanish, communicating with those in another culture with little loss of meaning would expand our world and cultivate understanding of those who are different from us.

The health world offers a smorgasbord of options. The technology could be used to discover new drugs more quickly or to tailor remedies on a personalized basis. We are already on the cusp of low-cost DNA sequencing.

Commentary *(continued)*

Unobtrusive devices that can monitor health readings and send reports to medical professionals are also within reach. Improved prosthetics to help those whose bodies are failing or who have been paralyzed promise huge benefits.

However, I am not so naïve as to believe that there will be no downside to increased AI abilities. We can already see the impact of this in the rapidly advancing surveillance capabilities of China. Citizens there are now graded on an index that will punish any criticism of the state. The chilling efficiency of artificial intelligence is something that must be limited if we are to retain a free society.

We all know that unique crises are not well suited to black-box decision-making. Cascading market failures, electricity blackouts, etc. can only be stopped by someone breaking the automatic cycle. This is not the province of machines, no matter how advanced.

With ongoing advances in AI algorithms and quantum computing coming sometime in our lives, the power of AI will continue to increase exponentially. We need to harness that power to make our futures better. If we avoid the challenge of managing the technology, large tech companies will control its use. Much better to establish limits when we can, and now is the time to start.

Market View

Since the last edition of this newsletter, monetary conditions have been tightened, but the markets didn't react as expected.

At their June get-together, the Federal Reserve raised the rate that they pay on bank reserves from 10 basis points to 15 basis points. They also extended a lifeline to the money market mutual fund industry by boosting the rate they pay on repurchase agreements from zero to 5 basis points. This drew over $1 trillion of funds onto the Fed's balance sheet. Furthermore, Chair Jay Powell indicated in his Jackson Hole speech that he was one of the individuals who expressed an expectation that the Fed's bond buying program could be tapered by year-end. (While the FOMC theoretically works by majority rule, the "majority" always includes the Chair.) All of these actions could be construed as putting upward pressure on rates and draining liquidity. The confounding result: lower long-term interest rates and record stock prices.

The question at this juncture is whether the initial reaction is real or a head fake. There are plenty of analysts who contend that the reason that interest rates are at rock-bottom levels is because the Fed is buying bonds with abandon. This is the simple supply and demand argument. Because a large relatively price-insensitive buyer is in the market, bond prices must be higher than they would otherwise be and consequently interest rates lower. The problem with this analysis is that the facts suggest otherwise. Every previous time the Fed has embarked on Quantitative Easing, longer-term interest rates have increased not decreased. The alternative explanation for the impact of QE is that it is a form of monetary stimulus which the market interprets as stabilizing the economy and encouraging it to grow. The eventual result is higher inflation, and hence, higher rates.

I believe that these second-order effects are the more powerful. This was highlighted by recent action in the ten-year Treasury as Chair Powell spoke at Jackson Hole. Rates fell even though he voiced support for an earlier taper. However, when the August employment report came in well below expectations, rates rose as the market concluded that tapering was still a way off.

Market View *(continued)*

No one can reliably predict how the market will react to news because it is close to impossible to fully understand market expectations prior to news releases and because human beings are always trying to get one step ahead. My approach is to discount the immediate kneejerk reaction in favor of the longer-term implications of a change in policy. Over time, this has served me well.

The longer-term trends that I see suggest that while a taper is coming at some point, that is a far cry from actually reducing liquidity. The Fed continues to be very accommodative and has forcefully stated that it will remain so until it achieves full employment along with stable inflation. I would not expect this happy state of affairs to arrive for at least a year and a half. Consequently, equity prices will enjoy positive liquidity conditions and could make modest gains from here. A key support to stock prices is the buoyant earning gains that companies are posting. As I have commented before, production has recovered while employment has not. This means that companies are experiencing solid gains in productivity.

Commodities can also be expected to be boosted by liquidity, but here, it pays to be selective. Those commodities with damaged supply chains are likely to stall, while those with declining long-term prospects (fossil fuels) have already peaked. Weather-related commodities will have their ups and downs as growing conditions fluctuate, but climate change suggests that prices will both bottom out and top out higher than in the past. New economy/energy commodities will enjoy secular demand and should be bought on weakness. Once again, I recommend crypto-currencies not precious metals.

Fixed income presents the most difficult market due to historically low rates coupled with a not particularly steep yield curve. However, cash rates are really lousy, so taking some risk makes sense. The sweet spot in the yield curve is three to seven years. At that term, you get a premium on short rates while taking only modest price risk.

Editor's Note

Trying to find a restaurant open on Monday is clearly a first-world problem. However, it is a problem that we run into from time to time, whether we are looking in the Rochester area or on the road. Recently, we found all but one of our top seven or eight choices closed until later in the week. The one that was open was where we had eaten the previous week. Seeking novelty and locating an eatery that didn't take reservations, we took a shot but were told that the expected wait was an hour. Plan B sent us to a Tex-Mex joint that Susan had sampled and found good. We sat down and were presented with their "burrito-only" Monday menu. Not the dining experience we were hoping for, but fortunately, they had chips, salsa, guacamole, and margaritas. I ordered the "small" burrito, which turned out to be big as a boxing glove, and our server brought us a second one because the kitchen had inexplicably made two (perhaps they laid in a large supply for the expected burrito rush). I ate most of the first one, and Susan consumed the leftover for lunch on Tuesday. I can assure you that the burrito box on our bucket list is checked off.

Michael Jamesson
Jamesson Associates
Scottsville, NY
(585) 889-8090

Mjamesson@aol.com
Michael@JamessonAssociates.com