JAMESSON ASSOCIATES

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QUARTERLY NEWSLETTER

Recent Economic Events

Inflation has slipped its leash and accelerated upward to levels not seen since the 1980s, and this was before the tragic events in Ukraine. After some adjustments in the seasonal adjustments, employment reports are echoing anecdotal evidence of a drum-tight jobs market. GDP finished 2021with its strongest quarterly growth of the year. As the Federal Reserve digested these statistics, it realized that it was well behind the curve in fighting inflation. The upcoming FOMC meeting will mark the end of bond buying and the beginning of rate increases. The liftoff is much earlier in the current economic expansion than in any of the last four. This promises to bring forward the timing of the next recession. Yes, I said (actually wrote) it out loud.

The PCE Price Index posted an annual increase of 6.1% in January, up from 5.8% at the end of 2021. The core rate, which omits food and energy, registered a gain of 5.2%, up from 4.9% in the previous monthly release. Both of these levels are well above recent history and make a mockery of the Federal Reserve's hopes for a "transitory" impact from the supply chain issues caused by Covid. On top of this, the monthly increases are staying stubbornly high at .6% (headline) and .5% (core). Anyone with a facility with numbers can multiply these levels by 12 to see that we could easily see a further acceleration in the indices. Furthermore, the Russian invasion of Ukraine promises to add to pricing woes because the global supply of energy (10% of the world's oil and gas comes from Russia) and foodstuffs (Russia and Ukraine control about one-third of the global trade in wheat) will be disrupted. Expenses for necessities will be much higher than we had thought, pressuring family budgets.

In January, the Bureau of Labor Statistics (BLS) made massive modifications in the seasonal adjustments that they use to gauge monthly job changes. Covid had upended the normal seasonal patterns as different variants of the disease swept through the country, causing lockdowns or simply discouraging consumers from venturing out of their homes. As a result, the job gains that had been attributed to the summer of 2021 were reallocated to the last few months of the year. This made a lot more sense as the gains now fit much better with the falling unemployment rate. February job creation totaled 678,000 while the unemployment rate registered a post-pandemic low of 3.8%. These levels are consistent with full employment even though they still represent over 2 million fewer jobs than we had pre-pandemic.

Fourth-quarter real GDP grew by 7.0%, pushing the full year figure to 5.6%. This was the best growth we have experienced in a long time. Also, because inflation was as strong as it was, growth in nominal dollars was close to 12%. The last time we had growth in double-digits was in the early 1980s. This remarkable performance was enough to keep the relationship between Federal government debt and GDP stable for 2021. Even though Washington was running a multi-trillion-dollar deficit, the economy grew by enough to offset the increase in debt. This year and next promise ongoing gains in current dollar GDP, and with a sharp reduction in the Federal deficit (down two-thirds through January); there will be a big drop in net new issuance of Treasury bonds. Looks like the one silver lining of high inflation is that it whittles away the debt burden.

Recent Economic Events (continued)

The Federal Reserve has clearly signaled it will be raising rates later this month and throughout 2022 to try to reduce price pressures. Projections suggest multiple bumps in the overnight rate. However, while rate increases can serve to slow the economy, they cannot solve supply chain issues, nor will they stop the Russian advance. Price pressures don't fit the normal pattern of an overheating economy stoked by excessive money. Currently, the markets are not only projecting sharp increases in short-term rates, but they are indicating that longer-term rates are near a peak. The implication: an inverted yield curve in early 2023. And we all know what an inverted yield curve predicts — a recession within a year. Based on history from the post-WWII inflationary times, expansions really are shorter than our recent history suggests. The logic is sound. Recessions generally occur when the Fed over-tightens and chokes off reasonably priced credit to the economy. I'm afraid that they have been backed into a corner by inflationary pressures and will repeat their mistake.

Commentary

At the risk of being out of date before the toner bonds to the page of this newsletter, I believe that the events in Ukraine deserve comment. We can all take comfort in the strength of the human spirit that animates the Ukrainian resistance in the face of a brutal assault. President Zelensky has risen to the occasion as have everyday Ukrainians. But we must also pay attention to the reality of invading forces that have an overwhelming superiority in men and materiel and are being sent into battle by a ruthless dictator. There will be many lives lost and much destruction before this ends.

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It's true that the first casualty of war is the truth, so much of what we are seeing from the battleground is designed to bolster the case of those providing the information. With that said, there are a few facts that we can glean.

First, no matter what ultimately occurs, Putin has made a colossal mistake. Whether he has become so removed from reality that he believed that the Ukrainians would welcome Russian "liberators" or whether he felt that the West would look the other way as we did when he annexed Crimea, it's clear that the response on the ground and amongst the global community has been far different. One of the most heartening developments has been the mass exodus of multi-national corporations from Russia. Perhaps, reputation has moved up the list of important considerations. The Russian financial system has seized up, and its economy will soon follow with skyrocketing inflation and shortages returning things to the "good old days" of the Soviet Union.

NATO has been strengthened. It now realizes the threat that an unrestrained Russia presents. Defense budgets in Europe will respond accordingly. Russia is a pipsqueak of an economy, smaller than Italy, and not to be missed in the global economy. The only thing that it had going for it was its large presence in providing energy to Europe. That leverage seems consigned to the dustbin of history as well.

The goal of absorbing Ukraine into a Greater Russia now seems to be delusional in the extreme. There are anti-war protests in Russia even in the face of repression. To install and support a puppet regime in Kiev will take a huge commitment of resources that Russia didn't have even before sanctions were imposed and certainly

Commentary (continued)

doesn't have going forward. The attempt to replace the Ukrainian government with a pro-Russian version will likely result in a guerilla resistance. How do you say quagmire in Russian?

The intermediate impact of an isolated economy will push Russia into a junior position with the only country that can offer some solace — China. I believe that this will prove even more humiliating than the advance of NATO and the European Union towards Russia's western border. By cutting off connections with Europe, Putin will lose the youth of the country.

It is even possible that the blowback from sanctions, especially on the elite of Russian oligarchs, may result in a forced retirement for Mr. Putin. While this in an unlikely turn of events today, don't be surprised at how quicky an authoritarian can fall.

Ukraine is a tragic case, and I don't want to sound like I am welcoming the chaos that I describe above. There is no good that will come of it for the people of Ukraine or of Russia. It is imperative that we keep in mind how dangerous it can be to put power in the hands of people who have their own version of reality.

Market View

The ten-year Treasury is yielding less that 2% while inflation is running at triple this level. This raises the question of what investors are thinking when they accept a return well into negative territory when considering the depreciation of the currency. Are they delusional, rationally expecting price increases to revert to the old trend, or has inflation become irrelevant to the level of interest rates?

It's hard to believe that bond buyers don't realize what is happening to prices. After all, the daily press is full of stories about rising prices, and even the most disconnected individuals have to pay the utility bill and eat. Plus, the trillions of dollars that take part in the bond market represent the collective beliefs of participants as to what constitutes value. Short-term deviations are common, but a long-term mispricing seems unlikely.

Will inflation then settle down enough to justify current rates? Once again, it would take a true believer to conclude that the present bout of price increases will melt away soon. This is especially the case now that price pressures have been turbo-charged by the Russian invasion of Ukraine and the resulting disruption of energy and agricultural trade. Even if the belief is that a price-crashing recession is on the horizon which will, it's hard to justify the wide difference between interest rates and inflation. This point is reinforced by the many respected market sages who are predicting that rates will have to go to 4% or more. These folks are looking at historical relationships.

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Using Sherlock Holmes' approach that when you have eliminated the impossible, you need to look at the other explanations, no matter how implausible, I believe that inflation has become temporarily irrelevant. The huge increase in wealth which is concentrated at the upper echelons of the wealth pyramid has changed the game. In fact, the National Bureau of Economic Research (NBER) has recently published a study that suggests that the concentration of wealth in the hands of the wealthy has been the main reason for the inexorable decline in interest rates. There is a lot to be said for this. Interest rates have been declining in line with increasing global wealth over the last few decades.

Market View (continued)

I'll leave readers to draw their own conclusions on this point. If it is wealth itself that is driving low rates and high asset values (stocks and real estate), we may have a self-reinforcing dynamic. That being the case, I see no reason for a take-off in longer-term interest rates even though inflation seems more entrenched than it did even a few months ago.

The Federal Reserve will certainly raise the overnight rate at least four times this year. One option is to park your funds in a Money Market Fund and ride the increase. Given all the uncertainty, that is a tempting option. But longer-term performance is dependent on taking some risk. In the fixed income arena, capturing a yield of 1.50% with a two-year Treasury seems a pretty good deal to me. This level is essentially predicting that the Fed will go well beyond four increases, but history shows that the market always over-estimates the momentum in rates.

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Stocks have taken a hit this year both because they were due and because of the Russian aggression. However, companies are still delivering strong profits and geopolitical hits are normally reversed relatively quickly. Because I fully expect the Fed to go too far in raising rates, threatening a recession, it is very important to lean towards quality in your stock selections.

Commodities, especially oil and grains, have exploded upward, but I would be wary of chasing. Remember that "high prices are the cure for high prices". Oil price spikes like we have seen are closely associated with significant economic slowdowns. Any wavering in the demand for commodities is likely to bring their prices back to earth.

Precious metals and crypto-currencies have been buffeted by uncertainty and volatility due to their relatively small size in comparison to stocks, bonds, and real estate. I would step back from them now.

On the topic of real estate, investing in income producing property may be the best option in today's environment. Not only are rents jumping, but real estate tends to do well if inflation is truly set for a multi-year upswing.

Editor's Note

Mardi Gras 2022 in New Orleans was almost back to pre-Covid revelry. The parades were a little shorter, but that didn't seem to reduce the tsunami of plastic beads and other tacky throws that rained on spectators. Our recently reported record trade deficit may be directly related. First-quarter Chinese GDP should see a big bump. Collecting any of the more unusual throws is definitely a contact sport, but since the crowds are pleasantly buzzed from either alcohol or pot, it is a friendly competition. As you can see from the accompanying picture, I was able to snag some foodstuffs (Moon Pies and Jambalaya rice) along with a pair of rose-colored glasses. I will be using the latter to help get through the market challenges.

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