Jamesson Associates

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Recent Economic Events

The American economy has geared down to a slower speed. GDP growth has decelerated as has employment growth. The good news is that inflation has also receded from its spring run-up. The bad news is that our twin deficits, Federal budget and current account, show few signs of joining the parade.

After achieving a string of four quarters in succession exceeding 4% growth, GDP slowed in the second quarter to a 2.8% advance. Somewhat discouragingly, the slowdown appears to be primarily the result of slower demand from consumers. Personal consumption expenditures increased by an anemic 1.6% during the quarter.

It is hard to determine so soon after the fact, the main causes of the retrenchment, but there are some obvious candidates. The most likely culprit is the price of oil and by extension gasoline. Prices ascended to over $2 per gallon in the late spring/early summer and clearly had a dampening impact on consumer spirits.

More fundamental issues may be involved as well. Debt levels continue to advance (Household debt grew 9.5% in the second quarter, twice nominal GDP growth.) and much of the stimulus from lower interest rates and tax cuts had run its course by the end of the first quarter. One might be also tempted to blame slowing employment growth for the poor showing. However, the second quarter should have benefited from the momentum of the best employment month in four years in March and two additional strong months (April and May). Only June could be classified as weak. It may be that the long awaited consumer pullback is beginning.

The chart on personal consumption expenditures as a percent of GDP paints a picture of concern. Note how the percentage has increased from its historical two-thirds to over 71%. The first part of the increase came during the stock market bubble of the late 1990s, but the most significant portion of the jump has been engineered over the past four years. If consumers are aiming to get spending back to historical norms, the second quarter may not be an aberration, but rather a harbinger of more modest growth to come.

Unfortunately, the wherewithal that might encourage consumers to keep spending at higher than normal levels does not appear to be at hand. Employment growth which had averaged 225,000 per month in the first five months of the year, has slowed to less than half of that pace (104,000) in the three months since. Remember that somewhere between 150,000 and 200,000 jobs need to be created each month to absorb new entrants to the labor force. On this basis, the recent performance is digging us in even deeper.

The reduction in demand has had a beneficial impact on one of our most important worries from earlier this year. Inflation has digested its springtime run-up and appears to have rolled over to lower levels again. The overall

(continued on page 2)

Recent Economic Events (continued)

Price index has declined for two out of the last three months even as we have been reading stories of record oil prices. On an annual basis, we are up 3.4%, but excluding food and energy only 1.5%. The Consumer Price index joined the march to lower prices as well with a decline in the overall index in July. August saw both headline and core inflation edge up .1%, bringing the former to a yearly increase of 2.7% and the latter to 1.7%. Both are clearly lower than the peaks we saw in the spring.

...deficit production... America truly leads the world.

The one category that doesn't seem to be showing signs of slowdown is deficit production. In that area, America truly leads the world. The most current estimate by the Federal government suggests that the deficit will total about $425 billion for fiscal 2004 (ending later this month). This is more than 10% higher than the record tally in fiscal 2003. Not to be outdone, the current account deficit for the second quarter registered an impressive $166 billion. Multiply this amount by four and you get a figure roughly 6% of GDP. Any way you measure it, these amounts are quite troubling.

The American economy has entered what Mr. Greenspan has termed a "soft patch." That is undoubtedly an accurate assessment. Driven by a slowdown in consumer spending and supported by high oil prices, slowing employment, and the ongoing challenges of high debt and twin deficits, the likelihood of continued below potential growth must be taken as equal to that of "an economy poised to accelerate." ❖

Commentary

The price of oil hit an all-time high a few weeks ago, but even as it was doing so, both gasoline and natural gas prices had receded from their highs. Electricity rates were also in a downtrend. What gives?

Take a look at this table which extracts prices at various points over the last year. I have highlighted the highest prices.

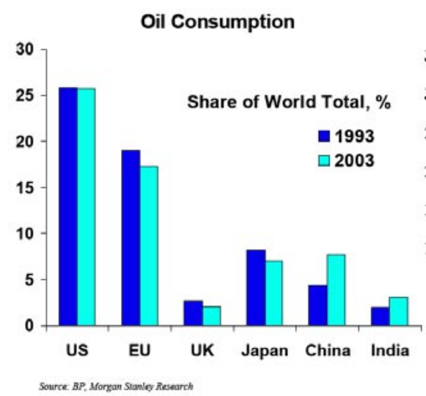
	December 03	March 04	June 04	Most Recent
Oil	$32.50	$36.00	$39.00	$44.00
Natural Gas	$5.10	$5.00	$6.00	$4.75
Gasoline	$1.50	$1.75	$2.00	$1.85
Electricity	$39.50	$47.00	$51.00	$46.50

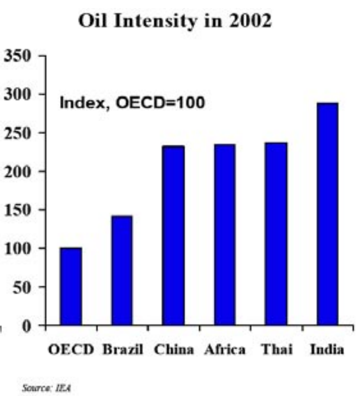
Oil is truly a global market while both natural gas and electricity are primarily North American markets (as far as the prices I have captured). Gasoline could be either, but with different domestic formulations and a crude oil rather than refined products infrastructure, it appears to operate more locally. Realizing this clears the picture. Domestic demand peaked in the summer and tended to drive down the price of energy in the United States. Why then didn't this drag down the global price of oil? Doesn't the world catch a cold when the US sneezes?

The demand spike is being driven by emerging countries. The key culprits are China and India. Both countries are growing quickly, and both countries are very oil intensive in their growth. Oil intensity measures the potential increase in oil consumption for an increase in GDP. Note India is close to 300% while China is over 220%. In the last year, the increase in demand for oil in China has exceeded that from the United States even though our economy is over four times as large as China's. (continued on page 3)

Commentary (continued)

It is time for the United States to take account of the implications of the oil market. As China, and to a lesser extent India, grow, it is possible that demand from those countries will drive up the price of commodities even if American demand is not strong. Furthermore, if the demand drives up the price of oil, we may find it causes a slowdown in the United States that does not serve to cure the high price.





China is growing at a rate of roughly 10% per year. The pressure on the Chinese authorities to keep this growth going is intense. Estimates are that 150 million of an expected 450 million people have already left rural China for the cities. The wave is not going to stop. On top of this, the Olympics are scheduled for Beijing in 2008. I see little prospect that growth will slow before then. With 10% GDP growth, oil demand will be up 20% or so. This means a doubling in China's needs over the next four years. Inexorable demand for over 6 million more barrels of oil per day means continued underlying pressure for higher oil prices.

The US needs to consider three things. First, the era of cheap oil is over. Even if demand from emerging markets were to slow the inevitable depletion of existing fields suggests that a return to $30 per barrel oil is not likely. Two, there is another dog on the block. China may be only one-quarter our size in economic terms today, but its growth path suggests that over the next 25 to 30 years, it will rival our economic might. Three, unless alternative energy sources are developed (and I might add quickly) contention for the existing sources will be a source of geopolitical instability.

We need the political system to address this whether it be by a serious consideration of nuclear power or by a full-scale research effort to develop renewable sources. Otherwise, we may wait in vain (and in the dark) for robust economic growth.

Market View

Although there has been plenty of news that would be expected to drive the stock market up or down, it has surprised most of us with its lack movement in 2004. So far this year, the Dow Jones has bounced between a high of 10800 and a low of 9800. Its average over the time period is pretty close to the middle of this range, about where it is today. In fact, as little as a 5% change up or down would be sufficient to create a new high or low for 2004.

How do we reconcile a high volatility world with a low volatility market? There are two main ways to do so. First, we can argue that the forces that are buffeting the world are strong, unpredictable, but essentially in balance. Whatever positive appears is offset by a negative soon thereafter. This is the pendulum theory of the markets. Until a firm direction is established there will be a number of minor indicators that oscillate back and forth without settling into a distinct

(continued on page 4)

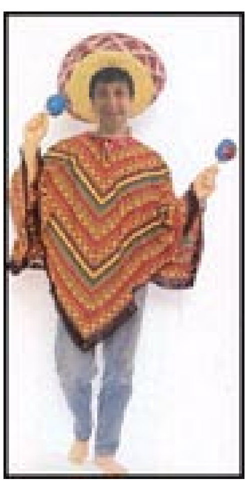
trend. The other option is that the market is under so much uncertainty that all of the smart money has moved to the sidelines, pending a definitive resolution.

I find parallels in the Presidential election. The polls suggest the race is close, but I believe we will see an electoral vote landslide. The reason: the undecided voters are all going to decide the same way. I don't know what event will trigger the decision process. It could be economics, Iraq, the debates, but when it happens, we will all know, and the outcome won't be in doubt. Same thing with the stock and bond markets. They are coiling in tighter and tighter ranges. The ten-year Treasury hasn't been higher than 4.30% nor lower than 4.08% since the employment report was released in early August.

In my last newsletter, I recommended buying TIPS and energy stocks. Both have performed well. TIPS are now expensive both in rate terms and relative to regular Treasuries. I would lighten up. On energy, I would stay long and buy on weakness.

I wimped out on the election, but I don't have that luxury with the markets. I believe we have seen the best earnings of the cycle and expect that the stock market will break its range to the downside. The challenges of a below potential growth economy, Federal Reserve "rate normalization," and eroding pricing power are not usually associated with great stock market returns. On the other hand, I don't see the decline likely to take us back to 2002 lows as the alternatives for investment are not particularly attractive. Staying with good earning stocks that pay a dividend while you wait still makes sense.

Although strict duration/yield analysis still suggests the best trade-off in the markets is represented by the two-year range, I believe it's time to take some risk. Instead of the two-year Treasury, I would invest funds in a barbell consisting of 25% ten-year Treasuries and 75% three-month Treasury Bills. This gives up some yield but offers the opportunity to take advantage of somewhat higher short rates in three months' time. It also allows for potentially capturing capital gains if the "soft patch" turns into something more serious. The risk/reward for extending maturity is still not compelling, but a month or two more of benign inflation figures will tilt the decision.



On the Fourth of July this year, I was surrounded by a restaurant full of Colombian immigrants laughing, eating, and singing entirely in Spanish. I was never more proud to be an American. Independence Day 2004 found me and my family in Charlotte, NC, at Mi Tierrita (My Little Country), a Colombian restaurant celebrating their "Grand Opening." We entered and were transported to another world. The owner and his wife made us feel welcome but had to call on their daughter to translate the menu for us. We ordered; the food was served; everything was good. While we ate, a steady stream of well-wishers entered. Traditional Colombian songs were played live on guitars, and everyone was singing. As we finished and paid the bill, I saw, in the owners' faces, pride in what they had already accomplished and faith in the promise of America. I, too, was proud that our little country could still kindle the dreams of a new wave of immigrants.