JAMESSON ASSOCIATES

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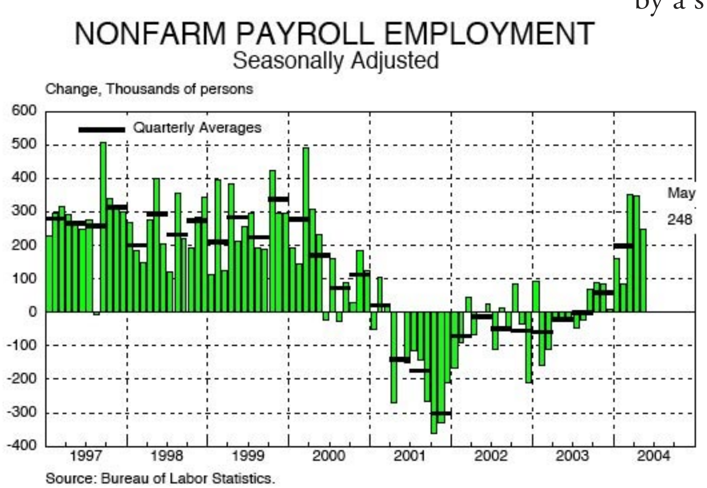
Recent Economic Events

Almost a million jobs created.
The inflation beast uncrated.
GDP is growing above trend.
The trade deficit hit a record again.

All the pieces of the puzzle have now fallen into place for the American economy. The last and most troublesome had been the employment picture. But over the last three months ending in May, payroll employment increased by 947,000. This is a remarkable turnaround from what we had originally witnessed in the three months ending February. However, even those figures have now been revised to show much stronger growth in jobs.



So far, the unemployment rate is stuck at 5.6% because the growth in employment has drawn in some workers that had previously given up looking for jobs. However, the increase in payrolls will eventually overcome this factor. If we can keep generating close to 300,000 jobs per month, we will start to drive the unemployment rate back toward effective full employment near 4%. This is indeed welcome news for wage and salary growth. As recently as March, we were showing so little growth in wages and salaries that inflation was eating up all the increase. Now the combination of higher employment and increased wages is creating momentum. Annual growth in total wages and salaries adjusted for inflation, which was non-existent as of year-end, is now up 3.0% as of the April.

Speaking of inflation, we now have a worry that had been entirely dormant. A surprisingly large increase in the core rate of inflation in March (.4%) was followed by a strong .3% in April. This brought the trailing three-month annualized rate to 3.6%. Compared to the annual change from April 2003 of 1.8%, it appears that inflation doubled. The headline rate which includes food and energy shows a three-month annualized rate of 4% up from the year-over-year rate of 2.3%. It is clear that these statistics show an acceleration in price increases. Although much of the publicity on inflation has focused on oil prices, it turns out that food prices have also increased at a faster pace over the last year. This suggests that the momentum behind inflation is stronger than we had suspected and helps to validate the strong economic statistics. The deflation dragon is dead, long live the inflation dragon. (Not really. Continued strong productivity combined with a coming tightening (continued on page 2)

cycle by the Federal Reserve should help to moderate future increases back toward the 2% target.)

Real GDP growth in the first quarter once again topped potential with a solid 4.4% figure. This brings the growth over the last year to 4.9%. By any measure, this growth is excellent. Furthermore, it has translated into record profits for corporations and has had the beneficial impact of helping to reduce the Federal Budget deficit from its previous projections of over $500 billion to near $400 billion. Although this would still be a record, it is at least moving in the right direction.

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The one item that doesn't seem to be moving in the right direction is the trade deficit. The United States had a record $46.0 billion deficit in March, the last month available. This reflects the continued over-consumption in the country and is echoed by a still increasing level of debt to GDP.

But now is not the time for doom and gloom. The strength of the economy and the build-up of jobs should help to cure many of the excesses of monetary and fiscal stimulus. Who knows, they may actually make some progress on our debt levels as well. And inflation, which clearly could become a problem is front and center in the Federal Reserve's thinking, so a remedy may be close at hand. ❖

Commentary

Market indications suggest to me that the Federal Reserve has fallen behind the curve and is risking rekindling inflation. There is plenty of evidence that pressures for higher prices are building from the price of commodities (especially oil) to the increased estimates derived from economists' surveys. However, I would like to focus on a more direct assessment of inflation expectations, one that has the benefit of real money behind it.

The US Treasury has been issuing Treasury Inflation Protection Securities (TIPS) for about seven years. A recent article in the *Economy Policy Review* published by the Federal Reserve Bank of New York, offers the following chart.

The idea behind this chart is that the difference between the regular 10-year Treasury yield and that on the TIPS should indicate an expectation of future inflation. There are some technical issues with the theory especially back in 1997 and 1998, but since then the spread had seemed to settle into a range. The market was suggesting that inflation would range between 1.5% and 2.5% with a median of 2%. That is not coincidentally the Federal Reserve's presumed target. Unfortunately, the most recent update to the figures shows a troubling development.

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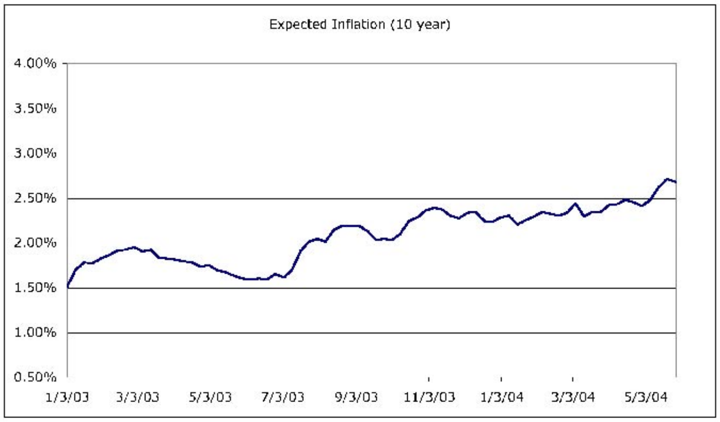
Commentary (continued)

From early 2003 until the April employment report released in early May, the range held. Since then the spread has increased culminating with the most recent prints above the important 2.5% level. Given the billions of dollars invested in both regular and TIPS issues, I must give great credence to this evidence. My conclusion: the Fed has lost market credibility and needs to regain it.



What should they do? In my opinion, an economy that is growing at well above trend, creating jobs, and delivering record profits to companies needs to be weaned from stimulative monetary policy. What we have today is aggressively stimulative fiscal policy (huge Federal deficit) combined with aggressively stimulative monetary policy. One has to go or we will find ourselves in an accelerating inflation spiral that can only end badly. Since this is an election year, there is no chance (nor is there time) to reduce fiscal stimulus. The Fed is the only game in town.

At this juncture, I believe the risks of raising interest rates at the end of this month by a full percentage point or even more are less than those of falling further behind an inflationary cycle. The sea of liquidity that has floated the economy upward during the Greenspan era needs to be drained, and June 30, 2004 is as good a date as any to begin the process. ❖

Market View

Interest rates have increased while the stock market has marked time over the last three months. Commodity prices seem to have receded from their highs but still remain in an uptrend.

The gathering strength in the American economy suggests that business will be good over the next year although interest rates will be increasing. These two factors tend to have offsetting impacts on the stock market. In a normal recovery, we would expect that the improved profit picture will overwhelm increases in interest rates. In fact, most historical studies show this very fact. The trouble with the studies is that there is no consistent reason for increasing interest rates.

Sometimes rates increase because the economy is growing too quickly and there is too much demand for money. Sometimes they increase because the Federal Reserve is trying to be pre-emptive, and sometimes they increase because inflation is driving them higher. Whether rates are increasing for real business reasons, government manipulation, or inflation really matters for the stock market.

I think we can rule out the first two items above. Although we are growing above trend, it doesn't appear at this point that rates are increasing due to too much borrowing demand. Also, the Fed is if anything

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Market View (continued)

behind the curve and following the market rather than leading it. That leaves us with inflation as the root cause.

Rising rates due to a build-up of inflationary pressure is not a good recipe for financial assets. In such times, bonds are a disaster, and stocks generally don't do much better than cash. The assets to look for are those that can keep pace with inflation. I believe there are two asset categories that fit the bill in today's market — TIPS and energy.

I have discussed TIPS before and feel that now that their yields have increased back to over 2% (10-year) there is some value in the product. Furthermore, it appears that if you are willing to hold the securities over a five year period, you can ride the real yield curve on them as well. The reason: yields on 5-year TIPS are 80 basis points lower than those on 10-year TIPS. This means that you can collect a real yield of about 2.2% plus inflation over the next five years. After that, you hold an item that has appreciated in real terms if the current rate curve holds. This looks like a good bet and a solid insurance policy against inflation. And even if inflation doesn't increase, you collect a pretty good return.

Energy has received a lot of attention now that gasoline is over $2 a gallon. There is probably a geopolitical premium in the price today, but the underlying picture is very bullish for oil. The geopolitical worries may dissipate, and then and again, they may not. However, the real prop to prices is the combination of strong global economic growth (led by the US and China) and significant underinvestment in energy over the last twenty years.

BCA Research recently did a study on the relative values of energy and financial services in the S & P 500. They found that in the early 1980's energy represented 25% of total market value while financial services was only 5%. As of the most recent reports, these percentages have been reversed. This suggests to me that the long disinflationary cycle we have seen since Paul Volcker took over at the Fed has been quite beneficial to financial services at the expense of energy. Since I believe that cycle is now over (not necessarily reversing, but over), I think it is time to move investment dollars away from financial assets (and companies) and toward those in the energy arena. Since this is likely to be a multi-year bull market, I would choose higher quality, dividend-paying, companies rather than high-risk exploration plays. ❖

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Editor's Note

A recent article in the Wall Street Journal cited a study by economists from National Bureau of Economic Research that concluded, "The effect of sex on happiness is statistically well-determined." The study indicated that more frequent (weekly rather than monthly) sexual activity had the same impact on happiness as did a $50,000 increase in annual income. There was no difference in the findings by gender. After having to live for years with the albatross of being called an economist, I am happy to find that there is some value in the economic profession.