JAMESSON ASSOCIATES

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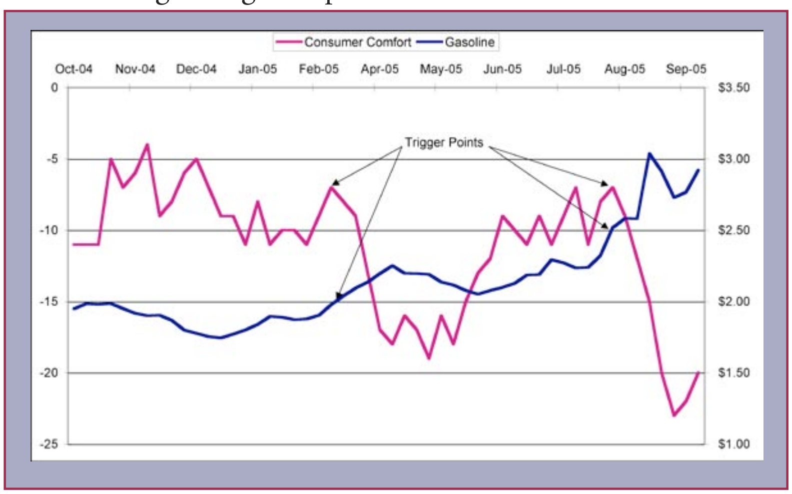
Recent Economic Events

Some of the most maligned reports in the field of economics are those that try to gauge the mood of consumers. In this case, however, I believe that they have some real value. All of the major consumer confidence reports have shown sharp deterioration in the past few months.

The indices are more consistent with the recessionary levels of 2001 and the early 1990's than they are with expansion. The key question is why. Is it because of the hurricanes, and therefore, temporary? Or is it due to the rising cost of energy coupled with a slowing in the pace of the housing market?

Note the chart showing the weekly plot of the ABC Consumer Comfort index and retail gasoline prices over the last year. The first decline in confidence coincided with the spring rise in gasoline prices, pushing the price above $2.00 a gallon. Once the price stabilized and headed back down a bit, consumers breathed a sign of relief, and the index bounced back. Then, in mid-August, the price crossed $2.50. Predictably, confidence plunged. The key point here is that the decline was <u>prior</u> to the Katrina price spike, and unless the price recedes below $2.50, it is unlikely that confidence will revive significantly.

Other economic statistics suggest that the economy was on a steady path in the summer. Consumers were enticed by "employee pricing" to send auto sales over 20 million in July. This resulted in an official savings rate below zero (-0.7%). Employment gains had been solid, pushing the unemployment rate down to 4.9%. This morning's report (post-Katrina) showed a modest 35,000 job loss, more than accounted for by the estimated 230,000 job reduction due to the hurricane. The unemployment rate rose to 5.1%. These figures suggest the economy is growing near potential.



Inflation has been well contained except for energy prices. The core CPI showed a .1% increase for the fourth month in a row, bringing the annual rate to 2.1%. Of course, some (the Fed?) may view the exclusion of a secular rise in energy from the statistics as akin to asking Mrs. Lincoln, "Aside from that, how was the play?"

The other big economic story revolves around housing. Existing home sales met resistance in August, and new home sales fell sharply. This was in the face of still-attractive mortgage rates. In addition, applications for mortgages have eased (continued on page 2)

Recent Economic Events (continued)

further since August. Furthermore, the supply of homes for sale has begun to increase. It was 4.7 months in August, up from 4.6 months in July and only 3.8 months in January.

A recent study from the Federal Reserve co-authored by Alan Greenspan, suggests as much as $600 billion of value was monetized by homeowners in 2004. Roughly half of the total is estimated to have found its way into consumption. This amount appears to be headed for a 50% decline this year. Note that the increased cost of gasoline (about $1.00 higher than last year) would eat up roughly $150 billion additional annual expense. This means that the housing market which had helped keep spending up may no longer be able to offset the higher costs of energy.

The economy had shown signs of accelerating employment and good growth prior to the most recent surge in energy prices — prices that rose before the hurricanes and show little signs of returning to early summer levels. Now that housing is no longer a big plus for the economy, the risks of a slowdown have increased. Problem is, our economic statistics will be hard pressed to tell the story accurately for the next few months. Right now, we are in a faith-based economy where we would do well to keep our fingers crossed. ❖

Commentary

Beware the Butterfly

The old saying suggests that the flapping of a butterfly's wings in Sri Lanka can cause a hurricane halfway around the world. Not sure how true that really is, but I believe that the current state of the global (and American) economy is quite dependent on potentially small changes in the background.

Although the third quote is fake, it certainly has the ring of truth. Note that the first two show just how out of touch the President was while the last suggests that Jimmy Carter has infiltrated the White House. The call to conservation now is likely to have as little impact as it did in the 1970's. Americans will conserve in response to only one thing: high prices.

Pick out the fake George W. Bush quote:

1. *"Out of the rubbles of Trent Lott's house -- he's lost his entire house -- there's going to be a fantastic house. And I'm looking forward to sitting on the porch."*
2. *"Brownie, you're doing a heck of a job."*
3. *"Not one dollar of tax cuts will be sacrificed to rebuild the Gulf Coast."*
4. *"We can encourage employees to carpool or use mass transit, and we can shift peak electricity use to off-peak hours as a way for the federal government to lead when it comes to conservation."*

The more serious and less partisan issue here is that the devastation wrought by Katrina and Rita to our energy industry in the Gulf Coast has revealed the dirty little secret of global capitalism. To wit: the downside of efficiency is the inability to handle crisis. In other words, the relentless drive to squeeze out the last dollar of profit results in less of a cushion when something out-of-the-ordinary occurs. (continued on page 3)

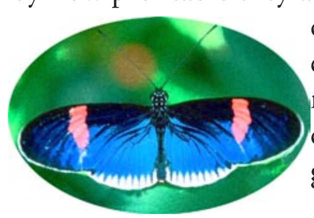
Commentary (continued)

This same philosophy is exhibited in Mr. Bush's remarks above and in his approach to government. The Reagan Revolution was predicated on the belief that government was the problem and that the private sector could do better. Subsequent administrations helped take this idea to its logical conclusion with results that are painfully obvious today. What talented individual would look to a career as a civil servant today? The constant denigration of government bureaucrats (as if business was not rife with bureaucracy as well) has chased many from government service. Cronyism is the alternative, and an alternative raised to high art by Mr. Bush.

Today's American economy is built on the idea that easy credit to tap equity in housing can sustain spending beyond our means. No politician will say that it has to stop. We have the largest current account deficit in the history of the world in absolute terms and probably the highest in percentage terms for a world-leading economy. The Federal Government is a spendthrift wastrel consuming years of accumulated goodwill by running serial deficits covered up by a soon-to-be eroding Social Security surplus. And even so, it cannot respond when needed. Oil production is just meeting demand, and there is a real question as to whether increased demand from emerging nations can be met at anything like a reasonable price. Both government and the private sector have failed us.

When the cushion in all areas is a tight as it is today, one butterfly can indeed upset the balance. Although it is foolhardy to predict a recession when most statistics point to continued growth, it appears to me that the risks have increased substantially. I would place the chances of recession in the next year at one-third and moving up. Unfortunately, we Americans and our government will not take action before a crisis hits. Consumers continue to spend even without income. Tilting at imaginary inflation windmills, the Federal Reserve risks a real recession. The Federal Government would rather spend on pork barrel projects, blame others when preventable problems occur, and then throw money at the situation after the fact.

How I long for some adults: real savers in the private economy, an honest monetary policy, and a government that might actually take responsibility and address real issues rather than fob them off on to the private sector — a private sector that chooses its jobs not by how beneficial they are to the whole but by how profitable they are to the few. Welcome to the logical endgame of free-market capitalism coupled with small government.



We need new thinking. If we don't get it, the threat of the butterfly is real. ❖

Market View

Given my somewhat dyspeptic view of the economy, it would be hard to recommend a wholehearted jump into the equity markets. In fact, I would be very wary on fundamental grounds, technical grounds, and on the calendar.

The trailing P/E Ratio of the SP 500 is still close to 20x while its dividend yield is only now approaching 2%. Until the late 1990's, these levels would have been signs of overvaluation. In fact, the market was at roughly this level (continued on page 4)

Market View (continued)

of valuation in 1996 when Chairman Greenspan made his famous, "Irrational Exuberance" remark. Given long-term historical averages of around 15x P/E and 3% plus dividends, stocks appear 25% to 30% overvalued on this basis.

The technical picture is not great. The two-decade bull run from 1982 to 2000 corrected for only two years to a low in late 2002. Timing suggests a bear market of at least one-half the duration of the bull market. Furthermore, the market's recent high was just short of the key resistance level of 1250 on the SP 500. Exceeding this level would have pointed to the end of the correction from 2000 and an extended bull market. Failure suggests tough sledding.

And then, it is October. Unfortunately, it appears that big crackups in the market have a higher chance of occurring in October than any other month.

The bond market has become more treacherous as well. Although I doubt 1970's style stagflation is around the corner, the market is worried. The best way to play fixed income now is to either stay short (up to three years) or to acquire TIPS which offer potential upside if inflation does take off. Stay with high quality names as the credit cycle is not going to improve from this point forward.

Commodities in general and gold and energy in particular present some thorny issues. On the one hand, we are likely in the early portion of a secular move in commodities. There is plenty of upside over the next few years. However, the run is showing signs of fatigue.

My view: add to positions in gold or gold stocks. This market has broken out of a multi-year decline on the charts and is psychologically poised to test the $500 mark. Energy is presently overextended. Look for a better entry point. The best choice is a stock that pays a secure dividend while you wait. Other commodities are even tougher to gauge. The best way to participate here is with a diversified mutual fund that invests directly in the commodity market. Once again, waiting a few months for a better entry point appears to be wise. ❖

Editor's Note

I am not generally disposed to superstition in clothing, but this set of coincidences is too much to dismiss. A few years ago, I purchased a tan summer-weight suit. The first time I wore the suit I managed to sit in a restaurant booth in which a previous patron had left a glazed donut. The dry cleaning never fully erased the stain. Then last year, I was driving to an early morning meeting when a deer jumped in front of the car. I slammed on the brakes and avoided an accident but spilled coffee in my lap. This time the dry cleaning worked. I had been avoiding the suit all summer but finally decided to wear it again at the end of August. Carefully taking it out of the plastic dry cleaning bag, I dressed and headed out. I wasn't five miles from the house when another cup of coffee drenched my pants. My conclusion: this suit really likes breakfast. If anyone needs a 38 Regular to disguise a trip to Dunkin' Donuts, give me a call.

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