JAMESSON ASSOCIATES

Spring Newsletter March 2005

Recent Economic Events

The American economy continues to cruise along at an above potential pace, and finally, employment seems to be joining the party. Notwithstanding regular new highs in the price of oil, inflation remains subdued. Dare we hope that we have re-entered the fabled "Goldilocks Economy"?

Real GDP increased by a healthy 3.8% in the fourth quarter, propelling GDP forward a very solid 4.4% during the calendar year 2004, the best growth since the heady days of "irrational exuberance." Note that the potential long-term growth rate of the economy is 3% to 3.5%, a combination of the natural increase in the labor force (around 1%) and the growth in productivity (2% to 2.5%). In fact, the 2004 performance is the first above-potential growth we have seen since 2000. This is somewhat unusual. Typically, the growth as the economy initially recovers from a recession is stronger than that after the expansion is well underway.

The same atypical recovery pattern has been evident in the labor markets. Job creation remains well below where we normally find it in the fourth year of recovery. It wasn't until January (pending revisions) that we matched the previous high in employment. However, February brought an acceleration in job creation (262,000), suggesting that businesses are finally beginning to gain confidence in the economy. Many other labor market indicators are positive as well. The number of new claims for unemployment moved into the low 300,000 per week range from its 2004 level of close to 350,000. After spending forever between 36 and 37, the Help-wanted index rose to 41 in January. At the same time, there are enough countervailing indicators to temper our enthusiasm. During February, the average workweek did not rise, and wages were unchanged. This suggests that workers' incomes stagnated even before inflation during the month and will remain below year-ago levels on a price-adjusted basis. Furthermore, the labor participation rate held at its recent low, and the unemployment rate increased from 5.2% to 5.4%. Not too hot, but not too cold either.

Inflation, as measured by indices close to the consumer, appears to have stabilized. If, however, we look at prices closer to the source of production, it can give us the willies. The CPI was up a very benign .1% overall and .2% excluding food and energy in January. The annual rates registered 3.0% and 2.3%, respectively. The personal consumption price index (Mr. Greenspan's preferred measure) came in at an annual increase of 1.6% on a core basis and 2.2% overall in January. These levels are showing little, if any, acceleration in prices. However, when we turn our attention to the Producer Price Index, the situation becomes more ominous. In January, the entire market was surprised by a sharp .8% increase in the core rate, bringing the annual increase to 2.7%. The overall index increased .3% to help the annual rate to a 4.2% gain. It is clear that these levels are above the comfort level both at the Federal Reserve and in the economy in general.

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Recent Economic Events (continued)

Normally, we expect that higher prices for producers will translate into higher consumer prices with a time lag. The theory, however, appears to have broken down. Producer prices have been accelerating since 2003, but consumer prices have lagged, and surprisingly, lagged even further over the past six months or so. The chart at the right shows the ratio of the CPI to the PPI. It suggests that consumers are simply refusing to accept price increases even though producers are facing higher costs. Whether consumers keep control or whether producers are finally able to push price increases through is the key economic question we now face.

The economy is growing at or above potential; employment is picking up; and as long as inflation remains well behaved in the face of increasing commodity prices, it looks like the porridge is just right. Let's hope Goldilocks has plenty of time to eat before the Three Bears reappear. ❖

Commentary

President Bush obtained his MBA from Harvard Business School, not from Yale. Apparently analytical rigor was not a prerequisite to graduation.

According to the trustees of the Social Security system, benefits can be paid under existing rules until 2042 at which time payments would have to drop to about 70% of promised levels. Other analysts (CBO) suggest that the system can make it to 2052, while minor changes in economic assumptions produce benefit coverage that continues indefinitely.

Recent statistics on America's oil consumption indicate we use roughly 21 million barrels per day of oil. Only about two-fifths is produced domestically, leaving a shortfall of around 12 million barrels per day. The cost of this oil at current prices is about $240 billion annually, or one-third of our trade deficit.

Can you guess which of these situations is the true crisis?

Mr. Bush is trying to raise an alarm over the funding of Social Security in order to pursue his long-held dream of private accounts (his "ownership society"). Even the administration no longer contends that these accounts will address the presumed funding crisis. And yet, great efforts are underway to promote an overhaul of the system. Alan Greenspan was recruited to help the case, and he has shown his true colors as a partisan supporter by simultaneously suggesting Social Security benefit reductions and a continuation of Mr. Bush's income tax cuts. On top of this, he recommends less government spending and replacing the income tax altogether with a consumption tax. Fortunately, this has the proverbial snowball's chance of passing Congress, and the Chairman's term ends in less than a year.

What about energy policy? There is a movement afoot to revive the idea of drilling for oil in the Alaskan National Wildlife Refuge. It may or may not succeed; however, it misses the point. Even if we tapped all the oil we could (continued on page 3)

Commentary (continued)

from this source, no responsible analyst contends it can reduce our dependence on foreign oil. The best we can hope for is keeping imports level. What we need to do is develop domestic, renewable forms of energy.

Since oil profits flow to both the Middle East and to Russia, I contend that those dollars are actively working against our global political goals. The most effective foreign policy action we could pursue is to push the price of oil back down below $20 ($10 would be even better).

In New York State, Governor Pataki has made an important step in the right direction. He has called for the percentage of renewable energy within the state to be raised from 20% to 25%. This is a cause we all can support.

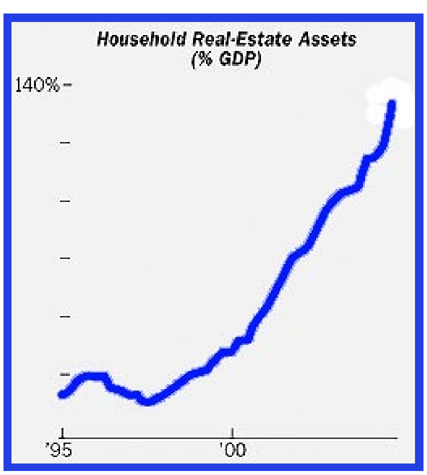
But, the Federal Government must do more. And it must do so while stepping on all the political toes available. Four ways come to mind. First, to make free marketeers happy, it needs to promote incentives for any type of renewable energy. Note this cuts out oil and gas producers. Second, it needs to cut red tape on non-fossil fuel projects. Wind, solar, biomass, and nuclear must be brought into the mix. So much for the environmentalists. Third, gas mileage standards on cars need to be raised. Fourth, it needs to spend money directly (goodbye deficit hawks) both to support research and to drive down breakeven costs. Why not immediately announce a schedule to move all of the Federal Government's electricity usage to renewable sources?

Have I left anyone out? Oh, yeah, individuals cannot escape blame either. We need to change our habits and be willing to pay the real price for our dependence on foreign oil. I have switched my electricity to renewable sources even though it is presently more expensive. If even 10% of consumers would make the move, a strong signal could be sent through market mechanisms.

The President has spent enough time on fake crises. Let's take on a real problem. $20 oil now! ❖

Market View

There's no place to hide, especially if you invest in dollars. Financial markets have benefited from a surfeit of global liquidity driven by high savings rates in fast-growing emerging nations. With so much money chasing ever-decreasing investment opportunities, it's no wonder that interest rates are low, P/E ratios are high, and real assets are hitting new highs.

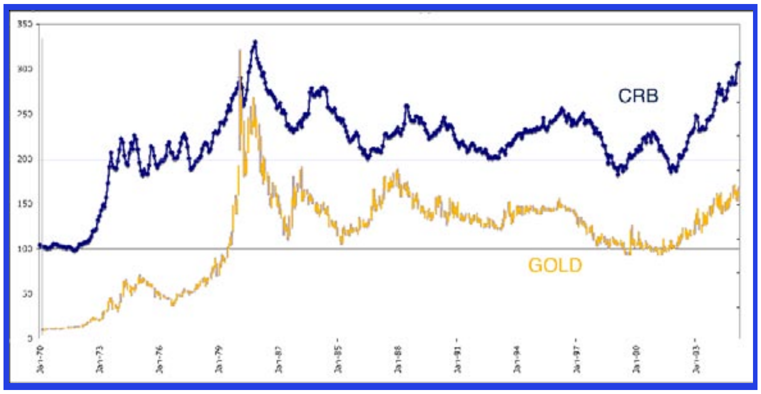


The irony of investing in times such as these is that it is increasingly difficult to find assets that are undervalued while at the same time, the huge reservoir of cash means downside is limited. This is a recipe for average returns. In an environment of average returns, the best course of action is to find assets that pay a good yield while you wait. Dividend-paying stocks fill the bill. The most promising areas to search in: the utility and energy sectors. Also, diversifying into foreign assets is a good way to play a potentially weaker dollar. Fixed income investors should look to place funds short (up to 2 years) and long (over 10 years), staying out of the in-between maturities.

After a good long run of out-performance, financial stocks are showing signs of topping out. The favorable background of disinflation is clearly behind us, and the level of competition has (continued on page 4)

Market View (continued)

increased. Furthermore, the secular move toward financial versus real assets has gone as far as it reasonably can. Lighten up on banks, insurance, brokers, and asset managers unless you are comfortable with both the dividend paid and the unique story presented.



Here's something that presents a real conundrum. Commodity prices have vaulted upward over the past month or so, pushing the CRB Index to levels not seen since the early 1980s. Note that commodities have now exceeded the peak prices from both 1988 and 1996. However, the price of gold has not kept pace. The easiest explanation is that gold is either lagging or it is being manipulated by central banks around the world. This suggests that investing in gold will pay off. Sooner or later, the lag will be closed or the central banks will run out of bullion. The alternative explanation suggests caution is in order.

In the early 1980s and again toward the end of the eighties, the driving force in both commodity prices and gold was a depreciation of the dollar through inflation. This time around, the inflation rate for goods and services is quite low. The driving force is demand for commodities needed for production. If this is the case, gold may well appreciate, but it will continue to lag.

Although I believe that the demand for commodities is in a multi-year upswing, I don't believe that it is due to inflation. In fact, I believe that deflation is a lot closer than most believe. Look to add to general commodity positions on weakness, but don't get mesmerized by the gold bugs. Bet on production, not on sterile hoarding. ❖

Editor's Note

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If I ever needed a reminder that following the crowd was a poor strategy, I learned it again a few weeks ago. On a snowy day in early March (Is there any other kind?), Susan and I headed out to discuss finances with our accountant. Noting the path from the street into his parking lot, I maneuvered my car into the well-traveled ruts and promptly hit the sidewalk curb, blowing my front tire. After determining that it was clearly too cold to change the tire myself, I called AAA to handle the job. Of course, they were extra busy because of the weather, but they eventually showed up and performed the switch quickly and professionally. As a silver lining, I enjoyed a nice lunch with my wife, learned a lesson, and since I needed new snow tires anyway, simply accelerated the purchase by a few weeks. Would that investing with the crowd turned out as happily.