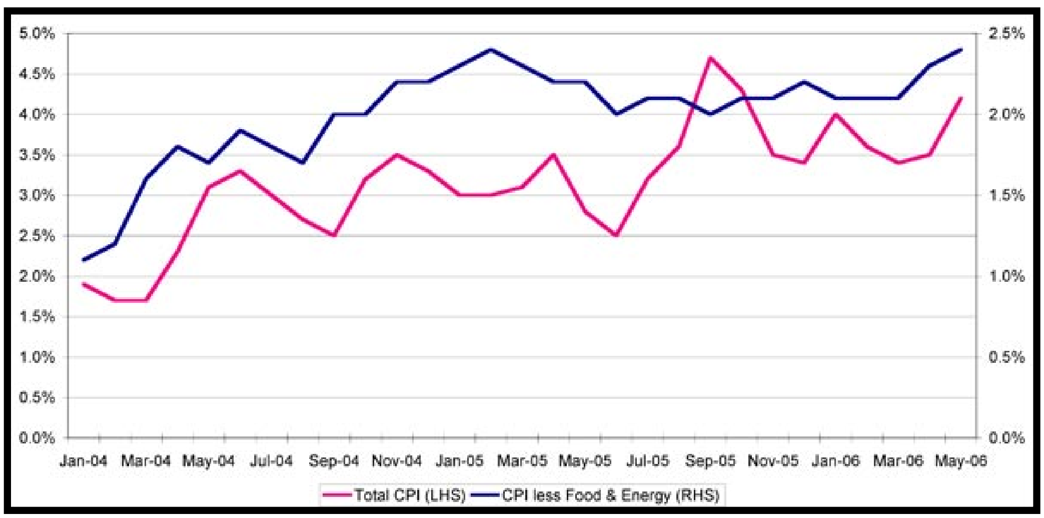
JAMESSON ASSOCIATES

July 2006 Newsletter

Recent Economic Events

There are increasing signs of a slowdown in the American economy. Stresses and strains are appearing in some previously strong sectors. Unfortunately, the deceleration is not currently having the intended effect on inflation. It appears that prices are beginning to rise in areas not directly related to energy.

Real GDP advanced a strong 5.6% in the first quarter, but most forecasters are expecting a much slower pace in the second quarter. The reasons are many. First of all, employment gains have moderated from the robust pace experienced in 2005. June job creation totaled 121,000 up from May's 92,000 figure, but well below expectations for close to 200,000 jobs and even short of the roughly 150,000 estimated necessary to absorb the growth in the labor force. The three-month average of jobs created fell to 108,000. This is substantially below the roughly 170,000 average that prevailed in 2005. In fact, the pace of job creation has slowed from its peak about one year ago and now shows a quite modest 1.4% annual advance.



Housing is also showing some stress. Sales and price appreciation have ebbed, providing less of a tailwind for consumer finances. New home sales in May were 5.9% below May 2005, and existing home sales were down 6.6%. Price increases have moderated to 6.0% and 3.1% for existing and new homes respectively. The heady double-digit gains of spring and summer 2005 are distant memories today. The near future looks even weaker with unsold inventory at a cycle high (over 6 months) and builder confidence in the tank.

Retail sales have followed a path of moderation as well. June showed an drop of .1% overall, driven by declining auto sales. This latter point emphasizes the weakness in the car business resulting from the inexorable rise in gasoline prices.

And rising prices have now taken center stage in the economic policy circles of the United States. Wall Street economists are concerned; stock and bond investors are concerned; and perhaps most importantly, the Federal Reserve is concerned. Based on an accelerating pace (continued on page 2)

Recent Economic Events (continued)

of consumer price inflation over the most recent three months, the Fed raised rates by one-quarter point for the seventeenth consecutive meeting. It does not seem to be working.

Total consumer price inflation is running at 4.2% year-over-year as of the May figures. The core rate is advancing at a 2.4% year-over-year rate, equal to the highest rate this cycle.

In the 1970s, we called slowing growth coupled with rising inflation stagflation. We have clearly not arrived at the deadly combination of recession and double-digit inflation that gave that term its original meaning, but the last few months have delivered some unsettling similarities. The next quarter will challenge policymakers to walk a very fine line. They need to exude confidence in their choices, hope that they have not already set the economy on a path to a hard landing, and see some thread of evidence that inflation has peaked. It's an open question whether the market gives them the room to do so. ❖

Commentary

I find myself in agreement with President Bush on the issue of immigration. The President's preferred plan, in large measure, matches up with that passed by the Senate in contrast to the House bill. The balancing act is to shore up border security while dividing currently residing illegal immigrants into categories for either deportation, guest worker status, or ultimate citizenship. The entire question has been characterized by plenty of heated rhetoric. The nativist view envisions a Berlin Wall at the Mexican border along with criminalization of illegal immigrants and those who help them. Immigration rights activists expect that everyone who is here or who can get here should be afforded the opportunity to join the melting pot.

Immigration is a plus economically for the US

This issue has three components that need to be resolved before any program can work. These are security, cultural impact, and economics. The first two are not the subject of this column; the last one is.

The economics of immigration centers on three major areas. There is the short-term impact on workers and communities here in the US. There is the impact on businesses and business customers which depend on immigrant labor to function, and there is the long-term demographic aspect of population growth over and above birth rates.

Economists have published many studies purporting to show the impact of low-cost immigrant labor on the job and income prospects of Americans. Some studies show that the supply of new labor pushes down wages and raises unemployment among unskilled workers. Other studies suggest that the net impact is minimal. This is due to the increased consumption of the new workers which creates other jobs. Essentially the maid or the construction laborer is renting a house, buying groceries, etc.

One area where there is more agreement is in the realm of public expenditures. Here it appears that low-income immigrants are using public services at a significant enough rate to raise costs for taxpayers. However, as with any public expenditure the real question is whether the dollars are an expense or an investment in the future. Extra garbage pickup is an expense, but education costs are an investment. If we believe that education expenditures ultimately raise America's standard (continued on page 3)

Commentary (continued)

of living, it is hard to argue it will not do so for immigrant children.

Certain businesses would be hard pressed to compete without immigrant labor. Fresh fruit and vegetables would carry much higher price tags and perhaps lose out to imported produce without inexpensive farm labor to harvest them. Restaurants and hotels would have to raise rates possibly reducing usage, and it is unlikely that our meat processing industry could long survive without the immigrant workers in their employ.

These issues, in my opinion, are transitory. Short-term local impacts and businesses that rise and fall are part of the normal dynamic of an economy. The real economic impact is what happens over the long term. On that score, immigration is a big plus for America. As we age, we will need to replenish the supply of workers. A story in this morning's Rochester newspaper was bemoaning the shortage of labor in Upstate New York. Multiply that concern nationally over the next fifteen years as we Baby Boomers retire. It is no wonder that Russia, Japan, and the European Union have less robust economies than does the US. They are aging quicker and have seen their native populations top out and begin to shrink. No advanced industrialized country in the world has a birth rate high enough to maintain its population. The US is close, but even we cannot increase population over the next few decades given present trends unless immigration continues.

Immigration is a plus economically for the US, and we need to find a way to encourage it to continue. There are real security and cultural issues that need to be resolved, but to give up the growth that would be expected from continued immigration (even illegal immigration) would be a poor choice for America's economic well-being. ❖

Market View

The more I observe markets, the more I am struck by the difference between value and price. Seers no less than Warren Buffet and Martin Whitman have opined over time that they prefer the market to go into short-term swoons so that they can buy companies at more attractive prices.

The activity in some of the more volatile areas of the investment markets over the last quarter fits this profile. As I feared this spring, investors' risk tolerance was ripe for a U-turn as central banks started to reverse their policy of excess liquidity. And on cue, commodities and emerging markets stocks showed sharp drops. This was a price correction, not a change in fundamental value. It appears to me that much of the adjustment in these areas has taken place, and that investors can begin to reenter the sectors.

It also appears that the worst may be over for the bond market. The chart you see suggests that rates have risen to their long-term trend line and have held below it. This is a good indication that the path of least resistance may be down from here. However, with all of the geopolitical uncertainty, I would commit only a portion of funds to bonds today, expecting to become more aggressive when we see a peak in inflation and an economy that is clearly slowing down. The next six months should provide that opportunity.

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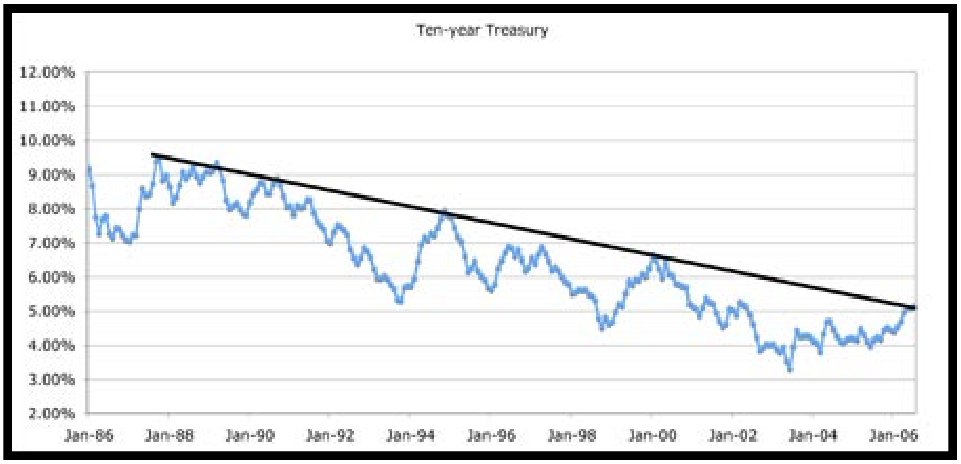
Market View (continued)

Domestic stocks, on the other hand, appear to be truly laboring. Seasonally, the summer is not a great time to add to stock positions. My take on this is that it makes sense to park money at short-term rates near 5% and wait out the hot weather. As we get closer to the fall elections and some of the dust has settled, we should be able to better choose the proper equity sectors. If you want to wait in stocks, I would continue to lean toward energy companies that pay good dividends. ❖



Editor's Note

Early this month, Susan and I stole away for three days to Savannah, Georgia. We stayed in a bed-and-breakfast and had the opportunity to talk with some of the other couples who were staying there during breakfast, tea (yes, I actually ate a cucumber sandwich), and dessert time. I was struck by the amazing diversity of talent I encountered in the short time we were there. We met a long-distance couple — he from New Jersey, she from Florida. He sold industrial sprinkler systems while she had a business providing custom medical prosthetics. A couple from Huntsville, Alabama paired a pharmaceutical executive with a high school guidance counselor. Her enthusiasm for her kids was so infectious we stayed up well past midnight talking with them. The next morning we sat with two couples, one from Florida and one from Mississippi. The former operated a business selling parachutes to the Army and Marines while the latter ran a construction company. In 2004, the construction executive was in Iraq successfully bringing a water treatment plant up and on-line. That afternoon we chatted with a couple who had decided to drive in from Oklahoma for a mini-vacation. He was in the oil field services business while she covered a three-state territory selling proprietary medical devices. I got to thinking that in that one little inn, Hollywood had the makings of a "last survivors on Earth" movie. The key question: what actor would play the critical role of the bank consultant?

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