Fall 2007

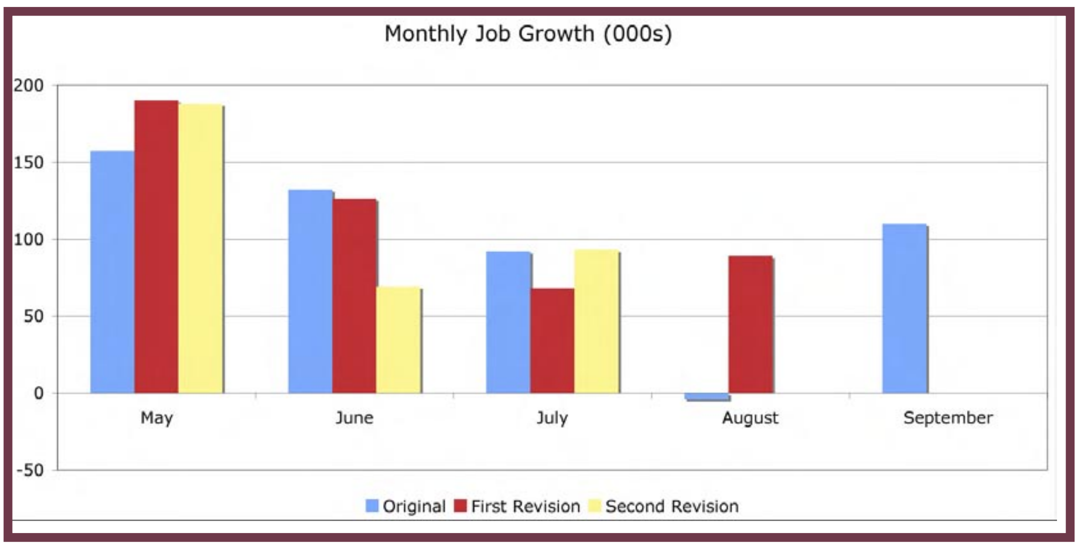
Jamesson Associates

Recent Economic Events • • •

Can't anyone at the BLS add and subtract?

Apparently, the slowdown in new job creation reported in early September never occurred. The bean-counters at the Bureau of Labor Statistics reviewed their figures and concluded that instead of jobs shrinking in August, they actually grew. September job growth was also solid. This has steadied the expectations for third quarter GDP growth while reducing the odds that the Federal Reserve will be forced to cut rates further at the end of October. Inflation trends have remained positive, but the phrase, "sound as a dollar" has come in for some derision.

What a difference a month makes. The September jobs report, released on October 5th, revised away the 4,000 job drop in August, pegging the new figure at an increase of 89,000. It also reversed the revision for July. The accompanying chart shows a summer slowdown but no collapse. Admittedly, the unemployment rate rose to 4.7%, but this was primarily due to a big influx of teenagers entering the labor force (expecting better prospects?) and is still quite low by historical standards. New claims for unemployment insurance have receded from higher levels in the summer and are now consistent with modest positive job growth.



Job figures for August originally showed a decline of 4,000, putting the market in a real funk. Combined with the weak housing picture, a shrinking jobs outlook seemed to be the final nail in the economic coffin. Many economists rushed to predict substantial slowing in GDP with a sizeable minority suggesting recession was at hand. The weakness also played into the Federal Reserve's September 18th decision to lower interest rates by a more-than-expected 50 basis points.

GDP in the second quarter was revised to a healthy 3.8% growth figure as exports helped to offset the weak housing market. The trade picture is one of the key bright spots in the American economy at present. It is being bolstered by the combination of strong global growth (expected to top 5% again this year) and a reduced appetite for consumption on the part of US consumers. Monthly exports are consistently 10% higher than last year while imports have slowed by 5% or more.

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Recent Economic Events (continued)

The weaker dollar should also help the trade picture. American exports are far more competitive while imports are facing cost pressures. Closer to my home, busloads of Canadian shoppers are streaming into upstate New York malls to take advantage of the ascent of the Loonie.

Currently, expectations for GDP growth in the third quarter are in the 2.5% range. This is below trend level. Note that positive, but below trend, GDP growth is exactly what Dr. Bernanke and his fellow governors at the Federal Reserve ordered to reduce inflation. And inflation has remained muted even as commodity prices continue to rise. The most recent reports on inflation show moderation both before and after adjustment for food and energy prices. August producer prices are up 2.1% and 2.2% for overall and core while consumer prices show 1.9% and 2.1%, respectively. PCE prices are up only 1.8% on both overall and core, placing the change within the Fed's 1% to 2% comfort zone.

After responding to market upheaval with a between-meeting cut in the discount rate in August, it is no wonder that the Federal Reserve used the economic information at hand when they met in mid-September to lower interest rates by 50 basis points more. Although an easing bias may be maintained at the next meeting, the new, revised US economy may slow the path to lower rate.

Commentary . . .

The book may not be entirely done, but an important chapter has been completed in the real legacy of Alan Greenspan. This is in contrast to the self-serving tome that the former Fed chairman is currently hawking.

The excesses of the free market have been on display for all to see this summer as a reasonably manageable problem with sub-prime mortgage lending has infected the entire market for credit in the US, and by extension, the global markets. The key contributors to the mess include lack of regulation, risk transfer, leverage, and lack of transparency.

Step one in the process is to extol the virtues of the free market as a risk assessor superior to a financial intermediary. This allowed many loans that would have resulted in a "no" at the bank to be extended. A key factor in this process was the lack of any regulator offering rules for the new lending products. It was left to the market to decide that rating agencies could do the job just as well. Only thing is, it turns out the rating agency ratings were being paid for by the folks who were making money selling the loans. Anyone think this has similarities to the Wall Street "analysts" who were talking up internet start-ups as their investment banker partners were selling IPOs in the late 1990s?

Then we have the alchemy of risk transference as the loans were changed from dross to gold. Note that a loan with an expected default rate of 10% or so (ultimately proven to be quite low) was sliced and diced into AAA tranches of securities. The riskiest portions of the security were sold off to "sophisticated" institutional buyers who could presumably shoulder the higher risk in return for higher yields. But because even those returns were not high enough to justify multi-million dollar salaries, the risky high-yield portions of the securities were leveraged with borrowed funds to enhance them further.

This process was all well and good as long as the loans kept flowing and the housing market continued to hit new highs. Any credit problems could be resolved by a refinance using the improved equity position of the borrower.

Then the music stopped. (continued on page 3)

Commentary (continued)

This is where the last piece of the puzzle comes in. Over the last decade or so, sub-prime loans have represented about one in eight dollars of new securitized residential mortgages and only about one in six of these is delinquent. This suggests that even with a 50% loss rate, the actual monetary damage will be in the range of $150 billion. Spread this out over two or three years in a $13 trillion economy, and this is hardly enough to cause a permanent problem. But concentrate the problem in the financial markets over a two-month period when no one really knows who is holding the paper behind the leverage (lack of transparency), and you do have a problem.

So who comes to the rescue of the free markets? If you answered, "Intrepid capitalists with profit on their minds," you would be wrong. Turns out Mr. Greenspan's Randian Objectivists become downright Marxian in their views when their own wealth is threatened. The real savior: government in the form of the Federal Reserve.

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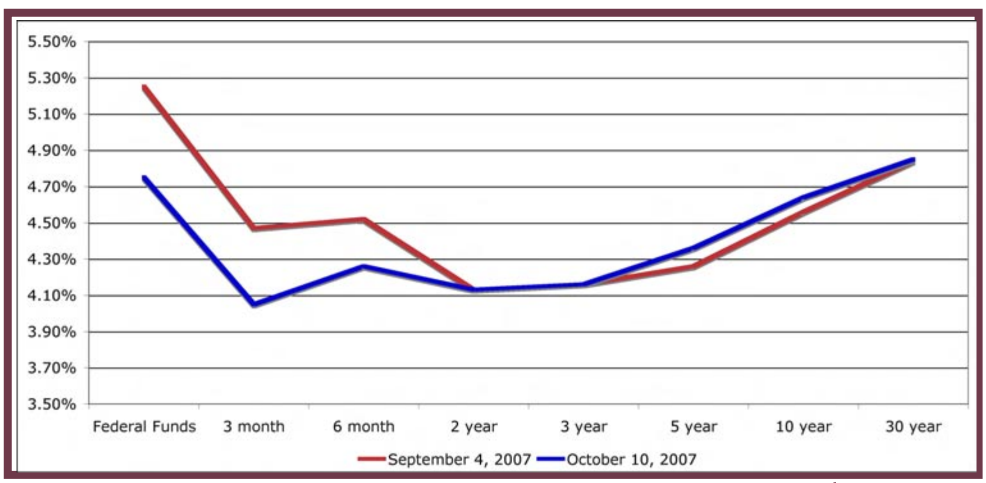
Although Mr. Bernanke strove mightily to let the market deal with its own excesses, he ultimately capitulated to avert a seize-up in the credit markets that could have easily spilled over into the broader economy. Just as Mr. Greespan had done in three or more previous episodes, the Fed started throwing money at the problem. Currently, some semblance of order has been restored even though spreads are wider than they were in the spring. The stock market is near all-time highs, and it appears that the worst has passed.

But make no mistake, the lesson has been reinforced. If you are too big to fail, the Fed will be sure that you don't. If wealth is threatened, plenty of cash will be at hand. But if you fall behind on a mortgage, well, that's just tough, because people have to be "responsible for their decisions."

Market View

I expect three things in the wake the Federal Reserve's rate move: lower short-term rates, increased fear of inflation, an economy that avoids recession. If you buy this, you should move funds out of cash into stocks and commodities but avoid long-term bonds.

As you can see on the yield curve chart, short rates are down substantially from early September when the maximum spread between Federal Funds and three-month Libor occurred while longer-term rates are higher. This is indicative of both the move by the Fed and the resulting market concern over inflation.



Further reinforcing this point is the recent all-time high oil price and the multi-decade high gold price. Gold is always an indication of inflationary concerns in the market. But a funny thing has happened as gold and oil have advanced. The number of barrels of oil that you

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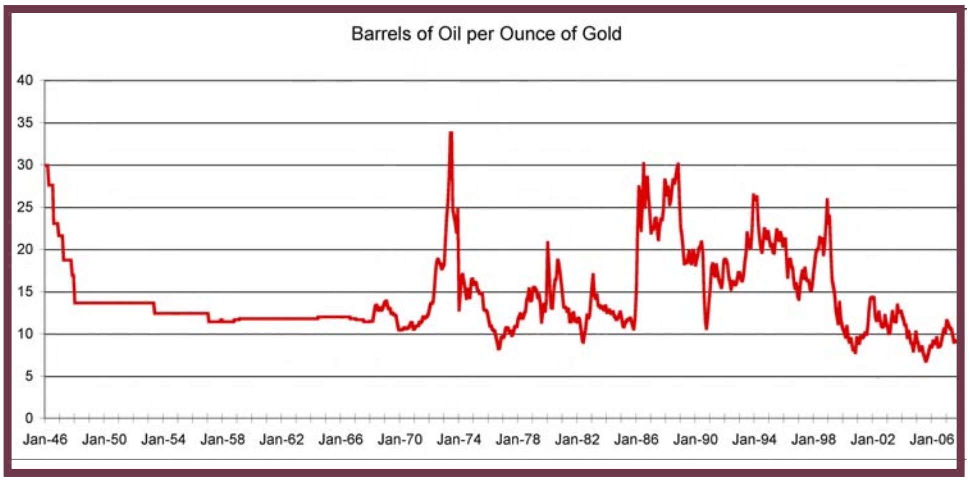
Market View (continued)

can acquire with an ounce of gold has not kept pace. The long-term chart of gold and oil prices shows that for much of the post-war period (up until the mid-80s), an ounce of gold bought between 10 and 15 barrels of oil. From the mid-80s until oilman George W. Bush was elected, gold bought about twice as much oil. But, almost on cue, the ratio began to fall. We have now occupied the sub-ten-barrel area for longer during the last 30 months than in the previous 60 years. A ratio of 9 barrels is a clear bargain for gold.



The combination of inflation fears (reinforced by a weaker dollar) and a still strong global economy argue for continued gains in commodity prices. And rather than lean toward those commodities used for production, I now believe that the odds favor more pure inflation hedges. Gold should advance over the next few years even more quickly than oil. After all, none of the leading Presidential candidates hails from an oil-producing state.

Stocks should also do well. By lowering rates, the Federal Reserve is signaling that they will not let a recession develop in the near future. This is not necessarily an all clear sign for the stock market, but history shows that an easing cycle is good for stocks as long as valuations are not excessive.

Long-term fixed rate bonds are clear underperformers in my scenario. Shorten maturities or substitute dividend-paying large-cap stocks as a source of income.

Editor's Note • • •

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I recently packed my middle son off to college, reducing the household to three from four. I might have expected a similar 25% drop in household expenses, but I experienced a pleasant surprise. Food costs have plunged and my gas bill (heating water for showers) is at a multi-year low. Would that the celebration could have been longer, but the tuition bill arrived in plenty of time to return me to fiscal reality. As an aside, I have decided that selling college textbooks might be the way to riches in an increasingly competitive economy. $150 for a math textbook? What have they discovered that needs a new edition?