JAMESSON ASSOCIATES

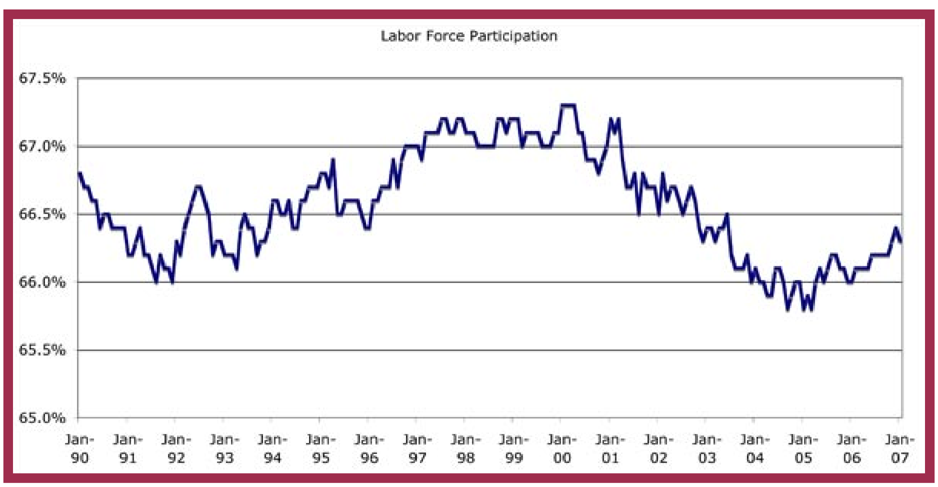
February 2007 Newsletter

Recent Economic Events

"Don't sell America short."

"Never underestimate the American consumer."

Just when we thought the US economy was set for a slowdown, the vast majority of economic statistic releases came in stronger than expected. GDP is back above trend; employment gains continue to show upward revisions. Exports appear to be booming and inflation has become quite well-behaved. Unbiased observers would conclude that the Federal Reserve has pulled off another soft landing.



Real fourth-quarter GDP advanced 3.5%, well above expectations from early December. In fact, although economists had consistently raised their estimates from below 2% to as high as 3% just prior to the release, they were still surprised on the upside. Full-year GDP growth registered an impressive 3.4% compared to 3.2% in 2005.

Key factors in the positive performance on GDP included personal consumption and net exports. These components were more than enough to overcome the third quarterly double-digit housing decline in a row. January's consumer spending rose further, as indicated in the chain store sales report. Overall sales were up 7%, year-over-year, suggesting an inflation-adjusted rate in excess of 4%.

Employment gains have continued as well. Although January jobs increased by a less-than-expected 111,000, both November and December improved due to revisions. In fact, December now shows a gain of over 200,000 jobs. Fourth-quarter job growth was revised upward from 136,000 per month to 170,000 per month. It appears that the Department of Labor's figures are still unable to capture all of the jobs created by new companies. The strong job market has had a corollary benefit, as labor force participation is now in a definite upswing.

There was more good news in the trade release. Not only was the overall deficit for November

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Recent Economic Events (continued)

a smaller-than-expected $58 billion, but it was driven by both an increase in exports (up 15% from a year ago) and a stabilization in imports (up less than 5% year over year). The US is far from closing the trade gap, but the direction and rate of change has turned positive.

Inflation indices are showing no signs of acceleration. December consumer prices on an annual basis were up 2.6% both overall and for core prices. Producer prices showed 2.0% and 1.2% for all prices and core, respectively. The Federal Reserve's favored inflation gauge, PCE, was up at an annual rate of only 2.1% in the fourth quarter.

As we go to press, it appears that the Fed has been successful. The economic statistics are still in positive territory, and employment gains seem to be offsetting housing market weakness. Let's hope our good luck continues.❖

Commentary

Prominent economists have called for a tax on gasoline consumption as the most effective way to reduce our dependence on oil and help forestall global warming. Although I am far from a "prominent economist," I add my voice to the chorus.

America is as moralistic as any country on the planet, but it has been disinclined to put its lifestyle aside in favor of altruism without strong economic incentive. I believe that there are two sound reasons to do so. The softer reason is that it will be good for the environment and lead to a better quality of life both for us and for future generations. By burning less fossil fuel, we will produce fewer greenhouse gases and presumably help to reverse the warming that is obvious to almost all (even the President is a convert). This appeal has weight with some, but to be candid, not enough to carry the day.

The stronger argument is related to national security. The US imports over half of its oil, and the dollars that pay for it go disproportionately to those who would do us harm. Note that some of the biggest beneficiaries of oil revenues include Russia, Venezuela, and Iran. On top of this, the largest oil exporter in the world is Saudi Arabia, original home to Wahhabism, Osama bin Laden, and the vast majority of the September 11th terrorists. Why should we support these countries with our dollars?

> ...begin taxing oil with a steadily increasing charge.

A much better approach is to begin taxing oil with a steadily increasing charge. Let's start at 50¢ and increase it by a dime every six months until we get to $2 per gallon. We could even accelerate the process if the price of oil began to fall. This would help to shift revenues away from our enemies as demand dropped. It would also provide domestic dollars that could be used to encourage conservation and allow for some rebates to reduce hardship for those who would be most impacted.

The US uses over 150 billion gallons of gasoline per year. So you do the math. (Hint: up to $300 billion). If we were to subsidize purchase of plug-in hybrids that achieved 50 mpg or greater at the tune of $5,000, many new car purchases would move in this direction. Based on the fact that a Toyota Prius passed me on the road last week when I was cruising along at 70+, I don't think performance will be an issue once the cost equation is solved.

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Commentary (continued)

To be sure that the subsidy is not an excuse to stifle innovation, it should be set to decline over time and/or kick in at higher and higher mpg levels.

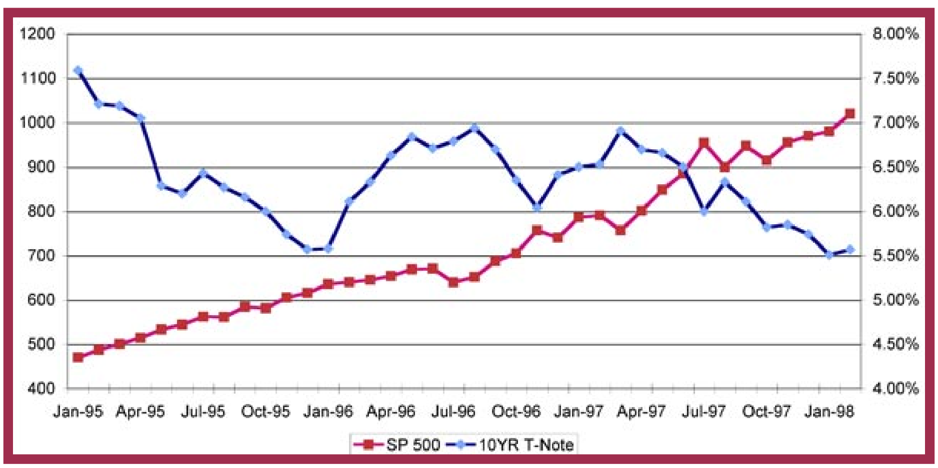
The US has substantial unused capacity for generating electricity during evening hours. This is precisely the time that we could be charging our fleet of plug-ins for the next day's commute. Although utilities would have to purchase more fuel to provide the electricity, they would not have to build new plants, but only use the excess nighttime capacity more fully. Note that less than 5% of our electricity is generated from oil.

The President has proposed a significant replacement of gasoline with ethanol over the next few decades. This is a laudable goal but one that may not be possible without impacting other sectors of the economy. Already, hog and cattle producers are complaining about the increased costs of feed and the inevitable cost pressure on meat prices.

It will cost money to become more energy secure, and we should start now, not stretch it out over time. I propose that the increased costs we impose go to domestic recipients, not to foreign oil producers that will use those dollars to oppose our interests around the world.❖

Market View

My last newsletter argued for continued good performance in the stock and bond markets based on strong liquidity flows around the world. This has been a good bet. The American economy appears to have achieved a soft landing or even a touchdown and takeoff. This suggests that continued growth, rather than a plunge into recession, is the most likely case for 2007-8.



Reviewing financial market performance in the wake of the previous soft landing would seem to be a good historical precedent to the current state of affairs. Consequently, I went back to see what happened in the markets in 1995-98. Those with long memories will immediately reach for the phone to call their brokers with buy orders. But those of a more cautious sort may like to review the evidence first.

From early 1995 to early 1998, the stock market roughly doubled while longer-term interest rates were falling by about two percentage points. Given current valuations and levels of interest rates, it may not be possible to achieve these lofty returns, and yet, it is hard to argue for a precipitous decline.

Why is this so? It turns out that there are a few key determinants of financial market performance over

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Market View (continued)

time. The factors that are most important in the short term tend to wash out over the long term. Intermediate-term performance is similarly subject to factors that revert to the mean when the time frame is appropriately long-term.

Over short periods of time, say a few months or so, idiosyncratic factors drive markets. These can be of the form of unexpected one-off events or simply the emotions that sometimes gain momentum in a kind of mania of greed (late 1990s) or fear (October 1987). No one can really predict these events and those who persist in trying to find a pattern are ultimately shown the folly of doing so.

Growth	Terminal P/E Ratio		
	7.5x	**15x**	**30x**
2.5%	3.1%	4.7%	6.6%
5.0%	5.5%	7.2%	9.2%
10.0%	10.4%	12.2%	14.3%

Over the very longest terms, lifetime investment horizons, earnings and dividends (for stocks) or coupons and inflation (for bonds) are the key factors. The table above assumes a stock with a starting P/E ratio of 15 and a one-third dividend payout (a dividend yield of 2.2%). Note how much more impact the difference in earnings growth has than does the P/E ratio when looking over 30 years.

However, as Lord Keynes said, "In the long-run, we are all dead." Returns over the intermediate term (two to five years) come down to changes in the valuation ratio, which in turn is ultimately based on alternative use of investment dollars. In other words, low or falling interest rates tend to keep P/E ratios high or drive them higher while rising or high interest rates depress valuations. Take a look at the same table over five years.

Growth	Terminal P/E Ratio		
	7.5x	**15x**	**30x**
2.5%	-7.8%	4.7%	19.5%
5.0%	-5.6%	7.2%	22.3%
10.0%	-1.3%	12.2%	28.1%

The evidence from the last soft landing suggests that the path of least resistance is lower interest rates and higher P/E ratios. The environment for earnings may be less sanguine, but that means that stock prices are likely to have a correction although not a major one. I would look for weakness to buy, but given our starting point in rates and valuations, I would not commit all resources.❖

Editor's Note

I have had a taste of retirement, and I am not sure that I am well suited. Susan and I stole away to Florida in early January to celebrate her birthday. We stayed in a small inn near the beach on Sanibel. Soon we exhausted the sightseeing options and restaurants and found ourselves on the shuffleboard court. There were a few curious onlookers (especially the mother and daughter who got a big kick out of Susan sending my disk into the rose bushes), but even with 300 channels, I don't think ESPN will be setting up cameras soon. However, I will note that a distinguished older gentleman did stop to watch one of our matches. Could it be he was the commissioner of the World Shuffleboard Association looking for fresh talent? I will keep my phone lines open.

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