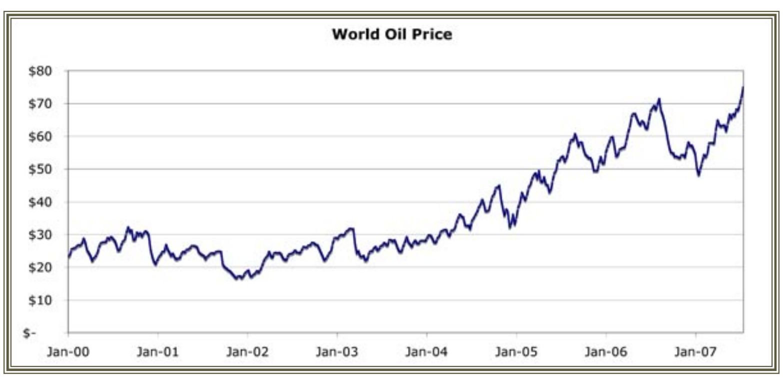
Summer 2007

Jamesson Associates

Recent Economic Events • • •

The American economy appears to be moving the Fed's way. Inflation has receded from its cycle highs while employment has held up remarkably well. After a pause in GDP growth during the first quarter of 2007, recent production statistics suggest that a bounce-back is in store. The headlines continue to be dominated by potential problems with the residential housing market and the apparently relentless climb in the price of oil. Either of these two problems could sink the American consumer, although they have not done so to date.

The one-year anniversary of the last change in the Federal Funds rate passed in late June. Although roundly criticized early in the pause, the market has now concluded that the impact of a year of sub-par growth has worked wonders on the inflation rate. The key measure that the Fed watches has come down nicely from its high point in the summer of 2006. As of May, the core PCE inflation measure is running 1.9% over the previous year, down from its peak of 2.4%. In addition, the core CPI was up only 2.2% from June 2006 while the core excluding the distorting influence of shelter costs was up by close to 1%. The reason that shelter has distorted the figures over the last year or so is that that initial impact of the weaker housing fundamentals was to chase first-time buyers out of the purchase market and into the rental market. This allowed landlords who had been unable to gain pricing traction some room to raise rents. That dynamic now appears to have played out.



June produced 132,000 new jobs, but the real news was the upward revision in the previous two months. Year-to-date, new jobs created are running a bit below 150,000 per month, enough to keep the unemployment rate at the low 4.5% level. In addition, the mix of jobs is skewing towards higher-paid opportunities. This suggests that the information economy is alive and well. Furthermore, it should provide the foundation of income necessary to keep consumers spending.

First quarter GDP was an anemic .7%, well below potential. However, more recent indications suggest that the second quarter could be very close to 3%. Industrial production for June was up a larger than expected .5% and both the ISM indices (services and manufacturing) have rebounded to their highest levels since early 2006. Some of these positive indicators are no doubt related to the continued excellent export performance that the United States has experienced. Exports have run at a relatively steady 10% year-on-year growth rate since early 2004 even while imports have dropped from a 20% annual growth rate to below 5%. And keep in mind, this is in the face of oil prices tripling from $25 to $75 a barrel.

(continued on page 2)

Recent Economic Events (continued)

Oil, of course, is not the only problem the economy faces. Housing has not recovered at all during the second quarter. Builders are more despondent than ever, and troubles in sub-prime residential lending have sunk some hedge funds, sapped the earnings of large Wall Street dealers, and put rating agencies and their customers on edge. Since psychology is such an important part of the housing slump's ultimate effect on the economy, we will have to wait and see whether it overwhelms the positives that are visible today. However, until the consumer truly wilts, we must expect continued modest growth.

Commentary • • •

> "Starts are expected to bottom out during the winter, while prices are not expected to trough until the spring of 2008… Loan losses and foreclosures, which are lagging indicators, are not likely to peak until late 2008 or early 2009."
>
> Standard & Poor's July 9, 2007

The seven stages of grief are shock, denial, bargaining, fear, anger, despair, and acceptance. We have clearly passed the first two stages in the residential housing market. Real estate investors had believed that house prices always increased and profits would flow from condo flipping and the like. The denial stage has been evident in the pronouncements of industry insiders. It started with the idea that maybe some local markets had gotten frothy but certainly we would not see a widespread downturn. Well, the most recent national figures show price declines over the last year.

Enough history. Where are we in the next stages and how long do we have to the end of the process? Do we really have a two-year time frame to go? I am afraid this is the optimistic view.

We are straddling the middle three stages at present. The bargaining portion has been characterized by less than honest mark-to-market prices in the portfolios of hedge funds. Note that Bear Stearns had to bail out two of their funds when honest prices showed a decided lack of equity in the accounts. Fear permeated the markets as these assets headed for liquidation and when both Moody's and Standard and Poor's announced that they were reviewing billions of dollars of structured bonds for downgrade. If downgrades force some owners to sell, the market may not be able to absorb the volume in an orderly fashion.

Anger is exactly what we now have in Congress. The irresponsible legacy of Alan Greenspan is coming home to roost. The free market does a terrible job of limiting excess. That is precisely when a regulator is needed and precisely when Mr. Greenspan went AWOL. Depending on the study you pick, there are either hundreds of billions or close to a trillion dollars of mortgage loans that were made in the last few years of the housing boom that never should have been extended. Delinquencies are running in the mid-teens and politicians are asking how the runaway train got going so fast. You can be sure that there will be plenty of grandstanding on the issue, but when stories about everyday people losing their homes hit the newspapers, anger will be real.

(continued on page 3)

Commentary (continued)

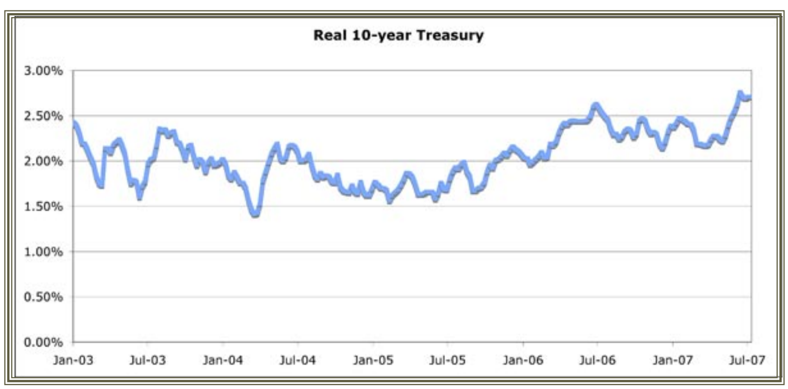
There is not enough money to save all those people, but there may be enough to delay the inevitable. This is the point at which the cycle can easily be extended. That is what I expect the political system to attempt. Remember the Presidential campaign will be heating up as the loan repricings hit in 2008. Until we get through the last two stages, the market cannot recover. Because this bubble impacts so many, I expect there will be attempts to spread it out. This means the time frame above is too short by at least six months and perhaps as much as a year or more. My guess for acceptance, the point where things are no longer getting worse, is much more likely to be 2010.

We will get through this as we always do, but the legacy should be that although financial innovation is good, at some point a responsible central banker must "take away the punch bowl." Mr. Greenspan's idea was to wait until the revelry was over and then round up the drunks. It has proven wanting.

Market View • • •

The stock market has exceeded even my bullish expectations, with both the Dow and the S&P hitting new all-time highs this month. Emerging markets have continued to do even better than this excellent performance. Market participants remain wary of the rise, suggesting that there may be further room on the upside.

Long-term interest rates have jumped in the last few months to the highest levels we have seen in quite a while. This does not appear to be due to a concern over inflation, but rather to an increased demand for funds to support the buoyant global economy. Increases in real interest rates explain all of the upward movement since spring.



Oil prices and commodities in general have resumed their bull market. Oil especially seems to be immune to retreat as every pullback is met by strong buying interest. A new report on the oil market from the National Petroleum Council indicates the demand for oil is likely to outrun the supply for a number of years.

How to reconcile these three markets? I think if we go back to two key factors we can make sense of what is happening and perhaps trace out some implications. These two factors are the momentum of globalization and liquidity.

Interest rates are on the rise throughout the world. The Federal Reserve was early to the party, but we have seen increased rates from Great Britain through the Euro-zone and on to Japan. Even China has joined in, attempting to slow the 11% growth train. The result: a weaker dollar as the yield advantage versus other currencies has eroded. The net impact on domestic American companies has been twofold. First, there is booming demand for our exports. Even though our imports have been running half again our exports, the trade deficit has improved over the past year. Once the price of oil stabilizes, this underlying strength

(continued on page 4)

Market View (continued)

will shine through. Second, American multi-national companies are not only seeing record overseas business, they are translating sales from strong currencies to a weak one. This boosts profits in dollar terms. So although the stock market has boomed, valuations have stayed pretty steady because of earnings growth.

This same global growth dynamic is creating demand for oil and other commodities. It is a fact that emerging economies like China use more energy to generate increases in GDP than do more developed countries. Furthermore, the demand for cars (and hence gasoline) is also positively skewed in countries that are rapidly moving up the affluence scale. Buying and using a car for the first time is more energy-consuming than is trading in a vehicle for a new one even if the new one is a Hummer.

Will liquidity submarine the positive trends of earnings growth and commodity demand? In the traditional model, we would expect the general monetary tightening by central banks around the world to do just that. But the genie is out of the bottle. It isn't the American banking system that has borne the brunt of the sub-prime mess, but rather the bond market. The financial markets are creating their own liquidity and new techniques are used to liquefy previously illiquid assets. Now this game cannot go on forever, but it can go on for a lot longer than people imagine.

My thesis is this. Globalization is driving profits and demand for commodities. This creates bull markets for stocks and physical goods. Liquidity has been self-reinforcing due to the huge US current account deficit that pumps close to a trillion dollars into the world economy annually and the financial innovation by clever investment professionals. Until the cost of borrowing gets much closer to the returns on investments, liquidity will still flow. The reason is simple — all the players are making money and no one wants to turn off the spigot, especially when they are using other people's money.

My predictions: the stock market will continue to move upward with perhaps a parabolic rise (melt-up) if psychology begins to become paramount. Bond yields, especially long rates, will rise both because the real demand for money is driven by global growth and because an improving US trade deficit will require less dollar recycling. If rates rise by another 75 basis points (over 5.75% on the ten-year), there will be real value in bonds. Commodities will continue to rise. Oil may very well hit $100 a barrel if geopolitical events deteriorate. Keep your bets on, but be ready to exit if everyone is talking about how smart they are.

Editor's Note • • •

One of the more interesting features of tromping around the country to attend our son's fencing tournaments is that we end up in destination cities during off-season. July in Miami Beach is definitely an acquired pleasure. We were subjected to consistently hot weather (albeit not much hotter than Rochester during the same stretch) and regular thunderstorms from a system just off the coast. We also were treated to 3 AM wake-up calls during our stay in South Beach as the bars let out and the car stereos amped up. I concluded that we would have been better advised to spend our honeymoon rather than our twenty-fifth anniversary there. Apparently, sleep needs increase with age. On the upside, we really enjoyed the Fourth of July fireworks display framed by palm trees, the beach, and the Atlantic Ocean. Maybe there is a reason for the crowds.

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