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Jamesson Associates

Recent Economic Events • • •

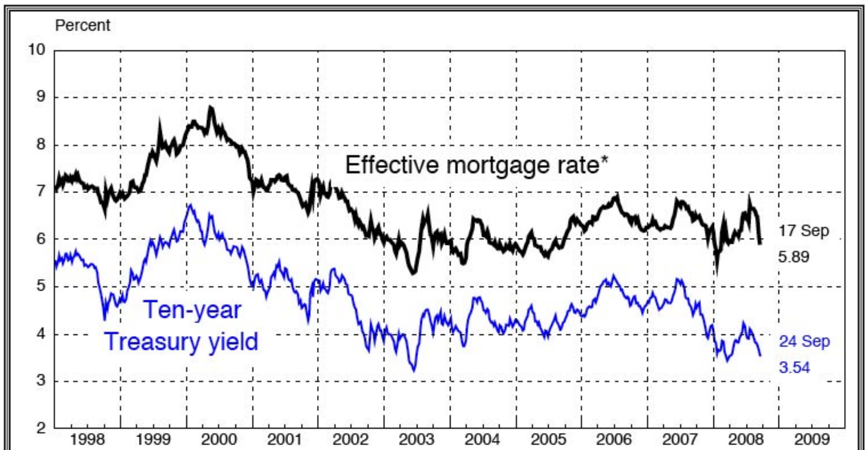
Shoes are dropping everywhere in the financial arena — FNMA and FHLMC, Lehman, Merrill Lynch, AIG. It is a real

act of courage to open the morning newspaper. But although the economy appears to be held hostage by the financial markets, there remains some separation. Main Street is not the same as Wall Street even if the pundits at CNBC and the *Wall Street Journal* would have you believe so. Difficult though it may be, I would like to turn your attention to some of the basic economic statistics.

GDP turned in a very solid performance in the second quarter, growing by 3.3% on a real basis. The key driving factor: net exports which contributed 3.1% of the total. This is the upside of globalization. Time will tell how well it holds up, but for now it is the most robust sector of the economy.

News focused on the consumer was not so positive. Unemployment jumped to 6.1% in August and is up by over 1% in the last six months. This is usually a sign of real stress in the employment market. This conjecture is reinforced by the eighth consecutive monthly decline in jobs created in August (down 84,000). Weak employment along with the end of the simulative tax rebate checks contributed to the poor retail sales figure we saw in August (down .3%). Back-to-school sales were soft, auto sales bounced back only modestly from the disaster in July, and retailers are glum about the upcoming Christmas sales season.

Paraphrasing the old blues song, "housing has been down so very darn long, it looks like up to me," August saw some stability in sales albeit at levels far below those of the pre-bubble late 1990s. They are also well below the equilibrium levels consistent with demographic trends. On this score, there may be help on the way. The FNMA/FHLMC bailout pushed mortgage rates down by over 1% from where they were a few short weeks ago. This has appeared to boost some mortgage application activity.



* Average effective rate on fixed-rate, 30-year conventional mortgages.
Sources: Freddie Mac and U.S. Department of the Treasury.

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Recent Economic Events (continued) • • •

The declining price of oil led to the best inflation numbers in quite a while. Headline inflation fell by (.1%) in August, the first decline since the fall of 2006. Unfortunately, this still left prices 5.4% above their level one year ago. Core consumer prices were well-behaved, increasing by .2% instead of the .3% we saw in the previous two months.

Were the most recent financial market troubles not the main story, optimists could find signs of some economic stabilization in the most recent statistics. Much of the correction in the work-a-day economy may be complete. For now, however, the keys to the economy regaining its footing appears to be in the hands of the US Treasury and Congress. It is a race between restoring the flow of credit and the risk of accelerating unemployment.

Commentary • • •

GWB = Gigantic Washington Bailout

Welcome to end of the Reagan Revolution. Consistent with the demise of the New Deal, it was the strongest advocates who caused the collapse. Our current calamities are courtesy of that merry band of deregulators and acolytes of free markets for every ill that plagues the Nation. Now the markets are in freefall, and the rhetoric has changed. "There are risks to the System." "The cost of putting up taxpayer money is far less than……" the never-stated alternative. We now know that when President Bush stared into the eyes of Vladimir Putin and "saw his soul", Putin was staring back and asserting Vulcan mind control. Listen carefully for strains of "L'Internationale" when the bailout plan is formally announced. By the way, is the President still in charge or has he decided to step down four months early? "Where's Waldo?" has morphed into "Where's W?"

No doubt scholars will be scurrying to the Constitution to find the enabling wording for the massive market interventions that have and will occur. But, there are some pesky details that still need to be worked out in return for our (US taxpayers) largesse. Will above-market prices be paid to reduce losses (create windfalls) in owners' (banks, hedge funds, etc.) balance sheets or will prices reflect current depressed (market) values, creating liquidity but not repricing the toxic assets? Who will be allowed to participate? (continued on page 3)

Commentary (continued) . . .

What will happen to the underlying mortgage loans? Will forbearance be the watchword or will the Feds treat borrowers who over-extended the same way a private bank would have?

There are probably hundreds more we could think of, but most importantly, will it work and suppose it doesn't?

For those of you with religious leanings, get down on your knees and thank the divine being that Ben Bernanke and Henry Paulson are in charge rather than the clueless ideologue Alan Greenspan and the simply clueless John Snow. The rest of us should thank our lucky stars.

I have been very impressed by the dynamic duo, but they are faced with a truly monumental task. No one really knows the depth of the problem because the global financial system has become much too large and opaque for anyone to get a full handle on it. Pollyannas (myself previously included) had thought this was just another normal turn of the cycle. It is much more. The extent of the leverage and the unknown off-balance sheet obligations suggest many orders of magnitude in size larger than any previous financial crisis. There are over $60 trillion in Credit Default Swaps outstanding, an amount roughly equal to one whole year's production of each and every human being on Earth.

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As we now know, leverage was the magic elixir that allowed Americans to continue to maintain their spending and lifestyle even in the face of stagnating incomes. We simply borrowed the extra money that we needed. But while many great fortunes have been built on leverage, virtually every great fortune that has been lost is because of leverage. This is true for individuals and companies, and we now will find out whether it is true for an entire nation.

The United States has been the most successful country in the history of man. It had accomplished this feat both because of the luck of geography and natural resources and because Americans worked hard and provided for genius to be leveraged for the good of many and the profit of the genius. But it worked because there were rules, written or unwritten, that maintained a sense of proportion and common interest. It is clear that this ideal has been perverted in the financial markets. Let's hope that our luck holds, order can be restored, and the old quote, "God watches out for little children, fools, drunks and the United States of America" proves accurate. If America's optimism and can-do spirit are not equal to the task at hand, we and the world will be a poorer place.

Market View . . .

I recently gave a talk in which I tried to distinguish between bubbles and mispricing. My theme was that markets are driven by human emotion as much as they are by cold financial logic. Boy, was I right.

When markets are operating in a normal fashion, logic works and mispricing can offer the opportunity for profit. When markets are gripped by fear, old rules do not work and the best course is to step back and wait. We are in such a situation now. Investments made in the present environment have much more in common with purchasing lottery tickets than they do with the standards of Graham and Dodd. You may profit and profit handsomely, but you may also find that the

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Market View (continued) • • •

market refuses to correct itself. Remember the advice of John Maynard Keynes, "markets can stay irrational longer than you can stay solvent."

The Federal Government has indicated that they will guarantee the principal in Money Market Funds. FDIC insurance still secures bank deposits. These options make sense for holding dollars safe. With guarantees in place on both FNMA and FHLMC debt, investors should be able to capture decent returns in maturities up to five years or so. I would stay away from longer issues because the bailout in progress will create massive Federal deficits which ultimately must either increase debt or inflation or both. That will raise longer-term rates over time.

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Inflation hedges such as gold and other commodities appear to have gone through corrections and offer a store of value, assuming the global economy does not implode. Note that there really is little benefit on betting on the end of the world because there will be no one around to pay you off. But with gold registering its largest one-day move ever, it is clear that it can represent a place to hide from some level of uncertainty.

Stocks seem to like the initial aspects of the bailout, but I am skeptical that we are on the cusp of a new bull market. It seems to me that the rebound in prices was more a relief rally than one of great conviction that problems are on the way to being solved. If you want to buy stocks be careful to find low debt candidates with secure dividends and businesses that are vital. Producers of staples are in; those of discretionary items are out.

I would avoid financial stocks. It is too early to tell how the bailout will work and there is too much uncertainty to know who will win and who will lose. It is also an open question if the business model of some of the financial firms makes sense in a world where rising levels of debt and off-balance sheet transactions become rare. If things stabilize after earnings season in October, then it may make sense to look at the most secure members of the financial community. However, it is too soon now.

Editor's Note • • •

As many readers know, my son is a competitive fencer. This is a low-participation sport which has its pros and cons. On the downside, tournaments are seldom local, requiring expensive travel and overnight stays. The upside is that admission is free and you are close to the action (generally within 20 feet). But, the real advantage is that you soon get to know the members of the fencing community. Because Philip trains at the same club that one of the silver medalists on this year's woman's Olympic team did, we were able to attend a celebration in her honor. I got to hold an Olympic medal in my hand. The front had a classical motif with a nod to ancient Greece while the back had an embedded ring of jade around the Beijing Olympic logo — old and new. As a token, it was ordinary metal and stone; as a symbol, it was an extraordinary link. The modern games stretch back about 100 years, but the full link covers over two millennia. Two millennia. In these rather troubled and chaotic times, this simple medal was a profound reminder of the constancy of the human spirit's quest for the ideal.

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