Summer 2008

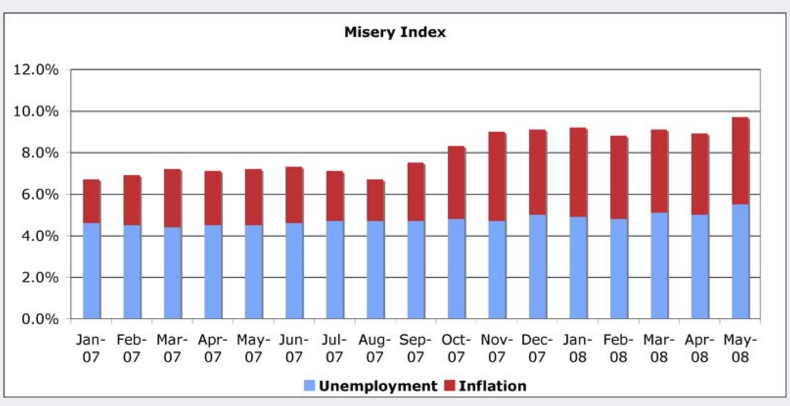
JAMESSON ASSOCIATES

Recent Economic Events . . .

Early June brought with it the biggest jump in the unemployment rate in decades, along with record gasoline prices and a still-weakening housing market. Although GDP figures were positive in the first quarter and may be so again in the second, the cold economic statistics betray a sour mood amongst consumers and businesses alike.

The American economy lost jobs in each of the five months reported this year. The declines have been modest, holding out hope that the slowdown would not become a recession. The May figures probably dashed that hope. Job losses were a somewhat smaller-than-anticipated 49,000, but the unemployment rate rose sharply from 5.0% to 5.5%, the largest increase since 1986. Initially thought to be the result of students entering the labor force earlier than normal, it turns out that the unemployment rate by age group rose for all of the major categories. In order to reconcile modest employment declines with a big increase in the unemployment rate, we need to look a little behind the number. The unemployment rate is up by a full percentage point over the last year while total jobs appear to be ahead as well. The explanation is twofold. First, natural growth in the labor force adds about 1% annually to the number of workers available. Second, the government makes an adjustment to estimate the jobs created by brand new businesses. Over the past year, virtually all of the jobs "created" have come from the estimate of new business hires. Needless to say, if the less hospitable business climate has caused fewer "new" jobs to be created than the estimate, there will be a catch-up when the revised figures are available.

Housing shows few signs of stabilizing. Prices according to the Case/Shiller index are down close to 15% from a year ago, and the first quarter rate of decline accelerated to about 25% annualized. Housing starts are below 1 million and appear to be shifting towards apartments from single-family homes. Existing unsold supply would meet sales needs for 11 months and foreclosures are hitting new highs monthly.



Weaker employment and housing would normally be expected to help moderate price increases. Would that this were so. The overall inflation rate as measured by the Consumer Price Index was up .6% in May, bringing the annual increase to 4.2%. Food and energy were the main drivers. (For those of you who don't eat or drive, the core CPI was up only .2% or 2.3% y-o-y.) There was more bad inflation news

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Recent Economic Events (continued) • • •

when the Producer Price Index was released. It showed May prices up 1.4%, pushing the annual increase to 7.2%.

Americans currently expect inflation to top 5% in the year ahead, and only about one in six believes that the country is on the right track. A solid majority believes we are in a recession. So, how come economists think a recession may be avoided? The GDP for the first quarter was revised upward to show a real growth rate of .9%, and projections for the second quarter suggest that it will also be positive. Economists have a hard time calling a recession if GDP does not fall. However, aggregate and average numbers are greatly influenced by the more affluent. Dollars rather than numbers talk. At present, the strongest parts of the economy, commodities and exports, appear just strong enough to offset housing and employment weakness in the overall figures.

The last time the US was in a high-profile standoff with Iran and led by a President with sub-30% approval ratings, pundits devised a Misery Index to show how badly off we were. It combined the unemployment rate and the inflation rate. As you can see, the index has jumped quite a bit in the last year, indicating that consumer perceptions may be more accurate than economist happy talk.

Commentary • • •

Gasoline now costs over $4.00 a gallon. Based on free-market principles, this should be impacting behavior. There is growing evidence that it is.

Total vehicle miles traveled by Americans were 4.3% or 11 billion fewer this March versus one year ago. I can testify to the reduced driving. On three successive weekends from mid-May to early June, I was on Interstate highways into or out of a major metropolitan area on Sunday evening. There was no traffic. I am guessing visits home to see mom and dad have plunged as have weekend getaways.

SUVs are piling up on dealer lots, while smaller high-mileage cars are the only bright spot in the auto industry. Mass transit ridership is up by double-digit percentages around the country even as transit authorities struggle with capacity constraints and increased costs for their own fuel. Airlines are adding per-bag charges to help offset skyrocketing jet fuel costs.

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We're not in Kansas anymore.

The changes wrought by higher energy (and food) prices promise to be transformative if, and only if, the costs stay high. This is the paradox and ultimately requires a policy choice. If we had the ability to wave a magic wand and replace all of our imported oil (over 10 million barrels per day) with alternative energy, would we? If all the dollars that are now flowing to our enemies (Russia, Venezuela, Mid-East regimes, and indirectly terrorists) could be redirected domestically, would we choose to do so, realizing that the resulting collapse in oil demand would likely drive the price below $40 a barrel? Could we then stay with the higher cost alternatives?

I have long argued that the number one foreign policy goal of the US should be to drive the price of oil down as far as possible to starve out those who profit from our oil addiction and use it to undermine our interests. Although high prices may help to moderate our usage, demand from the rest of the global economy appears to be more secular than (continued on page 3)

Commentary (continued) • • •

cyclical. The reductions we have made have clearly not brought down the price of gasoline over the last year. And furthermore, I don't believe that they should.

In order for Americans to make permanent changes in energy usage, the price of oil must stay high. If a few years of high prices pushes people to conserve and to switch to hybrids from SUVs, but then the resulting lower prices send us back to huge gas guzzlers, the next crisis will be even worse.

The right way to proceed is to keep domestic prices high and convince consumers that they will not fall. The bonehead ideas floated to reduce the Federal or the NYS gasoline tax over the summer to "help out consumers" is exactly the wrong approach. We need to institute a tax to keep prices high with a clear statement of policy that we will raise the tax if the underlying price falls. The tax revenue raised can be used not to fund some government boondoggle to research alternative energy but to actually buy vehicles and other devices designed to use alternatives. The Federal government could immediately begin buying only vehicles that run on something besides gasoline. Subsidies could be provided for private purchases of these vehicles. If we could get to the moon in ten years from a standing start, it would seem that we can use technology to make a transition to a non-oil future.

Changes are coming for the US regardless of whether my plan or something like it is adopted. The US economy is predicated on cheap energy. Sprawling suburbs with 50-mile commutes become problematic if gasoline costs $4.00 per gallon. Flying back and forth from Florida once a week is a lot tougher to do when flights cost $400 rather than $200. And importing products from China rather than making them locally must factor in transportation costs as well as labor costs. An entire paradigm must be changed. The resistance will be substantial as vested interests cling to an oil-centric way of life.

Mark my words. Unless there is a perceived permanent change in the cost of oil, the free market will create enough alternatives over time to "solve" the problem temporarily. The price will then fall. At the same time, we cannot have government directing the solution because it doesn't do a good job at that. We need both: government policy to set the rules of the game and free-market initiative to figure out how to win it.

Market View • • •

Heresy: an opinion which denies accepted dogma.

Is inflation the solution rather than the problem?

Since my last newsletter, commodities have generally advanced, especially food. The stock market has jumped and then receded, and longer-term interest rates have broken out on the upside. I should probably quit while I am ahead, but nothing ventured, nothing gained.

The Federal Reserve has been trying to convince the market that it will be raising rates to combat inflation. Given all the economic problems, I find this quite hard to believe. In fact, I believe that the Fed is secretly welcoming inflation as the best way to wiggle out of the box of collapsing collateral values on bank balance sheets. It also works to create a steep yield curve, which helps bank earnings as long as they keep short rates anchored at below-inflation levels. The only thing they can't do is admit that this is the goal. Over the longer term, this policy will not work because the benefits of curing the housing value problem will be eaten up in higher costs for everything. But for now, this looks like the plan to me.

How to play it?

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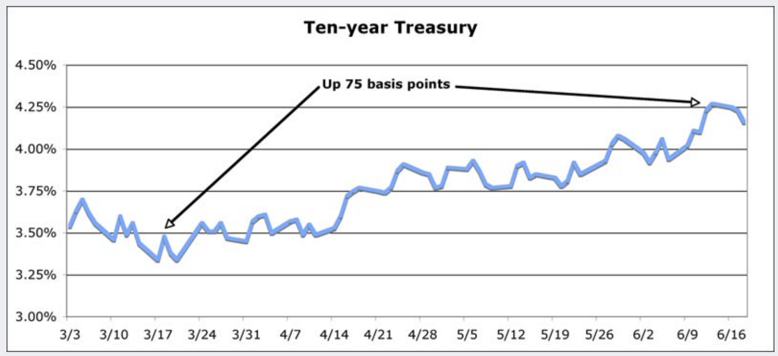
Market View (continued) • • •

The last twenty-five or thirty years have found inflation contained for goods and services, but unrestrained for asset prices. First, we had stock market values leap (remember the dot.com bubble) and then the price increases hit housing. The common theme in both cases was a rapid increase in debt. Whereas the ratio of debt to GDP (1.5x) was relatively stable from the 1940's to the 1970's, from the 1980's to today the ratio has doubled to 3x. This extra buying power had to go someplace. With the improved productivity of the domestic economy and the increased penetration of the global economy, it could not go into domestic prices for goods and services. Now, with no more assets to leverage, the dollars are likely to flow back to those goods and services.



The next chapter in the book will be a return to inflation for goods and services. Local prices will rise and commodities will extend their advance.

I continue to believe that gold is undervalued in this environment, but I believe other commodities are due for some type of correction. They can be bought on weakness. Long-term bonds will continue to erode in value but shorter-term options may make some sense. Bonds that pay off in inflation-adjusted dollars (TIPS) should be part of everyone's portfolio.

Equity choices must be made carefully. Domestic producers should win share back from China and other low labor-cost nations if demand for their products holds up. High-value export industries and anything related to agriculture also make sense. Banks and other financial companies are not yet done with the pain. And even after all the write-offs have ended, there is a real question as to whether the profit drivers in the financial arena will ever regain their lofty levels.

Editor's Note • • •

I recently returned to New Haven for only the second time since I graduated from college. (The first, about 20 years ago, was to attend the coldest Yale-Harvard game in the 100-year-plus history.) I found both the familiar and the new. While touring with my son, I pointed out the corner where, during a middle-of-the-night anti-war protest, I had to choose between jail and returning to my dorm to get ready for class. I chickened out, leaving my rap sheet clean. My biggest disappointment, however, was the gentrification of the street behind my college dorm. I fondly remember walking out the back gate, crossing the street, and plunking down $5.00. In return, I received a full quart (yes I am that old) bottle of J.W. Dant Bourbon and 2¢ change. Not only is the 18-year old drinking age gone, but the liquor store is now a Starbucks. The curse of aging Baby Boomers — trading bourbon neat for caramel macchiato (make that a skinny half-caf).

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