Jamesson Associates

Summer 2009

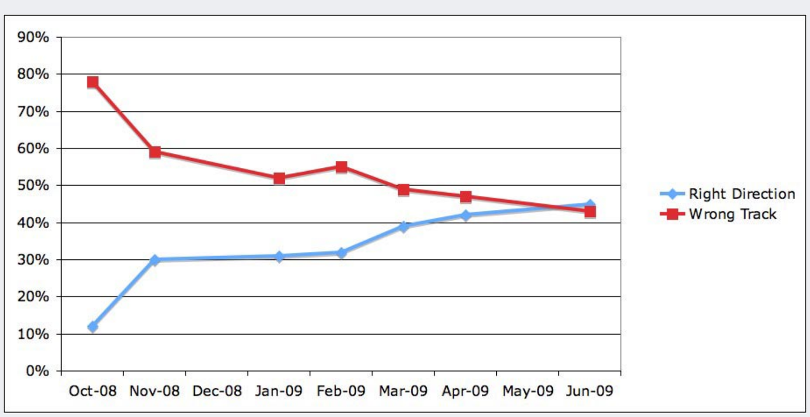
Recent Economic Events . . .

Things are still tough, but the end of the world has been postponed. That the recession continues can be gleaned from still-rising unemployment, collapsing inventories, weak retail sales, and shrinking GDP. The rebound in the markets, especially financial services-related investments, is evidence that the Four Horsemen can head back to the corral. Improved confidence is a necessary, albeit insufficient, harbinger of better times.

May job losses were reported at 345,000, down roughly 50% from the dark days of late 2008/ early 2009, and much better than expected. However, before you break out the bubbly, remember that the monthly decline in jobs is larger than any we saw prior to last September in this recession and exceeds the peak monthly loss in the 2001 contraction. In fact, if we exclude the period from October 2008 through April 2009, we need to go back to May 1980 to find a bigger loss. This dismal job picture is reinforced by noting the 9.4% regular unemployment rate and the 16.4% expanded rate. Unfortunately, these figures appear destined to continue to increase for at least the rest of the year.

Businesses are still in hunker-down mode. Inventories shrank for the eighth month straight, falling 1.1% in April as companies labored to align stocks with sales. Whether it is cutting back on employees, inventories, or orders for new plant and equipment, there is little positive to report on the business front. Fortunately, the pain of these reductions is being partially borne by overseas suppliers as is evidenced in our much improved trade deficit. We are currently running monthly shortfalls of less than $30 billion in contrast to roughly double that last summer.

The consumer has not recovered his free-spending ways. While retail sales improved by .5% in May, driven mostly by higher gasoline prices, they are still close to 10% lower than they were a year ago. The silver lining in lower consumption has been the increase in the savings rate. Americans set aside a multi-year high of 5.7% of income in savings during May. Consumer credit contracted by a huge $15.7 billion in April, continuing a string of frugality which has pushed the annual change in consumer credit negative. Negative! Perhaps American consumers have learned something.



GDP contracted by 5.7% in the first quarter. This followed the even worse 6.3% drop in the fourth quarter last year. The back-to-back declines along with third quarter 2008 weakness and a likely further contraction in the current quarter put this recession at the head of the class since the 1930s.

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Recent Economic Events (continued) • • •

Even in the face of this unremittingly bad news, the US economy is still functioning. I see no reports of street corner apple salesmen. A modern-day march of the unemployed on Washington is not at hand. Some banks are repaying their bailout funds, and the financial markets have staged a once-in-a-lifetime rally from the depths in March. Perhaps the worst is behind us judging by the remarkable statistic that the country now feels we are going in the right direction by a slight majority versus the overwhelming sense of being on the wrong track last fall. That's not enough to put paid to the recession, but it is a necessary first step.

Commentary • • •

Is capitalism dead? If so, what can take its place? If not, how do we protect against the next calamity?

The right and left have been arguing over the causes (and hence proper remedies) of the financial meltdown. A seemingly small problem of sub-prime mortgages in the US metastasized into a virulent cancer that struck the entire global financial system, threatening economic collapse. Governments around the world used a trial-and-error approach to stemming the bleeding that either pulled us out of the tailspin or made things worse (now or in the future). I don't want to wade into this controversy, but I have some thoughts about the benefits and dangers of free markets.

It should come as no surprise that few currently believe that unfettered financial capitalism is an unalloyed good. This was not the case a few short years ago. On the other hand, bureaucratic control is inefficient, whether it is pursued by large companies (General Motors, AIG, etc.) or the government (General Motors, AIG, etc.). The world may be too interconnected and complex to adopt the small is beautiful ideal, but a downsizing of some players would clearly help the stability of the system.

Normal markets self-correct to equilibrium. Abnormal markets blow up. The former can be left alone to work their magic while the latter need some type of circuit breaker to reset themselves. The problem is that the line between normal and abnormal is not easy to determine. Why did the collapse of Lehman Brothers trigger a panic when the ultimate losses involved were in the billions? After all, total American wealth had already dropped by trillions, and Bernie Madoff eliminated as much if not more wealth than Lehman without causing a further systemic alarm. The answer, I am afraid, is that any system with human beings involved can become irrational. Only if enough rational players are available to counteract fear can the system hold.

The solution is not to banish fear (impossible) nor to control every type of risk (even more impossible). Human nature is human nature and can only be moderated. The trick is to prepare for inevitable failure, keep the costs low, and create a known resolution method with losses borne by those who had benefited. The last part is crucial. Plenty of people have lost huge sums of money in normal self-correcting markets without bringing down the system. This is the heart of what Schumpeter called the creative destruction of capitalism. The system is strengthened when the cost of risk is made real. This was the critical mistake of saving Long-Term Capital Management (LTCM) in the late 1990s. Those watching concluded that the "too big to fail" (TBTF) idea would be invoked to save the private wealth of investors. The lesson: just get bigger.

The idea was revived with a vengeance in 2008. The government was even more explicit as it swung into action last summer and fall. Hundreds of billions were tossed into the markets in an attempt to restore order. And note a key fact. Whether it was FNMA and FHLMC or Citigroup, Wachovia, or AIG, the bailout made the bondholders whole at full value while either severely reducing or eliminating value for the equity holders. Why should this be the case? If I can pile debt on a minimal equity structure (continued on page 3)

Commentary (continued)• • •

(LTCM had a ratio of 25 to 1 while Goldman Sachs was in a similar leverage position last year) and know that I will be covered under TBTF, why not?

Insurance companies know that they cannot cover 100% of losses even on good risks because it tends to encourage reckless behavior. We all have deductibles on our cars and houses. Why shouldn't bondholders in TBTF companies have deductibles as well?

I don't know exactly what the amount should be, but if losses were mandatory when the government has to step in, it seems that more discipline would enter the system. The idea that 1% or 2% losses on a counter-party could bring the global financial system to its knees is evidence that the system is far too leveraged. Instituting mandatory deductibles will naturally make bondholders more vigilant and force lower leverage. With a bit of progressiveness to the approach (1% haircut up to say $10 billion, 2% to $100 billion, etc.), we could also force the TBTF companies to consider whether getting bigger and bigger is really the optimal strategy.

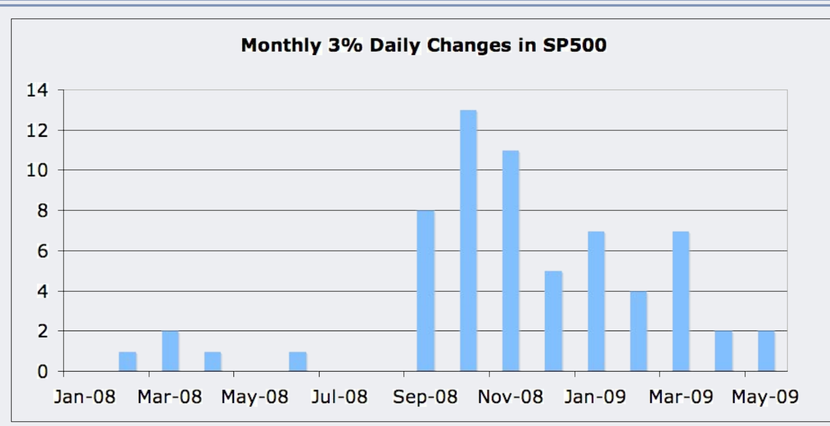
There is no magic bullet to address the greed/fear oscillation in human nature and the markets. However, if we as taxpayers can shift some of the costs back to those who have benefited, that is a good thing. While some TBTF institution will have to be rescued in the years to come, hopefully taxpayers can count their losses with fewer zeros than we have this time around.

Market View • • •

In my spring newsletter, I suggested a three-pronged approach to the markets. One, buy a basket of sub-$10 stocks on the theory that gloom had become far too pervasive, and we were due for a bounce on the most beat-up names. Two, purchase TIPS to benefit from the inevitable increase in inflation that we will face once all of the stimulus gets traction. Three, buy silver as it was a precious metal that benefits from inflation, an industrial metal that will pick up early signs of recovery, and because it was undervalued versus gold.

All three of these strategies were winners. Of course, buying almost anything would have worked out well over the past three months, so I will not pat myself on the back as much for the specifics as for the recommendation to leave cash behind.

The current returns on cash are still anemic. And while remaining in a low risk posture may be comfortable, it will be hard to pay the rent with sub-1% returns. My confidence in committing some funds to risk assets stems from a variety of sources. The "throw out the baby with the bathwater" approach of late 2008/early 2009 which drove returns for all markets in one direction has been reversed. Certainly, the initial bounce in March and April was a rising tide that lifted all boats. But since then, investors have been making some distinctions. That is healthy. Also, whereas huge daily moves in prices were common, recent activity has been more sedate. The VIX index of volatility is down by more than 50% from its peak. Note the chart on daily 3% or greater moves in the (continued on page 4)



Market View (continued) • • •

S & P 500. We are back to pre-panic levels. Finally, the power of the rally and the return to normality cannot be discounted. Momentum and confidence are key foundations for a healthy market.

If it is becoming safer to put dollars to work, where should they be deployed? My theme at this point is that intelligent risk-taking makes sense as long as it is balanced by a healthily dose of skepticism that all our problems have been solved. This leads to a focus on high-quality names to the exclusion of the most speculative and to a lean away from financial companies. The steep yield curve now offers a little more value than we saw previously even though higher rates are likely a few years down the road. Commodities have had an excellent run, but certain sectors still represent secular opportunities.

If you are an equity investor, look for financially strong companies that will be able to gain a competitive edge versus their weaker competitors. There are plenty of wounded players on the battlefield today. Those companies that are healthy can take advantage. Remember creative destruction.

While the happy talk business media would have us believe it's onward and upward for financial companies, the plain fact of the matter is that the risk/reward stinks. We are early not late in the credit cycle, and some companies that look good today will not make it. Delinquencies and loan losses are sure to increase when unemployment tops 10% (as it is surely destined to do).

The Fed is holding short-term rates near zero while ten-year Treasuries are close to 4%. The key question is how soon and how quickly the Fed will normalize short-term rates. Over the past 25 years (since double-digit inflation was vanquished by Paul Volcker), the Federal Funds rate has averaged 5.3% or about 2.3% over the average inflation rate of 3%. I am not so sure that a 4% rate is a good bet for ten years. Much better in my opinion, is a high quality corporate or municipal bond yielding 5% or more (tax equivalent) for a somewhat shorter period.

And we can't forget the risk of inflation. TIPS still make sense as does silver. For the more adventurous, the grain complex looks like a good bet on increased affluence and hence more meat eating in emerging nations such as China and India.

Editor's Note • • •

The month of May was a difficult one for me. My father had a heart attack and lived for only a few more weeks. He had a great 87-year run up until the end, but it was still hard. As I tried to put into words what he meant to me, I found that words were the wrong medium. Dad had influenced me not by what he said but by the example he set. You might imagine that independence, a healthy disregard for unearned authority, and an impish sense of humor were prominent. I was fortunate to be with my father for his last few weeks and talk with him. Sometimes that isn't possible. So if you have not spoken recently with people who are important to you, put down this newsletter right now and call them. (Remember, it's always free when you call from work.)

Michael Jamesson
Jamesson Associates
Scottsville, NY
(585) 889-8090
Mjamesson@aol.com
Michael@JamessonAssociates.com