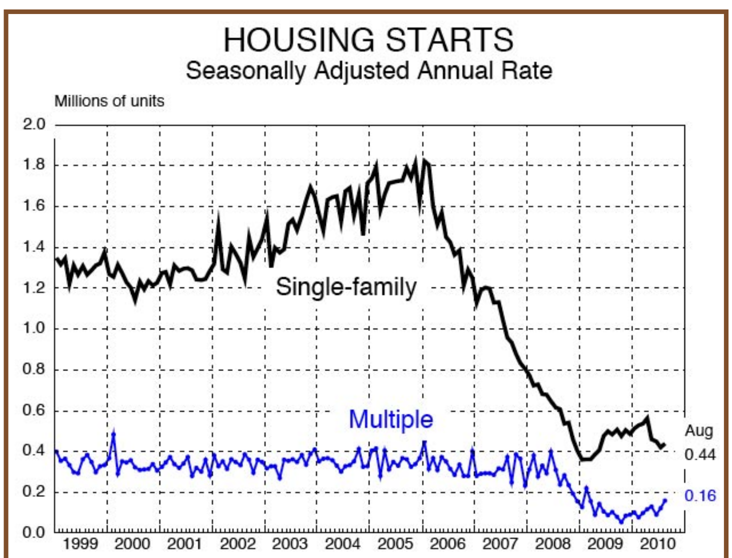
# Jamesson Associates
## 09. 2010 Newsletter

## Recent Economic Events

Hooray! Hooray! The recession is over. So says the National Bureau of Economic Research (NBER), the official arbiter of these things in the US. The announcement is likely to have considerably more impact on Wall Street than it has on Main Street. While GDP continued to advance in the most recent quarter, its pace of growth has slowed steadily since late 2009 and is insufficient to make any headway on the still-high unemployment rate. Inflation has apparently gone into early hibernation, proving zero interest rates and record fiscal stimulus have had little impact on animal spirits. Key sectors of the economy may have stopped falling, but solid improvement is hard to discern.

The NBER announced that the recession which officially began in late 2007 ended in mid-2009. They did caution, however, that the economic patient, while not dead, is still in guarded condition. This is clear in the GDP figures. They showed an anemic 1.6% advance in the second quarter and less than 2% growth since mid-2009 net of inventory restocking. In order for the American economy to match its potential, it needs to advance by 3% or more on an annual basis. To reduce unemployment, we need even more robust growth. Note that the unemployment rate, which registered 9.5% at the "end" of the recession in June 2009, was at 9.6% last month. Furthermore, non-farm payrolls actually declined by 329,000 from June 2009 through August 2010. So it sure doesn't feel like a recovery on the jobs front.



Source: Bureau of the Census.

Declining inflation would normally be thought of as good news, but the depths to which it has fallen is creating concern. If consumers and businesses come to the conclusion that their purchases will cost less as time goes on, they will delay them and contribute to weak and slowing growth. This tendency can be seen in retail sales, which have fallen from more robust (5+% annually) advances in the spring to wan (only 3.6%) as of August. Take out inflation (mostly energy), and we were up only 2% over the last year.

Deflationary psychology is probably key in the housing market. While three or four years ago it would have been hard to find someone who didn't believe in the idea of continually increasing housing prices, today it's equally difficult to find someone who does. Both existing and new home sales in the month of July plunged to multi-decade or all-time (since the figures have been collected) lows. On an annual basis, only 3.6 million single family sales took place in July. Compare this to over 7.5 million at the peak in 2005. Another interesting shift is taking place in the market due to housing price psychology. There is a bigger focus on renting. This is not surprising, as recent reports suggest that 23% of all homeowners have mortgages which currently exceed the value of the underlying homes and an additional 5% don't have enough equity to cover their sales costs. No wonder many families have decided that renting is a better choice than owning.

## Recent Economic Events (continued)

New single-family starts are up about 10% or so from the low point, while apartment construction has tripled. Both figures are well below the levels achieved prior to the recession. (That's why you haven't been able to turn Junior's room into a study.)

Car sales also seem to have stalled. August reports indicated total light vehicle sales ran at an annual rate of 11.4 million; as recently as late 2007, they were over 16 million. Estimates of scrappage (vehicles taken out of service) run at about 14 million or more per year. If this trend continues, the average 1.1 cars per driver will be working its way back down to a more reasonable ratio.

The American consumer is recalibrating spending to match up with income and real needs rather than ability to borrow and wish fulfillment desires. The frugal consumer is replacing the shop-till-you-drop model. Looks like Paris Hilton needs to make room for Jack Benny (and before you suggest you are not old enough to remember him, I too am only 39.)

## Commentary

### Bond bubble: yes or no?

There is a raging debate taking place among economists, bloggers, and pundits regarding the government bond market. It has gotten to the point where some are arguing that longer-term bonds have entered bubble territory. This contention is understandable, as it would be a real coup if an analyst could identify the "next bubble." After the dotcom meltdown and the housing collapse, anyone prescient enough to pick out the next spectacular crash would be anointed prognosticator of the year. The problem is that before you can identify a bubble, you need to define what a bubble is.

No doubt great and powerful minds can produce mathematical formulas to characterize a bubble. However, for our purposes, we need something more prosaic and understandable. I propose the following. A bubble occurs when the price paid for an asset is based not on the fundamental value derived from the asset but rather on the expectation of selling the asset for a higher price. This definition excludes the case of buying Microsoft at the equivalent of a few cents and riding it to millionaire status, as the price was ultimately justified by the monopoly profits generated from Windows and Office. It does include buying gold in 1981 (even though the price is higher today) as at $800 an ounce its price was well in excess of other commodities and had entered the buy-at-any-price zone. It's also clear that a homebuyer with a $50,000 annual income acquiring a house for $500,000 with an option ARM in 2006 was participating in a bubble market. The only way that transaction could work is for the house to appreciate sufficiently for the buyer to refinance. A bubble is a "greater fool" or "Ponzi" market.

With that definition in hand, what items can and cannot be subject to a bubble? Any asset with no optional or mandatory takeout at a fixed price. What does this mean? Well, there is no guaranteed price at which I can sell a house, a stock, an ounce of silver, or practically any physical asset. Furthermore, none of those assets require me to sell the item for a fixed price. This characteristic means that the price agreed to by a buyer and a seller is entirely dependent on the supply and demand of the asset at the time of the transaction. There is no limit in either direction on the price.

An example: I load a camel with many gallons of water and head into the dessert with a supply of rugs that I intend to sell at an oasis. I encounter travelers who are close to dying from thirst. I charge $100 a gallon to the group, providing enough to pull them back from death's door. The price is high, but it has real value to the thirsty. Suppose, however, one of the travelers decides to buy beyond his needs to head further into the wilderness, where he plans to charge others *(continued on page 3)*

## Commentary (continued)

$200 or more. No longer a fundamental purchase; the buyer is counting on finding someone as desperate and affluent as he was. He may be successful, or he may find no other thirsty travelers before he comes to an oasis where water is available for $1 a gallon.

What assets cannot be treated like this? Look at a regular dollar bill. No one rationally pays more than $1 for it because they have no prospect of selling at a higher price. Bank deposits also fall into this category, as do money market funds. In fact, any asset that has a fixed price at which you can redeem the asset is not subject to a bubble, because all rational buyers and sellers know that there is a certain price at which the asset will trade.

Now let's look at a bond. If the bond is due in the very near future, it acts very similarly to a bank deposit or cash: little chance of a bubble. How about a longer-term bond, however? If the bulk of buyers are purchasing the bond with the intent to sell to someone else at a higher price, a bubble is possible, but even in this case, it has a limit. No one will rationally pay more than the remaining interest and principal payments for the bond (this is the zero interest rate limit). Well, does buying the ten-year Treasury at 2.5% or lower qualify as a bubble purchase? I believe that you need to look at alternatives and consider whether a rational fundamental buyer finds value to maturity in a purchase. Seems to me that with short rates near zero and five-year rates below 1.5%, 2.5% for ten years is reasonable. Also consider that this rate would have beaten stock returns over the last ten years, and with little or no inflation, the return is close to historical levels. Bubble? Not that I see.

A related question (see market view section) is whether government bonds are mispriced at these levels. Paper losses can easily occur if I buy at the wrong time, but it is not a bubble because if I wait until maturity, my agreed-to return is delivered. Ask a buyer of Pet.com how long they will have to wait to retrieve their original purchase price.

There is a special case to consider. What if the government defaults? In that case, part of my prerequisite turns out to be false. There is no guaranteed takeout at a price certain. If you believe this, then all bonds are overpriced. They are not in a bubble, however, because the belief of buyers is that they will be paid, and while some sellers may believe in a default, they are not the ones driving the price higher.

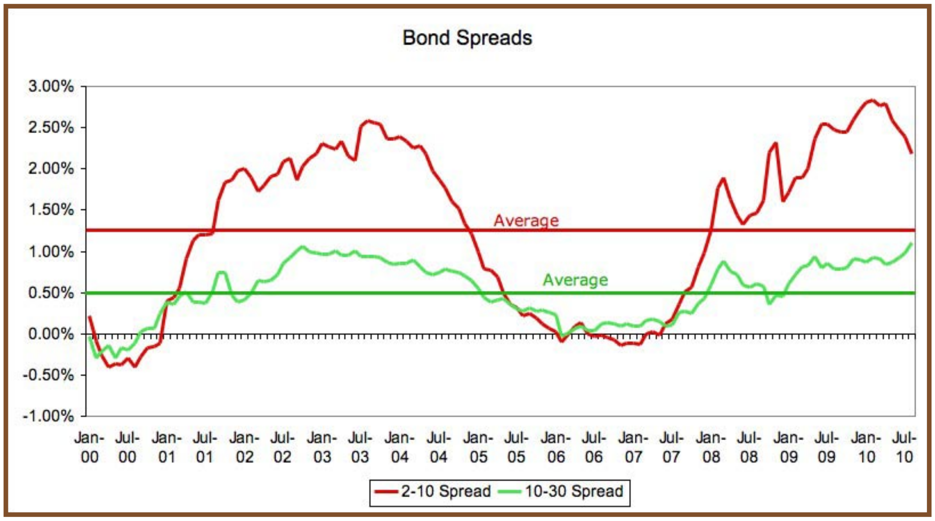
## Market View

The Federal Reserve announced this week that they are concerned about deflation and the sluggish pace of economic recovery. They hinted that they may do more. Since the armory at One Federal Reserve Plaza is nearly empty, the markets are assuming that the "more" is buying bonds to lower interest rates. Consequently, government bond rates are back to the lower end of their recent trading ranges. If the rule is "don't fight the Fed," logic suggests that the path of least resistance is still down on interest rates.

The other question at this time is whether Fed purchases are truly manipulating rates to levels lower than they would be otherwise or if they are simply hastening price discovery? Short-term rates in the US are near zero and the two-year Treasury is a bit below 50 basis points — close to the historical average. The normal spread between two and ten-years is around 1.25% and from ten to thirty another 50 basis points or so. So the math suggests the ten-year "should" be at 1.75% and the thirty-year at 2.25%. That's a long way from current levels of 2.6% and 3.8%, respectively. *(continued on page 4)*

## Market View (continued)

What's my recommendation then? I continue to believe that the optimal risk/reward trade-off is in the seven-year, as that is the point in the yield curve with the best income pick-up versus enough duration to create value. The speculative play for capital gains is the thirty-year. High quality corporates and municipals also make sense. Be very careful on credit, however; buy only the highest-quality names with good revenues and balance sheets.




Turning to stocks, I believe that the key remains dividends. A recent study suggested that roughly half the total returns on stocks over the past 100 years came from dividends and that all the positive return this century has been due to dividends. Even in the 80s and 90s bull market, dividends represented over 20% of the return. Find companies that have both the ability and the inclination to pay dividends (2.5% yield or better and a payout ratio below 50%). A basic needed product along with a low debt level is also a plus.

This week, gold hit a new high: over $1290 an ounce. How to reconcile with the weak economy and a threat of deflation? It appears that some investors have concluded that the risk of government currency manipulation, while not an immediate threat, could become one overnight. If currency is devalued, then precious metals are the place to be. Gold bullion has appreciated sharply over the past year (about 30%) but gold stocks are up only about half this amount. I think gold remains in a secular uptrend. It should be part of all investment portfolios, but it should be a small part (5% or so), and it is time to look at mining stocks rather than the barbaric metal itself.

## Editor's Note

*I recently had the opportunity to explore strategic issues with a group of friends and colleagues. The discussion was wide-ranging and served to open my eyes to points of view that I had not considered. I expect to present some of these insights on my website over the next few months as I review the deliberations and extract the most pithy of comments. But before I complete a more formal synopsis, I thought I would share a few of the biggest surprises. First, while the opinions expressed were forceful, there were no physical attacks. Second, it appears that over 70% of the country will be voting Republican in November and that about half is sympathetic to the TEA party. Virtually all members of the group expected recreational marijuana to be legalized in the next 10-15 years, and as one member opined, "I hope so, because with the economy, that's the only way I'm gonna have a happy retirement!" The group also predicted legal gay marriage, prompting the remark, "Why should **they** be happy?"*

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