JAMESSON ASSOCIATES

03.2010 NEWSLETTER

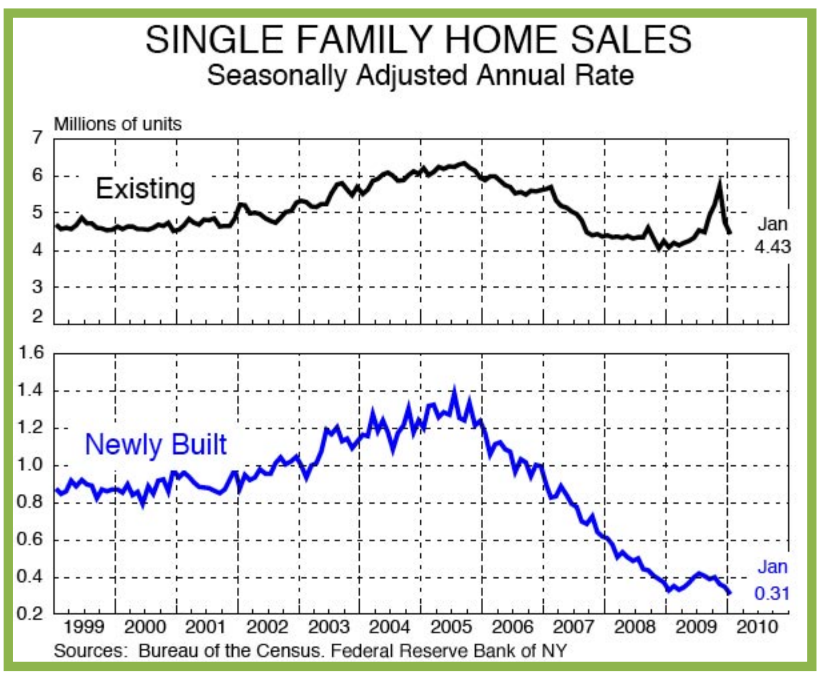
RECENT ECONOMIC EVENTS

The headline economic statistics are painting a picture of recovery while the country's mood continues to sour. GDP jumped to its best quarterly performance in over six years, unemployment seems to have peaked, and inflation remains benign. However, one would be hard pressed to find an American who doesn't hold a degree in economics or work for the Administration who believes that the recession is over. Consumer confidence stinks, and sales of houses and cars have rolled over.

The sum total of American economic production, GDP, advanced by a strong 5.9% in the last quarter of 2009. This would seem to put the recession in the rearview mirror. But the numbers are not as positive as first glance would suggest. 70% of the GDP gain was due to slower liquidation of inventory (not an increase, mind you; a slower decline). Net exports contributed about 5%, while domestic demand (pretty much the effects of the everyday economy) rounded out the total. Note that this latter figure is the permanent part of positive economic momentum. It was up only 1.6% in the fourth quarter, a slowdown from 2.3% in the third, and clearly insufficient to drive the economy forward on a sustained basis.

The good news in the February jobs report was that the unemployment rate held steady, rather than worsening; the bad news was that it held at 9.7% (yipes). We lost 36,000 more jobs in February, and average hours fell back towards multi-decade lows. Let's hope this latter statistic was impacted by the East Coast winter storms. What wasn't impacted by those storms was the stubbornly high rate of weekly unemployment claims, the 40%-plus level of long-term (over 6 months) unemployment, or the continued weakness in hiring permanent workers. February job losses would have been closer to 100,000 without census hiring and temporary job gains. One can wonder whether jittery businesses are using temporary help not as a precursor to permanent hires, but as stop-gap labor to replenish inventories.

Considering that personal income is down from a year ago when adjusted for inflation and that productivity (businesses producing more with fewer workers) spiked again in the fourth quarter, it is understandable that populist anger has not abated. Voters are so ticked off that they elected a Republican Senator from Massachusetts and are now judging the Federal Deficit a bigger threat to US security than Islamic terrorists. Whether fiscal prudence will break out in Washington is anyone's guess, but it is breaking out amongst American consumers.



Car and truck sales in the US have declined for two months in a row and have been below replacement levels (except for "cash for clunkers" sales in August 2009) since October 2008. Existing housing sales have plunged back to levels common before the first-time homeowners' credit was enacted, and pending sales predict

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RECENT ECONOMIC EVENTS (CONT.)

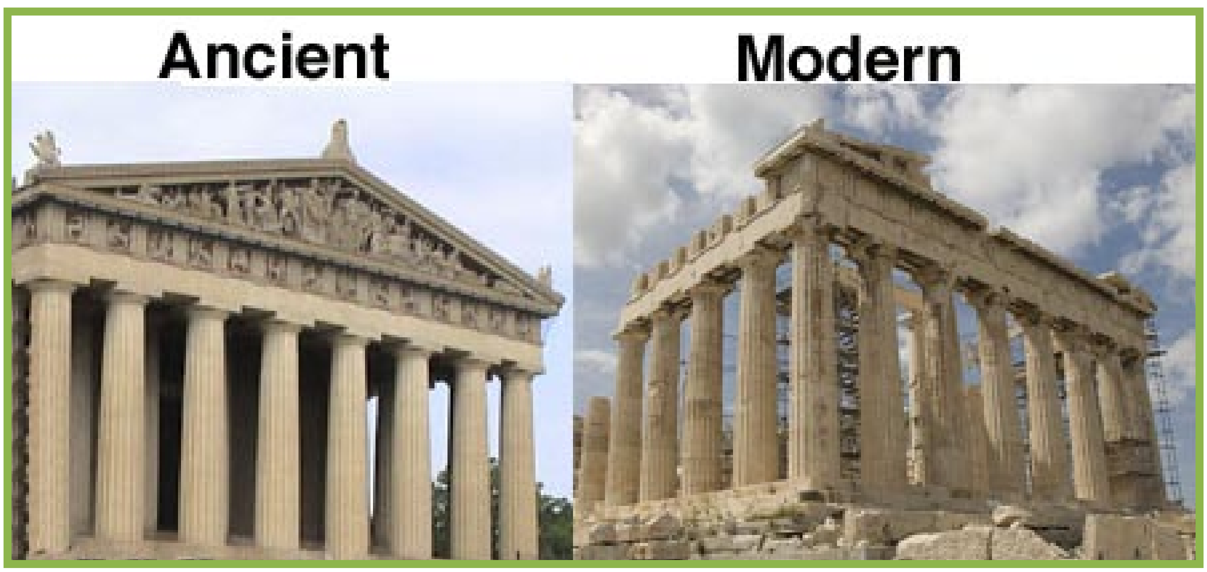
further slowing. New home sales peaked in July 2009 and are now running at an annual rate of less than 1,000 per day for the entire country. While the math is not perfect, with 50 states in the union, that works out to only 20 sales per day per state. There have to be that many houses burning down plus new households forming. Are all the kids destined to move back in with their parents and resume driving the family car?

Economic statistics are pointing toward a building, yet weak, recovery; opinion polls are pointing toward voter rebellion. As with anything involving human beings, the psychology of the situation is likely to trump the facts. The hope is that an accumulation of positive economic statistics will change the mood as the first signs of spring begin to appear. The fear is that the temporary factors that helped the fourth quarter will dissipate without any follow-through.

COMMENTARY

The Greeks are quite rightly proud of their role as founders of Western Civilization. Recent events may bring them full circle as the destroyers of same.

precipitating event in the crisis is the forthcoming need to roll over huge amounts of debt relative to the size and productivity of the Greek economy: their public debt



While the United States holds the record for absolute deficit spending, the Greeks have managed to build a percentage shortfall large enough to threaten the economic stability of the entire European Union. They have accomplished this goal both by giving away benefits to public employees (25% of the labor force) and by refusing to collect taxes to pay for the largesse. The

level is over 100% of GDP, and the government deficit is over 12%. On top of this profligacy, the government appears to have used derivative transactions with the devil—excuse me, Goldman Sachs—to cover up the extent of the shortfall. As one wag commented, "The only thing the Greeks have been economical with is the truth."

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Commentary (cont.)

Just like the Dubai default last year, the first response to the Athenian troubles was to look for a bailout from a better-heeled government. But who would be willing to provide the funds? The only credible party was Germany. Yet the German public was quite skeptical, so an apparent Greek-only austerity plan was hatched with just enough plausibility to sell bonds. Now, the Greek unions are holding nationwide strikes, and the jury is out on whether the plan will hold.

While this tragicomedy was playing out, Iceland heaped fuel on the fire. Recall that during the boom, Icelandic banks had solicited overseas deposits at very attractive rates. When the crash came, the banks went broke and were unable to pay back depositors. British and Dutch governments came to the aid of their citizens with deposits, figuring to be repaid by the Icelandic government over time. Although Iceland's government ministers agreed, its populace refused, voting over 90% against repayment in a national referendum. The global financial system is now staring at the specter of sovereign default.

Although Dubai, Greece, and Iceland are the stories du jour, prove to me why the United States is different. Federal government spending currently accounts for about 25% of GDP, while revenues are closer to half that. And it's not all due to the recession. Even if the economy were at full employment, the deficit would total about 7% of GDP. This is not sustainable. Half-baked solutions abound. The right wants to cut spending, never mind that the spending involved would include defense and social security. The left wants to raise taxes on the affluent, but the math suggests that income tax rates well over 50% would be necessary. There are no votes in Congress for any austerity, and we can't let President Obama off the hook either. He has frittered away his first year in office quixotically pursuing health care reform. We can add one more year to the Bush streak of eight years of cluelessness. Responsibility is on extended holiday.

The endgame is coming into view. Whether the political system can function well enough to make hard choices is beside the point. Deficit spending and debt accumulation at the present levels cannot continue indefinitely. Either the markets will revolt, or debt will be repudiated. I see little difference between the Greeks and Americans regarding deficits, and fear little difference between us and Iceland regarding willingness to pay for our past recklessness.

Market View

Some things to consider:

- Year-over-year CPI inflation has risen by over four percentage points since last summer.
- Savers are being paid less than the rate of inflation on their deposits in banks and cannot live on the returns, while borrowers either won't or can't take advantage of the low rates.
- I bought a new car. I wanted a red, stick-shift, performance vehicle. There was exactly one such car in Rochester, and I ended up with the only Volvo that fit that description in the Northeast.

Many would suggest that if I have decided to buy a new car, Satan might be strapping on the ice skates, but the problem with predicting the end of the world is that there is nobody to pay you off if you're right.

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Market View (cont.)

That suggests continuing to play the game, while trying to avoid the worst possible outcomes. Once again, the facts are hard to refute, but the timing is elusive.

The biggest risks: areas with excessive leverage. This means most of Europe and the US consumer. While I believe that the US government will honor its debts, it will do so only by severely reducing the net payment to American consumers (higher taxes and/or lower benefits) or reaching for a sprinkle of inflation. In the meantime, there will be massive debt issuance and growing concern over fiscal solvency.

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Quality will be the key until more clarity is established. Paradoxically, state and local governments that cannot legally run deficits and corporate entities with strong balance sheets should perform well. Beyond this, global focus will be necessary.

Note that commodity prices are in an uptrend even with the developed world generating sub-par growth, suggesting demand from elsewhere. Brazil appears to be on the cusp of establishing energy independence and a solidly democratic transfer of executive power. Other resource countries like Canada and Australia have weathered the storm.

The Fed is not likely to raise rates during 2010 both because of its impact on the cost of government borrowings and because it is running the most leveraged hedge fund in the world. Remember, it has short-term liabilities to the banking system funding a combination of traditional short-term assets and over $1 trillion of long-term Treasury, Agency, and MBS. A modest 1% increase in rates could cause a $50 billion or larger mark-to-market loss for Mr. Bernanke. Venture out a bit in fixed income choices, but not beyond three years or so.

Gold and other precious metals have held their own and still represent a good long-term insurance policy. Dividend-paying stocks also fit the bill and offer the added benefit of potential inflation protection.

Editor's Note

A few months ago Susan looked across the breakfast table and said, "Honey, those love handles are full size now; it's time to change some habits." Since I always do what she says, my choices were either cutting out good food (read: substituting celery for butter) and wine, or beginning a program of regular exercise. Genetically, Greeks cannot stop eating and drinking, so it was off to the gym for me. Never having been a fan of exercise, the machines I encountered conjured thoughts of a torture chamber. Why so many? However, with familiarity, I am gaining an appreciation of the myriad muscles that need to be built. I already notice an improvement. Now, when I walk my 11-year old dog, she gets tired before I do. Another positive: I can actually carry my cases of wine into the house without stopping to rest. I'd always thought that shooting my age in a round of golf would be my long-term measure of fitness. (The only way I accomplish that is if I join Walt Disney in a cryogenic chamber, am successfully thawed out at the end of the century when I will be pushing 150, and use the short tees.) My new goal is to lift my own weight. While that may not be much for a true gym rat, it'd be a big deal for me.

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