

RECENT ECONOMIC EVENTS

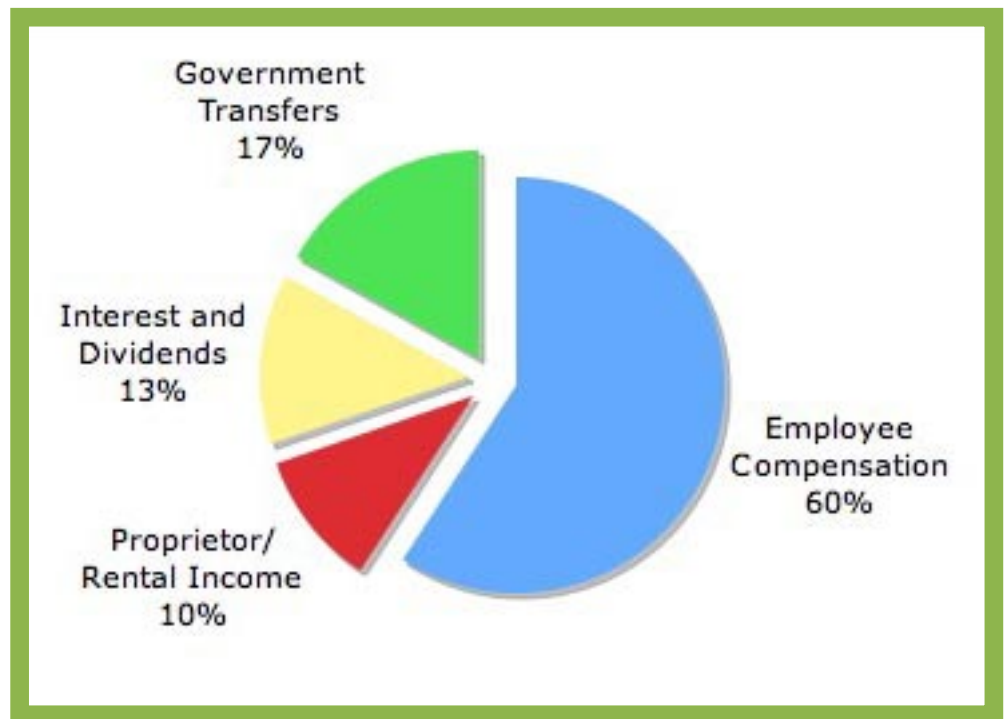
The American economy is in recovery, albeit one that is hard to discern at the individual participant level. Economic statistics report positive momentum, but the still-high unemployment rate (headline and expanded) belies the official story. Inflation is AWOL, with more prices dropping than rising. This may not be a good thing. The global economy, normally a non-issue for the United States, is no longer someone else's problem.

GDP posted its third straight growth quarter in early 2010, up by 3%. While slower than the 5.6% growth reported in 2009's final quarter, it was also less distorted by inventory swings. Nevertheless, real final sales grew by only 1.4%, suggesting that the private economy has not yet taken the baton from government stimulus. In fact, a recent study indicates that, but for government income support, consumers would have no more dollars available to spend than they did two years ago. A record one out of every six dollars of personal income today is due to a government transfer (see chart).

Employment is showing signs of recovering from the most significant job losses (8 million) in post-war history. May delivered new jobs totaling 431,000, but net of the 411,000 due to census hiring, the total was weaker than expected. The headline unemployment rate is still a troublesome 9.7%, and the expanded rate (including discouraged workers and underemployed part-timers) totals 16.6% or 27 million Americans. If we assume regular demographic growth and job gains of 250,000 per month, it will take about four years to drive the unemployment rate down to

5%. Note that in the five years from 2003-2007 (last expansion), there were only 10 months with job gains in excess of 250,000, and the average gain was less than 200,000. The employment mountain is indeed steep.

While you can never be too rich or too thin, it is becoming apparent that inflation can be too low. April saw a headline CPI report of price declines (-.1%). This lowered the YOY rate to 2.2%. The core rate, which excludes food and energy, was unchanged, driving the YOY rate below 1%. There are many problems with an inflation rate this low, but two important ones come to



mind. First, consumers conditioned to stable or falling prices pursue their purchases with less urgency. Overall growth can suffer as a result. Second, governments cannot rely on rising prices to naturally generate increased tax revenues or create cost savings. They must explicitly raise taxes or cut nominal spending to balance budgets. Not easy in an election year.

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RECENT ECONOMIC EVENTS (CONT..)

Just when we thought that domestic troubles were quite enough, the travails of the rest of the world have intruded. Greek debt and deficit issues have come close to unraveling the Euro, knocking its value down from over \$1.50 to less than \$1.25. This has chased funds into the dollar, both boosting its value and driving interest rates lower. The Chinese have become concerned that their economy is growing too quickly and setting the stage for a property bubble collapse. As a result, Beijing is tightening financial conditions. A stronger dollar, along with a slowdown in

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COMMENTARY (CONT..)

both Europe and China, leaves US manufacturers with less demand and threatens our recovery.

Strictly domestic events are positive for the economy, although they suggest less strength than we would prefer and an undue reliance on government support. Foreign developments are another matter, threatening our economic momentum through both financial and real impacts.

We may long for the days when the US was master of its own economic destiny, but we now find ourselves buffeted by the same global forces that have roiled other countries over the years. III

COMMENTARY

Hubris: extreme arrogance; overestimating one's own competence or capabilities, especially for people in positions of power.

Picture the scene: a small part of a complex system breaks down and the people involved, smart guys all, express incredulity given the high level of risk control and failsafes involved. Not only that, but the original problem is underestimated, and the situation ultimately metastasizes into a full-blown disaster.

Is it the Gulf oil spill, the Ohio electric substation failure, or the sub-prime/CDS crisis? The honest answer is yes. It is all of these. Modern society has become dependent on complex systems which have gone beyond the abilities of human beings to understand in their totality.

Those who profit from complexity contend that you can't put the genie back in the bottle. Once a level of complexity has been introduced, we simply have to depend on the "experts" to manage it for us. So what if accidents happen, the alternative is to stifle innovation.

The underlying assumption is that the benefits outweigh the costs.

I am not so sure. I think it is time to consider both the overall benefits and costs of advancing technology and their distribution among different members of society.

Let's take the financial meltdown and the reform package working its way through Congress. It is hardly news at this point that the combination of inadequate risk management and a seizure of liquidity following the Lehman Brothers failure brought the global financial system to the edge of the abyss. No one was willing to trust anyone with their funds until the Federal Reserve provided a security blanket for the entire system.

The important takeaway: the private financial system did not and could not fix itself (are you listening, Kurt Gödel?). The only option was government intervention, and just like at an old-time ice cream store, it came in only two flavors — bailout or nationalization. The former was chosen, to the benefit of private investors and highly

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COMMENTARY (CONT.)

compensated employees of the companies rescued. The net cost to taxpayers was commensurately higher.

An argument was advanced that the government shouldn't nationalize because they wouldn't be able to run the complex institutions. I say baloney! The people in charge of these institutions, no matter how highly paid, were the ones who took us to the brink. The government could hardly have done worse. Deep down, Main Street realizes this, and that's why there is so much anger directed toward Wall Street.

My point is simple: no one can safely operate financial institutions of this size and interconnectedness. The answer is not more regulation (a 3,000-page bill where Glass-Steagall ran only 34 pages?). That is a "Whack-a-Mole" strategy. Complexity and scale beyond normal

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human understanding inherently creates risk. No way to avoid it. The answer is small and simple.

Andrew Haldane, executive director at the Bank of England, recently suggested that banks had no additional private economies of scale once they hit \$100 billion, and instead created clear public diseconomies beyond that point. The solution is obvious: break up the big banks. There is, of course, tremendous political disincentive to doing this, as lobbyist funds flow liberally to those representatives willing to defend the largest players. What I hope is that one clever politician somewhere will figure out that breaking up the big six who control over \$9 trillion in assets into 90 or more smaller entities will increase the potential source of contributions by maybe fifteen times as the new players jockey for position. That would truly be the political system working for the greater good. III



MARKET VIEW

Theory: The history of financial recessions, as opposed to inventory/inflation fighting recessions, suggests an outcome of private debt liquidation and deflationary tendencies. To forestall the worst effects, governments attempt to maintain demand through higher spending and/or lower taxes. This results in the substitution of government debt for the private debt being retired (either through payments or default). Ultimately, the economy recovers, although its vigor is sub-par because it is based on temporary stimulus rather than self-sustaining private activity.

Facts: Bank loans are in a downtrend as is consumer credit in general. Annual core CPI inflation is less than 1%, while the Federal government is on the way to its second straight \$1 trillion-plus deficit. GDP growth, excluding inventory swings, is up less than 2% on an

annualized basis since the recession officially ended last summer and unemployment is still near 10%.

Looks like we are following a preordained path. While there is always some uncertainty, I would caution against the false hope that things will be different this time. The speed with which the Eurozone troubles spread to the US suggests that emotion can take over from fundamentals at any point. The risk of higher volatility and sharp market moves has increased and is likely to stay with us until there is a better balance between government and private activity.

Investment choices in such an environment must lean towards safety of principal and income generation. Fortunately, the balance sheets of many US corporations are in excellent shape and the

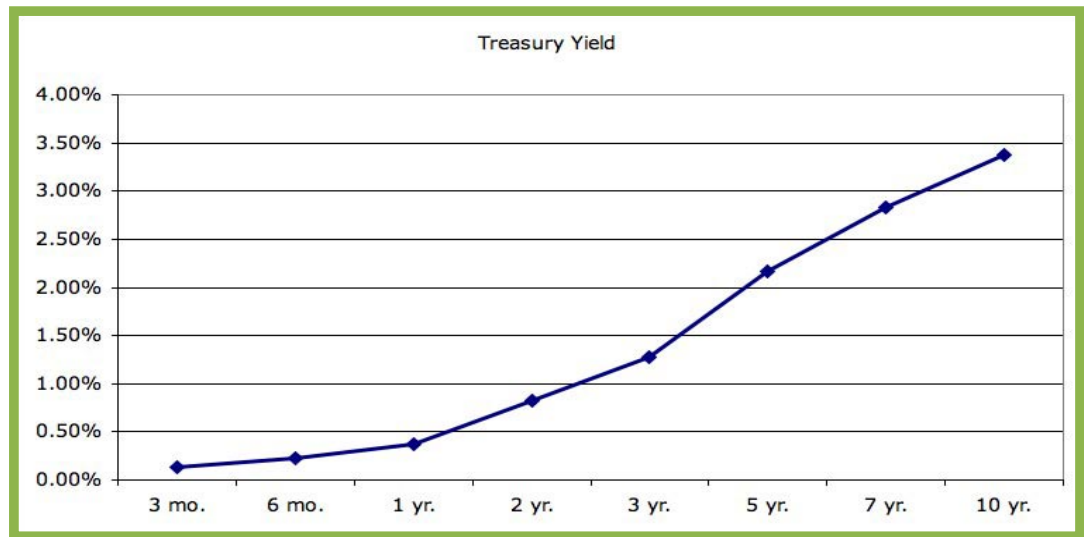
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MARKET VIEW (CONT.)

downward pressure on wages is creating a solid profit picture. Either good dividend-paying stocks or the bonds of highly rated companies make sense.

History suggests that the time it takes for balance sheet repair after a financial recession is as much as a decade (Japan is up to two decades). This means that interest rates are likely to stay low for longer than expected and may not increase as much as we had thought when they begin to rise. With the market still worried about fighting the last war (inflation) and betting on higher rates (steep yield curve and close to record short positions in Treasury futures), it makes sense to take the other side of the trade. Right now the five to seven-year point on the curve offers the best risk/reward tradeoff.

Deflationary pressures point to lower prices for commodities and other hard assets. The exception may be gold as a safety hedge. While headlines reported strong prices for trophy art objects this spring, overall sales were down over the last year. Real estate continues to labor under pre-crash debt loads and makes sense only if it cash flows (commercial) or is cheaper than renting (residential). Welcome to the new normal. III



EDITOR'S NOTE

In May, Susan and I traveled to NYC to move our son home from college. We borrowed a van to be sure we had room for everything. Since you can't just pull up and park on Fifth Avenue and since Philip's pre-packing was nil, I had to park in an underground garage a few streets away. The total space could physically hold about 50 cars if they were packed in bumper-to-bumper. I would guess there were about 47 cars there. You leave the key, and they move it into the grid. When I returned for the van three hours later, it was buried about five cars deep and two rows over. I figured a half hour wait. However, between the two attendants — one Russian, one Hispanic — they retrieved it inside of five minutes, performing a Tetris-like ballet of vehicles with no missteps and no verbal communication. I was both mesmerized and frightened. What if Russia can move war materiel with the same alacrity?

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