JAMESSON ASSOCIATES

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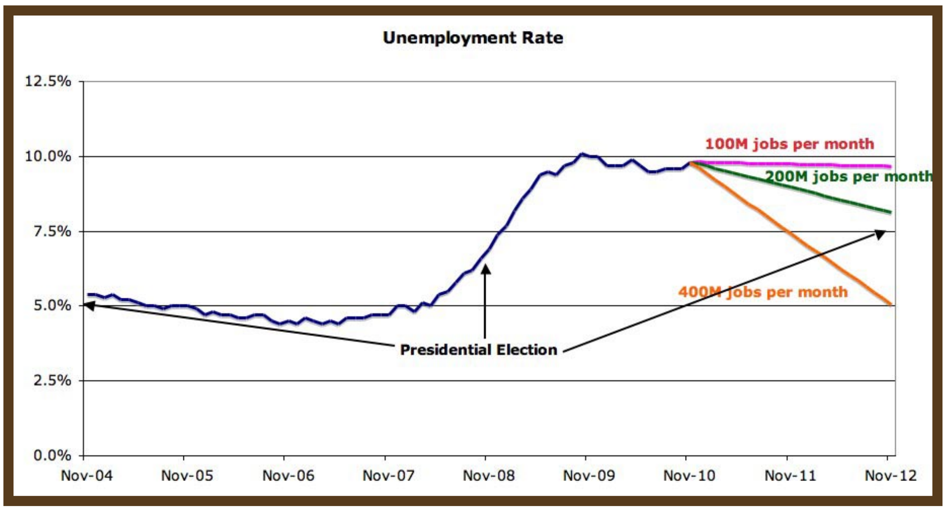
RECENT ECONOMIC EVENTS

The broadest measure of economic activity in the United States, GDP, once again posted positive but below potential growth in the third quarter. This lackluster performance has done little to reverse the trends in inflation or employment. Nevertheless, consumer sentiment has picked up and sales of cars and other retail goods have been stronger than expected going into the holidays. Housing has not joined the party. Although much of the overseas economic news has been negative, there are some encouraging signs for American exports.

Real third-quarter GDP rose by 2.5%, a bit of an acceleration from the second quarter (1.7%), but well below the typical 4%-plus pace normally seen at this point in an economic expansion. While consumer purchases contributed to the gain as did investment spending, many of the items bought were imported, limiting the overall benefit. Government spending also added to the totals in the form of both direct purchases and transfer payments. Even so, the economy didn't grow fast enough to cover productivity gains and labor force growth. The result: no improvement in the unemployment rate.

The employment picture has had some bright spots. Job openings are trending upward, withheld taxes are growing, and new claims for unemployment insurance have declined to levels suggesting healthy monthly job gains. However, the November employment report did not validate expectations. It showed only 39,000 jobs created, pushing the unemployment rate up to 9.8% after three months at 9.6%. The rate is lower than the 10% posted in November 2009, but higher than the recent low of 9.5% we saw in June and July. To the 15 million unemployed Americans, add 9 million involuntary part-timers and 2.5 million discouraged workers, and we arrive at 17% labor underutilization. With about 100,000 new job seekers each month, it will take truly huge monthly gains in jobs to reduce unemployment to acceptable levels by Election Day 2012.

A weak employment market and sluggish growth has helped keep inflation at bay. Overall consumer prices are up only 1.1% from a year ago, and core prices which exclude food and energy have increased by only .8% in the last twelve months.



The combination of low prices, retail aggressiveness, and holiday spirits has propelled the Christmas season to solid gains. Car sales are now running above 12 million on an annualized basis and other retail sales are up 6% over a year ago. University of Michigan consumer confidence jumped to 74.2 in early December from a recent low of 67.7 in October. Unfortunately, this improvement in psychology has not translated into much of a bounce for housing as sales of both new and existing homes are well below year-ago levels, and prices have resumed falling.

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Recent Economic Events (continued)

It's hard to review the economic news from Europe without becoming depressed. The Irish are the current bailout poster children, but debt contagion is spreading to Portugal and Spain. The large improvement in the US trade picture, therefore, came as a surprise. Our trade deficit fell to $38.7 billion in October, the only print below $40 billion since January. Key contributors were a decline in oil imports and a record level of agricultural exports. This latter factor is driven by demand not from Europe, but from emerging nations looking to improve the quality of their diets. According to Dutch global agricultural lender Rabobank, China is expected to boost imports of corn over the next few years by a factor of 20 times, to over one billion bushels. Agriculture is a very capital-intensive business which also requires land and transportation infrastructure. America sports world-class advantages in this industry, but it's not likely to help the job picture much: permanent agricultural employment is less than 1 million.

The US economy is making some progress, but the slow pace and the capital/technology aspect of the growth is keeping the labor markets unusually weak for this point in a recovery. The good news is that inflation remains subdued and consumers who have jobs are becoming increasingly confident. This should make for a more Merry Christmas.

Commentary

The Federal Reserve has embarked upon what has been termed Quantitative Easing II (QE2).

The hope: buying bonds to the tune of $600 billion will lower interest rates, thereby driving up the value of American assets. This wealth effect will generate more spending and stimulate as many as 700,000 jobs in 2011 that would not have otherwise been created.

The fear: without additional stimulus, prices will begin to fall on an economy-wide basis, ushering in dreaded deflation. This will stymie economic growth as purchases are delayed and a general malaise settles over the economy (see Japan circa 1990-2010).

The hidden agenda: weaken the dollar to help bolster exports and to put upward pressure on prices.

The reality: interest rates have jumped since the official announcement in early November and are even higher than they were when initial intimations of the program surfaced in August. The stock market has responded positively, but cause and sustainability are hard to determine. Perhaps the Republican election sweep was the bigger factor. Residential real estate values have resumed their decline.

All in all, the impact of QE2 has not been as the Fed intended. The official announcement was met with derision across the board, including some of the harshest criticism I have ever seen from presumably responsible foreign government ministers. Domestic support has been lukewarm.

We can generally discount the comments of foreign governments, as they have no interest in allowing the US to make headway on its trade deficit by debasing the value of the dollar. They clearly see this as a threat to their manipulations. Note that Germany and China, the two countries most dependent on exports for growth, were the most vocal opponents. But what to make of domestic critics?

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Commentary (continued)

Some of those against are concerned that the Fed will set off an inflationary (or hyper-inflationary) spiral. Setting aside that this is exactly the goal (see hidden agenda above), we are nowhere near inflation at present. Another criticism is that buying government bonds will discourage Congress from being fiscally responsible. I would suggest there is nothing that will cause Congress to be responsible, as shown by the recent Bush tax-cut extensions larded with additional deficit-increasing programs. The Fed has no power over Congress.

In fact, I believe that QE2 demonstrates that the Federal Reserve has no power at all. In the old days, when the Fed embarked on a policy, it could feel relatively secure in seeing results. It was the biggest gorilla in the room, and no one wanted to "fight the Fed." QE2 reveals two things. First, the rest of the world is no longer buying what the Fed is selling. They will fight it. Note that China is now on the path to monetary tightening and that Brazil is instituting quasi-currency controls. Looks like the room has a few more large apes.

As important, if not more so, what makes anyone think that this is going to work? QE1, which was much larger in scope, had support throughout the markets, and was aligned with fiscal stimulus, did not create above-trend growth, nor did it lead to job creation. It didn't even result in lower overall rates from the time when it was announced to when it ended.

The story of QE2 and traditional fiscal stimulus is that the game is over. Neither monetarism nor Keynesianism works anymore. The artificial increase in demand that was the goal of both macroeconomic strategies is just that — artificial.

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The only lasting impact from QE2 is the Fed's lost credibility. On top of this, since important emerging nations are in the process of tightening, there is an open question as to who will win the battle. If China's monetary tightening and Europe's fiscal austerity vanquish the loose money and fiscal stimulus of the US, we will have the best evidence yet of the end of the American Century.

Market View

Silly me. I was suckered in by the talk regarding QE2 and did not process the old adage to buy the rumor and sell the news. Interest rates have clearly risen since September, but the reasons are different from what I had expected. I think rates are up over worries about America's future.

The action in gold is my touchstone. In the last few weeks, it has hit an all-time high against all three major currencies: dollars, euros, and yen. Markets are voting "no confidence" in currencies in general and are trying to determine which governments will default — either explicitly or implicitly. The former is likely to include some of the weaker members of the European Union like Greece, Ireland, and perhaps Portugal and/or Spain. The latter type of default may include the rest of the developed world where a revaluation versus emerging nations is inevitable in my opinion.

Well, the plutocrats won. The President got rolled by the Republicans on the Bush tax cuts, and Tea Party austerity is a dead letter in Congress. Both the left and the right are howling about the plan. This suggests that we face a Carteresque White House, *(continued on page 4)*

Market View (continued)

along with a Congress divided both between and within the traditional parties. If you enjoy food fights, pull up a seat.

This paints a relatively lousy picture for investments, but the mattress is stuffed full. I believe that high quality is even more important to success in the markets over the next year or so. The idea that a flood of Fed induced liquidity will drive the riskiest assets permanently higher is a fool's game. Look to stocks with good balance sheets and decent dividends. Exposure to emerging nations is a plus as well.

Fixed income options are more attractive today than they have been since the springtime, as any default is likely to be years in the future. I continue to believe that government bonds in the five to seven-year range make sense as do general obligation municipal securities with high ratings. Plan on holding to maturity, however, as volatility will limit capital gains to only the most nimble.

The diverging prospects of developed and emerging economies suggests a number of opportunities. Agricultural commodities have secular tailwinds behind them and could prove to be big multi-year winners. Precious metals continue to reflect strong price action. Ultimately, a weaker dollar should help all traded commodities as the markets conclude that the US is not going to do anything to address longer-term problems.

Real estate in either income-producing form (REITS, direct investments) or in raw form (land, especially farm land) has been an excellent stealth performer this year. The trends that have helped this performance are in place and are likely to continue for years.

What to avoid? The mortgage mess is still not fully resolved, nor are the problems of peripheral Eurozone countries. This means to stay away from large financial stocks and bonds. In fact, selling rallies probably makes sense.

Editor's Note

There is a darn good reason that I stay away from currency predictions. I usually get it wrong. This lamentable performance was on display earlier this year when Susan and I were planning a trip to Spain. Viewing the turmoil in the Eurozone, and projecting the point when the Spanish would kick off another meltdown in the Euro, I argued we should book our trip in early October. Great timing. Our flight was scheduled to land on the day of the Spanish national strike, so it was canceled. We traded a day in a four-star Madrid hotel for one in a run-down airport motel in Atlanta. Plus we found the world's slowest Waffle House waitress. If you want to spend over an hour for breakfast, I have the address. Did we enjoy the benefit of a plummeting Euro in response? Nope, in fact it rallied higher and higher as each day of our stay passed, only reversing course the moment our return flight touched down in New York.

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