Jamesson Associates
09. 2012 Newsletter

Recent Economic Events

The global economy is clearly slowing and financial market stresses are legion. But when we zero in on domestic American statistics, things are looking a bit brighter — not good enough, mind you, but a bit better. Whether we look at employment, inflation, housing, or our trade balance, we see modest improvement. Even government seems to be catching a break, as revenues are increasing in the face of continued spending restraint.

Chinese GDP growth fell to 7.5% in the most recent quarter, and the Eurozone is now in recession. Every time you pick up the newspaper there is another story of financial institution shenanigans. If it isn't a futures dealer going broke after embezzling customer funds or a computer-trading program run amok, it's presumably-upstanding British banks laundering money for the Mexican drug cartel or the government of Iran.

In the face of such sensational stories, it's hard to focus on what appears to be a pretty decent set of US economic reports. After months of really lousy employment releases, the July figures were upbeat. 163,000 jobs were created, plus hours worked and hourly pay both increased. All of this helped to boost personal income by a solid .3% in July. Since the personal consumption price index was unchanged during the month, all of the gains translated into real improvement for American consumers.

For the first time since before the recession, excluding the distortion due to the special housing tax credit, home prices increased year-over-year according to the Case-Shiller index. The gain was only .5%, but it was a gain. Furthermore, housing starts are taking notice. They were up 21.5% in July from a year ago. Admittedly, we are still well below pre-recession levels, but nevertheless….

The United States trade deficit declined substantially in June on the combined strength of exports (a new high) and lower levels of imports. Falling oil prices also helped shrink the deficit to $42.9 billion from over $50 billion as recently as April.

Government has been blamed for contributing to the anemic recovery we have experienced since the recession ended in 2009. There is some truth to this: state and local governments have cut back on spending and employment as their revenues have plummeted. There is now some light at the end of the tunnel. State and local government revenues have increased on an annual basis for over one year. And our biggest worry, the Federal government deficit, is set to decline by about $200 billion this fiscal year versus last. Make no mistake, $1.1 trillion is still a big number, but it is gradually getting smaller.

> "The American economy is lumbering along …[but] Things could be worse."

The American economy is lumbering along at a growth rate a bit below 2%. Employment is growing and prices are under control. US businesses appear to be productive enough to keep boosting exports in a difficult global economy. Things could be worse.

Commentary

Resurgence of Upstate New York

I could have entitled this section the Renaissance (too hoity-toity) or the Revenge (too snarky), but I think Resurgence captures the point well.

My father used to say, "I can't see why anyone would want to be anyplace else in August, but let's keep it our secret so we don't get overrun with people." I know just what he meant. Fresh tomatoes, sweet corn, and roads unencumbered with traffic. As I look out the window at a pristine blue sky framing green trees swaying in the wind, it's hard to imagine that there is anyplace prettier. But it is more than scenery that prompts my thoughts.

Upstate New York agriculture won the lottery this year without even buying a ticket. Farmers' markets are overflowing with ripe tomatoes, and I don't remember healthier fields of corn and expanses of soybeans. Hot, sunny weather coupled with enough rain has helped local farmers avoid the problems of the Midwest. Yields may be down a bit, but not as much as prices are up. This means happy times for farmers and their suppliers.

This Goldilocks theme of not too hot and not too cold also carries over into the housing market. Almost alone in the US landscape, Upstate New York housing has held value or even appreciated during the last five years. This is a testament to two important facts. First, there was no boom in housing (construction or prices) because the area is just not a hot spot for overheated growth. Second, because we are generally served by community banks and not by transactional mortgage brokers, the incidence of sub-prime lending on homes was far less than average. Housing was driven by fundamentals and didn't get into a bubble.

And how could I forget the gift of the Greeks? Upstate New York has been heralded as the "Silicon Valley of Yogurt". We are poised to produce more than any other state in the union as several brand-new plants near completion. The reason: the Greek yogurt craze. Upstate New York is the closest dairy region to the huge east coast market.

This location near affluent city-dwelling tourists didn't seem to help tourism much until now. The industry in the Finger Lakes has hit critical mass. While we are not yet at the density of restaurants, lodging, and spas you can find in Napa Valley, we are rapidly upgrading the options. There are wineries, breweries, and distilleries for imbibers to sample, as well as a cheese trail for visitors who are teetotalers. You now could easily spend a long weekend visiting. (Please note, I am not an employee of the Finger Lakes Tourism Council, but I would entertain an offer.)

The other big plus for Upstate New York is that Governor Cuomo is positioning himself for a run at the Presidency in 2016. This means he wants to establish a record of fiscal prudence by standing up to pressures to spend. He also needs to create a legacy of well thought out infrastructure improvements to boost economic growth. His support of the Tappan

Commentary (continued)

Zee Bridge replacement is no accident, nor is his competitive regional development grant process. Also, note his push to clear the way for milk producers to support the yogurt industry (it takes three times as much milk to produce Greek yogurt as it does to make regular yogurt). Stable tax rates, along with modest growth, will generate increased revenue for the state. And since most of the taxes come from downstate, we Upstaters get the benefit of going along for the ride.

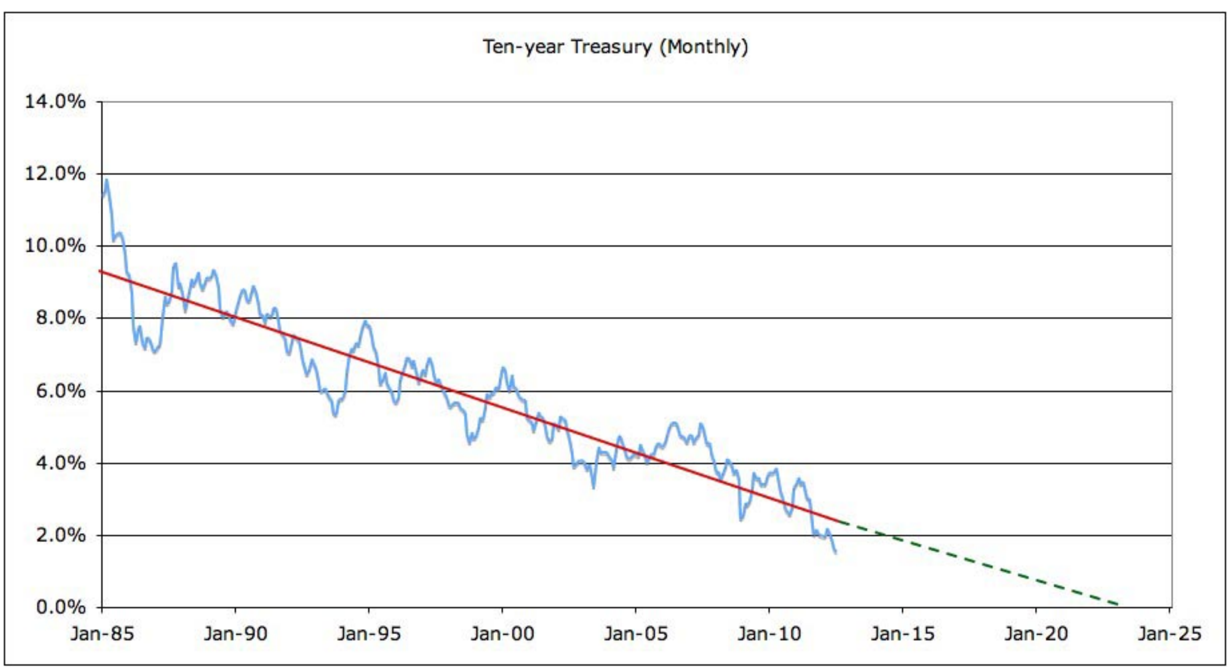
Now remember what my father said, and let's keep this our secret.

Market View

I recently ran a regression analysis on ten-year Treasury rates. It turns out that the annual average rate has been falling by about 23 basis points a year for over 25 years. With the 2011 average at 2.78%, it looks like we have about eleven more years until we hit zero. I make this point for two reasons. First, the trend towards lower rates is long and powerful; we need a real reason to predict that it will end. Second, while it will end before we hit zero, we could easily spend many more years within the trend.

By turning off the talking heads on CNBC or Bloomberg TV who try to explain every little wiggle in the markets, you find that most of the day-to-day and even month-to-month action is simply noise. Steeping back to look at multi-year charts unveils a persistence of direction, sometimes lasting decades. Key themes dominate.

From the 1960s through the early 1980s, inflation was the theme. It decimated bond returns and ultimately sank equities as well. Both gold and oil benefitted. Then



Market View (continued)

the great bull market in stocks and bonds took over from the 1980s until the end of the century. The rally in stocks was artificially extended into 2007 with cheap money and irresponsible private debt accumulation. Since then, the key theme of the economy and the markets has been reversing indebtedness (read: deflation).

My guess is that this one has a few more years to run. The reason: the pain from extinguishing the debt has not yet touched enough investors. The endgame, as I see it, offers two paths. One is a collapse where the debt is written off through default. This is not good for any but the most nimble. Two is that central banks and governments hold things together just enough to allow the natural resiliency of the global economy to muddle through and reduce the debt to manageable levels. I am betting on the latter.

If you buy that analysis, the investment options go like this. Hold high-quality fixed income securities, but be ready to trade them out when rates fall more than is justified. Conversely, buy back in if rates rise but don't violate the long-term trend. Shift assets to stocks with secure finances and dividend-paying ability. Due to diversification, they can actually survive a debt collapse. Commodities in general will not keep up with stocks, but those that have secular demand (agriculture-related) can out-perform. Stay away from commodities that can be replaced by technological advances (this means oil). Real estate, as always, comes down to location, but I suspect the next few years will reward those who acquire either rental or residential properties in urban areas. The long-term trend will ultimately drive people into cities and away from sprawling suburbs.

Editor's Note

Susan and I took a week in late June to celebrate our 30th anniversary. Our travels took us to two of the three unique cities in the US — New York and New Orleans (San Francisco completes the troika). We did not experience temperatures below 90 degrees on even one day of our week away, with a couple of days kissing 100°. Although we have visited New Orleans many times (even once earlier this year), we had never stayed far from the French Quarter until this visit. We booked a room at a Bed-and-Breakfast near the Garden District and were treated to an amazing stay. Not only did we linger over breakfast for hours each morning talking with a series of other guests, we were informed of plenty of inside-New Orleans experiences by our hostess, a lifelong resident of the city. One of her best tips was that Commander's Palace (the restaurant that spawned both Paul Prudhomme and Emeril) had a special deal for lunch during the week. For a little over $20 you could order a two-course meal, or for a couple of bucks more, a three-course. Not bad in itself, but the real kicker was that doing so allowed you to sip on 25¢ Martinis (limit three). We got our full $1.50 worth and had a great meal.

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