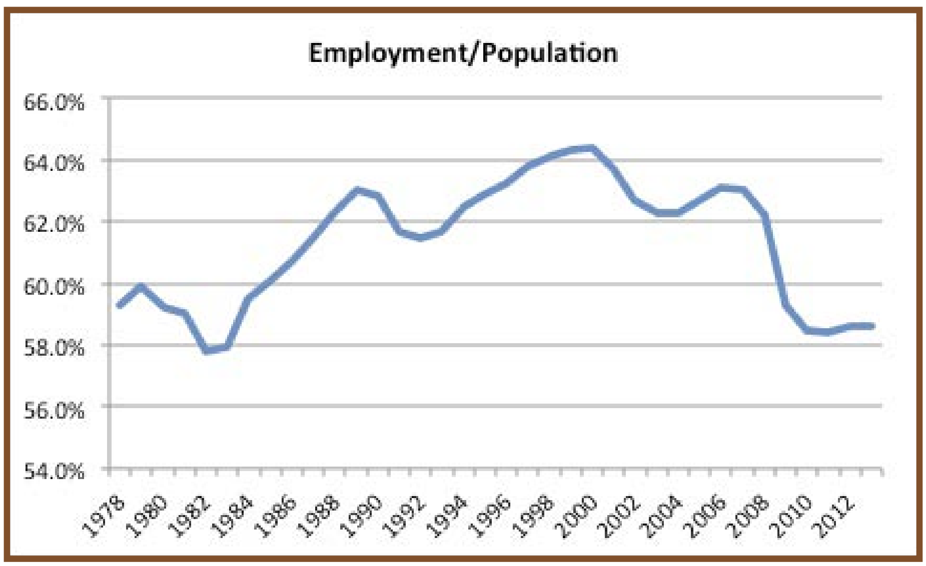
Jamesson Associates
09. 2013 Newsletter

Recent Economic Events

The news from the domestic economic front is that there is no news. Things are pretty much as they have been: sluggish overall growth, jobs being created just fast enough to keep hope alive, housing rebounding from a generational collapse, and inflation quite benign, even in the face of higher oil prices and record monetary stimulus. Are we stuck or is change in the wind?

The financial markets appear to have decided that change is coming. In recent months, the stock market hit a new high and interest rates have bounded upward. It's the age-old question of whether the market predicts economic change or lives a life of its own. Since the stock market has predicted seven of the last five recessions, I believe it is better to look at the facts. Do they point to an unambiguous change or is the more probable path uncertainty and muddling through?



The US Bureau of Economic Analysis updated GDP figures to incorporate a new methodology for R & D and intellectual property and to change the approach to pension accounting. The impact was to increase total GDP by over $500 billion or about 3.5%. Since the changes went back to 1929, the annual differences built over time and had only marginal impact in any one year. Nevertheless, the US is now "producing" more than before. If only simple changes in reporting could create real growth.

Using the new approach, GDP advanced a healthy 2.5% in the second quarter, powered by personal spending, a sharply improved trade situation driven by a turnaround in the country's oil picture, and signs of a housing rebound. While this is excellent news for one quarter, the year-over-year growth rate remains mired below 2%.

Job growth had seemed to gain steam earlier this year, but during the last three months, its pace slowed even as the unemployment rate continued to fall. How can this be? Well, it turns out that folks are leaving the labor force (10,000 Baby Boomers turn 65 every day) fast enough that even anemic job creation is sufficient to reduce the unemployment rate. The statistic that we need to zero in on is not the unemployment rate but rather the percentage of Americans who have a job. On that score, the employment-to-population ratio has been below 59% for the last four years. Prior to the 2007recession, this ratio was over 63%. With the pertinent population (those 16 and older) at about *(continued on page 2)*

Recent Economic Events (continued)

250 million, this means that we have about 10 million fewer employed persons than we would have if the ratio had held at its previous level. Yipes!

Housing has been on the mend. However, there may be storm clouds on the horizon. Mortgage rates have increased by over 1% from their lows early this year, boosting a typical mortgage payment by about 15%. Couple this with housing prices that have risen more than 10% over the last year, and potential homebuyers (especially first-timers) may be priced out of the market. New home sales and starts have topped out, pointing to a slower growth path.

Mid-East turmoil has helped to boost oil prices above $100 per barrel. Even so, gasoline prices in the US have come down from their early summer highs and inflation itself is well-behaved. The most recent monthly inflation figures for consumer prices (.2%) and personal consumption expenditures (.1%) remain very low, and the annual change on both of these measures is between 1.2% (core PCE) and 2.0% (headline CPI), well below the level at which the Fed would become concerned.

So, key economic statistics say, "old news is new news," while financial markets are "predicting the turn." Human beings need narrative to make sense of disparate facts; sometimes, however, those narratives turn out to be fiction rather than truth. Keeping an eye on the real facts of growth, employment, and prices is likely to make for a better forecasting record than checking the financial pages.

Commentary

Because the news media has been distracted by Syria, the ongoing improvement in the Federal Deficit has slipped from view. It now appears that the red ink this year will be down about $500 billion or so from last year. Both increased tax revenues and minimal spending gains are responsible. And these two trends look like they have legs, suggesting that the Federal shortfall could decline to a sustainable 3% of GDP in the next few years. Will this good news have an impact on our representatives as they reconvene in Washington?

I wouldn't bet on it. The GOP is ramping up rhetoric to defund Obamacare and to hold the debt ceiling ransom against even further spending cuts. The Democrats are in pretzel mode as they try to explain NSA revelations and the haphazard foreign policy response to chemical weapons in Syria.

The American public has rightly become tired of the dysfunction in our nation's capital. The rock-bottom ratings Americans give our government speaks to the success of the anti-government wing of the Republican party. They seem to have won the propaganda war, discrediting the notion that government can ever be a positive force.

The almost universal opposition to even a limited strike against the murderous regime in Syria speaks to real war weariness and a belief that the Mid-East is riddled with blood feuds of millennial duration. The US has tried nation building, and we were rewarded by increased chaos. Were it not for oil, no one would give a damn about these people who apparently can't escape the mindset of retribution. Failures of force and diplomacy fuel the neo-isolationism now on the rise.

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Commentary (continued)

Domestic oil supplies give us the chance to escape the cycle, and many Americans want out.

But is this a good thing? I think not. While I have real reservations against a Syrian strike, there is a big issue that needs to be debated. Can the US really extract itself from foreign policy? Perhaps we can't be the world's policeman, but are we really going to leave the job to Vladimir Putin? And domestically, can we shred a social safety net while the most affluent of us continue to prosper? Is this really the kind of country we want?

I see signs of a backlash against the small-mindedness that nurtures these thoughts. California has achieved a tenuous fiscal balance and is cautiously restoring some social spending. The Democratic governor of Missouri is making a case against GOP tax cuts by pointing to the impact it will have on education. A progressive won the NYC mayoral primary, positioning himself as an antidote to the pro-business Bloomberg administration.

And while President Obama is hardly the poster boy for effective government, it appears that health care reform is actually working as the Heritage Foundation originally intended it to. Medical cost inflation is slowing and insurance exchanges are offering coverage at lower cost than anticipated. There have been a handful of prominent front-page stories reporting how patients have negotiated down the billings from providers. It seems as though using a combination of transparency on costs and competition is working. Who'd a thunk it?

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Ultimately, the United States is a country that must see a better future for itself and its children. It is in our DNA. Like it or not, a well-functioning government which has the confidence of the public is a necessary part of a successful future. I hope my optimism is not misplaced, for without optimism, we become not the last best hope for mankind, but rather another cynical nation pursuing our own selfish needs without regard for others.

Market View

"When you're one step ahead of the crowd you're a genius. When you're two steps ahead, you're a crackpot." Rabbi Shlomo Riskin

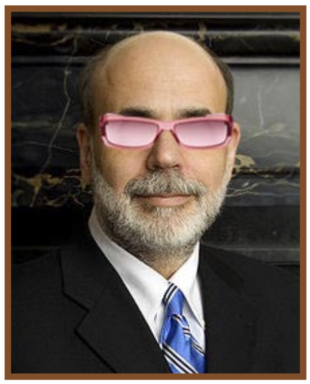
No one would call me a genius based on my recent forecasting record. Not only did I warn against the stock market, I suggested trying to catch a falling knife in the bond market and zeroing in on agricultural commodities. None turned out well.

At the risk of solidifying my reputation as a crackpot, I believe that much of the movement in the last few months has been detached from economic fundamentals. And I believe that the fundamentals will ultimately prevail for investors.

In the long run, stocks are driven by earnings, and earnings need to flow from increased business. There is only so much cost cutting a *(continued on page 4)*

Market View (continued)

company can pursue if sales are not growing. Third quarter top-line growth estimates for the S & P 500 are below 3%. While earnings estimates are still positive, it is a fact that estimates start out much higher than actuals deliver. Consider that profit margins are still at close to record levels and mean reversion is a powerful trend when it comes to margins. Also, remember that September and October are historically not the best months to be invested in stocks.



Fixed-income investments have been pummeled this year, with most sectors of the market showing negative returns. However, the fundamentals of bonds depend on borrowing growth and inflation. Neither is setting any records. With a shrinking Federal Deficit, we may have a supply issue as well.

Commodities eventually converge on marginal costs of production. This year's fantastic growing conditions helped to overcome the ongoing secular demand for agricultural products. As time goes by, secular will trump the tactical.

The coming "taper" by the Federal Reserve seems to be a key part of the narrative of the financial markets since the idea was broached in May. They have ascribed the reason for reduced monetary stimulus to the Fed's belief that better economic fundamentals are on the way. Well, Mr. Bernanke and his cohorts are seeing the same thing that all the rest of us see. Are the fundamentals really better or are they donning rose-colored glasses?

My view is that we are still in an environment with little chance of a real acceleration in either growth or inflation. This is an environment that should argue against further rate increases; it also suggests a range-bound stock market. So, my crackpot recommendations stand. Hold back on new stock investments, cautiously add to bonds up to five years, and look for an entry point on agricultural commodities.

Editor's Note

I have noticed that my personal comments at the end of this newsletter may have taken on a formulaic cast. Well, time to break the mold. Travel may provide fodder for most of the year, but summer in Western New York is the best time of all. Who can argue against vine-ripened tomatoes, fresh sweet corn, and green leaves framed against a bright blue sky? Not me. Susan and I now spend our evenings eating out in our gazebo with a perfect view of the flower garden (her doing not mine). However, for all good things there is a price. Turns out, extended repasts are the devil's playground. In musing one evening, Susan suggested that the dining room chair I use needed to be repaired. "Of course," I said innocently. Now, we are refurbishing the entire table and chairs, and since the set is out of the house, it is a perfect time to replace the carpet. Well, I decided that you can't go modern with a dining set and carpet and hang on to the traditional chandelier. If GDP surprises on the upside due to a jump in home furnishing sales, you'll know the reason.

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