JAMESSON ASSOCIATES
06.2013 NEWSLETTER

RECENT ECONOMIC EVENTS

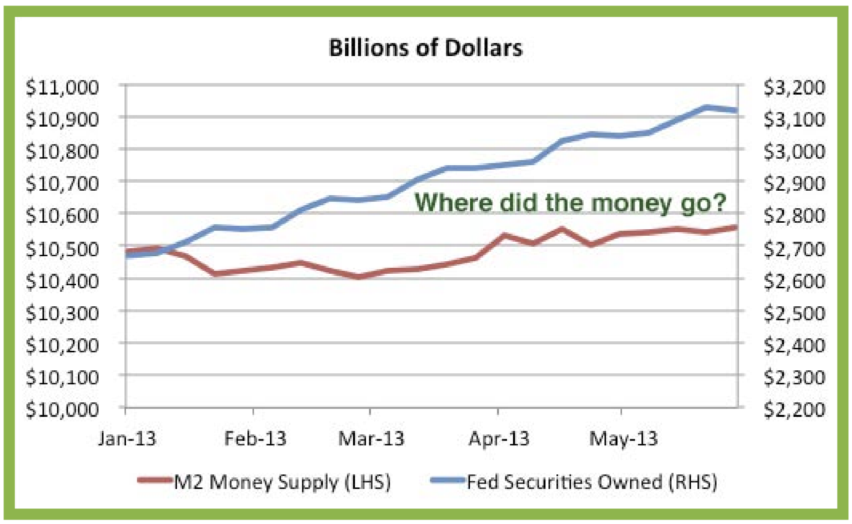
You put your fiscal stimulus in;
you take your sequester out.
You put your quantitative easing in,
and you shake it all about.
You do the hokey pokey,
and you turn yourself around.
That's what it's all about.

We have entered the realm of Hokey Pokey economics, and it appears the effectiveness of policy actions is about equal to the chances of the Hokey Pokey serving as prep for a tryout with the Rockettes. Not to denigrate the feel-good aspects of communal dancing, but the results of fiscal and monetary stimulus are falling short. GDP is lumbering; unemployment remains stubbornly high. Even money growth, which should be directly tied to Fed activity, is punk, and given recent trends, deflation seems as likely as inflation. Admittedly, there are some bright spots — housing and stock prices. But the truth of the matter is that few Americans are seeing the benefits.

First quarter GDP growth was pegged at 2.4%, which is a nice improvement from the .4% gain in the last quarter of 2012, but not enough to boost the year-on-year gain up to 2%. It goes without saying that such an anemic growth path will be insufficient to reduce the unemployment rate by much.

Although job figures for May showed a gain of 175,000, the unemployment rate actually increased to 7.6% from 7.5% the previous month. Other labor market statistics are also weak. Personal income was unchanged in April, and personal consumption expenditures (PCE) were down by .2%. From a year ago, both figures are up by less than 3%, and when adjusted for inflation, by less than 2%. It is hardly surprising that GDP is laboring to hit 2% growth.

The Federal Reserve has been buying $85 billion of MBS and Treasuries per month all year. Despite this, total money supply is up less than $100 billion from the last week of December to the end of May. If we do the math, we have to ask how over $400 billion of presumed money printing turns into less than $100 billion of money supply. Monetary stimulus is spent.



We can see this in the inflation picture. While many have warned about the risks of out-of-control prices, the facts suggest otherwise. The core PCE price index posted an annual gain of only 1.1% in April, the lowest annual rate since 1959, when the statistic was first computed.

So where is the money going?

It appears that the dollars being provided are simply bidding up the price of assets instead of boosting the real economy. Depending on which housing price index you choose, annual gains are as high as 12%. Although some have pointed out that investor money is a key factor in the price gains, the improvement *(continued on page 2)*

Recent Economic Events (Cont.)

seems to be quite widespread. Unfortunately, the extent of the previous price declines in many markets means there is still a distance to go before equity values will be fully restored. That is not the case in the stock market, which just posted new highs. Volatility has clearly increased, but even with more swings, the total value of stocks has regained its pre-recession level.

But how have the benefits been distributed? The average net worth of American households based on the last figures available (2011) was almost $340,000, or excluding home equity, about $250,000. However, if we consider the median value, the halfway point on the scale instead of the average, the situation is not nearly as positive. Median household net worth is less than $70,000, or less than $20,000 excluding home equity — down from its level at the turn of the century. Roughly half of the 120 million households in the US hold net assets of only about $16,000 aside from any value that they have in their homes. It will be hard for this group to help drive the American economy forward with any vigor.

It is encouraging that the Fed has helped asset prices recover and that average wealth in the US is back to prerecession peaks, but when we consider the median or typical American family, the story is not so rosy. The top 10% can only power the economy so much by themselves. And that's what the new normal is all about.

Commentary

Workers, both here in America and around the world, consistently lose out to investors. Why is it that the saver is more privileged than the worker? Job losses through austerity? Hey, that's just part of the rough and tumble of a free enterprise system. Savers to lose some of their money in Cyprus? The foundation of the developed world is at stake. Money market funds to unfix the $1.00 guaranteed price? The industry will collapse. This dichotomy in protections is played out in myriad controversies around the globe, but none more so than the clash between austerians and stimulators.

The case for austerity has taken a blow from the same source that stymies climate change deniers — the facts. A rather famous study which provided statistics on growth and government debt levels had suggested that high levels of debt were associated with slower growth in GDP. A review of the data supporting the study uncovered a few problems with the analysis. First, the study had posited a sharp decline in growth once government debt hit a level of 90% of GDP. This finding was found to be erroneous based on a bad spreadsheet. While growth does slow as government debt grows, it appears to be a relatively steady path to lower GDP growth rates. Second, while slower growth is associated with higher levels of government debt, causality is a question mark. Does high debt cause slower growth, or does slower growth lead to an increase in debt? Statistical support for the arrow of causality points from growth to debt, not the other way around.

> Does high debt cause slower growth, or does slower growth lead to an increase in debt?

Why does this matter?

Government austerity has been justified on the grounds that debt needs to be reigned in to protect the future growth of GDP. If there is no drop dead point, and if causality is uncertain, the argument melts away.

The facts suggest that the US has avoided the worst of the post-recession period because it didn't take the hard path of austerity as did Europe. (continued on page 3)

COMMENTARY (CONT.)

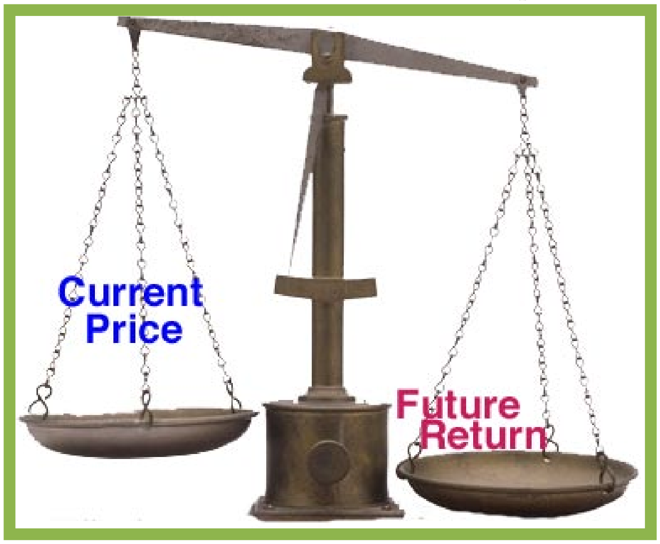
While not exactly burning the barn down, the US is growing while Europe is in recession.

The Federal Reserve has pointed to the unemployment portion of their dual mandate as a reason to maintain monetary stimulus, but critics have argued this will unleash inflation or even hyper-inflation. Nonsense. The inflation target is 2% and the level of inflation is 1.1% and falling. Unemployment currently stands at 7.6% with a target of at least 6.5% and more realistically, 5.5%. Why is there a question whether the monetary spigots should stay on or not? My answer: the undue influence of wealth over income in our economic discussions. A country that is more concerned with holding on to what it has rather than creating more, is a country in decline. As Ben Franklin remarked, "He who gives up freedom for safety deserves neither."

Just on an aside, this argument has current traction regarding the efforts of NSA snoopers to "keep us safe from terrorists." I for one will vote for stimulus and less government surveillance. I'll take the risk that Americans have historically welcomed for a freer and more prosperous future.

MARKET VIEW

The stock market is hitting new highs and the question is why? Clearly, liquidity from the Federal Reserve and other central banks is a contributing factor. However, when one observes the volatility in the Japanese market, bets on monetary efficacy become more questionable. Bulls will point to reasonable valuations based on recent earnings while bears focus the fact that those earnings are based on record profit margins, destined to revert to the mean. A more empirically driven approach is to realize that current values are elevated because future returns are expected to be lower than average.



Huh, you say. That doesn't sound right. So let me pose an analogy.

Fixed-rate bonds are contracts between buyer and seller wherein the buyer hands over an amount of money with the expectation that she will receive regular interest payments while the bond is outstanding and the return of principal when the maturity date arrives. The expected payments (excluding credit risk in my example) never change, but the price of the bond in the market can. When the interest payments on the bond are higher than those available from newly issued bonds, investors increase the price they will pay for the older bond. By increasing the price, the future expected return of the older bond is made equal to that of a new bond.

I suspect we are seeing that in the stock market today. Stock prices are being bid higher because expectations of future returns (the new normal) are lower. The pivot point in this calculation is whether the stream of future earnings holds up better than the alternative returns available to investors. If future earnings hold up better, stock prices are justifiably bid up. If future earnings fall short of expected alternatives, prices should fall. The bulls are currently winning the relative return game. *(continued on page 4)*

MARKET VIEW (CONT.)

With this insight, how should an investor position his portfolio?

Let's look at bonds first. The concern over Fed tapering (slowing or stopping their bond buying binge) has contributed to an increase in interest rates of about 50 basis points as measured by the 10-year Treasury. The current rate is near 2.25%. With low inflation and low inflation expectations, this seems like a fair price to me. However, discretion being the better part of valor, I would zero in on the five to seven-year portion of the yield curve where returns are 1.25% to 1.50% in Treasuries. Municipal bonds in this range or a little longer also offer value for those in high tax brackets. Keep quality high, however, as volatility can play havoc with lower quality names. Note that, had you acquired a 5-year Treasury a year ago at roughly 75 basis points in yield, it would be a 4-year Treasury today selling at about 85 basis point yield. This would bring your total return over the last year to about 35 basis points as the small price decline was more than offset by the coupon collected. When you consider that money market investments over the period yielded less than 20 basis points, this is not bad even in the face of rate increases.

Stocks are vulnerable. Traders should reduce exposure to the lower edge of their limits while investors should avoid adding new funds at present. Once again, quality is very important as a market swoon is increasingly likely. As long as core earnings hold and the dividend is paid, the price of the security is less important.

Commodities will remain under pressure, especially industrial commodities and precious metals. China and other emerging nations are slowing as exports are finding a more difficult environment in developed markets. Significant capacity has come on line as technology marches forward. The oil and gas markets are the poster children for this due to advances in fracking and other techniques. Agricultural commodities offer better prospects because the demand from emerging nations continues to build.

EDITOR'S NOTE

"What's more important, people or things?" With this question, my father returned from his trip downtown to buy the Sunday paper. I knew immediately that he had taken my car and managed to hit something on the 3-mile journey. Upon investigation, the damage was slight (especially considering it was my Peugeot with over 200,000 miles). This phrase came to mind as Susan and I travelled to Louisville this May for the Kentucky Derby. We made a mini-vacation of the event by driving to Columbus, Ohio mid-week and on to Louisville for a three-day stay. In Columbus, we stayed at a B & B that we had visited before, solely because of the hostess. She regaled us with stories and inside Columbus info, and of course, had the usual assortment of interesting guests for breakfast. Louisville was just as welcoming as we stayed in an "overflow" B & B with a trio of charming hosts. The property had been at one time divided into nine apartments. It is now restored to its former glory with a wealth of antiques that offered stories of their own. We heard things about Churchill Downs and Louisville that you won't learn at the Hilton, and no moment was lacking interesting conversation. Before leaving, both B & Bs offered something that chain hotels don't — a goodbye hug. My father was right, "People are more important than things."

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