Jamesson Associates
12.2013 Newsletter

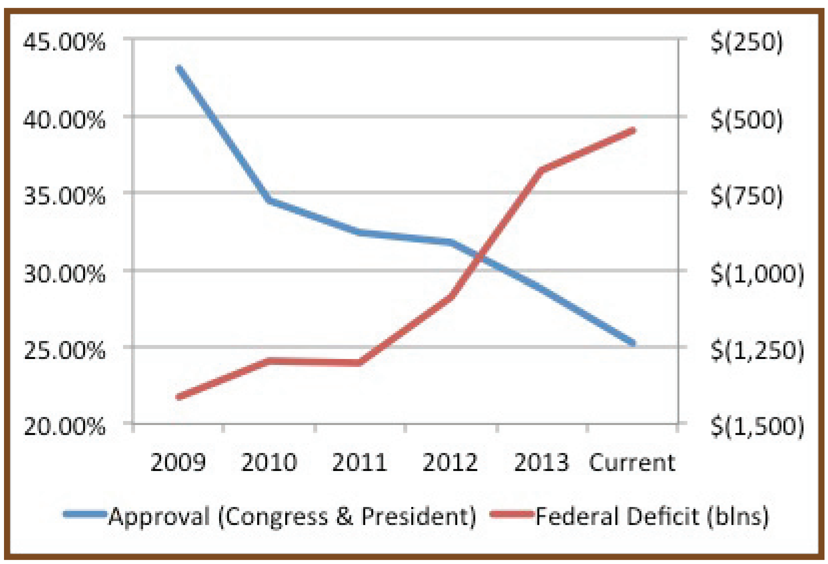
Recent Economic Events

After the summer doldrums, the American economy is on a run of generating jobs. The gains have overcome the government shutdown and helped to power key economic statistics higher. US competitiveness, especially in manufacturing and energy, has boosted exports to an all-time high and whittled away at the trade deficit. As a result, speculation regarding tapering the Federal Reserve's quantitative easing program has taken over the headlines. Good news seems to have broken out in other areas as well. The Federal Deficit dropped sharply and is still falling, and inflation remains well contained, perhaps too well contained.

November job gains topped 200,000 for the second month in a row and the unemployment rate fell to a five-year low of 7%. This positive news was accompanied by a gain in the average workweek of a tenth of an hour (this works out to the equivalent of an additional 300,000 jobs). While many of the jobs are still not high-paying ones, there appears to be a broadening in the range of industries that are hiring. New claims for unemployment insurance are also falling, with the most recent weekly report dropping below 300,000. This suggests that December's job gains could be even stronger than November's.

Corroborating statistics include a jump in new home sales, car sales topping 16 million annualized, and a surprisingly strong GDP revision in the third quarter. While the latter report was mostly powered by a big gain in inventories, the increase might be tied to a more confident business outlook. We will have to see if there is payback in the current quarter. American competitiveness in manufacturing, agriculture, and energy pushed exports to a record high ($193 billion) in October, reducing the trade deficit to a bit over $40 billion. Keep in mind that prior to the recession, $60 billion-plus deficits were common.

No good deed goes unpunished, however. The improved economic picture has stoked speculation that the Federal Reserve may begin to taper its $85 billion/month bond-buying program. The reduction may come as early as mid-December, but most analysts expect no decision until Janet Yellen takes her seat as Chair of the Federal Reserve Board early next year. Ms. Yellen has been a consistent supporter of current Fed policy, and most observers expect a cautious and gradual reduction in monetary stimulus.



With the popularity of the Federal Government at what may be all-time lows, the fact of a reduced Federal Deficit has been lost in the shuffle. It couldn't be that the fewer goodies Washington hands out, the lower the approval, could it? Fiscal year 2013 ended with a deficit of $680 billion, down from over $1 trillion in 2012. Ongoing improvements in revenue, along with a stalemate on government spending, promise continued reductions in

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the deficit over time. In fact, the most recent multi-year projections are for a deficit of less than 3% of GDP a few years out. There is clearly a longer-term issue regarding retiring Baby Boomers and their health care costs, but the current picture is much brighter.

This also goes for inflation. All of the statistics that measure prices are stable or falling. The positive view of this is that wage gains will translate into consumer buying power. The alternative view is that we are perilously close to falling prices (dreaded deflation: da-dum-dum) with the negative connotations that implies (see Japan 1990-2013).

The American economy has strung together a series of solid economic statistics, suggesting that the extraordinary stimulus applied in the wake of the Great Recession can now be reduced. Markets will be watching carefully to see whether the economy can stand on its own as tapering begins, fiscal stimulus declines, and an eventual increase in interest rates looms. Time will tell, but for now, let's enjoy the holidays.

Commentary

Larry Summers may have lost out on the race for Federal Reserve Chairman, but his recent speech discussing "secular stagnation" put him back in the news. Mr. Summers suggested that over the last twenty years or so, the United States in particular, and the developed world in general, has had a chronic lack of aggregate demand. Consequently, economic growth has been captive to inordinate stimulation. In effect, he argued that the interest rate necessary to clear the market at full employment is negative and that the attempt to engineer negative interest rates produced serial bubbles.

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The point Mr. Summers has raised is one I have wrestled with frequently: what do we do when our ability to produce goods and services outruns our capacity to buy them? Over the long expanse of history, leaps in technology enabled bounds in human productivity. The first great technological advance was the transition to domestic agriculture. This led to the initial stirrings of civilization in the Middle East and China and later on in Central America. Long-distance trade transformed the Middle Ages into the Renaissance, and the steam engine launched the Industrial Revolution. Our present age is built on the microprocessor and ubiquitous communication. At each stage, efficiencies have created a pool of excess labor needing an outlet.

There are three ways to address the issue of surplus labor: war, public monuments, and leisure. The rise and fall of empires characterized early human civilization, but humans also created the Seven Wonders of the Ancient World. The pyramids of Egypt were a direct result of the amazing productivity of the fertile lands in the floodplain of the Nile River. Greek and Roman temples and Chinese palaces were all built with the surplus labor of the day. Human sacrifices in the religious ceremonies of the Aztecs were a grisly but understandable solution as well.

By the time humans had "progressed" to the 1500s, war and empire building were coupled to the construction of soaring cathedrals and royal castles. Also, according to economist Juliet Schor, it was unusual for a laborer in medieval Europe to work more than half the year. In addition to Sundays and other holy days (about 90 per year), there were an additional

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Commentary (continued)

90 rest days set aside by the Church. One would be hard pressed to conceive of the slaughter of the Civil War and the two World Wars without the deadly efficiency of the assembly line.

It seems quite natural to me that we are again in a surplus labor situation in the wake of a transformative jump in efficiency. In fact, it would be surprising if we were not. Processing the change is what is difficult. We have moved from an economy that was characterized by the need to work to one that produces enough to satisfy everyone's needs. This is profoundly challenging to the core culture of Western society, the Protestant work ethic, and especially to its offspring, capitalism.

An aside: in October, I vacationed in Portugal and Spain where unemployment is over 15% and 26%, respectively. Youth unemployment is even higher. Yet, there were well-dressed citizens shopping in areas with little sign of economic stress, few beggars, and no demonstrations in the streets. The social safety net was working well enough to provide basic needs.

The key issue is, if the United States is able to produce a GDP higher than at any previous time in its history with only 60% of its working-age population, why should we want to force the unemployed into jobs rather than simply paying them a basic income? The Swiss will soon be voting on this very question, and conservative economists in the US have suggested replacing all the various anti-poverty programs with a simple cash stipend.

It is time to realize that a modern developed economy does not need all the workers it has available. Given the three historical ways surplus labor has been absorbed in the past, I opt for leisure rather than either war or more public monuments.

Market View

There are two investments that have soared in 2013 — Tesla and Bitcoin. I have no view on the former, but the latter seems to be a real phenomenon. For those not familiar, Bitcoin is a digital currency that only exists online. It can be "mined" through a complicated and expensive process which uses computers to solve mathematical problems. Total Bitcoin issuance is limited to 21 million with about 9 million currently outstanding. The great advantage of the currency is that it is not tied to any central authority but is rather decentralized. This allows it to be used like cash with no paper trail. As you will note, a Bitcoin is a lot like a digital bar of gold. Enough of the basics.

Earlier this year, one could acquire a Bitcoin for less than $50, but it recently topped $1,100. Talk about volatility. I view this as a rank speculation, but one that could prove profitable. If you have money you can lose completely and not impact your lifestyle, buy a couple and see what plays out. I am planning to do the same, but offer no guarantee.

bitcoin

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Market View (continued)

On to more prosaic investment choices. The improving economy has both heartened the stock market and brought fears of rising interest rates to the forefront. With an imminent Fed taper on hand, it is wise to look at history. Quantitative easing has had a relatively straightforward impact on financial markets. Each time it has been put in place, the stock market rallies, most recently to a new high. Each time it ends, even if temporarily, stocks fall. Surprisingly, while the presumed goal of the easing is to lower long-term interest rates, ten-year Treasury rates have trended higher during quantitative easing, falling when it is withdrawn. Now, the folks at the Federal Reserve aren't stupid. They can see as well as anyone else that the impact of quantitative easing on interest rates is not as advertised . In fact, the one constant impact of the various programs has been to chase dollars from high-quality assets into riskier ones.

Using that as our touchstone, I expect the gradual reduction and eventual elimination of quantitative easing to result in stock market headwinds. In my opinion, the movement in longer-term interest rates has already incorporated tapering. The new focus for the financial markets will be the timing of a change in short-term interest rates. That timing is dependent on how strong the economy turns out to be and will attract everyone's attention once the formal tapering announcement has been made. I expect tapering to begin in the first quarter of 2014, with the buying program gradually shrinking over the spring and summer and ending by Labor Day.

All of this makes 2014 a wait-and-see year. I would gradually exit riskier equity positions and lean toward higher-quality stocks. Dividends remain important. Fixed income choices should focus on the steepest part of the yield curve (three to seven years) and should include both high-quality municipal issues and well-regarded corporates. Since I don't see rates falling back to the levels of a year ago, items with options like MBS and callable securities at a discount offer extra yield. Commodities are the toughest call of all. I continue to like the secular case for agricultural commodities, but feel that industrial items (metals and energy) have been overtaken by technology improvements. Precious metals: see Bitcoin above.

Editor's Note

After 31 years, Susan and I returned to Portugal, using it as a base to travel through southern Spanish wine country. We ate seafood and other Iberian delicacies seasoned with a healthy dose of olive oil and garlic. Of course, the local wine accompanied each meal. Because Susan was saddled with securing the travel arrangements, she rewarded herself by scheduling visits to castles, museums, and gardens as well as the occasional sherry bodega. We put about 1100 miles (that's 1700 kilometers for the metric inclined) on our rental car, motoring from seacoast to mountains and back. Our most memorable stop was in Marvao, a small village on the Portuguese/Spanish border. We sat in the very same mountain-top Pousada (Portuguese inn, usually in a repurposed historic building) where we had honeymooned, and where I had promised an eventual trip to Spain. It was an emotional return, highlighted with bright blue skies overlooking an expansive valley. Upon arriving home, I dreaded stepping on the scale — but I had lost three pounds! I think it was the wine and garlic. Susan says it was the sightseeing.

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