Jamesson Associates
09. 2014 Newsletter

Recent Economic Events

As many hoped, the American economy bounced back in the second quarter from weather-induced weakness during the first. A key question at this juncture is whether stronger growth can continue or whether the second quarter represents yet another false dawn. Positives: business investment, overall employment growth, and low inflation. Challenges: poor job quality, global growth slowdowns, and perhaps, a mini-housing bubble.

US GDP jumped by 4.2% in the second quarter. While about one-third of the gain was due to inventory building, which has been the source of much of the quarter-to-quarter volatility over the last few years, there was a solid increase in business investment, representing roughly one-quarter of the total gain in GDP. The other most significant factor, as per normal, was the advance in consumer spending. It accounted for approximately 40% of overall growth, driven (so to speak) by strong auto sales. The rest of the factors were small modest positives in government spending and housing, along with an offsetting negative in our trade picture.

While the second-quarter figures were heartening, there are two issues to consider. First, even with the strong growth, the gain from the second quarter of 2013 is only 2.5%, and year-to-date, the average is about 1%. This is clearly not strong enough to argue for an economic takeoff. Second, how durable is second-quarter growth?

Annualized quarterly inventory growth over the last four recovery years has averaged only .10%, far short of the 1.40% second-quarter figure. Falling back to the average would knock growth to below 3%. The other questionable support for GDP lies in decelerating personal consumption expenditures since early Spring. Retail sales showed no growth at all in July.

How can that be, with unemployment falling and job gains averaging over 215,000 per month in 2014, even with the weaker figures for August? Turns out the quality of jobs is punk. The US now sports an all-time high in number of jobs; however, within the total, full-time jobs remain below their 2007 peak. Part-time jobs have become the hallmark of US employment gains. In fact, total hours worked remain below the last two pre-recession high points. It is then of no surprise that gains in salary and wages are hewing to the 2% line, an increase that barely keeps pace with inflation.

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Inflation, however, is one area where early-year increases seem to be moderating to the benefit of the economy. Oil prices have retreated even in the face of shooting wars in both Ukraine and the Middle East. Lower gasoline prices equal more spendable income for most Americans. This speaks to one of the most positive economic stories in recent US history — the boom in domestic oil and gas production resulting from fracking technology. The weather, which was a real drag in the first quarter, appears to be in payback mode throughout America's agricultural sector. Record grain crops are on the horizon, orange juice is near all-time lows, and with multi-year lows in sugar prices, it will cost less for Americans to satisfy our collective sweet tooth. The rising price pressures observed earlier in the year have recently moderated, bringing all the headline and core inflation indices to 2% or below.

Perhaps a "good news-bad news" reason for the improved inflation performance *(continued on page 2)*

Recent Economic Events (continued)

is the slowdown in the global economy. Eurozone GDP showed no growth in the second quarter, and its main engine of growth, Germany, actually went negative. It appears that the wheels are once again coming off the Eurobus. Prices are dangerously close to a deflationary spiral; sanctions against Russia are hurting both sides; and the noxious effects of double-digit unemployment have not gone away. China is also showing weakness. Property prices are retreating all across the country, partially as a result of the anti-corruption drive by President Xi and partially because of rampant speculation come a cropper. The decline in real estate prices had, and will have, a chilling impact on overall growth and on non-performing loans in the Chinese banking system.

And American housing seems poised to repeat some sins of the recent past. While housing sales have come off their lows, they are lower than they were a year ago in both new and existing home arenas. Trouble is, housing starts are well ahead of a year ago. The result: a build-up of unsold inventory. Parallels with 2006 are not quite perfect, but the combination of rising housing prices, slowing sales, and full-speed ahead building is a bit scary.

It appears that the US economy has bounced back nicely from the lousy first quarter, but only back to what many (FOMC, CBO, CEA) believe is the new growth speed limit of 2% to 2.5%. With positives and negatives roughly balanced, neither a strong acceleration nor a recession is likely in the near future.

Commentary

Where have all the deficit scolds gone? You know, those folks who had us all speaking Greek as the government's debt turned us into a third-world economy with rampant inflation.

Well, their voices have quieted as the Federal Deficit has fallen from over $1 trillion to about $500 billion (still a lot of money). However, from a shortfall that was nearly 10% of GDP in 2009, this year's estimate is below 3%.

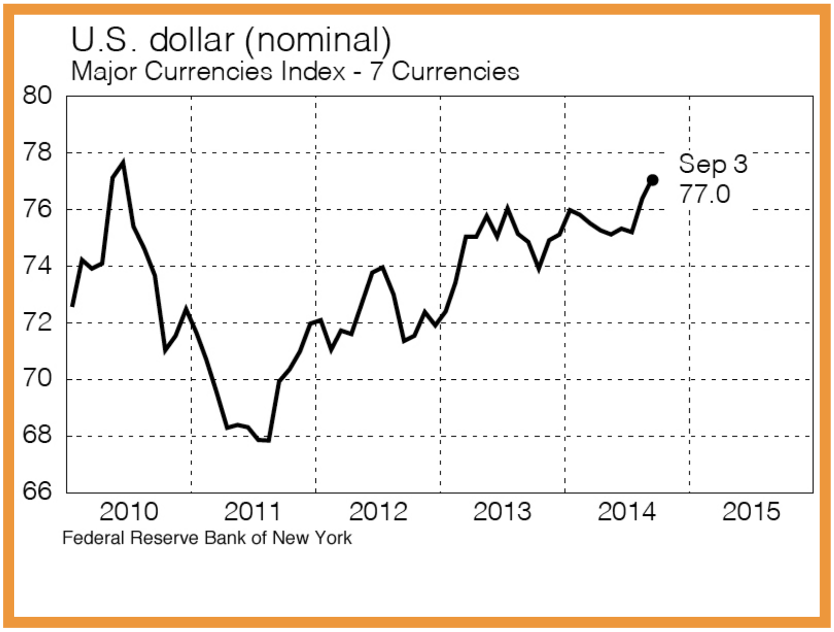
The improvement in Washington's finances has occurred because spending has leveled out while revenues have continued to grow. Furthermore, future projections suggest that the dire warnings regarding health care spending are not coming true. Expected Medicare costs per beneficiary in 2019 have fallen from over $13,500 to less than $11,500 between the 2009 and current year projections. And to support the validity of the projections, actual costs have fallen from over $11,500 in 2009 to a little over $11,000 this year. This is really good news, as the fact that Baby Boomers are aging past 65 at a pace of about 10,000 a day will inevitably increase the Medicare rolls.

So if the worrywarts are no longer fixated on the deficit, what have they shifted to? They now rail against the Federal Reserve. The contention is that the Fed is printing an ungodly amount of money which will cause hyperinflation and a corresponding jump in gold to $2,000, $5,000 or even $20,000 per ounce. Just like the hysteria over the Federal budget, the real deficit appears to be in the analysis ability of the Chicken Littles. Anyone who believes that the Federal Reserve is anything but a wholly-owned subsidiary of the Federal Government is simply not paying attention.

Let's try a thought experiment. What if, instead of issuing its traditional debt at various maturities, the Treasury had recourse to variable-rate debt? How would this be any different from the Fed buying Treasury debt and crediting bank accounts at the Fed with deposits on which they pay a variable rate? The idea that the deposits at the Fed are spendable money as *(continued on page 3)*

Commentary (continued)

opposed to simply another claim on government is false. In fact, the money supply has grown at an average of only 6% annually even in the face of a ballooning Fed balance sheet.



However, let's further assume that I am dead wrong on my analysis of the Fed's actions. Why hasn't the market deserted financial assets? Not only is inflation benign and falling, but the dollar is strong and rising. Can it be that the investors who move billions and billions of dollars around in global markets on a daily basis are deluded, and the gold bugs are the only folks seeing clearly? I don't think so. The multi-year advance in the dollar as the Federal Reserve has been boosting its balance sheet is proof to me that, once again, Armageddon has been delayed.

I have little doubt that the Puritan streak in our pundit class will reassert itself, warning about some other perceived threat to our economic health. Beware the psychological need behind these warnings and the normal human tendency to put more weight in intimations of impending doom than in reports of good news. After all, if no news is good news, then the media needs bad news to capture web traffic. How else to explain the ongoing popularity of wrong-way forecasters?

Market View

Everyone who would rather lend 10-year money to the French at 1.25% or the Spaniards at 2% instead of the good ole USA at 2.45% raise your hand. As I thought.

I have been trying to figure out whether current rates are (as Goldilocks would say) too low, too high, or just right.

The too low argument is based on the idea that the average 10-year rate over time is equal to inflation plus 2% (or about 4% today) or the annual growth in nominal GDP less about .75% (3.50% today). The too high argument includes the global comparison above, along with other relative value assessments. For example, the spread between the 10-year and the 2-year Treasury is typically 1% to 1.25%. This implies a 10-year rate of about 1.75%. The level of the 10-year rate at a point nine months before the Fed begins to tighten (expected mid-year 2015) is typically 1.5% over the starting Fed Funds rate (1.75% again). The problem with averages is, of course, that you can drown in a pond with an average depth of two feet.

I believe that the right answer is that US rates are roughly right with a downward bias as geopolitical turmoil and real slowdowns in Europe and Japan, along with possible weakness in China, weigh on the markets. Don't get greedy, however; limit maturities to seven years taxable and ten tax-exempt. If we see rates fall another 50 basis points, lighten positions.

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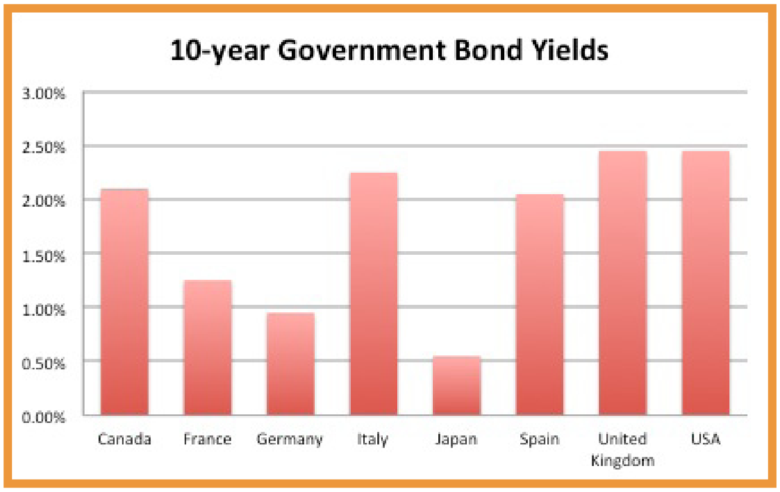
Market View (continued)

If interest rates are about right, and the expected Fed tightening is consistent with term rates, we will see the funds rate top out in the low 2% area. This suggests that stocks are not overly expensive as the competition from fixed income is decidedly weak. I continue to expect a correction but not a full-blown bear market. Perhaps the fact that others are in my camp is why no correction has occurred.



Commodities have clearly weakened recently even in the face of events that boosted them in the past. Both gold and oil are lower today than they were when the Russians began to pressure Ukraine or when the Islamic State began its military push. More understandable is the decline in agricultural prices and weaker natural gas as a result of ideal weather. My read on commodities is that weaker global demand is the underlying force.

Real estate also seems to have slowed its advance. The rebound from the free fall of 2006 to 2012 is behind us and prices are more in line with affordability today. Over time, residential real estate only keeps up with inflation once we adjust for taxes, repairs and carrying costs. There are no longer screaming bargains.

The bottom line is that all investment options are poor. The excess of investment dollars seeking returns is the driving force today and about the best we can hope for is modest forward returns. Investing is a relative and not an absolute game. Dogma on rates, values, etc. seldom produces steady returns. Flexibility and understanding value in context is the key.

Editor's Note

Hi, my name is Michael, and I am an addict. (Hello Michael!) Here is my story. I have been high for the last month and expect to stay in a state of ecstasy for another one at least. I know that I am not alone and hope to get input on how others prepare their fix. Do you cut your tomatoes across the grain to reveal the lattice-work of seeds or north/south to avoid the top slice with a hole? Is a sprinkle of salt enough to bring out the flavor or do you add some herbs and extra virgin olive oil? What about the companion drug: sweet corn? Here the options fan out more significantly. Do you peel, shuck, or husk the ears? Once you are ready to eat, do you roll the ear in the butter or use a knife? Then, when you actually dig in, do you always eat from one end and return like a typewriter carriage when you finish a row or go back and forth like a windshield wiper? Will anyone admit to eating around in a circle? Finally, when you are done, is the part left over an empty or a cob? Without answers, I am afraid I and many others will continue to suffer with late summer culinary disorder. Don't ignore this plea for help.

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