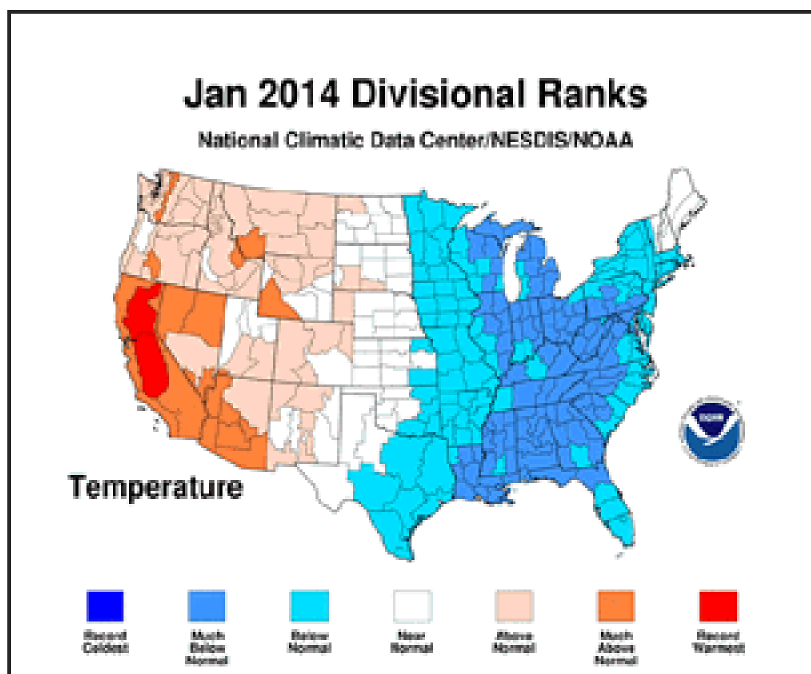
Jamesson Associates

03.2014 Newsletter

Recent Economic Events

Brrrr it's cold outside, and many are saying the economic statistics were chilled as a result. It would be hard to argue against some impact from the frigid weather, but the United States is a big country and while the Eastern half of the country definitely experienced bitter cold, those west of the Mississippi were sweltering. The average January temperature in the lower 48 was just a bit below average (including balmy Alaska would bring it in above average).

Employment in February bounced back from dismal numbers in December and January, but with little oomph. In late 2013, the economy had seemed to be breaking out of its slow growth path, but upon revision, it was still near stall speed. That's especially the case given the pop in inventories we saw late last year. Booming domestic oil and gas production helped drive down the trade deficit, but a weaker world economy promises to limit the gains. Finally, the Federal Budget deficit continues to shrink, making it much easier for the Fed to scale back its purchase of Treasury debt.



The American economy generated 175,000 jobs in February, up from the weak revised figures of 84,000 and 129,000 in December and January, respectively. This is still not what we need to gain traction in the labor market, remembering that we were averaging about 200,000 jobs per month for the year or so before December. The unemployment rate actually ticked up to 6.7% while the average workweek declined by .1 hour. All in all, a better report than the previous two, but still weak.

GDP was initially estimated at a decent 3.2% growth in the fourth quarter, driven by consumer spending and net exports. Alas, the first revision sliced away about one-quarter of the advance, mostly from consumer purchases. The resulting 2.4% growth remains in the stumble-along range we have seen since the recovery began in mid-2009. Furthermore, a good portion of the GDP growth during the second half of 2013 was due to inventory builds. Reversal is at hand as durable goods orders fell 5.3% in December and an additional 1% in January. While much of the decline was due to lumpy orders for transportation equipment, even excluding that portion of the total, orders are up a scant 1.2% from a year ago. Not much to build an accelerating economy on.

The US trade deficit fell to the mid-$30 billion range in November but returned to $39.1 billion in January. The good news is that ongoing gains in domestic energy production allowed oil imports to fall to multi-decade lows. We now produce more than 50% of our oil needs, a real turnaround from a handful of years ago. The bad news: developing countries' growth is slowing, so future export gains will be tougher.

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RECENT ECONOMIC EVENTS (CONT.)

Speaking of deficits, the Federal Budget deficit continues to shrink on the basis of increased revenues and decreased expenditures. For the first five months of the fiscal year (October through February), the deficit shrank by $115 billion from last year, with revenues up by $94 billion and outlays down by $21 billion. Who says Washington is dysfunctional? More seriously, while the Federal Reserve is tapering purchases of Treasury bonds by $10 billion per month so far in 2014, the deficit is declining over $20 billion per month.

The economy continues to grow, albeit at a slower than ideal pace. Employment recovered from truly dismal reports in early winter, but we need more to say we are home free. As we wait for warmer weather this Spring, we can take some solace in knowing that our twin deficits (trade and Federal) are shrinking, allowing the Federal Reserve to reduce its extraordinary support of the bond market.

COMMENTARY

America's business mantra: "Please serve yourself." And, honestly, we consumers have taken it to heart as well. We feel more in control of the process when we do it ourselves.

If you are as old as I am, you remember a gas station attendant pumping your gas and cleaning the windshield — oil check optional. When you picked up the telephone, someone said, "number please." You recall the days when the airline clerk checked you in. If you are really an old-timer and from a rural area, you can remember being served at a grocery store counter, not just by the butcher, but for dry goods too.

Now, except for New Jersey, you pay for and pump your own gas with no other human in between. Try getting an operator on a phone call and you will probably run into a voice recognition system instead. On my recent airplane trip, I scanned in my own passport. At the grocery store, you not only fill your own cart, you can bag and check out by yourself.

Why this trip down memory lane? I am following up on my concerns about the future of jobs in an increasingly technological economy. If we serve ourselves, where will the former servers work? Will the new jobs that are created allow for enough skill (and hence pay) to support a middle-class standard of living?

"Please serve yourself."

Much of the advice to the unemployed, whether they were previously in the labor force or soon to enter it, is to improve skills, get more education. However, I wonder if this path is as fruitful as it has been in the past. Is a college education the ticket to a better standard of living or just a way to end up with plenty of debt and a job that didn't require the education received?

As I peer into my crystal ball, I see those jobs that can be done self-serve as highly replaceable. Think secretary or mid-level manager, even college professors once online courses proliferate. Casual food restaurants are now installing iPads at tables to replace waitpersons taking orders. A much less costly (and non-tipped) server delivers the food.

The path to ongoing relevance in an increasingly technological world will be using technology to deliver something folks can't do for themselves. Any creative endeavor fits, whether it is entertainment, fine arts or unique crafts. I don't see plumbers, electricians, or repairmen being automated — plus technology can enhance their productivity. Finally, jobs that require direct human interaction (social workers, counselors, high-end salespeople) will always have a place and are likely to see increased compensation because not everyone can be empathetic.

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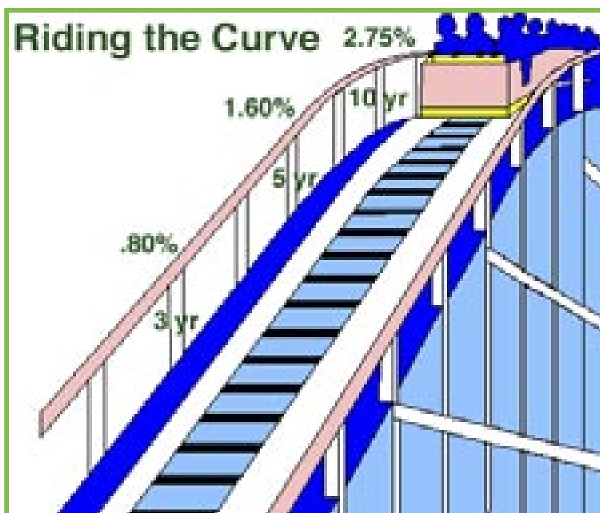
Commentary (cont.)

If I am even half right about the evolution of jobs, a great number of current ones will disappear. That requires us as a society to figure out what the folks displaced by technology will do. The significant decline in labor force participation is but one manifestation of what I see coming. I don't believe this is a temporary or tactical issue, I think it is a fundamental challenge for our current worldview of work and worth.

Market View

Investment markets react to a combination of emotion and fundamentals. In the short run, the former predominates, while over the long haul, fundamentals wll out. I have been reviewing market analysis that points out some time-proven facts and have also done some analysis on my own. A key constant involves mean reversion: the idea that values eventually return to long-term averages even if they diverge for extended periods of time.



In the stock market, we need to consider ratios of prices to some other factor that implies value, such as Price/Earnings ratios, dividend yields, etc. The current PE Ratio of the S & P 500 is close to 20 times versus a long-term average of about 15.5. This implies an over-valuation of about 30%. However, while I expect that the ratio will revert to the average sometime in the next few years, it could very well be that earnings grow faster than expected, rather than prices fall. Even so, the literature on this is quite clear. At the elevated level of 20 times, forward returns in the stock market will be no better than the low single digits over the next 5-10 years.

Looking at bond rates, you might conclude that an annualized return of, say, 3% to 5% is not bad. Let's look at history. I have run an analysis of five-year Treasury rates over the last forty-plus years. What I found was that the best predictor of where the five-year Treasury rate would be one year down the road is where is it today. Here's the skinny: the prediction is unbiased, a little low when rates are low, and a little high when they are high. Guess what? That means that the rates revert to a long-term mean, and the net result is that there is a predictable profit in riding a positive sloping yield curve.

Commodity prices also revert to the mean. Over the long haul, commodity prices cross the marginal cost of production. If prices get ahead of themselves, new production is planned and brought on line. This takes time, so elevated prices can last a while. However, when the new production comes on stream, it becomes costly to shut it down. This helps to explain the exaggerated cycles we see in commodities. Over time, technology finds ways to improve the productivity of securing commodities or, alternatively, finds substitutes. The long history of commodity prices is a general downward path once adjusted for overall inflation trends.

Remembering that markets can diverge from fundamentals for an indeterminate time, what does all this imply for the current state of affairs? One could make the case that all the markets are ahead of themselves as a result of the extra liquidity being pumped into the system by central banks around the (continued on page 4)

Market View (Cont.)

world. I believe that to be the case, but you need to put money someplace.

In my opinion, the stock market is quite exposed on valuation. Overall sales growth is slow and most companies have squeezed about all they can from cost cutting. With global markets also facing headwinds, I find it hard to argue that the current PE Ratio is justified. If you can find good companies cheaper than the averages that pay a decent dividend while you are waiting, go ahead and buy. If not, I think there will be better opportunities after a correction.

Fixed income also offers little to recommend itself except for the fact that the yield curve is quite steep. Buying a bond which works its way down the yield curve from say five years to three years offers excellent potential price appreciation along with a decent coupon. If you can use tax-exempt income, municipal securities in the seven-year range have value as well.

I believe commodities are priced above their marginal cost of production and would stay away at present. While the Ukrainian crisis has temporarily boosted prices, the more fundamental story is the Chinese slowdown.

Editor's Note

If you ever play word association and they say, "Vietnam", the answer is "motor scooters." More on that below. So far, 2014 has found me playing vagabond. In early January, we left Western New York blown south by the polar vortex. No temperatures above 32° until we crossed Lake Ponchartrain on the approach to New Orleans. Our return in late January was one step ahead of debilitating ice, snow, and cold throughout the Old Confederacy. Figuring that things would be better in Asia, we flew from New York to Japan, stopping for a few days on our journey to Vietnam. Our first full day brought the heaviest snow in Tokyo in 45 years. I don't know about you, but I am detecting a pattern. Since we were traveling to Vietnam for my son's wedding, we couldn't turn around, but we were concerned that our arrival could decimate the tropical flora in Saigon (now Ho Chi Minh City). Fortunately, it was plenty warm (mid-90°). I am convinced that the combination of the engine heat from the millions of scooters and the cacophony of horns honking are what kept Old Man Winter at bay.

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