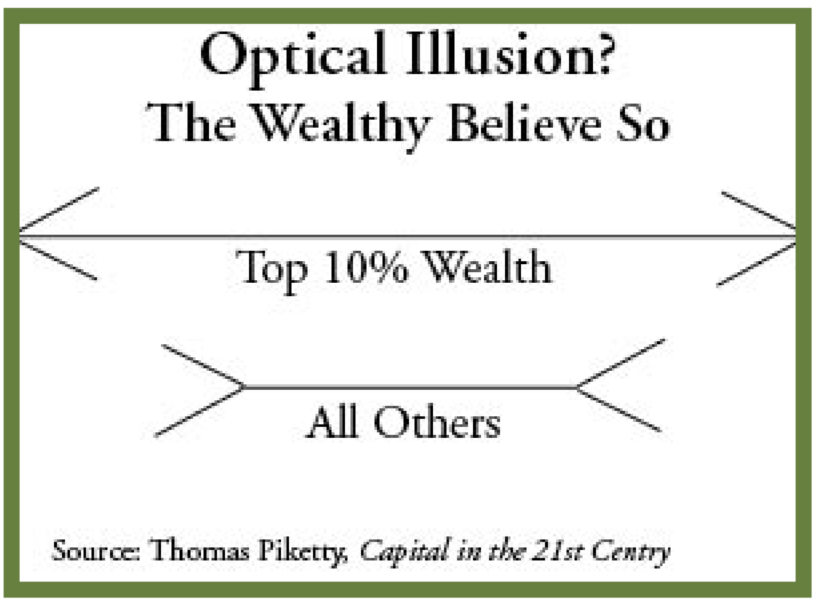
# Jamesson Associates

06.2014 NEWSLETTER

## RECENT ECONOMIC EVENTS

The American economy took a step back in the first quarter, only partially due to the weather. Although some of the weakness was payback from previous periods, some is of greater concern. The steady, if uninspiring, pace of employment gains has not been matched by a proportional gain in wages. Financial markets have liked the developments (perhaps more than they should), but the ongoing disparity between Wall Street and the everyday economy has raised issues regarding income and wealth inequality.




Contrary to the positive expectations of economists for modest growth in the first quarter, GDP fell at a 1.0% rate. There was plenty of weakness to explain the decline. Net exports plunged as the global economy's appetite for American goods waned. Both business and personal investment fell, the latter as the housing market hit a wall based on increased prices, higher mortgage rates, and the dearth of first-time homebuyers, who are finding new mortgage rules challenging. The only thing keeping the economy from an even heftier decline was personal spending on services. Turns out medical care expenditures (Obamacare premiums for the previously-uninsured) and utility payments thanks to the weather were up big-time. Overall, some weakness in car sales and housing could be weather-related, but the other items suggest more widespread issues.

Job gains over each of the most recent four months (February through May) topped 200,000. This had not occurred since early this century. In addition, the unemployment rate fell to 6.3%, and total jobs in the American economy exceeded the pre-recession high for the first time. Normally, all of this would be cause for celebration. However, when we look deeper, we find troubling data. The decline in the jobless rate is almost entirely due to reduced labor force participation as both demographics and lousy job prospects have chased many out of the labor market. Jobs are up strongly and in total at the highest level ever, but the quality of those jobs is a question mark. During the recession almost five million middle-income jobs were lost, but the recovery added back only about half this amount. The offset: close to five million low-wage jobs against their recessionary decline of nearly three million. Yes, high-wage jobs have grown by a few hundred thousand over the time period, but this simply highlights this spring's cause celebre´, rising inequality.

The theme of inequality was raised by French economist, Thomas Piketty, in his bestselling book, *Capital in the 21st Century*. His key point is that capitalist economies tend to concentrate wealth because the returns on capital exceed the growth of the

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## RECENT ECONOMIC EVENTS (CONT.)

economy. Because growth ultimately determines the share of income that goes to labor, over time capital will get a larger share of the pie. The facts pretty strongly support the historical analysis, although the future may not look the same. Presently, new highs in the stock market fueled by low interest rates, benign inflation, and monetary authorities bent on keeping the game going, all reinforce inequality. This dynamic helps to explain why the record levels of wealth in America are not leading to widespread economic growth or to increases in consumer confidence.

## COMMENTARY

Let's review the history of "Everybody Knows."

Everybody knows
that Dewey beat Truman.

Everybody knows
that Joe Namath had no chance against the Colts in Super Bowl III.

Everybody knows
that Saddam Hussein had weapons of mass destruction.

Everybody knows
that because of the Fed taper, rates will rise in 2014.

Since year-end, we have seen a decline in ten-year US Treasury rates from 3.0% to 2.8% to 2.6%. They then appeared to settle into a range. However, just as everyone concluded rates were range-bound, they fell even further to 2.4%. At this point, reasonable people might have concluded that rates had moved to a new lower range. Not true. No sooner had we hit the low at 2.4%, than the market turned around and headed back up to the 2.6%-plus level.

These, therefore, are the confessions of an interest rate agnostic.

Always believing I had no more than a 50/50 chance of getting the stock market right, I had faith that I could discern the direction of rates, not over the short-term (a few weeks), but over the course of a few quarters. No longer. I am giving up and assuming that wherever rates are today is the best estimate of where they will be in a year.

Being freed from the dogma of tying interest rates to activity in the economy, the phases of the moon, or actions by the Federal Reserve is liberating. However, sometimes those with no set *(continued on page 3)*

## COMMENTARY (CONT.)

religion find themselves aimlessly bouncing from pew to pew. I concluded that I should have some facts to support my revelation.

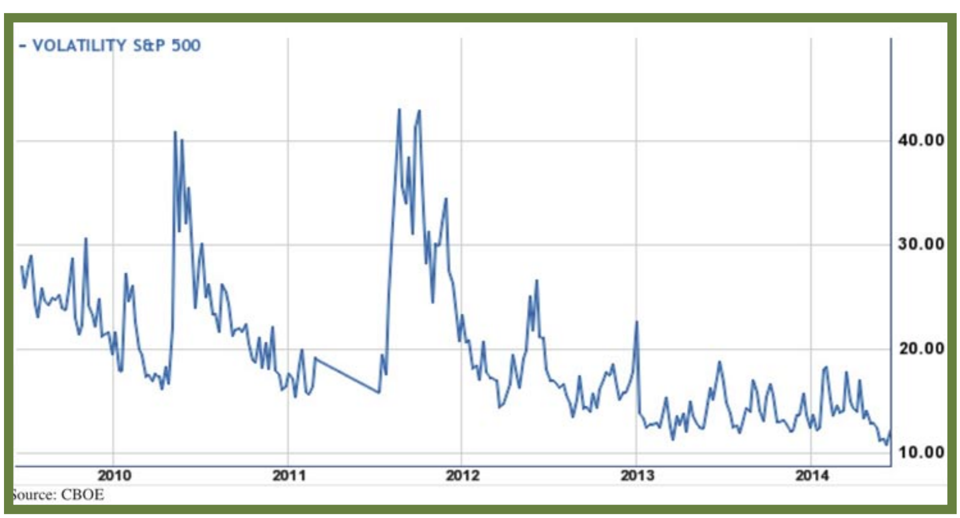
I went back as far as I could with Federal Reserve interest rate data and compared the ten-year Treasury rate in each March from 1955 to 2014 (any month would have sufficed). I found that there were 32 years where rates were higher and 27 where they were lower. The average change in rates was about 13%. For the last twenty years, the average change was 16% with 9 up years and 11 down ones. In today's environment that means around 35-40 basis points. For all intents and purposes, that is close to stability.

However, even an agnostic sometimes asks, "Why?" Here's my take. Bond markets, as opposed to stock or commodities markets, have a destination value: the par value at maturity date. This creates an anchor of value at a future date. In any transaction, whether it be between issuer and buyer or between buyers and sellers in the secondary market, those who want to put money to work and those borrowing need to agree on a price. This price clears the market and since the buyer/lender believes she is getting value and the seller/borrower feels he can't get the money any cheaper, there are equal forces to push rates up and down. With billions, if not trillions (or as Dr. Evil might say, millions), of dollars trading fixed income everyday, a rough equilibrium obtains.

Keep in mind that when everybody knows that interest rates have settled into equilibrium and that they will show rough stability over a twelve-month timeframe, it will be time to get that old-time religion once again.

## MARKET VIEW

Bull markets are appearing everywhere, but the one that may be most important is the one in complacency. As measured by the VIX, implied (read: expected) volatility is well below average. The reading is near 11% versus an average of 18% and a high level of near 80% during the panic of 2008. It seems that the market is taking the Federal Reserve at its word, expecting no surprises over the next year or so.




There are a number of warning signs when the expected course of markets is as calm as it appears to be now. First, everything that depends on the level of volatility for its price or spread tends to narrow. If everything is going to be as it is, lower-quality credits are just as good as higher-quality, and investments with options included, such as MBS, tend to trade with a more stable profile and less of a spread to comparable Treasury securities. Second, *(continued on page 4)*

## MARKET VIEW (CONT.)

as the spread contracts, the smart guys (those with powerful computer algorithms) decide that they can take advantage. This encourages leverage to boost returns up to an acceptable level.

We can all see that these trends will increase risk as they pump up the market and decrease forward returns. However, we all believe we can jump out of the car just before it goes over the cliff. More formally, this is known as a "Minsky moment," for Hyman Minsky's idea that stability itself ultimately creates instability through the mechanism of increased leverage. Those who don't jump soon enough experience the dreaded "up by the staircase, down by the elevator shaft" with their portfolios.

The steady march of the stock market (SP 500) with no correction in excess of 10% since the bull market began in 2009 certainly qualifies as eerie calm. For those of you wise enough to not have taken my advice on the stock market over the last year or so, I believe it is time to cash in some chips. Possible geopolitical wild cards include Ukraine, Iraq, and the South China Sea. With this ferment, low volatility should not be trusted.

High-quality fixed income investments in the 3-5 year range seem to be a good risk/reward destination for any funds freed up from stock sales or for new money. Cash returns are atrocious, but their downside is only 1% to 2% (inflation erosion) versus a potential 15% to 20% stock market correction.

Because I believe that stocks are not necessarily overpriced based on earnings and future prospects, I am not in the doomsday camp. We are not likely to see a bear market decline of 30% or more because fundamentals are still reasonable. This means that if we get a correction, steeling yourself up to buy will be the winning strategy.

## EDITOR'S NOTE

*I am in one of those transition-in-life stages that families go through. No fewer than three households in my immediate family are in the process of moving. Moving is not fun. I know this first hand because Susan and I rented a cargo van to move different pieces of furniture to our winter home in New Orleans. First of all, we needed help from a friend to load a very heavy coffee table (oof). Next we became experts in bungee cord feng shui. Once loaded and sitting in the cargo van driver's seat, I observed a unique point of view — shorter in the front, longer and half blind in the back with a turning radius quite a bit larger than any other vehicle I have ever driven (and I did take an AMC Pacer for a test drive). My appreciation for teamsters who drive large semis (especially the doubles) grew mile by mile as we headed south. The concentration necessary to keep a larger vehicle on the road at 70 mph completely outruns that for a normal passenger car. Despite being someone who drives hours on end to visit clients without concern, I was worn out after 90 minutes. I cannot imagine trying to parallel park the monster. Bottom line: United Van Lines has nothing to worry about.*

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