JAMESSON ASSOCIATES

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QUARTERLY NEWSLETTER

Recent Economic Events

Job numbers continue to impress, but wages struggle to keep up. Plunging gasoline prices are holding overall inflation in check, boosting auto sales. Other retail sales are less impressive. Although GDP remains in positive territory, it is now being driven almost entirely by domestic consumption as businesses cut back. These developments have not gone unnoticed by the markets. Credit stress is evident in bond and loan spreads. Housing, which was in a nice uptrend earlier this year, seems to have hit a plateau, suggesting pent-up demand has been met. Without a new catalyst for growth, the future may bear an uncomfortable similarity to the recent past. Nevertheless, the Federal Reserve appears to be determined to raise rates.

After a lethargic August and September, jobs numbers improved nicely. A super report in October (298,000 jobs created) was followed by a solid November (211,000). The unemployment rate has fallen to a post-recession low of 5.0%. Wage gains have picked up and now are running at a 2.3% annual rate. That is hardly enough to get folks dancing in the street, but it easily exceeds price gains as measured by the CPI. The headline rate is up only 0.2% from last year while core rates excluding food and energy are up 1.9%, I don't know many folks who don't eat, and climate change is unlikely to fully eliminate the need for heat this winter.

Check the newspaper inserts, and you will detect a note of desperation on the part of retailers

Consumers have responded to the lowest gasoline prices in years by ramping up their new car purchases. Annualized auto sales in September, October, and November registered over 18 million. Never before had they done so. Full-year 2015 sales are likely to hit an all time record. Would that other retail sales were keeping up! Total sales are ahead a much more subdued 1.4% from a year ago. Plus, it appears the hype around Black Friday is wearing off, as those sales were down over 10% from a year ago. Check the newspaper inserts, and you will detect a note of desperation on the part of retailers.

But, if not for personal consumption, GDP would be hardly growing at all. During the third quarter, consumption was up 2.1%, exactly matching the GDP figure. The remaining components cancelled each other out. Foreign trade was down about what government was up, and investment (including both residential and business) was flat, dragged down by inventory liquidation. Those inventories are still too high, so it appears that the US economy depends even more on everyday spending by Mr. and Ms. Public.

Few wish to admit the obvious slowing and increasing dependence on this single source of strength in the economy. However, credit markets have noticed. Spreads on lower quality bonds and leveraged loans have jumped higher — from 100 bp to 700 bp depending on industry. The knock-on effect of this increase in funding costs will be an even bigger challenge to business investment.

Weak housing is both a surprise and a disappointment. In the late summer, it appeared that both existing and new home sales were finally gaining positive momentum. Unfortunately, that momentum has stalled. Note that this has occurred even in the face of low and declining mortgage rates. Remember the multiplier effect of housing sales, especially new ones. New homes need appliances, furniture, window treatments, etc.

The American economy is growing, although not as strongly as earlier in the year. High inventory levels promise to hold back new production even if slow

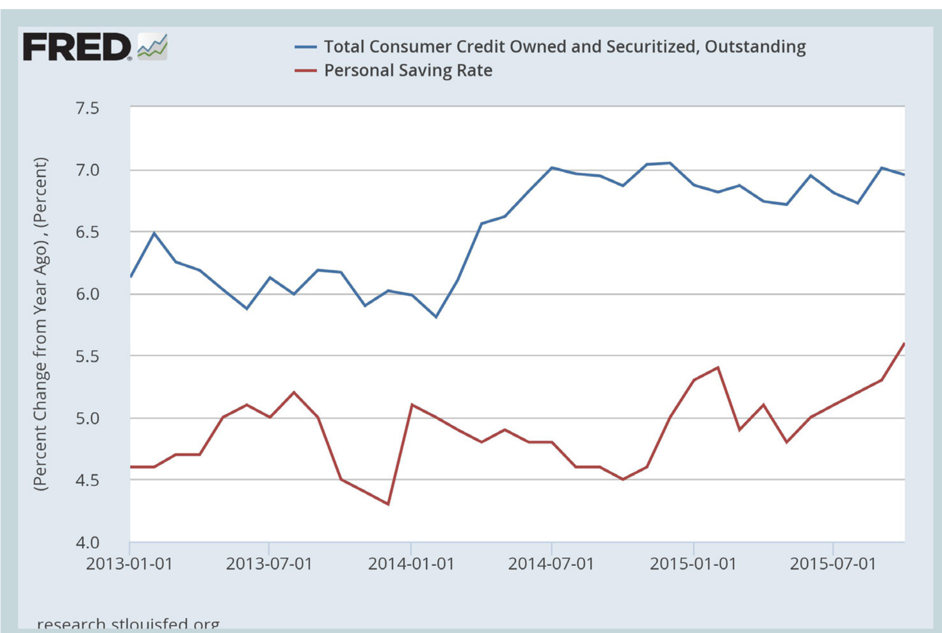
Recent Economic Events *(continued)*

initial holiday sales prove to have been poor predictors. Furthermore, businesses are simply not investing in new plant and equipment, either because they don't see sufficient demand or because increased funding costs have made it uneconomic. I am afraid we could easily see declines in total investment in 2016.

With this as background, the Federal Reserve is planning to increase interest rates at their December meeting. It appears that politics and previous statements carry more weight than does data dependency. In any event, the real issue for the Fed is not the first move, but rather what comes next. If the economy takes the increase in stride and appears to be making progress towards stronger wage gains along with ongoing job creation, the Fed will be able to continue to bump rates up. The fear is that they will have tightened too soon and will be forced to reverse course if even 25 bp proves too much.

Commentary

Let's look at the logic of debt. It is obvious that there must be a balance between dollars lent and those borrowed. An explosion of bonds or loans cannot occur if no one is willing to buy them. Parallel to the increase in debt leverage in the economy is the increase in savings. But it should be noted that the folks lending are not the same ones who are borrowing.



A study just released by the Pew Research Center reported that middle-class households in the US totaled 120.8 million while the combination of lower and upper-income households registered 121.3 million. It's the first time in the study's history (since 1971) that the middle-class total has fallen below 50%. This rather dispiriting fact may help to explain a paradox in some recent economic statistics. The savings rate of Americans has been ticking upward in the last year or two, rising from around 4.5% in late 2013 to about 5.6% according to the most recent figures. However, at the same time, consumer borrowing has been increasing, especially in the auto loan arena.

I believe that these trends are the direct result of growing inequality in wealth and income in this country. More affluent Americans have satisfied their pent-up demand from the recession and are now devoting an increasing share of income to savings. They may be concerned about the increased market volatility or geopolitical events, and there is probably a demographic component as well: Baby Boomers are aging into retirement. At the same time, the ongoing weakness in wage growth, especially at the lower end of the income scale, has sent borrowers back into the market. This demand, coupled with lender memory loss, has resulted in an increased percentage of sub-prime auto loans. And by the way, do you know anyone

Commentary *(continued)*

who is being targeted by those ads about buying a car as a Christmas present? A Hess truck is the best most of us can swing.

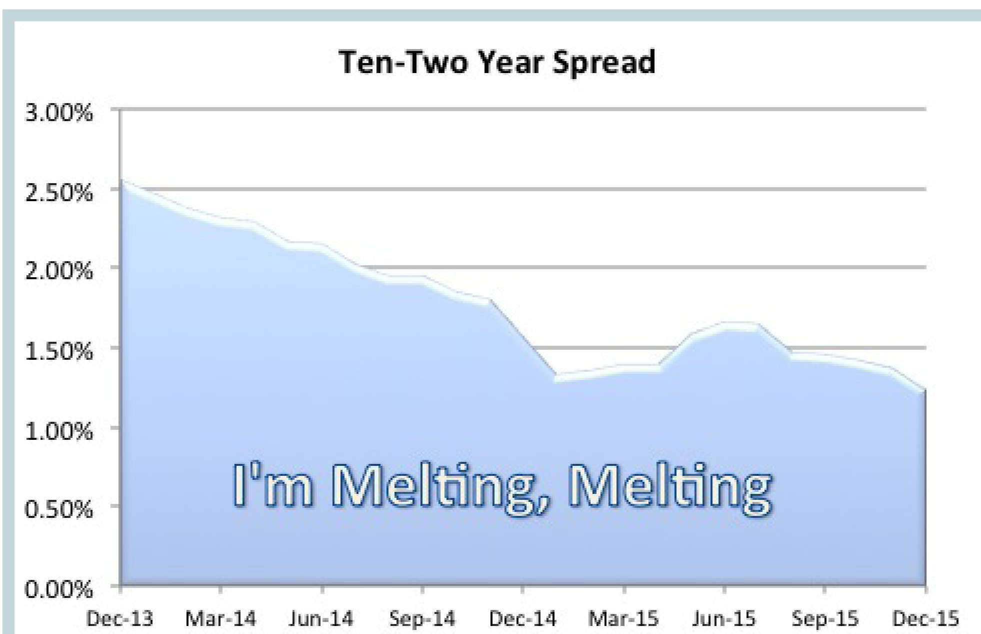
Those who can are saving; those who can't are borrowing.

There is another troubling aspect to income inequality that has been documented by newly-announced Nobel Prize winning economist Angus Deaton and his research partner Ann Case. They found that mortality rates among white Americans aged 45-54 have increased from about 400 to 425 per 100,000 from 1990 to 2013. Not bad you say, but consider that for US Hispanics the rate has fallen from 375 to 275 over that period and for the French and Germans from about 450 to 325. Improved medical care and reduced smoking has created a secular decline in mortality for most demographic groups in the developed world with the exception of middle-age whites in America. Furthermore, the study found that the increase was driven by those with a high school degree or less. These are exactly the folks most impacted by the hollowing out of the middle-class discussed above. If you graduated college, your mortality rate fell, although not quite as dramatically as it did in Europe.

Both Democrats and Republicans running in the Presidential primaries have raised the issue of income and wealth inequality, although it has been overshadowed recently by terrorism. In fact, all candidates with national support over 25% (Clinton, Trump, and Sanders) are in favor of taxing hedge fund carried interest at ordinary income tax rates. With hard facts that the middle class is shrinking, savings rates rising even as borrowing is picking up, and increased mortality for those who had been the backbone of the manufacturing workforce, the political system will not be able to ignore inequality much longer.

Market View

Over the past two years, two-year Treasury yields have increased by roughly 60 bp, equaling the decline in ten-year Treasury yields. Consequently, the spread between the two has melted from about 2.5% to half that level. It is destined to go further. Federal Reserve tightening cycles are generally characterized by short rates rising by more than long rates, just as easing cycles pull short rates down by more than long rates. Part of this is due to the greater stability of long rates, which take into account an entire economic cycle, and part is due to market foreshadowing.



Market View *(continued)*

This time around, the expected has not happened. Instead of increasing in anticipation of a tightening, long rates declined. When what is normally expected to happen doesn't, it's time to rethink investment assumptions.

Two ideas. One, the Fed is simply making a mistake and will have to reverse course well before they achieve their targeted neutral rate. Two, the forces of deflation are enough to offset the Fed's actions.

In good lawyerly fashion, I can make the case for both. First of all, all of the developed country central banks that have embarked on a tightening cycle since the Great Recession have had to reverse course as they found that even small increases in rates were deadly for their over-indebted economies to handle. Why should the US be any different? In fact, remember the stealth tightening that occurred in 2013 when mortgage rates rose up from 3.5% to 4.25%. Even though the latter rate was still a bargain, the housing market went into reverse.

Point two: deflation has taken over from inflation as the economic problem of the day. OEPC is kaput; few industries have escaped improved technology and globalization; S & P 500 revenues have been down for three quarters in a row. This isn't a prescription for a booming economy that can overcome an ill-advised tightening.

What should one do with investment dollars in this environment?

Commodities are in free-fall, and it is always dangerous to try to catch a falling knife. Stay away until some stability returns. (And this means you gold bugs as well.) If you really can't help yourself, buy a top quality company with little debt; they will probably be able to pick up the broken pieces of the industry at some point.

Non-commodity equities represent risk but may be the best game in town. Choose stocks with well-covered dividends that can mitigate what is likely to be a span of years with modest appreciation opportunities.

Fixed-income offers, what I believe is, the best risk/reward. Municipal securities out to ten years work best if you are paying taxes in a top tax bracket. The credit cycle is on the downside, so I would lean towards Treasuries and would target intermediate tenors such as 3-5 years. That offers the best trade-off of yield and risk.

Editor's Note

Earlier this year, I was laid low by a sharp pain in my left side. I figured I twisted something, and it would go away soon. It didn't. The only good thing about it was that it covered up the dull pain on my right side that has been there a few years. Eventually, I broke down and visited a doctor who diagnosed the issue as sciatica. He basically told me it would go away by itself. It did, but my right side pain returned. Susan convinced me to visit her chiropractor. Best move I have made in quite a while. She prescribed certain muscle strengthening exercises which helped, but the critical advice she administered was far more prosaic — take that huge wallet out of your back pocket and lose weight. As Susan pointed out, she has been telling me this for years. (Are all husbands this thick-headed or only me?) Nevertheless, the doctor contended that one pound lost from my belly takes 10 pounds off my back. So far I am down 100 pounds of back stress. How did I do it? Tomatoes! My lunch menu now frequently consists of a tomato salad rather than something more substantial. It's harder to do now with winter tomatoes but not impossible. This simple change has helped to shrink my stomach, and I find that I just can't eat as much as I did before.

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