JAMESSON ASSOCIATES

FALL 2016

QUARTERLY NEWSLETTER

Recent Economic Events

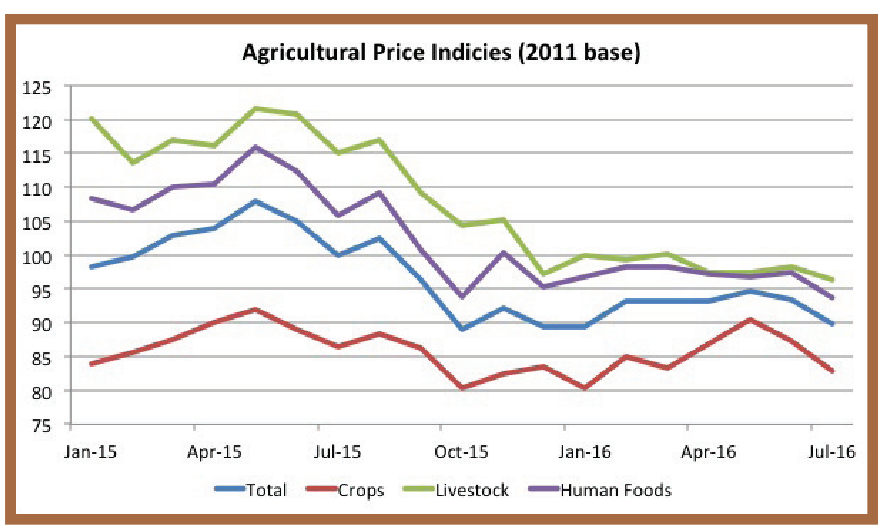
It would be an understatement to say that the economy is not cooperating with the Federal Reserve's preferred narrative. GDP has slowed considerably since the rate increase in December, and more recent economic releases report lethargy rather than get-up-and-go. Businesses are reluctant to invest in anything beyond their own common stock, suggesting lousy productivity metrics are unlikely to turn around soon. Employment, while still showing gains, has shifted to a more modest growth path, and the workweek has become shorter, limiting worker incomes. The one clear piece of good news is that inflation is AWOL.

The Commerce Department revised GDP going back a few years, determining that growth was more robust from 2013 to 2015. However, since then, we have experienced a marked slowdown, with the first quarter posting an anemic .8% gain and the second a not-much-better 1.1%. For those of you who are mathematically inclined, you already calculated that the first half of 2016 has produced a growth path of less than 1%. As we dig into the figures for the second quarter, we find that the consumer was the primary engine of growth. Personal consumption expenditures contributed 2.9%, while business investment, led by shrinking inventories (-1.3%), subtracted -1.7%. The export picture and government spending rounded out the net number. Because of the way that the GDP calculation works, if businesses slow their inventory liquidation, we will see some rebound in third quarter. However, moving from negative to less negative is not the kind of improvement that we can build upon.

In fact, during the most recent period available (February through April), companies in the SP 500 bought over $165 billion of their own stock, up 15% from 2015 figures. Contrast this with net business investment of around $185 billion (gross business investment of $575 billion less depreciation of about $390 billion) during the second quarter.

It is hardly any surprise that, in the wake of this woeful performance, productivity is depressed, falling for the third quarter in a row in the three months ending June. This dragged the year-on-year rate down to -0.4%, one of the worst annual readings in US history. As long as businesses invest in their own stock rather than productivity-enhancing machinery and software, it is hard to see this turning around. Furthermore, if employment keeps exceeding production, it won't be long before job gains slow dramatically.

We may have seen some of the beginnings of that idea in the August employment report. Instead of the expected 175,000 jobs created, we got 151,000 (25,000 of them government hires). Plus, the average workweek shrank. Put together with wage gains totaling only 0.1% in August, weekly earnings posted a punk 1.5% year-on-year gain. Adjusted for inflation, the "raise" totals a whopping $5 a week.



Recent Economic Events *(continued)*

In spite of the near or actual drought in much of the US, agricultural price indices are lower than they were a month ago, a year ago, and in the base year 2011. I guess that's what happens if you actually do invest in better equipment instead of buying back stock. Price weakness is not confined to food. From a year ago, gasoline is lower by about 20%. For all goods and services, the CPI is up only 0.9% which presumably softens the blow from poor weekly earnings gains.

An even more remarkable statistic is that the Federal Reserve's preferred inflation metric, the PCE core index, has been below 2% for about two-thirds of the time over the past 25 years (roughly a generation). Since the end of the financial meltdown in 2009, we have experienced only four months of annual PCE core inflation over 2%. That is less than 5% of the time.

Economic weakness has become more expected than not. The causes are many, but neither monetary tightening by the Fed nor financial engineering rather than real engineering are helping matters. Until and unless there is a catalyst that changes the basic lay of the land, it is hard to envision a change in the statistics.

Commentary

I am a believer in cycles. Not bicycles, but economic and financial cycles.

The Industrial Revolution broke the age-old feudal structure, liberating the bourgeoisie from the aristocracy. Its stresses and strains ushered in World War I, communism, fascism, and the Great Depression. From its ashes, the New Deal arose, birthing the Great Society and ultimately ushering in the Reagan Revolution. The rightward tilt of this turn was aided by the Chamber of Commerce President, Bill Clinton, and a coterie of deregulators. That ended in tears with the Financial Meltdown. A swing leftward is now evident with calls to help labor by raising the minimum wage, limiting immigration, and back-tracking on free trade.

An important but perhaps naïve question: Don't we ever learn? Are we as humans destined to oscillate between extremes or can we craft a stable compromise? America's political polarization offers a timely test.

Our digitally-enabled and unprecedented abilities to self-sort the news to reinforce our preconceived beliefs contributes to the view of two Americas talking past each other. A recent study indicated that those with the most extreme views on climate change are mostly immune to contrary facts but become more convinced of their position with supporting facts. (In the study, the same made-up facts were presented randomly to both extreme groups.)

I am deep down a stubborn optimist. In fact, I am reminded of a quote from our second President, John Adams, who said, "Facts are stubborn things; and whatever may be our wishes, our inclinations, or the dictates of our passion, they cannot alter the state of facts and evidence."

I see signs that the polarization cycle is reaching its apogee. While Donald Trump and Hillary Clinton have vastly different approaches, they have both dismissed "big ideas" — Mr. Trump with an approach to "knock heads and get a deal done" and Secretary Clinton with measured responses to specific voter concerns. Maybe America hasn't chosen the worst two possible candidates out of 325 million to run for President. Maybe we have a choice between two people who will disdain big ideas in the search for solutions that work for everyday Americans, not the pampered elites. What if the cycle is moving away from elites with grand ideas that don't work to a more pragmatic approach to problems? What if both political parties are reaching a breakdown point where their old verities are discarded? Can a new political consensus form?

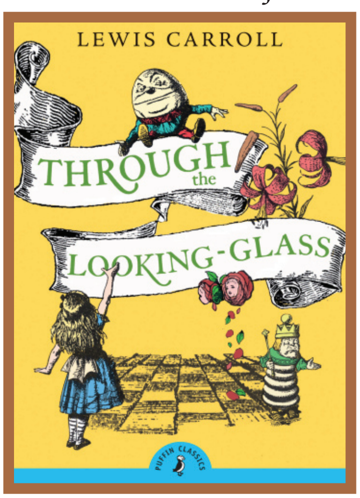
Commentary *(continued)*

I, for one, will be looking for facts as this political season unfolds and making my judgments based on them. And the best place to look for facts is in the writings and comments of those who disagree with you. After all, to persuade someone who already agrees with you takes little effort at all. When you honestly contemplate opposing views, supported by facts, the chance for compromise increases. If we all turn down the heat and focus on facts, perhaps the cycle of polarization can be reversed.

Market View

Has the investment world fallen through Lewis Carroll's looking glass? Is bad news good news, and good news bad news?

The Brexit vote in June was expected to usher in a recession and hard times in the United Kingdom. Contrary to those expectations, the British stock market has been a top performer, up over 8% from pre-vote to now. The threat of upheaval moved the Bank of England to provide stimulus, offsetting initial worries.



In the past few weeks, comments out of the Jackson Hole Symposium suggested the economy was just fine and the hawks were in control. Subsequently, ISM releases for both manufacturing and services indicated a much weaker picture. While you would think that a stronger economy would help the stock market and weakness would cause a pullback, you would be wrong. Weakness has propelled the stock market to or near all-time highs.

A cold, hard, empirical look at asset markets reveals that they are all overpriced. Rational investors, given options, will not purchase bonds at negative yields. They will also shy away from stocks priced at multiples of normalized earnings exceeding levels which preceded market crashes in the past. Ditto for housing prices which top relative prices from the peak in 2006. So why have they done so?

Maybe the heroine isn't Alice but Goldilocks. Just enough economic weakness to keep the Federal Reserve on the sidelines is market positive. Too much strength puts a near-term rate hike on the table, and pressures the market.

As long as central banks around the world are pumping cash into the financial markets, the funds dislodged from their normal habitats will seek better returns elsewhere. Voila, any type of investible asset gets bid up in price. The question at this point is how much longer the central bankers can keep the game going. However, since they appear to be the only game in town, it appears they will keep going until something happens on the fiscal side.

The recent get-together at Jackson Hole unveiled the thinking of many important global players. Essentially

Market View *(continued)*

they admitted what the rest of us already know: monetary policy has lost its ability to impact the real economy. The cries for fiscal stimulus to take up the battle were hard to ignore. And that, I feel, gives us a way to make sense of the markets.

Wealth and income are clearly related but are distinct entities. By its very nature, wealth must be invested in something, while income has the option of being invested or spent. (I make the rather sensible psychological assumption that people are loath to spend the principal portion of wealth, normally limiting themselves to spending only its income.) Since there are only so many places to invest and since monetary authorities are sucking up a lot of them, the result is that investible wealth seeks out alternatives. If there aren't sufficient alternatives, the price goes up for those on offer.

Now what would happen if fiscal stimulus were to pick up while monetary policy shifted to neutral? In this case, two things happen. First, the supply of investible assets begins to increase just as the demand from central banks decreases. Second, income gains shift from the upper class (investors) to the middle-class (spenders). The former retards price gains in investible assets, while the latter boosts demand (and prices) for goods and services.

So here is how I would play the markets. Until there are real signs of fiscal stimulus, assume that liquidity will continue to drive investible asset prices. This means support for stocks, bonds, and income-producing real estate (as long as it isn't retail). Since the zero bound has been broken, there is really no natural stopping point for this process, and there is a risk of a euphoric blow-off. However, when there is serious talk of government spending on infrastructure or other projects, reduce riskier investments and add to cash reserves. Setting stops or buying puts to protect against a declining market are prudent options. Remember that markets that are overpriced can fall quickly and steeply when the narrative changes. Today's markets could very well fit the profile of going up the staircase, and falling down the elevator shaft.

Editor's Note

I have begun musing on expiration dates. A recent sad story told of the demise of a 400-year old sugar maple near Rochester, the largest in New York State. Turns out the tree, which had been supported by wires, couldn't withstand a downpour that knocked off a huge branch. Another report recorded the plight of an Indonesian man claiming to be 145 years old. He is bemoaning the fact that he has outlived wives, children, grandchildren, etc. and is ready for the Grim Reaper. That would be hard to handle, but apparently I have plenty of time to prepare.

One thing that has expired is the use by date of my most recent grocery coup. I always check the mark-down specials at our local Scottsville grocery store, and at the beginning of the month, I spied a red "Sale Today" sticker on a package of sirloin steak. On closer inspection, I noted the 99¢ per pound price and the September 1st use by date. I bought the meat (total cost: $1.60) and immediately tossed it in the freezer. We thawed, cooked, and ate it at a family gathering on Labor Day. There were no additional expirations. I think I have found a way around the high cost of aged beef.

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