JAMESSON ASSOCIATES

FALL 2017

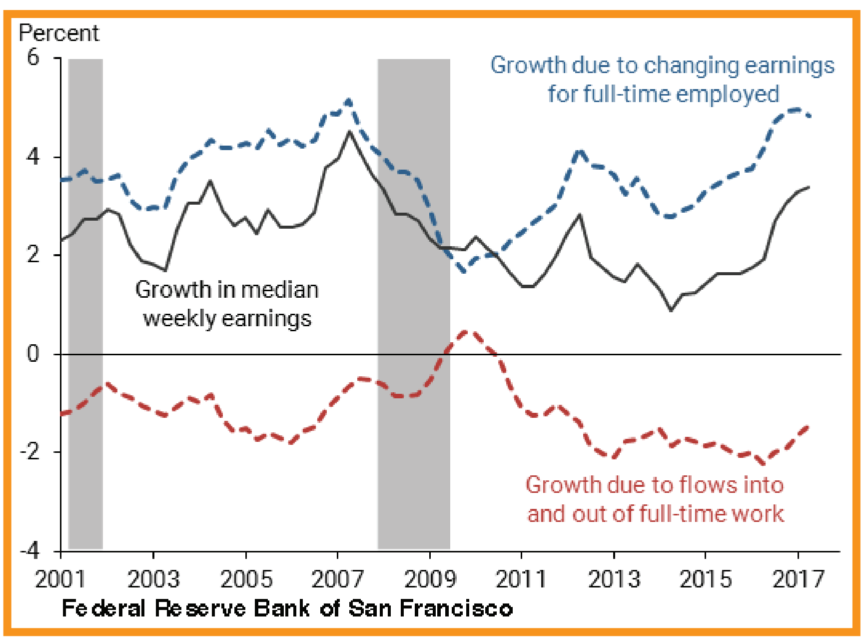
QUARTERLY NEWSLETTER

Recent Economic Events

While the American economy showed faster growth in the second quarter, we are not threatening the speed limit. Neither are we in danger of pricing pressures as inflation has continued to languish. An important recent development is the growing realization that weak wage gains in the face of low unemployment may be the result of a changing mix of jobs. Furthermore, the housing market is facing some unique challenges that don't seem to conform to traditional economic reasoning.

The American economy accelerated to 3.0% growth in the second quarter, besting the anemic 1.2% gain posted in the first quarter. On average, this works out to a little more than 2% year-to-date. The details indicate that the consumer was once again the key driver of growth, explaining over three-quarters of the advance. Investment was the next most important piece of the puzzle, with business investment overcoming a step back in residential investment. Foreign trade, helped by a weaker dollar, added modestly to the picture.

Looking in more detail at the consumer, we find that spending has consistently outrun income over the past year and a half. As a result, household debt is at an all-time high and the savings rate has fallen to only 3.5%. This is obviously troubling considering the increasing number of Americans nearing retirement age. Unless and until income catches up, the economy's momentum is at risk.



Fortunately, inflation is has gone AWOL. Both the Producer Price Index and the Consumer Price Index for July came in below expectations with the former actually declining. The Federal Reserve's preferred measure of inflation, the PCE Price Index, was similarly benign in July, posting a year-over-year increase of 1.4% for both headline and core. This is well below the Fed's goal of 2%.

Wage gains have exceeded the rate of inflation, but just barely. They were up by 2.5% versus a year ago in August. Pundits have wrestled with the low pace of wage growth in the face of a 4.4% unemployment rate. Many ideas have been advanced to explain the conundrum, but a consensus is developing that the weak average gains are due to a shifting mix of job-holders. As Baby Boomers with higher salaries and experience retire, they are replaced by younger workers without the full skill set needed. Employers then shift wage costs into training programs. In addition, the gig economy is drawing more part-time workers into the mix. This also results in lower average pay. A recent study from the Federal Reserve Bank of San Francisco confirms the suspicion by showing that wages for consistently employed full-time workers have increased in line with previous expansions. Exits (retirement), entrances (new workers), and moves to part-time have actually resulted in falling wages.

Recent Economic Events *(continued)*

The changing dynamics of employment may help explain the lethargy in the housing market. Those doing well are buying and pushing up housing prices to levels that now exceed the peaks from the bubble in 2006. However, turnover has been muted, suggesting the rest of the market is not participating. Housing sales, whether new or existing, have plateaued and supply is pretty thin. It appears that folks are considering the cost of trading up and deciding to stay put.

The long but weak expansion has tested many traditional views of how the economy works. The consumer is still the main factor driving growth, but overall wage gains in only a portion of the labor market are simply not enough to move the inflation needle nor to produce a broad-based acceleration in spending. If you are fortunate enough to be part of the consistently employed, this is good news, but if not, the challenges are not likely to dissipate soon.

Commentary

The ascent of Europe is perhaps the most surprising story of 2017. Whereas last year brought us Brexit and real worries about the break-up of the European Union in a populist putsch, this year produced a centrist victory in France and a strengthening Euro. It's the United States that appears to be in the throes of populist collapse. Exhibit 1: The dollar.

While some may argue that the dollar's decline is inspired by the dysfunctional American government, I believe that it is far more related to economic developments. For the first time in quite a while, Europe appears to be growing at a pace close to that of the United States. And although the annual inflation rate has also come down from a higher level earlier this year, it bounced up from 1.3% to 1.5% in August instead of heading on towards zero.

A key factor in the resurgence has been aggressive monetary policy by the ECB. It has both engineered negative short-term interest rates for Bank reserves and purchased huge volumes of Eurozone bonds, driving those rates down to low or negative levels as well. In fact, the stimulus has been so great as to push Euro junk bond yields below those of comparable maturity US Treasuries.

For all the ideologues who contended that negative interest rates would not work, the success in Europe has been a cold splash of reality. This raises the issue domestically. Are negative rates a more effective way to boost the economy than quantitative easing, or will both be needed the next time the Untied States goes into recession?

This question is no longer theoretical. President Trump has already nominated two members for the Federal Reserve Board of Governors. They are currently awaiting Senate confirmation. There is one additional vacancy to be filled. On top of this, it is reasonable to assume that, if Janet Yellen is not reappointed (good

Commentary *(continued)*

bet), the President will have even more seats to populate. By the time a year has passed, it is possible that the make-up of the Fed will be substantially different. Mr. Trump is unlikely to pick hawks who will submarine his economic record with higher rates. Furthermore, if a recession hits, the pragmatic European success will loom large.

There are two arguments that have been used against negative interest rates. First is the contention that they are simply not natural and distort the market. Well, guess what? Any rate set by a central bank is an artificial rate that distorts the market. That is the whole point. Results should determine. The second reason may be more pertinent. Negative rates can clearly cause stress in financial institutions if they don't pass on the negative rates to depositors. Apparently this has caused bank failures in Germany. The trade-off then is some banks on one hand, the overall economy on the other. This is less an economic choice than it is a political one. There will always be winners and losers in the economy. On that basis, I don't see an overwhelming reason to shy away from negative rates in the United States.

My guess is that we will find out whether I am right or wrong before the end of this decade.

Market View

The Fed contends that it needs to raise rates and reduce the size of its balance sheet in order to be in the position to apply monetary stimulus when the next recession hits. However, Economics 101 argues that raising interest rates results in lower GDP growth (almost always ending in recession), reduced inflation, and higher levels of unemployment. Furthermore, history shows that recessions cause equity bear markets. Of course, after the bad things happen, the Fed can pump in liquidity and encourage a recovery. Round and round the circular reasoning goes.

Vermont Senator George Aiken famously advised Lyndon Johnson to declare victory and exit Vietnam in 1966. It would be nine long years before his advice was eventually taken. Would that a Senator Aiken were around today to offer similar advice to Janet Yellen. The Federal Reserve has essentially achieved price stability and full employment. Why argue with success? But argue they apparently will, with the market and with history.

> ...the expectations of 16 FOMC participants on the one hand and millions of investors with trillions of dollars at risk on the other

The Federal Reserve began operating in 1913 and has concluded 16 tightening cycles since then. In all but three, a recession ensued. That offers pretty lousy odds on avoiding a mistake. If we start with a GDP growth rate of 2% to 2.5%, how much can it slow down before we call it a recession? This is what the market sees, and consequently, rate expectations are nowhere near what the Fed is projecting in their dot-plots. Where Ms. Yellen and company see rates moving up steadily to 3% over the next few years, the market indicates a high point of about 1.60% in mid-2020.

So we have the expectations of 16 FOMC participants on the one hand and millions of investors with trillions of dollars at risk on the other. It's clear that the market expects the Fed to realize its limits, but until it does, a strong dose of caution is warranted.

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Market View *(continued)*

The stock market is at elevated levels and has recently shown signs of exhaustion. Whether this is due to specific company fundamentals or general worries over Congressional dysfunction (2018 Federal Budget, debt ceiling, tax reform) is anyone's guess. However, after an extended period of very low volatility and few significant stock market drops, down days are now vying with up days for supremacy. On top of this, seasonal tendencies in October do not bode well.

The risk/reward trade-off in the stock market is not good. If the Fed bows to reality and stops raising rates, the economy could continue to lumber ahead, providing some support for the stock market. However, that is a tough bet to make in view of the longstanding desire to "normalize" interest rates.

The time has come to sell lower quality stocks, especially those with weak credit ratings. Structural downward pressure on prices makes these companies subject to unpleasant earnings surprises. Retail stocks have been the poster children for this so far in 2017, but the pain is now expanding. The Amazon/Whole Foods merger is a shot across the bow of both traditional grocers and packaged-food companies. Costs are being squeezed out of the system to the detriment of debt-fueled profit margins.

Commodity prices have held up or advanced, presumably on the hope that Chinese growth will continue apace. This is a dangerous place to be in my opinion. Ditto for Bitcoin. If you still decide to buy it, vaya con Dios, but don't come begging to me for meal money.

Government bonds offer an interesting option even though rates are toward the low end of the 2017 range. If the Fed relents and stops tightening, bonds should do well. If the Fed persists and causes a recession, they will do even better. If the Fed is right that inflation is just around the corner, bonds will tank. Make your choice accordingly.

Finally, it may be time for cash to become a more important part of your holdings. Yields north of 1%, perhaps close to 1.25%, are available on immediately-available funds from a variety of sources. This is not a bad place to hide while the dust settles.

Editor's Note

Upstate New York in late summer is what makes America great. Sweet corn, tomatoes, cukes. Fantastic. We need a wall to protect it, a beautiful wall to keep out the East Coast snobs and make our borders secure. We'll make the Canadians pay for it. If they can pay for a health care system, they can pay for a wall. Believe me they can pay. But back to global warming. It is very green here because we have had a lot of rain, not epic like Houston, but a lot of rain. Some people think it's because of climate change. I think it is complicated, but it is a lot of rain. A lot of rain. Soon the leaves will change color, and the first-graders will head back to ~~Washington~~ school. Some teachers will tell them that two and two make four. Sad. Two and two can make a lot more when America is great again.

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