JAMESSON ASSOCIATES

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QUARTERLY NEWSLETTER

Recent Economic Events

The most comprehensive measure of American economic growth, GDP, posted its second consecutive quarter of 3%-plus performance. There is some question about the level of distortion caused by Hurricanes Harvey and Irma, but there is no denying the top line numbers. Unfortunately, in trying to recover from the weather-related destruction, consumers drove the savings rate to an unsustainably low level. Job growth continues at a steady pace, and the unemployment rate resides at a new recovery low. Would that wage growth had been boosted to a recovery high, but alas, the benefits appear to have settled into the coffers of employers rather than employees. But while paycheck rewards are meager, they have managed to stay ahead of the lethargic pace of price increases. Furthermore, productivity has recently outrun wage gains, allowing companies to enjoy flat or falling unit labor costs, and the spike in commodity prices is meeting resistance. On top of all this, the Federal Reserve is keeping to its plan to raise rates and reduce its hoard of government bonds. All of these trends bode well for continued good news on inflation.

After an anemic first quarter, gains in real GDP have hit their stride. The second quarter posted growth of 3.1% while the third quarter saw an acceleration to 3.3%. As usual, consumer spending represented the bulk of the increase. Auto sales in September jumped to over 18 million annualized, which was the strongest performance all year. This was clearly in response to the destruction wreaked by Hurricane Harvey in the Houston area. Estimates were that as many as 500,000 cars were destroyed in the flooding. Many Texans faced the stark fact that they needed a car to get to work. Subsequent to the September jump in vehicle purchases, October and November resumed the generally downward path in sales we have seen in 2017.

Adding to borrowing (now at a new all-time high) or drawing down rainy day funds knocked the savings rate down to a post-recovery low of 3.1%. This is not a level that can be sustained long term. For the consumer to keep spending, we need income gains. Here the news is mixed. Job growth recovered from the Hurricane Irma induced slowdown in September by posting back-to-back months of over 200,000 new jobs. This has kept the unemployment rate at 4.1%, its lowest level in almost seventeen years. You would think that the decline in available workers would induce businesses to increase wages in order to retain or attract employees. If so, you would be wrong. Wage gains remain mired in the 2.5% annual range. Note that when the unemployment rate was at a similar level in late 2000, wages were increasing over 4% annually. (That's more than 50% faster.)

The offset to the lethargic wage growth is the even more restrained increase in prices. Depending on which measure you look at, inflation ranges from

Recent Economic Events *(continued)*

1.4% (core PCE index) to just 2.0% (headline CPI). And future prospects are favorable. Businesses are enjoying flat unit labor costs because gains in output (productivity) are matching increases in compensation. Brutal on-line competition (read: Amazon) is expanding its reach into all areas retail. Technology improves every day, allowing companies to take costs out of the system through automation. My last two meals in airports were ordered on an iPad.

Perhaps one of the most significant developments on the price front has been the ongoing decline in electricity costs driven by low-priced natural gas and competitive wind and solar installations. Full-cycle costs for renewables are at or below those for fossil fuels. OPEC had to extend its original six-month production cutback to almost two years. There is plenty of oil.

Finally, the Federal Reserve is expecting to raise rates in December and a few more times in 2018. The impact of their past actions can clearly be seen in money supply and loan growth which, predictably, have slowed as the cycle has progressed. That should hold back inflation, but at the price of GDP challenges. A modern economy runs on money and credit, and if money and credit are slowing …….

2017 has extended the Goldilocks economy of modest but positive growth, ongoing job creation, and low inflation. However, the main engine of that growth, consumer spending, is showing signs of stress as wage gains are MIA. There is no reason to expect a recession soon, even as the recovery passes the eight and a half year mark, but there is a reason to wonder how long we can keep the wolf at bay.

Commentary

The Republican Congress showed its true colors by producing a tax bill that only its donors could or do like. In fact my Republican Congressional Representative admitted, "My donors are basically saying, 'Get it done or don't ever call me again.'" Apparently, representing his district is well down the to-do list.

Because tax acts like this frequently acquire tortured acronyms, I propose the following:

Repaying Our Backers By Exclusively Rewarding Billionaires And Rich Old Nepotists

Clever readers will realize that the first letter of each of the phrases spells out ROBBER BARON. By doubling down on Trickle-down, Congress has driven down its approval rating to only 13%, according to an average from Real Clear Politics. Limbo, limbo, how low can you go? Perhaps the President will tweet that he is three times as popular as is Congress, and according to most polls, his sub-40% approval rating easily exceeds that of the tax bill.

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Because the final version of the tax plan is not available as I write, we really won't know the details and their ultimate impact for a while. However, there are three things that we can conclude with near certainty.

1. The Federal Deficit will increase.
2. Income and wealth inequality will grow.
3. America's partisan political pendulum will swing back towards the Democrats.

The University of Chicago (hardly a bastion of progressive politics) polled economists regarding the impact of the GOP proposal. Among the 38 responses, all but one (subsequently retracted) expected more government

Commentary *(continued)*

debt and only one expected to see faster GDP growth as a result. These answers are not surprising, as every tax cut enacted since Ronald Reagan's in the early 1980s has increased the deficit, while the one tax increase (Bill Clinton 1993) led to increased government revenues and a balanced budget.

The poor marks on growth are a little more puzzling, but they are related to the details of the plan. Instead of a tax reform that simplified the code by trading lower tax rates for fewer loopholes, the proposed plan lowers corporate rates significantly while doing little for personal rates, especially those on the lower end of the income ladder. Corporate CEOs are on record indicating they will reward shareholders with increased dividends and stock buybacks versus increasing investment or hiring and wages. This should help the stock market maintain its momentum, building wealth for the top 10%, but it may also encourage the Federal Reserve to try to rein in a bubbly market with more aggressive rate increases.

However, the key reason that growth is not likely to pick up as a result of the tax cuts is their distribution. Economics 101 suggests that those benefiting the most (wealthy) are already spending what they want and will save a high percentage of any additional tax benefits. Does anyone really think that Donald Trump's heirs will go on a spending spree because they beat the government out of the estate tax? The people who would spend any gains they received are at the lower end of the income scale. Here the savings are quite modest and many of them sunset over the next ten years. (Note: corporate tax cuts are permanent.)

The broad unpopularity of the tax bill coupled with the rank hypocrisy of Republican fiscal hawks (Marco Rubio says not to worry, cutting Social Security can reduce the deficit) will fuel another populist wave in the voting booth. Democrats will benefit. It would be quite ironic indeed if this tax plan plants the seeds of its own destruction as progressive policies like a wealth tax and single-payer healthcare gain support in 2018 and 2020.

George W. Bush's ill-conceived invasion of Iraq led to Barak Obama. Obamacare led to a Republican Congress and Donald Trump. The next swing of the political pendulum looms.

Market View

Boy, was I wrong on Bitcoin. Had I bought even one when I advised against it in my last newsletter, I could have printed this newsletter at magazine-quality resolution and overnighted it to all recipients. Oh well, free investment advice is worth exactly what you pay for it.

2017 has clearly been a year when many investment truths have been upended. The stock market has powered ahead with virtually no setbacks. Volatilty has been muted as the "buy the dip" mentality has overwhelmed fundamentals. The strong move

Market View *(continued)*

by investors from actively-managed mutual funds to passive funds has been the rising tide that is lifting all investments.

Are pundits right that financial assets are in an everything bubble? Maybe. If so, is there anyplace safe to hide, or must we continue riding the tiger? Either option entails risk. Can you stand the psychological pain of losing out if you sell too early? What if you hold on through a downturn, only to cash out at the bottom?

Because stretched valuations can always become more stretched (see Bitcoin above), I am reluctant to recommend wholesale liquidation in favor of cash. However, considering the excellent performance to date in US stocks (up roughly 20% or more), some diversification is called for. I would review your portfolio for those holdings that have easily exceeded the 20% gain with an eye to selling or gifting some of the holdings to reduce concentration. Look to rebalance your portfolio so that no one holding exceeds 15% and no two are over 25%. I would also seriously consider setting trailing stops on those holdings you can't part with now but would be happy to sell if you knew they were going down.

Where to put the proceeds? Cash is becoming more attractive as both bank deposits and Money Market Funds are now catching up to market rates. With the Federal Reserve expected to raise rates a few more times in 2018, this may be an attractive place to wait.

Short-term bonds (2-3 years) may also make sense as they will mature soon enough to be reinvested if there is a correction. For those still likely to be in the top tax bracket, high-quality municipal bonds represent value.

There's one equity sector that appears to be undervalued and under-owned by Americans — foreign stocks. Both Europe and Japan seem to have shaken off multi-year slowdowns. For the more adventurous, emerging markets offer higher growth prospects at a lower PE ratio. I recommend foreign exposure of at least 10% of equity holdings.

The strong gains in financial assets over the last few years rewarded those who embraced the risk in the face of uncertainty. The current environment offers enough reasons to take some profits, diversify holdings, and build a store of risk-free reserves.

Editor's Note

After four driving trips on the Iberian peninsula, there are some key lessons I have learned. First of all, American-sourced GPS has been intentionally hobbled to protect national security. Make sure you check the route before heading out or you may be treated to a scenic journey through the hilly countryside on what Susan christened "goat paths" as you spend 15 minutes traveling what would have been about a mile on the correct route. Specific locations are also problematic as we discovered when we arrived at what was supposed to be a resort winery only to find it a broken-down shack surrounded by feral dogs instead of grapevines. It also appears that the term "highway robbery" was coined to explain the egregious tolls (€5 for every 30-40 km) on the Spanish expressways. There are upsides, however. The "One-Way" signs are advisory only, especially when there is time pressure. Nobody looks askance when you drive your car onto the sidewalk to unload at a hotel, and best of all, there is no need to get collision insurance on the rental car because Eurozone rules specify car damage inspections can only be performed by the legally blind.

Michael Jamesson
Jamesson Associates
Scottsville, NY
(585) 889-8090

Mjamesson@aol.com
Michael@JamessonAssociates.com