JAMESSON ASSOCIATES

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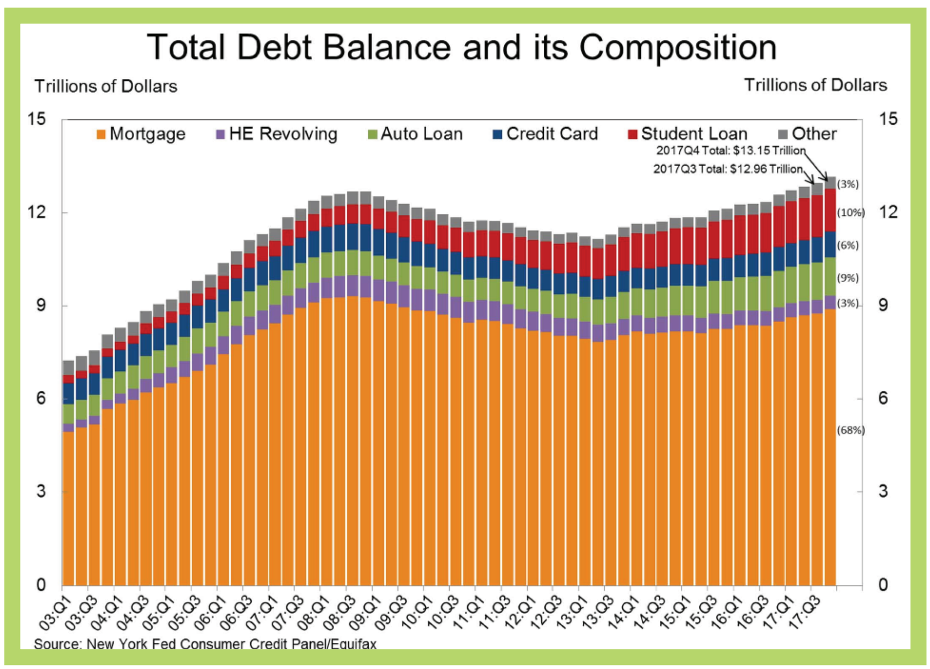
QUARTERLY NEWSLETTER

Recent Economic Events

GDP growth decelerated in the fourth quarter even as consumers in Texas and Florida spent heavily to replace cars destroyed by last year's hurricanes. The jury is out on whether the spending spree can transfer to other goods and services, or whether debt financing, coupled with rising interest rates, will stymie the momentum. The highest mortgage rates in over four years have contributed to a flat market for both existing and new home sales. The hope and promise of the tax cuts enacted in late 2017 is that businesses will invest, expand, and hire more workers who will benefit from higher wages. Early returns on this score are mixed. Companies have announced big increases in stock buybacks and dividends for shareholders, but plant expansions are less notable. Jobs are being created at a somewhat faster pace in early 2018 than they were late last year, but wages don't seem to be responding proportionally to the the apparent tightness of the labor market.

Just when we thought the economy was picking up speed, the fourth quarter GDP disappointed. Real growth was pegged at 2.5%, down from the back-to-back 3%-plus growth we witnessed in the second and third quarters last year. The consumer kept up her end of the bargain as consumption expenditures accounted for pretty much all the growth. Business investment was mixed, with some plant and equipment spending but a large inventory drawdown. The growing trade deficit basically offset the net gain from investment. It appears the extra consumer demand was met by imports rather than domestic production.

And there were some soft underlying details in the consumer spending figures. First, car sales, after having generally declined during most of 2017, showed strength from September through November. This was due to replacement purchases by folks who had to get to work after the havoc wreaked by Harvey (Texas) and Irma (Florida). Since the artificial boost, car sales have resumed a downward path, contributing to the flat sales in December and the actual decline experienced in January. This is hardly surprising, as the Federal Reserve reported that household borrowing levels have now surpassed the peak we saw prior to the financial meltdown.



The combination of high debt levels and increasing interest rates will be a challenge to ongoing consumer purchases. In fact, housing already seems to be suffering the effects, as both new and existing home sales stalled in January. The former fell by close to 8% from the revised December figure, while the latter declined by over 3% from the month before. Both measures are down from a year ago.

Recent Economic Events *(continued)*

The tax cuts passed by Congress in late 2017 have only been in place for a short time. It is therefore premature to try to measure the actual impact of the legislation. However, we can get an early taste of what may be happening by looking at business announcements. Here we see a sharp rise in both stock buybacks and dividend increases, rewarding shareholders. The *Wall Street Journal* reported roughly $200 billion of new stock repurchase programs announced from December through February compared to about $70 billion last year and no more than $110 billion in any of the previous three. M & A expectations have also jumped. What has not increased is hourly wages. After a nice increase in January (maybe due to statutory increases in minimum wages), wage gains slowed in February. On an annual basis, wages are up only 2.6%.

On the plus side, many more Americans are employed. February saw an increase of 313,000 jobs and a jump in the labor participation rate to 63%. The unemployment rate held at the low 4.1% level, suggesting that the market remains tight. However, the jobs up, wages not so much conundrum continues to bedevil economic pundits. (Not surprising as economic pundits are frequently bedeviled.)

Bewilderment aside, the economy is on sound footing but doesn't seem to be picking up steam. The impact of the tax cuts has mostly appeared on Wall Street, not Main Street. Until the latter begins to benefit, I am afraid the economy will continue to trudge along rather than breaking into a sprint.

Commentary

Paul Volcker's tenure as Chairman of the Federal Reserve coupled with Ronald Reagan's presidency marked a clear break with the post-World War II consensus. Decades of ever higher inflation and interest rates driven by the guns-and-butter economy of Vietnam and the Great Society gave way to 20%-plus interest rates, the destruction of PATCO, and substantial tax cuts on capital. Folks with money to invest, whether in bank CDs or in the stock market, saw big rewards, while workers suffered through back-to-back recessions and stagnant incomes. The last 35 years have been a golden era for financial assets and have pushed wealth and income inequality to levels last seen at the end of the Roaring 20's. Interest rates have dropped from the mid-teens to low single digits and stocks valuations have jumped from less than ten times earnings to over twenty times.

It is always dangerous to predict the end of a secular era, especially contemporaneously, since often we don't know an era has ended until well after the fact. But I am going out on a limb and suggesting that it is time to plan on a different set of assumptions for the next twenty or thirty years. The days of capital receiving all the benefits of a growing global pie seem to be in their last throes. I would mark the December tax cut as a key date similar to G. William Miller's inflationary tenure as Federal Reserve Chairman.

Straws in the wind include the recent rise of populism throughout the developed world, the West Virginia teachers' strike, China's shift from production to consumption growth, and a new SEC rule requiring companies to disclose median worker pay along with that of the CEO.

Let me discuss each in turn. Populism by definition shifts the focus away from the elites to the masses. While President Trump was elected on a wave of populism, his policies until recently had hewed to the gospel of the rich. Tariffs on steel and aluminum, opposed by virtually all traditional Republicans, are a clear break. Expect more of the same. A trade war is the flip side of free trade. The latter was billed as a benefit to all

Commentary (continued)

countries, but the reality was that the benefits within countries were unevenly distributed. The pain of a trade war will be similarly lumpy, and on a relative basis, the elites will be hurt more.

West Virginia has always been a hotbed of labor activism, and the effectiveness of the teachers' strike has encouraged Oklahoma teachers to contemplate one as well. It hardly goes without saying that both states went strongly for Mr. Trump. If the Republicans can't deliver on their promises to the working class, perhaps the Democrats will.

President Xi is now fully in charge in the world's most populous country. The new marching orders are focused on improving the environment and providing goods to everyday Chinese. The days of full-bore production are gone and the pressure on global labor is dissipating as Chinese labor force growth slows and begins to fall.

Finally, SEC-reporting companies are now required to disclose the median pay of employees. This allows comparisons which were previously unavailable. Suppose you are working for a company and your pay is below the median? Suppose the CEO makes 200 or 300 times what the median worker makes? This puts pressure on companies to raise pay for workers, just as comparisons of CEO pay pressured Boards to raise the pay of their CEO.

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While I expect that labor will start getting a bigger share of the pie, I don't expect this to translate into higher inflation, as the ongoing pressure from technology to lower prices will not change. The result that I expect is that the costs of increasing wages will come out of corporate profits. As President Obama said, but was unable to deliver, "I think when you spread the wealth around it's good for everybody."

Market View

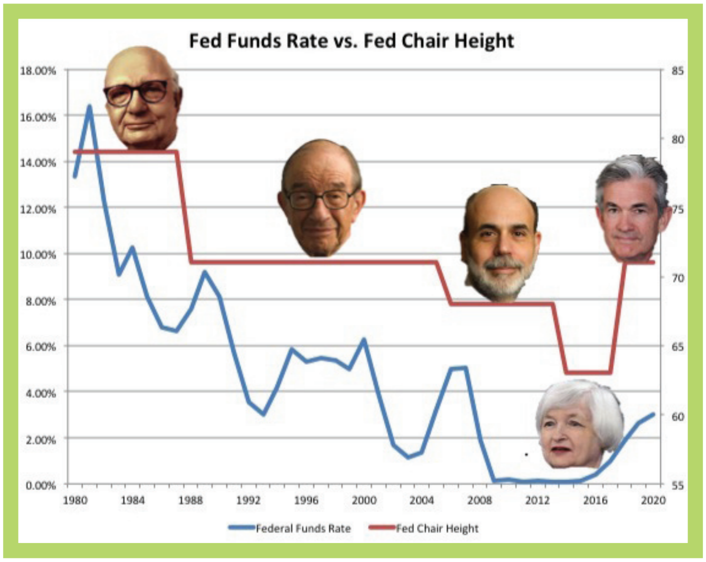
I don't know. And based on the increased volatility in the markets, the feeling is widespread. In times like these, it isn't surprising that investors reach for unproven "certainties" and investment schemes (e.g. Bitcoin) proliferate. Being human myself, I am not immune and therefore offer the following for contemplation. The height of the Chair of the Federal Reserve is closely correlated with the level of Federal Funds (and hence interest rates in general) during their term. Before you dismiss this out of hand, check the chart on the back page. The only conclusion to draw from this is that short-term interest rates are heading up.

Long-term interest rates are another matter. At present, the ten-year Treasury has not been able to break through the 3% barrier which has held for almost seven years. This is in the face of a strong stock market, a weak dollar, potentially record-breaking government deficits, and the stirrings of inflation. While I am not ready to predict a decline in longer-term interest rates, I am confident that they will rise by less than short-term rates. That implies that the yield curve is destined to flatten, not continue its year-to-date march steeper.

For those willing to be patient, I would add to long-term bond positions if the ten-year ventures into the 3.25% to 3.50% range, as I believe that is as high as it is likely to go in this cycle. The pay-off: when the next recession hits (probably the result of the Fed tightening too much), longer-term bonds will rally, perhaps even to a new all-time low near 1%.

Market View (continued)

The stock market is pressing very high valuation levels, and the January/February swoon showed that stocks can go down just as well as they can go up. Furthermore, volatility has clearly jumped, significantly increasing sleepless nights for those close to retirement. History and human nature both point to the irrationality of investors selling in panic when markets head south. To protect against this, I recommend pruning the portfolio and perhaps setting stop loss orders 10% below current prices.



The good news is that there is now a reasonable place to park stock sale proceeds. Certificates of deposit in the one to two-year range now exceed 2%, as do Treasury securities. If you can use the tax benefits of municipal bonds, they also make sense in this maturity range. For those who want to surf along with Federal Reserve rate increases, both money market funds and bank money market accounts can currently capture 1.50% returns. A couple of Fed tightenings and the yield will exceed the dividend yield of the stock market.

Oil and other commodities have rallied over the past year or so both because of a global economy growing in sync and because of a weak dollar. Momentum suggests this is likely to continue, but the trade is getting quite crowded. Also remember that, while the cure for low prices is low prices, the challenge of high prices is high prices. The shale revolution promises to catapult America to the status of top oil producer in the world either later this year or early 2019. Commodities are cyclical and I believe that the next turn of the cycle will be down. Don't know when, but down it will be.

Editor's Note

On a recent trip to an Ikea in Tampa, Florida, we spied a sign marking the parking lot for Columbia Restaurant, the oldest in Florida. Not to miss a chance at history, we put our name in for a table. While we waited, we wandered through the attached gift shop and then repaired to the bar. The verdict: Mojitos excellent; food pretty good. The experience got us thinking about how many oldest restaurants by state we had visited. Louisiana was easy as we have dined in each of the five oldest restaurants in the state. We also checked off Mississippi and Ohio due to our peripatetic ways, but our most surprising victory was in Denver, Colorado. A number of years ago, we ate at the Buckhorn Exchange, a restaurant with big game trophies everywhere you looked. The menu informed us that Buffalo Bill was an early meat supplier. Consequently, I ordered a bison rib-steak (of more recent vintage and only a distant cousin of the wall menagerie). I also chanced the antelope sausage. As many of you know, I am a big fan of oysters, having eaten them from coast to coast, but the oysters I like come from the ocean, not the pasture. I just couldn't work up enough courage to try the Rocky Mountain variety. Susan was kind enough to pass as well.

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