JAMESSON ASSOCIATES

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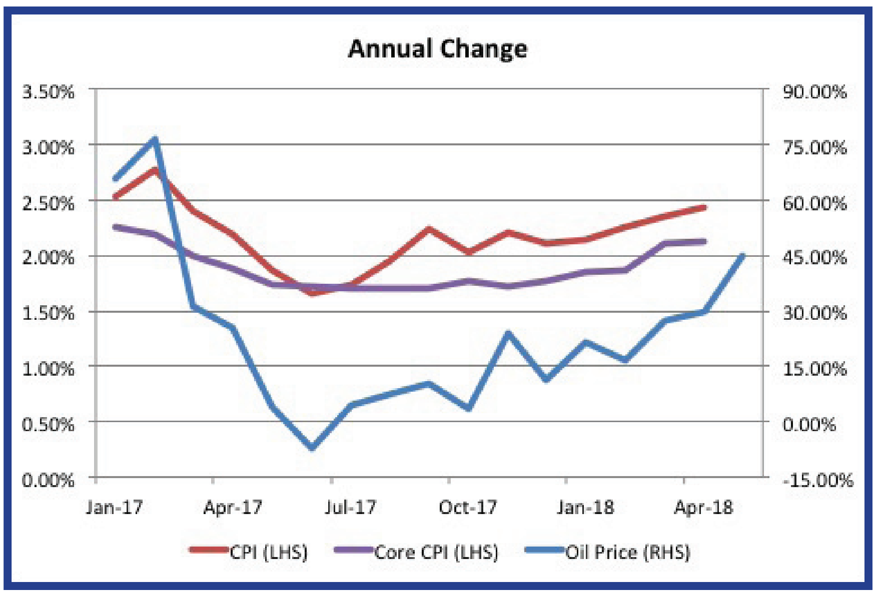
QUARTERLY NEWSLETTER

Recent Economic Events

Inflation is back, and not because of accelerating activity. In fact, the synchronized global growth story has given way to a geopolitical theme. President Trump's America First agenda has been brought front and center. Scuttling the Iran-Nuclear deal and re-imposing sanctions has set the US on a collision course with our European allies, while tariffs on steel and aluminum have added Canada and Latin America to the list of the aggrieved. In another significant change, the renewed strength of the dollar, coupled with higher interest rates engineered by the Federal Reserve, has played havoc with emerging nation economies. In the midst of all of these foreign developments, domestic American economic statistics paint a picture of ongoing, albeit unspectacular, growth.



In April, the Consumer Price Index (CPI) posted a year-over-year increase of 2.5% while the core rate was up 2.1% from a year ago. A key reason is the increase in the price of oil. While energy represents less than 8% of the market basket of goods and services captured by the headline CPI and is specifically excluded from the core, you can see by the chart that it is a leading factor for both. Were this a gain due to a stronger economy, it could be justified and perhaps even applauded. However, the causes are not strictly market-related. Growth in the US, Japan, and Europe slowed in early 2018, making it hard to argue that the increase in oil prices is demand-driven. So what is happening on the supply side? Well, the United States, responding to higher prices, is producing record amounts of oil. However, production restrictions from OPEC and Russia and a collapse in Venezuelan output, coupled with renewed sanctions on Iran, have offset US gains. Unfortunately, when oil prices rise independently of economic growth, they act like a tax.

Oil prices aren't the only threat to growth. US tariffs on steel and aluminum have raised, and will continue to raise, domestic prices. They are also likely to trigger retaliation. The tit-for-tat nature of a trade war can easily provoke inflation while slowing growth. 1970s "stagflation" may be closer than we think. Let's hope that bell-bottoms and pastel ruffled shirts are not on the way as well. (What were we thinking?)

Emerging nations have certainly not escaped recent developments. The combination of a rising dollar and higher Fed-induced interest rates has shown the folly of piling up debt denominated in a currency that you don't control, even if it looks cheap on day one. Foreign exchange markets have punished Argentina, Turkey, and Indonesia with collapsing currencies. This has led to higher local rates for these nations, further threatening the global economy.

While karmic balance would argue for the United States to be most impacted by the disruption it is visiting on the world economy, domestic performance

Recent Economic Events (cont.)

has been remarkably steady. First quarter GDP of 2.2% was down from the fourth quarter, but since it replaced an even slower first quarter in 2017, the annual rate actually improved.

Job growth continues to power ahead. The American economy produced a solid 223,000 jobs in the month of May, dropping the unemployment rate to a post-recovery low of 3.8%. For the first time ever, there are now more job openings than there are unemployed Americans. Private job growth has been positive every month since early 2010, the longest streak since records have been kept. But far from resolving the sluggish wage conundrum, May's 2.7% annual increase was barely ahead of inflation. With punk wage growth and accelerating inflation, it is no wonder that consumers have been running down savings to maintain their standard of living. The latest read on savings puts it at only 2.8% of income. This is obviously a pretty thin reed to support future growth in spending, especially considering that it's not evenly distributed. A recent poll stated that four in ten American adults couldn't handle an unexpected $400 expense without borrowing.

It is hard enough trying to understand the domestic American economy and the prospects for growth without the distraction of geopolitical events. For better or worse, we live in an inter-connected global marketplace. Recent actions by the Trump administration have pressured the system, thus far with most impacts occurring overseas. This will not last forever. As increased tariff costs are passed along, inflation will continue to increase. A slowing global economy along with trade retaliation will also take its toll. And speaking of tolls, let's remember the words of John Donne, which apply to countries as well as human beings, "No man is an island, entire of itself; every man is a piece of the continent, a part of the main…and therefore never send to know for whom the bells tolls; it tolls for thee."

Commentary

There are a few sacred cows that I aim to hasten to the slaughterhouse. My targets fall into the category of having plausible theoretical support while being short of empirical evidence. And it may be that knock-on effects are more important than many believe.

Let's start with "inflation is everywhere and always a monetary phenomenon." Proffered by Milton Friedman, this contention has been disproven by years of excessive money creation that has hardly budged the inflation rate. In fact, inflation's lack of correlation with monetary stimulus or tightening is so obvious that only diehards can possibly support the causal connection. The Federal Reserve has been trying to boost the core inflation rate to 2% for the entire stretch of the expansion. As we saw on the chart in previous section of this newsletter, rising oil prices have finally put their goal within reach. However, rather than celebrate this as the result of effective monetary policy, I believe it highlights its ineffectiveness. The monetary stimulus that was supposed to stoke the fires of inflation instead leaked into the financial markets, boosting stock, bond, and real estate prices. Paradoxically, cheap capital fostered innovation helping to keep prices down (see fracking, Uber, etc.)

Then we have the venerable Phillips Curve. This idea contends that wage gains are inversely correlated with the unemployment rate. As the latter falls, constricting labor supply, wages will rise to reestablish an equilibrium in the market. Well, it hasn't turned out that way. Wage gains are not much higher today than they were in mid-2016 when unemployment was closer to 5%. And adjusted

COMMENTARY (CONT.)

for inflation, wages are growing even more slowly than they were when the recovery was just gaining traction. It appears that companies anticipating the pressure on wages turned to technology and globalization as offsets.

How about the law of supply and demand in the housing market? Constrained supply has led to higher prices, but higher prices have not led to increased supply. Quite the opposite: the lack of supply continues to encourage higher prices and multiple bids per house. It appears that housing prices are not as important as housing payments. Higher rates have served to keep homeowners in their present abode, renovating or adding on, because they don't want to give up their current low mortgage rate.

Do lower taxes boost the economy? We have been starving government of taxes for most of my adult life, and yet economic growth has been slowing for decades. Taxes have been held too low because politicians (and those of us who elect them) put off whatever they can, figuring that while the music will ultimately stop, it may not happen on their watch. The ticking time bomb of expense includes infrastructure, pensions, and investment in the education of America's youth. This latter issue is getting some notice as states around the country are facing teacher protests over the underfunding of education. It's pretty obvious that instead of curtailing current spending, the lower tax regime has robbed us of investment and has beggared our productivity. Investing for the future used to be an American strength. It may take years to recover from the dearth of infrastructure investment before renewed benefits start to flow.

The key to investigating hoary economic ideas is to look at the facts. When they don't support the "truths", we need to change our ideas. Time moves on and it would serve us well to remember that solutions proposed in the past simply may not work in today's world.

MARKET VIEW

The corporate tax cuts have had the impact which anyone not deluded by ideology would have expected: companies are showering investors with record amounts of dividends and stock repurchases. This has been a boon to stock prices even as the previous source of fodder for equity gains has dried up. That source was, of course, the massive liquidity poured into the financial system by central banks around the world. However, all good things must come to an end, and we may be seeing the beginning of that end.

The *Wall Street Journal* recently reported that while first quarter earnings for the S & P 500 were up by over 20% from last year, those reported by the Federal government in the quarterly GDP report were flat. In fact, without the tax cut (running about $470 billion annualized), corporate income would have been down 6% according to the GDP figures. A number of factors were responsible for the difference. GDP numbers include all businesses, not just public companies, and they also account for one-time charges while reported S&P earnings tend to exclude them. However, a bigger issue is more the result of accounting practices than anything else. S&P earnings are per share, while GDP figures are total dollars. It appears that record levels of stock repurchases are a major reason for improved earnings; underlying income has stagnated.

Recall that part of the reason for lowering corporate tax rates was the idea that corporations really don't pay taxes. The taxes paid are borne by labor through lower wages or consumers through higher prices. Capital will, like water, always seek an equilibrium of after-tax returns. Since it is far more mobile than labor, it will flow from high-tax to low-tax countries in search of that equilibrium. Countries should, therefore, lower taxes to attract capital investment. In the long run, this should boost production and increase the demand for less mobile labor while

Market View (cont.)

tightening competition. Eventually, benefits will flow to workers and/or prices will fall. While I am skeptical of this theory, I will assume it holds true. Note that if so, this implies that after-tax returns will seek an equilibrium near where they were before. Competitive pressures will lower pre-tax returns over time until they are consistent with the new tax rate and risk.

HIGHER INTEREST RATES ARE NOW PROVIDING SOME COMPETITION FOR EQUITIES

Consequently, the best days of the corporate tax cut for earnings are behind us, further suggesting that stock repurchases may be peaking as well. Consider what a trade war might do to the global supply chain, add on the fact that the interest expense line in the P&L statement is no longer negligible, and voila — stock market challenges look formidable.

In fact, higher interest rates are now providing some competition for equities. The yield on the three-month Treasury Bill is higher than the dividend yield of the S&P 500 (1.90% versus 1.85%). At the one-year point, Treasuries exceed 2.25%. Since extending maturity to ten years only captures 2.90%, the risk/reward in the fixed income markets is decidedly on the short end. I would recommend maturities up to two years or, alternatively, over ten years on a backup in rates. Fixed income options include high-quality municipal bonds for those who can use the tax break.

It's hard to invest in inflation, but TIPS represent one avenue. A future inflation measure put together by the Federal Reserve Bank of New York suggests that core inflation is headed toward 3% based on factors already baked in the cake. If we get a surprise on the upside, TIPS should keep up. Here, extending to the ten-year maturity makes sense.

I continue to be wary of commodities because the prices appear to be driven by non-economic factors rather than economic ones. Gold has been comatose even with plenty of reasons to rally. Oil is all politics, as are other commodities that could be the subject of a trade war. Best to stand clear unless you are more thrill-seeker than investor.

Editor's Note

I recently experienced a Bit-O-Honey incident. Let me explain. When in my office, I will typically consume cup after cup of coffee. The mug is right at hand. Furthermore, so is the bathroom. The process satisfies my natural nervousness and has the collateral benefit of keeping me on my toes. When I am on the road, driving to a client meeting, the calculus changes. Coffee costs more, and pit stops upend timing. As a consequence, I shift from caffeine stimulus to sugar high. While Smarties, Gummy Bears, and licorice are in regular rotation, so are Bit-O-Honeys. You would think that dental cement is strong enough to resist chewing, but that is not the case. The bad news: my crown left its proper place. The good news: I didn't chew it up and swallow it. My dentist recemented it to my molar in a relatively quick procedure. On closer inspection, however, the smiling bee on the Bit-O-Honey wrapper bears a startling resemblance to the one on a poster at my dentist's office. Perhaps this is the conspiracy the FBI should really be investigating.

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