JAMESSON ASSOCIATES

FALL 2019

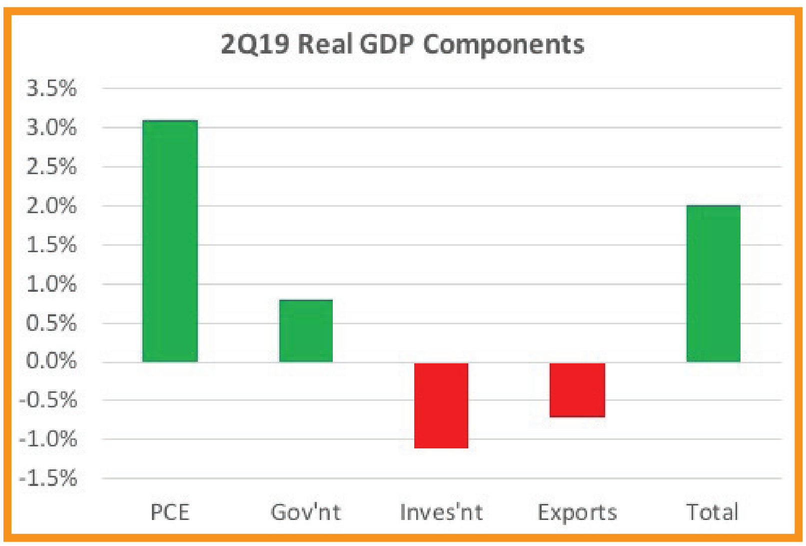
QUARTERLY NEWSLETTER

Recent Economic Events

The trade war with China is having an impact both on business confidence and on actual trade volumes. An economic slowdown is evident in the global economy even if it hasn't yet fully hit America's shores. US second quarter GDP growth reflected strong consumer spending and an understandable bounce in government expenditures from the self-inflicted first quarter shutdown. Investment, both business and residential, was MIA, and net exports were an ongoing drag. One wonders how long the indomitable American consumer can defy weak business activity. The key, as always, is employment and wage growth. On that score, things are positive, although not as positive as they were earlier in the year. The good news is that inflation remains well contained, notwithstanding tariff-related increases. This and modest household debt levels should help. However, low interest rates don't seem to be boosting either housing or car sales, suggesting the benefits of monetary stimulus is less potent than in the past.

The US imposed 10% tariffs on over $100 billion of Chinese goods on September 1st with more to be assessed after the Christmas rush. Once these tariffs were announced by tweet in early August, the Chinese retaliated by allowing their currency to depreciate past the psychologically important seven-to-the-dollar level. This is about as textbook a tit-for-tat trade war escalation as there is. The IMF has lowered its global GDP expectations to 2.8% which is a big drop from actual performance of 3.4% just a year ago. This qualifies as a growth recession for most of the developing world.

Back in the USA, the impact of previously imposed tariffs was apparent in the second quarter GDP figures (up 2.0%) for both net exports (-0.7%) and domestic investment (-1.1%). In fact, the only positives in the report were personal consumption (3.1%) and government spending (0.8%). Note the latter was a one-off payback for the government shutdown in January. This puts the onus on the consumer to keep the economy moving along. Increased borrowing ($23 billion) helped prop up spending in July, but that can go only so far. It is jobs and wages that support real growth, and here the story is mixed.



Job growth is slowing (only 130,000 in August with 34,000 of the total due to census hiring by the Federal government). It is averaging about two-thirds of the monthly pace originally reported in 2018. However, BLS recently indicated that there were 500,000 fewer jobs than previously reported as of this spring. Wage growth is still on the plus side of the ledger, up 3.1% from a year ago, but this is off the peak gain earlier this year. Average hours worked are actually down from last year, suggesting weekly earnings are weaker than the gains in hourly wages imply. Even with these cracks in the employment picture, we don't want to lose sight of the fact that unemployment is near a 50-year low at 3.7%, consumer confidence is at elevated levels, and inflation remains well below wage gains. We also shouldn't discount the falling price of gasoline.

Recent Economic Events *(continued)*

Even with the recent strong borrowing growth, overall household finances are in very good shape, which means that lower rates should be helping. However, existing home sales are still no better than they were a year ago, and car sales (which really are SUV and truck sales) have plateaued. The very noisy new home sale report indicated sales have advanced from 2018, but they fell rather sharply in July from June. If lower rates turn out to have lost their mojo, it's hard to see what the catalyst for continuing economic growth may be.

The American economy completed its tenth year of growth in June, and positive momentum appears to have continued since then. However, increased uncertainty is taking its toll on the economy. Businesses have pulled back on expansion plans, world trade is stalling, and ever-lower interest rates seem more a result of weakness than a spur to growth. Everything depends on the American consumer because fiscal stimulus is caught in gridlock and monetary options are mired in stubbornness (White House and FOMC).

Commentary

In a clear break with economic history, an important feature of current global financial markets is the rise of negative-yielding debt. Were this a few million dollars or so, it would be an interesting anomaly for a junior professor's stab at academic fame. However, as I write, the total of debt with rates below zero is near $17 trillion. This is no small amount, suggesting that the rules of the past are no longer operational.

> "...the total of debt with rates below zero is near $17 trillion.... the rules of the past are no longer operational."

So have we investors, like Alice, fallen through the looking glass? Should we conclude that the collective hysteria will wear off and simply hunker down? Or must we expand our understanding of the financial landscape as we did with the idea of imaginary numbers like the square-root of negative one? That conceptual change greatly enhanced mathematical reasoning and has led to surprising applications in the real world. If understanding negative rates offers similar potential, there is real upside to investigating the implications.

The first question is whether negative rates are a serious feature of financial markets or a temporary aberration. I believe that there are a number of reasons that negative rates are a rational feature of today's markets which, while not permanent, are at least likely to appear from time to time. There are three strong reasons for my belief.

Let's start with demographics. As people age and enter retirement, they are more inclined to save rather than spend. The very real desire not to run out of money or to leave a legacy takes precedence over current spending. This means that the knowledge that some level of funds will be there in the future is worth accepting a haircut. The key to this idea is the fact that most of the economically pertinent global economies (North America, Europe and East Asia) are getting older. This idea is reinforced when one realizes that inflation in the economies referenced is itself low or negative.

In fact, falling prices offer the second reason that negative interest rates may be more permanent than many think. If the value of money is increasing rather than eroding, it is entirely rational to accept fewer dollars in the future than you invest today. Inflation has morphed into deflation in some areas and is clearly

Commentary *(continued)*

what keeps central bankers awake at night. Whereas investors have traditionally demanded a premium to lock up money for a longer period of time to compensate for unforeseen inflation, term rates today incorporate a discount. This may simply be the market taking into account the unforeseen risk of deflation.

My third reason is much more arcane. It has to do with the huge level of debt itself. Current estimates suggest that investment-grade global debt is well over $240 trillion, or more than three times global GDP. How to stop the debt from swallowing the entire economy? Traditionally, there were three ways that debt was eliminated beyond being repaid as agreed. First, the authorities could declare a Jubilee where debts were deemed forgiven. There appears to be some Biblical support for this. However, the details are problematic. Second, the borrower could refuse to pay and simply default. Once again, this may be an option for a small amount of debt but would create havoc on a large scale. Then there is inflation. If the currency can be made much less valuable, debts can be repaid, albeit at a lower real value. The challenge here is to get inflation to appear quickly enough to eliminate historical debt while not causing lenders to raise rates so high that new debt offsets the benefits. It seems that we are at an impasse with all possible solutions wanting.

Enter negative rates. Here's a thought experiment. What's the difference between long-term government debt at a negative or even a zero interest rate and the currency we carry around in our pockets or hold at the bank? I would argue that they are functionally equivalent, and as long as the demand is there, it effectively monetizes debt. In other words, negative interest rates are the market's way of creating a voluntary Jubilee. Nice trick that.

If I am right about the reasons why we have negative interest rates, there is no reason for them to disappear unless the forces driving them reverse. Since it isn't likely that they will, it makes sense to consider the implications. I'll touch on the investment consequences in the next section of this newsletter. The options for government action are clear: spending should not be constrained by deficits but should be targeted at the needs of the public. Debt can be funded, or currency can be issued. Unless and until demographics and deflationary trends change, this is the way forward.

Market View

Interest rates have fallen over the summer and promise to continue to head downward although not necessarily in a straight line. This is an environment that favors high-quality bonds and stocks of companies with sound finances and well-protected dividends. While I hate to admit it, the elevated level of uncertainty bolsters gold and even crypto-currencies, although they are not so much investments as they are hedges. Cash looks pretty good right now, but the future path of short-term interest rates suggests that it is a strategy with a near-term expiration date.

One of the best investments of the year has been the Austrian government's 100-year bond. It has generated a total return of over 70% year-to-date. Long-term bonds of Germany and Japan have appreciated smartly even though they started from negative yields. The gains were generated as rates became even more negative over time.

This highlights what I believe may be the best current investment opportunity: long-term US Treasury bonds. The 30-year Treasury has already touched an

Market View *(continued)*

all-time low just below 2%, but it offers plenty of upside if rates continue to fall. The secret to taking this risk is quality and term. Don't choose a corporate that could see credit deterioration or even a municipal that can be called away from you. If rates fall as I expect, you want your purchase to stick around for either the capital gains or the steady interest return.

Equities present a quandary. On the one hand, lower interest rates increase the value of earnings and should boost the prices of common stocks. On the other, an economic slowdown or an actual recession has historically pummeled stock prices. If you concentrate on what is really the point of investing in common stocks, namely dividends, there is a way out of the paradox. If you have the stomach for declines in the market value of stocks while the dividends they pay continue to accrue, the present environment still offers opportunity. The most important characteristic is safety of the dividend and long-term viability.

"I am arguing for capital gains in the bond market and steady income from stocks."

My recommendations have turned traditional investing on its head. I am arguing for capital gains in the bond market and steady income from stocks. I guess that's what happens when we enter a new paradigm. If low and negative interest rates are the landscape of the future, it is very important to understand the dynamics of the market options. Steady guaranteed returns (US Treasuries) will be valued at higher levels simply based on the math; uncertainty and chaos will help their prices. Stocks, on the other hand, will wilt in the face of uncertainty, but if the underlying companies are well run, they can continue to reward investors with dividend payments.

Editor's Note

For Christmas, I got Susan tickets to a Rolling Stones concert in Philadelphia. Because of Mick Jagger's heart surgery, the event was postponed from early June to late July. Remembering a very pleasant week we spent on the Eastern Shore of Maryland six years ago, we returned to the B & B on Chincoteague Bay. When George and Carol, the innkeepers, asked what we planned on doing, we replied, "nothing" except that Susan had wanted to try crabbing. We knew nothing of the process, but our hosts gave us the skinny. You take chicken parts and put them on a metal hook tied to a long piece of string. Then you drop it into the water off the pier letting it sink to the bottom. Pretty soon you will feel a tug on the line which is the signal to slowly bring the bait to the surface. If the crabs are still holding on to the chicken, you net them and put them in a bucket. The rule is that they have to be a certain size to be a legal catch. While we snared several dozen, none were large enough to keep. Oh well. After charging our batteries in Maryland, we proceeded to Philadelphia to hear the Stones. It sprinkled a bit, but that didn't dampen the spirits of the 40,000 or so in attendance or the band members who were clearly having a great time performing on stage. I forgot to mention that we gorged on all types of crab delicacies during our sojourn. Strange to say, they all tasted like chicken.

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

Mjamesson@aol.com
Michael@JamessonAssociates.com