JAMESSON ASSOCIATES
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QUARTERLY NEWSLETTER

Recent Economic Events

Economic releases have clearly flattened out, suggesting a return to the long-run average growth rate of the American economy after the temporary sugar high induced by fiscal stimulus. On top of the organic slowing we have seen, potential hits from tariffs loom. The open question is whether a reversal to lower rates by the Federal Reserve will be timely enough and large enough to arrest the weakness.

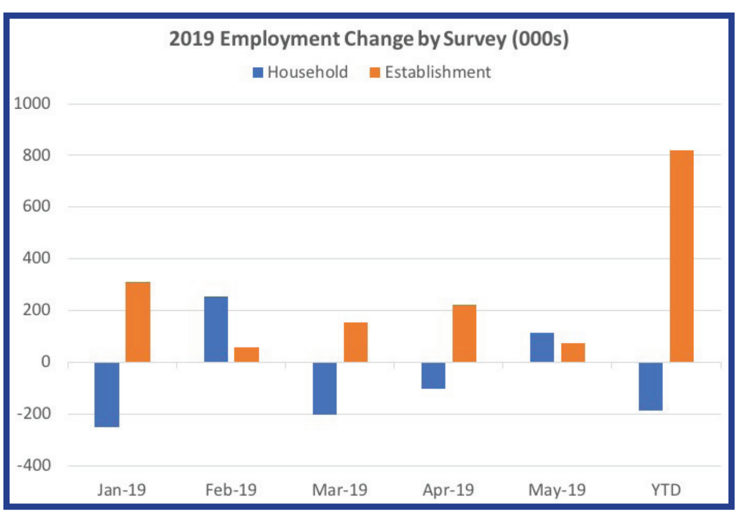
The picture of the American economy is considerably less rosy today than it was last I wrote. While some headline economic statistics seem to have improved, the stories behind the numbers are not as positive. First-quarter real GDP posted an impressive gain of 3.1%, but much of the advance was due to inventories, one-time export growth, and government spending. Excluding these factors, real sales to domestic purchasers were ahead a far more modest 1.3%, weakening for the third quarter in a row. Ultimately, it is purchases by American consumers that drive the long-run growth of the economy. On that score, April retail sales were down from March by .2%.

According to the establishment report from the Bureau of Labor Statistics, job gains are decelerating. In May, only 75,000 jobs were created, and revisions to March and April combined to reduce employment by an equal amount. This means that the estimated jobs figure at the end of May was equal to that at the end of April, dropping the 2019 monthly average gain to 164,000 versus 2018's 223,000 pace. That's actually the good news, as the household survey, from which the unemployment rate is derived, shows that there are fewer folks employed as of May than there were at year-end 2018. See the chart.

Various other key statistics on the economy confirm a weaker overall picture. Industrial production was down .5% in April. ISM surveys of manufacturing and services peaked last summer and have posted monthly declines more often than gains since then. Manufacturing orders fell in April while inventories rose. These are not signs of a healthy economy.

Inflation represents another important data point suggesting headwinds for the economy. Core PCE inflation continues to run below the Federal Reserve's 2% target at 1.6%, and first quarter GDP inflation decelerated to 1.2% annualized. Consumer price inflation has apparently topped out and is likely headed lower on the strength of falling energy prices. And after accelerating to 3.4%, hourly wages have now receded to a 3.1% year-over-year advance. Productivity jumped by 3.4% in the first quarter, helping to <u>cut</u> unit labor costs by 1.6% during the period. This bodes well for further restraint on prices and puts the lie to the Federal Reserve's argument that weak inflation is a "transitory" phenomenon.

With this as background, the President has decided to add tariffs to the mix, targeting China with escalating levies. European autos could be included



Recent Economic Events (cont.)

as well, and although Mexican products were granted a reprieve, they could easily return to the docket. The tariffs initiated to date have had only a small impact on trade, but proposed fees could be quite disruptive of global supply chains. Estimates vary, but the consensus is that tariffs will slow global trade and reduce growth while having less impact on prices than many expect. The reason: importers and consumers will shift purchases to other providers or forego them altogether creating excess capacity while financial markets adjust currency values to offset much of the direct price impact. Although Mr. Trump contends that "trade wars are easy to win," most objective observers have concluded that trade wars are lose/lose propositions.

The Federal Reserve is faced with a daunting landscape. Economic developments call for ease while calls for ease from the White House have raised political risk. The market and I happen to agree with the President and many of his advisors that a cut in the overnight rate is warranted. However, threatening tariffs in order to tank the economy, thereby forcing a rate cut, smells more like incoherent desperation than it does a well thought out economic program. Furthermore, since monetary actions operate with a lag, even a large immediate rate reduction may not stave off a recession. In that event, the Fed will have both capitulated and failed. Janet Yellen may be quite happy she didn't get reappointed.

Commentary

The Federal Reserve is in the crosshairs of both the White House and Wall Street. The former has called for rate cuts of 50 basis points; the latter has bid up the odds of rate cuts in the futures markets while also producing an inverted yield curve. In contrast to the old rule, anyone who decided to "fight the Fed" has profited handsomely.

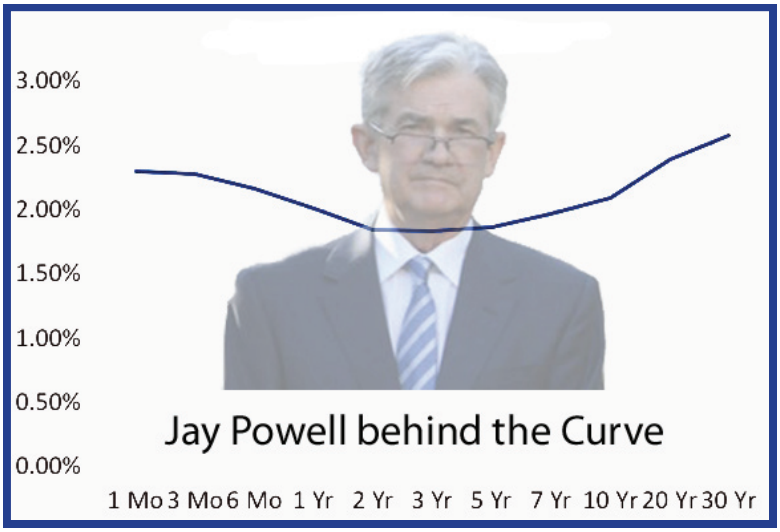
With the benefit of hindsight, it is increasingly obvious that the Fed made a mistake in raising interest rates in December. In fact, one might argue that the problem is even more deep seated. Recall that in late 2017, the FOMC decided to simultaneously reduce its Treasury and MBS holdings while raising the range on overnight rates. Lo and behold, the free-market rate started to rise relative to the range. This prompted the Fed to start shaving the interest it paid banks on reserves held at the central bank in order to nudge the free-market rate back down to the middle of the range. Not surprisingly, reserves fell, putting even more upward pressure on short-term market rates. Somewhat stealthily, the Fed actually cut the rate it pays banks in April while leaving its range intact.

The combination of political and market pressure, along with a decreased ability to control even the short-term interest rate, has severely eroded the aura of Fed invincibility. In fact, given the developments of the last few months, it is hard to see the Fed as anything more than another player, albeit a significant one. The implications are noteworthy.

Being both an economic force and a political actor has required the Fed to balance its rhetoric against its honestly held economic forecast. This leads it to overstay restraint as it tries to maintain confidence in the economy. If it voiced its concern regarding economic weakness too early, it risked creating a self-fulfilling prophecy. On the other hand, if it started raising rates when it felt prudent, instead of when it was obvious that higher rates were needed, its independence would come under question. Damned if you do, damned if you don't.

Consider that monetary policy always operates with a lag on the real economy, and further consider the political constraints that force the FOMC to act later rather than

Commentary (cont.)

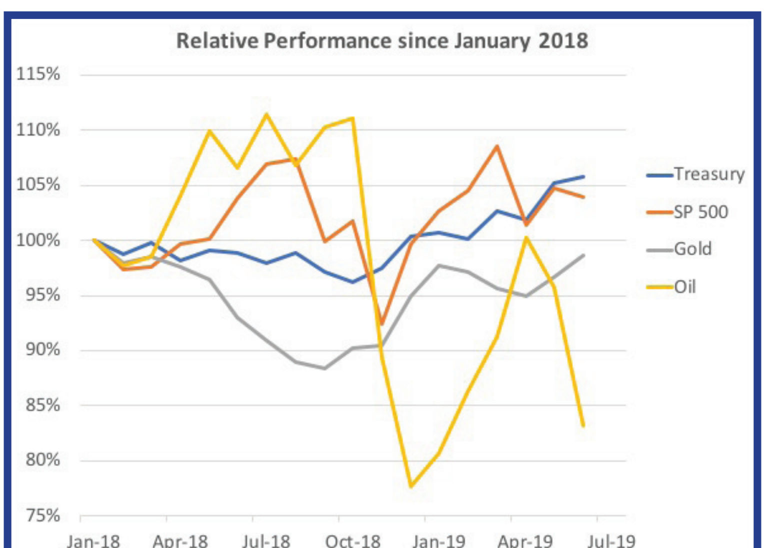


sooner. This means that the Fed will always be behind the curve and will be acting in a pro-cyclical fashion much of the time. So, instead of following Chairman William Martin's dictate to "remove the punch bowl when the party is really warming up", Jay Powell is destined to arrive late and clean up the mess that the revelers have made. Perhaps that is the best we can hope for in this world of ubiquitous access to information where the Fed can no longer hide behind the veil of opacity.

We find ourselves at a point where the Federal Reserve made an honest mistake in not fully understanding how its balance sheet reductions tightened more than it thought. This, combined with its desire to "normalize" interest rates, has led us to where we are today. Rates are at least 50 basis points and perhaps as much as 1% higher than they should be. This has helped to slow the economy and will most probably send the United States into recession. If there were ever a time for admitting an error and changing course, it is at hand. The long-term independence of the Fed may, paradoxically, turn on it bowing to political pressure today.

Market View

The stock market has made little if any progress since early 2018, notwithstanding its recent rally. Both gold and oil prices have bounced around returning to roughly where they were eighteen months ago. On the other hand, bonds have showed less volatility while appreciating nicely over that time frame. Rates on the ten-year Treasury have fallen about 60 basis points since New Year's Day 2018.



History is there for all to see. The reason you read this newsletter is to get a glimpse of the future. I believe that the key question on the table is whether or not the Federal Reserve will act quickly and decisively enough to keep the slowdown from becoming an outright contraction. My judgement on this is straightforward. If the overnight rate is not at least 50 basis points lower by the end of the summer, thereby recreating a positive sloping yield curve, a recession is sure to follow. The Fed has a chance to address this issue during their June 18-19 meeting. If they

Market View (cont.)

stand pat, reducing equity exposure in favor of either cash or fixed income is the strategy I recommend.

This means cutting positions of economically sensitive stocks such as transportation and manufacturing names. If you want to maintain core equity holdings, lean towards quality defensive names with dividends—utilities, non-discretionary consumer companies, etc. The fixed income market has already rallied significantly, but if a recession hits, rates will continue to fall. Don't take credit risk with bonds. The best bets are Treasuries, US Agencies, and highly-rated corporates. For those of you fortunate enough to benefit from high tax rates, municipal bonds make sense as well. I would target maturities in the five to ten-year range.

If Jay Powell throws in the towel and begins lowering rates, options become more complicated. Be careful what you wish for because a drop in rates engineered by the Federal Reserve will validate fears of economic weakness. If history is any guide, there will be a near-term selloff on the news. Then, an assessment of whether or not the cut will work will determine what happens next. Predicting an if/then is always treacherous, but here goes.

If the cut is only 25 basis points, and the statement is mealy-mouthed, I would continue to expect a recession. The advice above still holds. However, if they cut 50 basis points and indicate that they are open to more if the economy continues to slow, then a program of adding to equity holdings over time makes sense. Set up a program to invest over a six-month time frame. This will protect against the emotional urge to stay on the sidelines in the face of a weak market. Once a recovery is in process, the stock market tends to jump, leaving late movers behind. If the Fed lowers rates sufficiently to drive the 3-month Treasury Bill below the 10-year Treasury Note yield, refrain from adding longer-term bonds in favor of stocks. And if the stock market rallies by 10% or more from a low, look to sell bonds that you may own at a profit.

Historically, commodities rise at the end of an economic expansion because of supply constraints. That doesn't seem to be the case this time around. We have probably seen the peak on oil and other industrial commodities while weather seems to have created an upward trajectory for grains and meats. I would avoid these markets as they seem to be more volatile and politically driven than usual.

Editor's Note

I like candy. In fact, I like it so much that I always have some behind the driver's seat of my car. As I drove off to a meeting, I would reach around the seat to grab a treat. Repeated forays seeking sugar goodies caused me to inflame my rotator cuff. A trip to the doctor and physical therapist resulted in an exercise regimen which has returned my mobility. However, there was a secret ingredient that accelerated my recovery: hemp-derived cannabidiol cream. CBD is the non-psychoactive product of a relative of the marijuana plant. I have been rubbing the cream on my affected shoulder for the last few months. The results: a general tingling sensation along with a reduction in pain after my exercises. Oh, I should also mention a craving for munchies. Maybe I'll add potato chips to my candy stash.

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