JAMESSON ASSOCIATES

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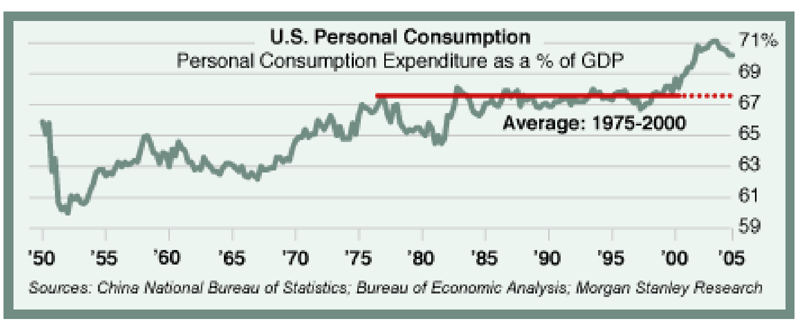
Recent Economic Events

It looks like the American consumer is finally showing signs of strain. Although third quarter GDP figures still reflect solid momentum, the more recent data on employment and retail sales are much weaker. On the plus side, and in spite of a weak dollar and high oil prices, inflation appears to be well-behaved.

The hero of the shallow recession in 2001 and the recovery since then has been the American consumer. Facing consistent predictions of imminent weakness, he and she have surprised observers with continued willingness to spend. In fact, the percentage of GDP accounted for by consumer spending has moved well above its historical average of 67%.



Sources: China National Bureau of Statistics; Bureau of Economic Analysis; Morgan Stanley Research

However, recent data suggests that we might get a visit from the Grinch this Christmas. First, the post-Thanksgiving sales figures were weaker than expected, especially for those retailers serving the lower end of the market (Wal-mart). Then motor vehicle sales for November tallied a puny 16.3 million units. Domestic manufacturers were especially weak. This is another indication of stress at the lower end of the market. Finally, the weekly chain store sales report for early December posted an additional decline (1.7%) from late November, dashing hopes that the post-Thanksgiving slump was temporary.

If we gaze back in time to the third quarter, we find more positive news. The GDP increased by 3.9%, up a bit from its second quarter performance and completing over a year of growth above potential. If this were a normal economic recovery, growth in overall GDP for this long would have easily overcome the employment declines from the recession (over three years ago) and pushed us to new highs. Didn't happen.

Total non-farm employment remains below the peak in 2001 and is at least 8 million jobs behind where we would have expected it to be based on historical comparisons. A gap of that magnitude proves that we really are in a different environment today. There were strong hopes for job growth in the wake of the October figures, originally pegged at 337,000 new jobs. But when the November report was released earlier this month, the October figure was revised downward to 303,000, and the November total registered an anemic 123,000 jobs. Furthermore, the average workweek declined by a tenth of

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Recent Economic Events (continued)

hour, and hourly wages were up only 1¢. In fact, weekly wages were actually down even before inflation. This performance is clearly not enough to keep the consumer happy and spending, a fact recorded in the unexpected decline in Consumer Confidence reported for November.

Confidence at the consumer level is not the only thing flagging. The US dollar has tanked in the last month. It has fallen to an all-time low versus the Eurodollar and is threatening to break through the 100-yen barrier, not seen since the early 1990's.

There are concerns that this weakness will lead to higher inflation as importers pass along their higher costs and domestic companies take advantage of the pricing umbrella to raise their prices as well. There is some evidence of acceleration in the most recent figures. In October, the CPI was up .6%, bringing the year-over-year rate to 3.2%. Excluding food and energy, the rise was a more benign .2% or 2.0% year-over-year. Keep in mind, however, the indices take us only through October. Oil has plunged by about 25% since then, and Wal-mart admitted its sales were weak because it tried to hold prices higher than competitors. We may be witnessing the inflation high point rather than a step along the way to even higher levels.

The American economy (and by extension that of the world) depends on the American consumer to buy, buy, buy. Recent statistics suggest that at least some consumers are showing signs of fatigue. Unless employment regains momentum, we may have seen the best part of the current recovery. ❖

Commentary

It's now official. Credibility is not a requirement for a position in the Bush cabinet.

The architects of our disastrous Iraq policy, Condoleezza Rice and Donald Rumsfeld, have retained or increased their stature. And after over a week of speculation about his imminent exit from the cabinet, Secretary of the Treasury John Snow was asked to stay on by President Bush. Mind you, this was after a particularly catty quote from an unnamed "senior administration official" that read, "He can stay as long as he wants, provided it is not very long."

Setting aside the blood sport of Washington politics, one has to wonder about the effectiveness of a Secretary of the Treasury who has been hung out to dry by the White House. An administration that has been nothing if not controlled in its message was clearly of more than one mind on this one.

Perhaps lack of credibility was what they were seeking. The President's dollar policy has been classic. Even thought Secretary Snow has voiced verbal support for the dollar, the actions pursued by the administration have been quite effective in weakening its position. It is hardly a coincidence that renewed dollar weakness followed in the wake of the President's re-election.

The economic issues facing the US during a second Bush term are daunting. Having dissipated the budget surplus he inherited with a dramatic series of tax cuts, the President is now focusing on a dual platform of tax reform and Social Security privatization. The constraints: no new taxes and continued deductibility for home mortgage interest and charitable contributions.

Needless to say, this is a tall order. If Mr. Snow's past "successes" (continued on page 3)

Commentary (continued)

dollar, errant projections of job growth from tax cuts, and ridiculously low estimates of the costs of last year's Medicare enhancements) are any indication, the agenda is already in trouble.

To be fair, the initiatives that have been floated are very broad-brush at this point. They do, however, bear a striking similarity to other riverboat gambles that the President has pursued. The sweeping changes that are contemplated take little note of either the current fiscal position of the government (deficits don't matter) nor of the impact they will have on further polarizing the income and wealth distribution in the country. As Vice President Cheney famously remarked, "we won, and we can do what we want."

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The history of second terms is replete with hubris. Initial indications suggest this second term will be no different. If I were a betting man, I would take the other side of the President's gamble on tax reform and Social Security privatization. My prediction: the complete takeover of the government by Republicans will engender intra-party fractures, and the sweeping changes articulated by the President will not make it through a divided Congress. I expect fiscal responsibility to win some unexpected victories. ❖

Market View

One of the most puzzling facts of the investment landscape over the past few years has been the apparent disconnect between record levels of deficits and debt in the US and the historically low level of interest rates. This is true on both a nominal and a real basis. A recent study by BCA Research suggested what I believe is the most plausible explanation.

They point out that even though the US is draining worldwide savings to the tune of $650 billion (up $200 billion since 2002), global savings are growing even faster. Turns out that as we have sunk further into debt, Latin America has repaired its chronic savings shortfall, and the nations of east Asia, including Japan, have continued to over-save. In addition, the sharp rise in oil prices this year has created significant excess revenues for Russia and Mid-East oil producers. Put the excess savings all together, and they total close to $300 billion more than they did in 2002. With more savings growth than borrowing growth, interest rates tend to fall.

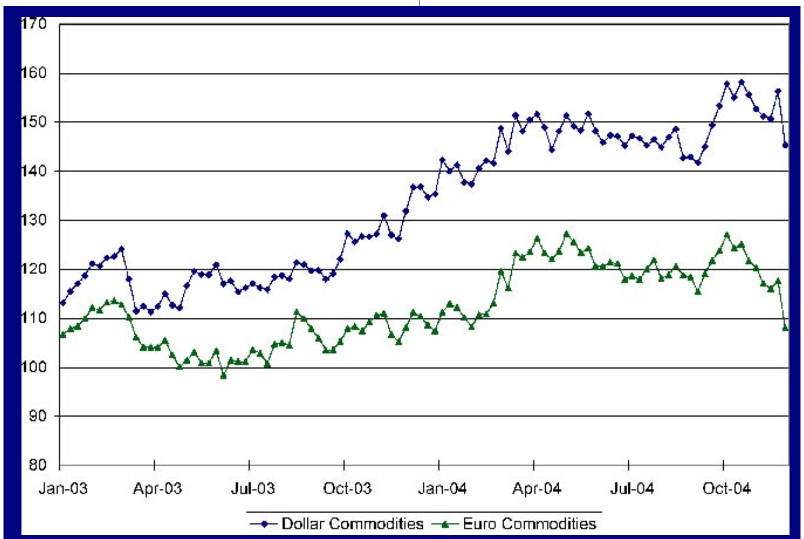
If this explanation does a good job with the past, the big question is whether it will work in the future. Can we expect others to continue to fund our borrowing at attractive rates?

The recent auction of the five-year Treasury offers some insight. Out of $15 billion auctioned, indirect bidders (generally conceded to be foreign central banks) ended up with $9.7 billion or a record 66%. Dealers got caught short, receiving only about $5 billion. The rest went to non-competitive buyers and non-dealer direct bidders. Demand appears to be strong.

An interesting fact found buried in the third quarter GDP release was the decline in corporate profits adjusted for inventory revaluation and capital consumption. Some of the decline can be attributed to the impact of hurricanes, but the deceleration of profit growth has been apparent for a few quarters now. (continued on page 4)

Market View

Then, of course, there is the obvious. The dollar is under pressure. The Eurodollar touched a new all-time high this month, although if we were to recreate the currency based on historical values of its constituent parts, it was higher in the early 1990s. The British Pound is near a twelve-year high, and the Swiss Franc is near an all-time high. Clearly, confidence in the US dollar is under pressure. This suggests caution in claiming the global cash flows will continue to recycle. However, if we claim that, we must review the question of commodity price inflation.

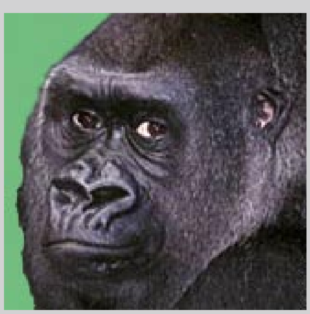


If we express the price of commodities in dollars, they look like they are in a bull market. But, if we look at them in Eurodollar terms, inflationary pressures are much less obvious.

At this uncertain juncture in the markets, I offer these thoughts. Interest rates will remain range bound; the weak dollar will encourage foreigners to buy US real assets and Americans to invest overseas; and dividends continue to pay you while you wait.

If these thoughts prove to be true, investors should move another portion of ready cash into longer-term bonds (especially on weakness), foreign markets, and real estate in the US that benefits from foreign dollars. This latter category suggests hotels, especially those on the east and west coast. Furthermore, my oft-stated (and accurate) recommendation to look for dividends becomes even more important. ❖

Editor's Note



Michael Jamesson
Jamesson Associates
Scottsville, NY
(585) 889-8090
Mjamesson@aol.com

It's funny the things that catch your interest, and the connections that you draw. Susan and I recently attended a Holiday Ball where I wore a tuxedo (read: monkey suit). Just today I read a touching story about a gorilla that had died and how the other gorillas in the zoo were offered the opportunity to "pay their respects" to the departed. The observed situation had an eerie resemblance to a wake and suggests a much closer psychological/emotional tie than I had ever considered. And before the inevitable emails and phone calls start, it is quite obvious which picture is mine and which is the gorilla's.