JAMESSON ASSOCIATES

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Recent Economic Events

The US economy continues to frustrate bulls and bears alike. Growth is tracking along at potential and although employment is not as strong as we would like, price pressures are weaker than expected. Consumer consumption is strong while domestic manufacturing is in the doldrums.

Most economists peg the potential growth rate of the economy at 3% to 3.5%. Real GDP advanced by 3.5% in the first quarter, completing a string of eight quarters with growth at or above potential. Contributing most positively to the growth figures were personal consumption, business investment and inventories, and, of course, residential real estate expenditures. Our global trade activity acted as a brake on growth.

Employment continued its saw-tooth pattern of alternating strong and weak months. During April 274,000 jobs were created, but May produced only 78,000. The best way to view the employment picture is to average a longer period of time together. For example, over the last year, 165,000 jobs were created on a monthly average basis. This is a figure that is close to the natural (potential) growth of the labor force and resulted in a few tenths of a percent decline in the unemployment rate over the last year.

Although the employment picture is solid not super, we can reverse the adjectives when we look at inflation. Core inflation measures appear to have peaked for this cycle. The most recent core Producer Price index was up .3% (2.6% year-over-year), the core Consumer Price Index was unchanged, bringing the year-over-year figure to 2.2%, and the core Personal Consumption Expenditures Price Index increased .1% (1.6% y-o-y). Note the further you get away from commodity prices and closer to consumer choice, the lower the price gain becomes. Americans may be consuming goods and services with borrowed money, but they appear to be driving a hard bargain on price when they do.

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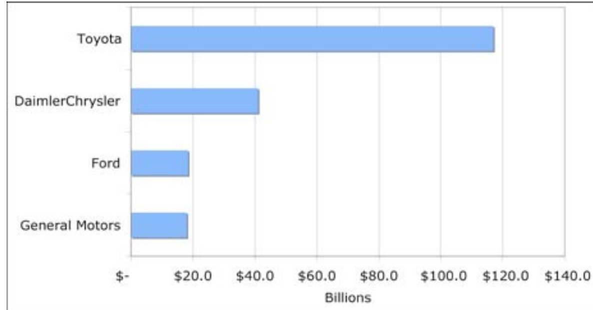
The relentless pressure towards lower prices is the driving thrust behind the woeful performance of the US manufacturing industry. Once again, manufacturing jobs fell during May. The decline of 7,000 jobs brought the cumulative loss since last August to 67,000. On top of this, two past icons of American manufacturing prowess, Ford and GM, were ignominiously dropped to junk bond status since my last newsletter. General Motors is now the subject of billionaire Kirk Kerkorian's "investment" overture. Note that within weeks of the takeover artist's move, GM announced plant closings and

(continued on page 2)

Recent Economic Events (continued)

25,000 job cuts. To see the travails of the US auto manufactures, look at this chart that compares the market values of the top four global producers.



The economy's dynamic at this time includes solid consumer spending at bargain prices. This draws in low-cost goods and services from overseas and puts pressure on domestic manufacturers. The predicable result: poor employment prospects for these companies' employees with ever-increasing debt levels for the consumer sector as a whole. As long as the money flows continue, the trends appear to be durable, and America's transformation from goods-producing to finance-based service economy powers ahead.❖

Commentary

Anne Bancroft, aka Mrs. Robinson, died this past week, and it got me thinking about the famous line from "The Graduate". Today, the whispered advice would not be "plastics" but rather "learn Chinese."

There is good reason for the focus on China. It is the most populous nation in the world and has one of the highest economic growth rates. Credible analysts suggest it will be the largest economy in the world before the midpoint of this century. Currently, China is generating both a strong bid for raw materials to feed its growth and a disinflationary wind for its finished products. And yet politicians from both sides of the political spectrum and both sides of the Atlantic are complaining. Are they justified or must we all realign our thinking?

Secretary of the Treasury John Snow and New York's senior Senator, Charles Schumer, are on record complaining about unfair currency manipulation by the Chinese. They want a revaluation of the Yuan to "help American products compete." The surge of textile exports to Europe has led the European Union to look at reinstituting quotas.

But is the value of the currency really to blame? I think not. When most analysts look at the "China Price" they find that it is anywhere from half to one-quarter the domestic price. And this price has not been much changed over the past several years. The change in the equation has been the rapid increase in quality from China. Where the price differential a few years ago forced domestic manufacturers to go up the quality ladder to maintain market, the Chinese have now caught up. But have they done it by lowering the value of their currency? No! In fact, during the Asian currency collapse in the late 1990s, other countries devalued, but China held at the now-famous 8.3 Yuan to the dollar. This level has been fixed for ten years.

Think of China as another state of the United States. In fact, it's a lot like the US south in the wake of air conditioning. Prior to that invention, it was difficult to get the productivity common in cooler climes because the heat and humidity would sap worker energies. After A/C, there was a steady exodus to warmer areas as companies took advantage of cost differentials for labor. This trend has continued to gain momentum and many European

(continued on page 3)

Commentary (continued)

and Asian companies have entered the US south with new production facilities. Money, jobs, and people moved south. First, the capital markets adjusted, and then, so did wage levels and amenities. There was no currency differential between Michigan and South Carolina; there was an initial difference between wage levels and productivity that companies exploited.

If we consider China in this same light, we can start to see the real dynamic. The Chinese have had a tremendous increase in productivity over the past ten years, but this has not been reflected in either wage scales or in the value of the currency. It is being reflected in lower prices for quality goods in the developed world. Ultimately, the benefits will be more widely distributed, but a change in the currency value anything like what is being considered by China-bashers (15% or so on the high end) is not likely to change the overall fact that China is the world's low-cost producer. And they are the low-cost producer not because of the currency rate but because they have been able to use modern production techniques combined with a well-trained and outfitted labor force. Now they are improving quality.

My view on the revaluation of the Yuan is "Be careful what you wish for". Any level of change that could be reasonably contemplated by the Chinese will expose the productivity issue and force Americans to consider how they will ultimately compete in the global economy.❖

Market View

How I Learned To Stop Worrying And Love The Bond.

In the tradition of Stanley Kubrick's "Dr. Strangelove", the markets have driven longer-term interest rates to unexpectedly low levels. The ten-year Treasury broke below 4%, but that's not the lowest level of rates in the G-7. In fact, long-term rates in most of the developed world are lower than those in the US. Why? First, inflation is not going to get out of hand, and second, there is a dearth of yield and duration in the global world of investing.

Note that these are market/valuation issues rather than fundamental economic considerations. Note also, that these same two points can be supportive of the stock market. Most importantly, note that there is a good deal of disagreement over the truth of these statements. Opinions and markets can change quickly.

Just like the global game of chicken depicted satirically in "Dr. Strangelove", the bond market and the Federal Reserve are trying to see who will blink first. At this juncture, it appears that there is some uncertainty on the part of both sides of the debate.

(continued on page 4)

The Fed has been sending mixed messages to the market through the remarks of different Fed Presidents and members of the Federal Reserve Board. Richard Fisher, president of the Dallas Fed, commented that he felt the tightening process was in the "eighth inning" and that the "ninth inning" was coming up later this month. A few days later Board member Edward Gramlich suggested the game was more likely in the middle innings. The final word came from Chairman Greenspan who initially declined to disavow the late inning analogy in a speech on June 6th only to follow up with a repetition of the need for "measured" rate increases to "remove monetary accommodation" on June 9th.

For its part, the market lost its nerve after powering through the 4% barrier and touching 3.8% (ten-year basis) in the wake of the disappointing employment report. Since then, it has been marking time and retesting the 4% level.

Although uncertainty reigns at present, market commentators do not have the luxury of punting on a forecast. So here goes. I believe that the level of interest rates is far closer to normal than does the Federal Reserve; however, I am not convinced at this time that they have a lot of room to fall. This means focus on collecting the coupon rather than capturing capital gains. I would concentrate on the longer end of the curve as well. Ten years and beyond seems to be well supported with buyers while the shorter portion of the curve (two to three years) continues to be buffeted by the actions of the Federal Reserve. The middle ground (five to seven years) looks like the worst place to be. Too short to provide the best yield and too long to reinvest if I am wrong. I would also stay with high quality, and for those who can use tax-free income, municipal securities appear to have value.

My stock market views are unchanged. Look for dividends, not potential price appreciation. Consider that the most significant economic event of the last fifty years has been the "Baby Boom" generation's buying habits. The front edge of the cohort will be entering retirement by the end of this decade. Their need for income will supercede their desire to trade stocks for gains. This, combined with the continued excess savings from around the world, should make stocks with good and potentially increasing dividends the best choices for the next several years.

Commodities have corrected the sharp upswing during the spring but still have a solid underpinning. Since I believe that the global economy will continue to grow at potential, the demand for commodities is likely to remain strong. This market is most probably nearer to the beginning of a multi-year bull market than it is to the end. Buy on weakness if you have the opportunity. Adding energy-related stocks is another way to play this trend. ❖

Editor's Note

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

I finally took the plunge and acquired my own domain name, Jamessonassociates.com. The new web-site is under construction but has both a blog (I encourage you to post your comments) and an archive of newsletters. Both my old and new email addresses will work.