Jamesson Associates

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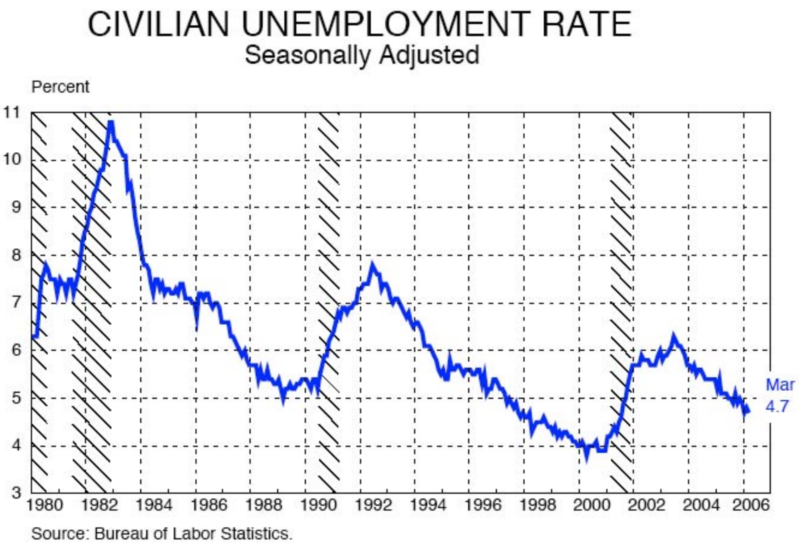
Recent Economic Events

Most economic statistics reinforce the notion that things are going well. Projected growth in the economy is picking up while unemployment has hit a new low for the cycle. Inflation is receding. Confidence in the economy has increased at the consumer level although it may not be as apparent with businesses. One caveat: the housing market is clearly in a slowdown.



The final GDP estimate for the last quarter of 2005 was 1.7%. This was the result of the disruption of activity due to the hurricanes last year. Most economists expect the first quarter this year to bounce back strongly (4% to 5%), and more recent economic statistics bear this out. Retail and business sales have remained strong, and this has led to a new low in unemployment for the cycle, 4.7%.

In March, job growth totaled 211,000, pulling up the first quarter average to almost 200,000. Even so, other job market statistics were more muted. The average workweek did not budge (33.8 hours) and wage gains eased back to .2% from .3% in February.

Inflation, the Fed's bugaboo, is remarkably low. The Consumer Price Index both overall and core increased a modest 0.1% in February. This brings the annual increase in these measures to 3.6% and 2.1%, respectively. Both are below their peaks for the cycle set last year. Other inflation measures, such as the PCE and the PPI are also showing few signs of acceleration. While it is understandable that Mr. Bernanke is trying to prove his mettle against rising prices, it appears that this is a dragon that will not fight.

As you might expect, growing employment and modest inflation have helped to keep consumer spirits high. The various consumer confidence measures have all improved nicely over the quarter. Most impressive is the Conference Board index which is threatening a post-2002 (after Iraq) high.

Unfortunately, there are two possible negatives on the horizon. Businesses, which would be expected to be quite optimistic, are still hoarding cash rather than expanding, and the housing market is showing signs of a slowdown. In the fourth quarter, business

(continued on page 2)

Recent Economic Events (continued)

profits hit an annual rate of $1.5 trillion. This is an all-time high in absolute terms and is close to one in percentage of GDP terms. However, businesses are not reinvesting the cash. 2005 ended with a net excess of cash flow over and above new capital spending that was close to $100 billion.

The housing market has exhibited many signs of slowdown. Sales have generally softened and the inventory of unsold homes has increased. Prices are no longer rising as briskly as they had been, and builders have become decidedly downbeat.

The traditional economic statistics are showing good strength and momentum. Jobs and overall growth are in good shape and inflation remains quiescent. Consumer confidence is high, which should keep the economy growing. The open questions at this point are why businesses haven't picked up on the enthusiasm and whether housing will eventually drag down the consumer. Right now it appears the forces of optimism on the economy are on top, and we can cautiously endorse continuation of the expansion.

Commentary

George W. Bush is teetering on the brink of a failed Presidency if he has not already gone over the edge. A failed Presidency is one where the credibility of the President is so eroded that he cannot govern. In my adult life, there have been two failed Presidencies — Nixon and Carter. Fortunately, these examples lasted less than one year as the former resigned and the latter lost re-election. Mr. Bush still has close to three years in office.

S&P 500
1973: - 17.4%
1974: - 29.7%

President Bush has not had an approval rating over 40% in any poll released in the last month. The most recent figures place him in the mid-30% range. Furthermore, his base in the Republican party has begun to fade. From levels consistently over 80%, he is now registering 70% or lower.

Just as important as the rank and file deserting the President is the exodus of opinion-makers. Conservatives and neoconservatives alike have broken with him on Iraq (William Buckley, George Will, Francis Fukuyama), small government types over the deficit (Bruce Bartlett), and Kevin Phillips over, well, over being Bush. Congress has also moved from partial revolt at the Harriet Miers nomination to full rebellion on the Dubai Ports deal. Republican discipline is in shambles.

Why is this important and especially why is it important to investors? Although we Americans love to complain, the fact is that we depend on a well-functioning government for the stability necessary for economic success. A quick review of market performance in 1973-74 shows Mr. Nixon's last days to have been the worst back-to-back stock market years since the Depression. Although 1980 (when Mr. Carter's failure over the Iran hostage crisis played out) was not nearly so bad for the stock market, it was a disaster for the economy (GDP: -0.2%), the bond market (10-year: 12.8%), and price stability (Inflation: 12.4%).

The sad spectacle of a failed Presidency is one that should concern Americans of all political stripes. Without credible leadership at the top, the excesses of a free-for-all Congress will take center stage. Given the grandstanding we have seen already (Dubai Ports, immigration, Chinese currency policy), it is hard to be optimistic. (continued on page 3)

The current economic situation is one where the initial burst of growth from recovery is behind us. Real problems abound from the twin deficits to health care and energy policy. Not to mention foreign policy and Iraq.

A Democratic takeover of one or both houses of Congress is no panecea either. Although some checks and balances come into play, we would also be presented with a parade of hearings on what Mr. Bush and his advisors have done wrong. That will not solve problems. The best we can hope for is that the President gains back enough credibility to hold things together until 2008, doing no more damage. However, hope is not the best way to manage money.

Currently, the markets have taken a rather sanguine view of the state of affairs. Interest rates are up a bit, but by and large risk premia are not much different from what they have been. The complacency of the markets coupled with the real possibility of a failed Presidency is jarring in its dissonance. Based on my current read of the risk/reward ratio, now is a good time to take some chips off the table and reduce risk. If things work out, there will be opportunities to reinvest. If they follow the path of 1973-74, you will be happy to be in cash.

Market View

There are some strange things going on in the markets. Long-established trends are poised to or have already reversed. Although the street is littered with broadsheets purporting to call the turn, I believe that three items could be harbingers of secular trend change — gold, Japanese monetary policy, and the US international income position.

Gold recently touched $600 per ounce, its highest level since January 1981. Not coincidentally, that date corresponds to the inauguration of Ronald Reagan and the double-digit interest rate policy of Paul Volcker to bring down inflation. Success drove the annual inflation rate to just over 1% in 2002. Since then, inflation has risen, but only modestly as measured by the core rate, certainly not enough to justify multi-year if not all-time highs in gold and other commodities.

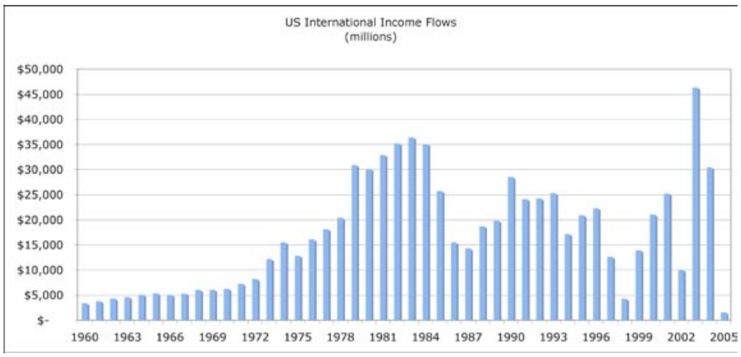
Japan has announced that they will soon end their "quantitative easing" policy. Essentially what this approach involved was dumping liquidity into the system by acquiring government bonds. It was a way to ease even further than maintaining a zero interest rate policy (ZIRP). The development that prompted this change was the first positive annual inflation rate in Japan in 7 years. Furthermore, job openings exceeded job seekers for the first time in over 13 years, and Japanese stocks have achieved levels not seen since the collapse in equity prices took hold in the early 1990s.

The United States has been the most profligate borrower in the history of the world, piling up external liabilities of approximately $13.8 trillion versus foreign assets of $10.5 trillion at the end of 2005. That nets to a $3.3 trillion shortfall. Some have argued that we can't just look at balances because the make-up of our assets and liabilities is different. Most American foreign assets are either direct investment or equity holdings while most of our liabilities are fixed rate borrowings. This has led to the curious fact that our net international income account is positive even though our balance sheet is massively negative. However, this happy state of affairs is draw- (continued on page 4)

Market View (continued)

to a close. After a long stretch of positive income figures, the US dipped negative in two quarters of 2005. The annual position is ready to go negative this year.

The facts: a multi-decade breakout in the price of gold, a turn in the Japanese economy that will lead to the reversal of aggressive liquidity pumping, and the net investment position of the US following its balance sheet into negative territory. So, what does this mean?



Normally, higher gold prices signal impending inflationary pressures, but it can also signal other worries.

I think it is hard to over-estimate the impact of the ZIRP over the past seven years. Global liquidity has been primed by the extremely low cost of borrowing funds in Japan to be used to make levered investments in assets around the world. The other prop to trading profits has been non-appreciating yen. Now both parts of the trade are unwinding. Can you see elephants heading for the door?

With US international income flows joining the asset/liability position in negative territory, the last rational reason to be long the dollar has faded. However, the dollar is still the linchpin of the global economy.

I think the three secular trends I have cited, taken as a whole, are signaling the same thing — risk is increasing in a world with still-low rewards for accepting risk. In my opinion, the markets are poised for a rough ride with little reward. Sell investments not part of your permanent, long-term holdings. Why not wait out the storm in short-term (up to one year) fixed-income options yielding 5%? If it turns out that we do have "blood in the streets," there will be plenty of time to buy beaten-down bargains.

Editor's Note

Just so you don't think that I am a Gloomy Gus all the time, I submit the accompanying photograph taken at the Scottsville Library Mardi Gras fundraiser. My wife Susan helped to organize the event which successfully raised proceeds to jointly benefit libraries locally and in New Orleans. Further note, I am the sun while Susan is the rain.

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