JAMESSON ASSOCIATES

April 2007 Newsletter

Recent Economic Events

All eyes appear to be on the housing market, and for good reason. The boom is over as both sales and starts have dropped sharply over the past year. Nevertheless, GDP continues to grow, helped by an improving trade picture, and the unemployment rate is at a recovery low. While inflation appears to have peaked, it remains stubbornly high, hemming in the Federal Reserve.

It is hard to pick up a newspaper today without seeing some story related to the slowdown in housing. We have recently been treated to the spectacle of increased delinquencies (north of 13%) in "sub-prime" mortgages and the failure of more than a few of the lenders specializing in this portion of the market. Far from being a sidelight, it appears that "sub-prime" borrowers, along with their kissin' cousins "Alt-A" loans, accounted for about 40% of mortgage originations in 2006. Not only are these folks defaulting at higher than expected rates, but because of tightening credit terms, they no longer represent a steady supply of first-time homebuyers, providing liquidity for those wishing to trade up. Sales of both new and existing homes are down over the last year (minus 20% and minus 3%, respectively). And yet, homes for sale have grown to represent a real drug on the market. Not surprisingly, this has had the result of sharply curtailing residential construction. Starts plunged to below the lows seen in the last recession, although somewhat better weather caused a bounce-back in February.

Fortunately, housing is not the entire economy. Although we have witnessed double-digit annualized declines in residential investment over the last three quarters, GDP remains in positive territory. The fourth quarter 2006 estimate reported 2.5% growth, suggesting that housing took about .75% to 1% off the rate of increase.

A key prop to growth has been America's export performance. Unbeknownst to most, exports have managed to maintain at least a 10% year-over-year increase since early 2004. In total, our exports are almost 50% higher than they were three years ago. Now that imports are finally slowing down (up less than 2% from 2006 in January), we are seeing a positive contribution from our foreign trade component. There is a long way to go, but the momentum is toward smaller trade deficits.

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Recent Economic Events (continued)

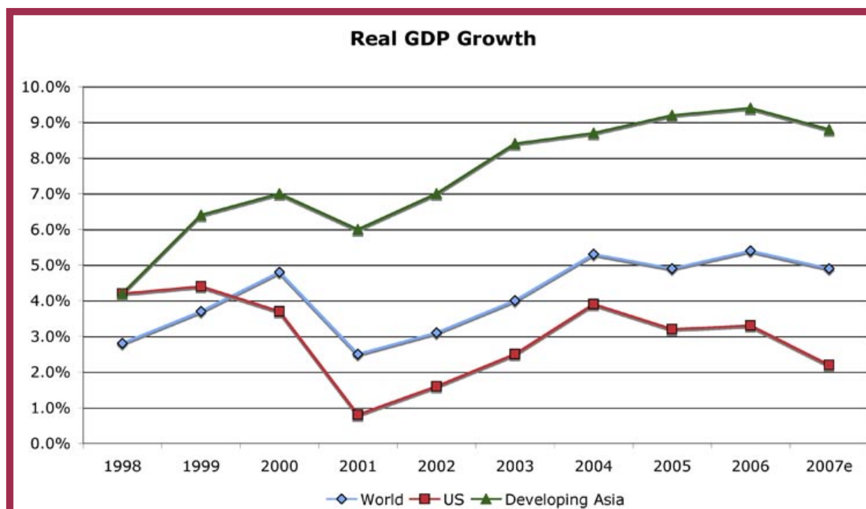
The truly good news story is the continued momentum in job creation. March figures indicated 180,000 new jobs were added, and the unemployment rate receded to 4.4%, tying the low for the recovery. It is clear that the March total was impacted by the vagaries of the weather, but the first quarter average was a solid 150,000, and for the umpteenth month in a row, the previous estimates were revised upward. There is no reason to expect that this will not be the case going forward, as the Labor Department struggles to capture jobs from new companies and new areas of the economy.

February's inflation reports were disappointing. Core CPI was up .2%, bringing the annual increase to 2.7%, uncomfortably close to its high for the cycle. Core PCE increased by .3%, pushing its annual advance to 2.4%. None of these figures give the Federal Reserve any room to lower rates in the near future. However, if we look inside the figures, an interesting fact emerges. If not for the rent component of inflation, both core measures would be well within the Fed's tolerance range. Since the housing market is now showing signs of price weakness along with weakness in sales and starts, we may find some pleasant surprises on inflation reports as the spring and summer play out.

Currently, the American economy is growing below trend as housing is subtracting more than export acceleration can add. Employment, however, remains strong and a break in inflation could allow the Federal Reserve some wiggle room. ❖

Commentary

The American economy is the largest in the world, but it is no longer the key driver of global growth. Over the last decade, the US has moved from an above-average growth rate to below average when compared to the total global economy. Its position as the engine pulling the train has been superceded by emerging nations. The 21st century has seen the developing Asian economies take the lead in growth.



Note that, in some recent years, developing Asia has doubled or trebled US growth. Furthermore, the strong growth over the past three years, and that expected for 2007, represents excellent performance by the global economy. In other words, things are good even though the US is responsible for less of the impetus.

The implications of this transition are significant. It is no surprise to me that the price of oil has held up. Even with a slower growth path in the US, demand from China (and to a somewhat lesser extent India) is keeping oil producers in clover. Demand for other goods is also strong, and the correction in the major com-

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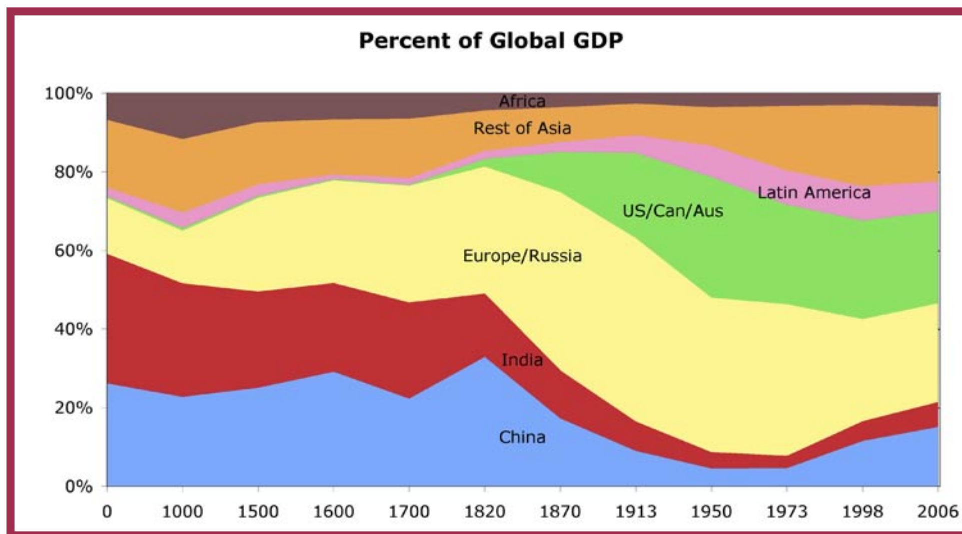
Commentary (continued)

modity indices was not as deep and long as many expected. In fact, if we view the history of global production over the past two millennia, we find that for most of that period China and India were the largest economies in the world. It is not a reach to suggest some people alive today will live to see this occur again.



The key takeaways from these observations of global growth are threefold. First, in order to predict economic trends, we can no longer maintain an American-only myopia. Overseas developments must be factored into our projections. Second, it is not all George Bush's fault that the US is losing relative position in the world. Converging labor and educational skills and the inexorable force of population make the changes inevitable. This said, it doesn't make sense to make things worse. Picking a trade fight with countries that we need to sell to or that hold trillions of dollars of our securities is just plain dumb. Third, money will flow to where it is needed to support growth. Successful investing must include both domestic companies with significant global reach and foreign companies poised to benefit from overseas growth. ❖

Market View

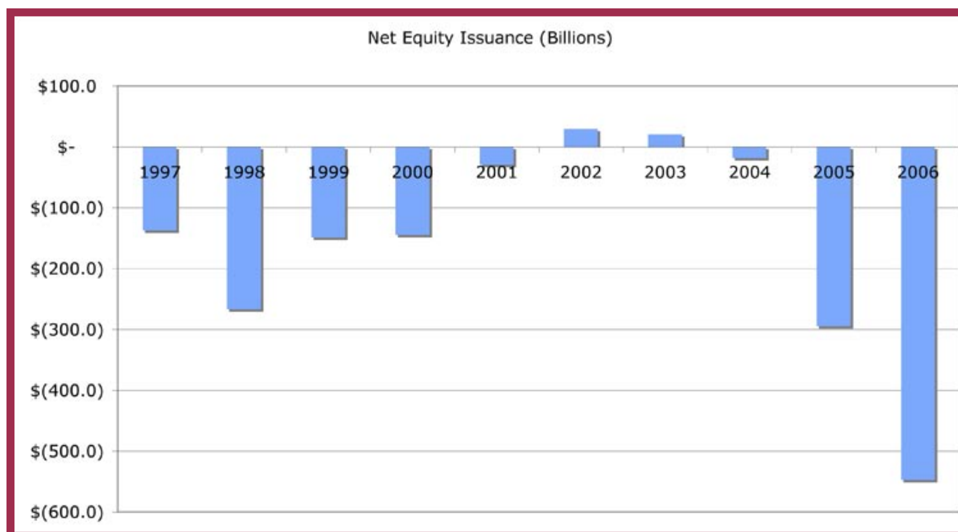
A funny thing happened in the wake of the Federal Reserve's decision to go on hold with the Federal Funds rate last summer. Money supply growth started to increase. After pushing the growth of M2 down below 5% on an annual basis and to around 2% on an annualized quarterly basis last May, the stay-the-course policy has created annual growth of almost 6% and annualized quarterly growth near 8% as of February. Preliminary March measures suggest further acceleration. Increasing liquidity is not a sign of an economy likely to plunge into recession. It is, however, a possible sign of increasing price pressures.

The next few months are likely to feature a battle in the markets between the "sub-prime lending contagion" group on the one hand and the "looks like inflation is speeding up" crowd on the other. Both developments suggest that investors should stay away from financial stocks. Citigroup validated this point with its recent announcement on sweeping job cuts.

However, the last few years have been characterized by excess global liquidity trying to find its way to the best returns available. This has helped markets of all types, and there is every reason to suspect that any new liquidity growth (continued on page 4)

Market View (continued)

will add to the demand for investment assets. Indeed, a very real manifestation of this development is the cascade of dollars flowing into private equity funds and the resulting use of these funds to acquire public companies. A consortium of funds announced they were acquiring Texas Utilities in a $32 billion deal — the largest LBO ever. In fact, the *Wall Street Journal* reported earlier this week that due to the combination of stock buybacks and private equity takeouts, the supply of equities in the US markets shrank by a record $548 billion in 2006.



With liquidity up and shares disappearing, it seems like a good time to stay fully invested. But based on the last time this happened (in the run-up to the dot.com collapse in 2000), beware of any turn by the Federal Reserve to drain liquidity as they did right after Y2K worries had passed. I believe that at this point in the cycle the key to investing is watching liquidity and interest rates rather than earnings.

Other major asset classes must be considered using the same rubric. Liquidity is trying to find a home, and it will seek out real estate, commodities, or bonds just as well as equities. On a tactical basis, I think it is too early to buy homebuilders or lenders but not too early for commercial-oriented real estate like REITs. Just stay away from those that are really lenders disguised by the REIT structure. Commodities should be acquired on weakness now that the mania to turn crops into ethanol is with us. This ties agricultural commodities to the overall upward thrust we have seen in energy and industrial commodities. Bonds should be played based on the established trading range. Use the ten-year Treasury as a market trigger. When it gets near 4.75% to 5%, buy bonds with maturities in the two to five-year range. ❖

Editor's Note

I have been less than regular with the editions of this newsletter, resulting in my Spring 2007 issue fighting record snowfalls in February to be delivered. Consequently, I have decided to print a special issue to try to get back to a reasonable seasonal schedule. This, of course, suggests that I will become more regular in the future. Those readers with a good grasp of probability may wish to fade that proposition.

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