

Recent Economic Events . . .

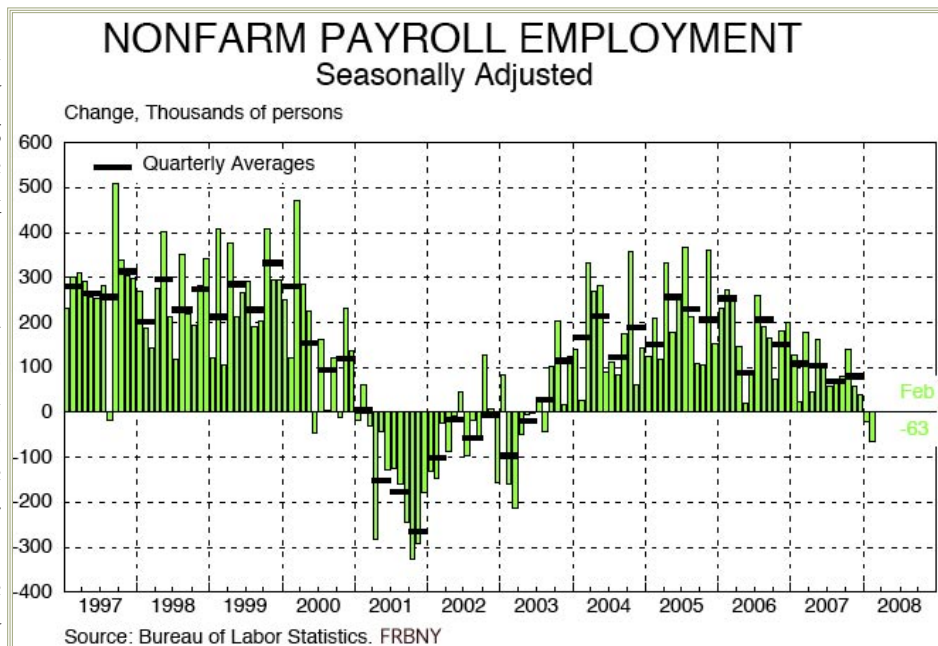
Although the official arbiter has not yet spoken, there can be little doubt that the American economy is in recession. Employment is falling; the stock market is in panic mode; interest rates have been slashed well below the (rising) inflation rate, and there is, as yet, no end to the housing market weakness. Not a pretty picture.

If America can be defined by the unabiding optimism of the consumer, dark days are at hand. A recent CNN poll indicated 74% of us believe we are in recession. This helps explain the fall in consumer confidence to 70.5 on the Michigan survey in early March.

This is lower than at any time since the recession of the early 1990s. Retail sales plunged in February, bringing the year-on-year increase to a measly 2.6%. With inflation clocking in at 4%, real sales are contracting.

Forecasters have become accustomed to shrugging off temporary weakness on the theory that if consumers could find the cash, they would spend it. Unfortunately, two months of declining employment (three if we exclude government hiring) means personal income has stalled. Total employment declined 63,000 in February after a 22,000 drop in January. The only reason that the unemployment rate did not increase in February was that 450,000 people left the labor force.

The housing market, which peaked in mid-2006, continues to contract. The latest report from Case-Shiller shows median prices are down 9.1% over the past year. This helps explain weak sales (existing homes down 23% from last year, new down 34%) and single-family housing starts (down 40% over the last year and 62% from the peak).



We might credit healthy exports as a silver lining in the clouds, but even here the strong advances in oil prices have offset the benefits. The monthly trade deficit is stuck near \$60 billion because our oil shortfall

has increased to \$35 billion from \$12 billion since 2004. All of this is price-driven, as volumes have been flat for years.

Financial markets are in turmoil, but fortunately the Federal Reserve has overcome its inhibitions to aggressive action. Lower rates and ample access to funding are a welcome development.

Economic statistics currently point to a recession. The question of the day is how deep and long the slowdown becomes. With luck, we can stabilize and begin recovering by Labor Day. If the Leprechaun is AWOL, the contraction could easily extend much longer. ▮

Commentary . . .

In his book, *The Black Swan*, Nassim Nicholas Taleb argues that the most significant events in our lives and by extension in the markets are inherently unpredictable from experience. “The observation of millions of white swans does not allow one to conclude that all swans are white.” However, this is what Europeans believed until a black swan was spotted in Australia. Similarly, other unanticipated events (think September 11th, the 1987 stock market crash, Google) have the power to entirely reset the assumptions of our existence. The sub-prime crisis that has metastasized into a cancer of the financial markets, claiming Bear Stearns as its most recent victim, is another such event.

There are many reasons that things got out of hand, but the key one is the lack of limits and regulation in the trading of new financial instruments. Once the extortion of Citicorp and the Fed (Mr. Greenspan) changed the rules, commercial banks were able to use their balance sheets to compete for investment banking business. Washed away was Glass-Steagall which had kept investment banking and commercial banking separate since the Depression. Previously, investment banks had been able to run with small balance sheets, arranging transactions, placing original issues, and using their capital to support trading in liquid securities. Now they had to keep some of the deals they arranged as bridge loans or as financing that no one else wanted. Instead of financing these illiquid assets with longer-term liabilities, they kept the old method of funding short-term. But investment banks are not commercial banks. They cannot rely on stable deposits to carry them through. So, when funding was withdrawn, the old option of simply selling the assets did not work.

This event shows the folly of allowing unrestrained free-market capitalism to extend into all aspects of

financial life. Fortunately, the Federal Reserve has tossed off the shackles of fundamentalist ideology to engineer a bailout. Gone is the “markets know best” cant in favor of government intervention to avoid a meltdown. There remain a few clueless supporters of the old theory — Alan Greenspan, Henry Paulson, and, of course, George Bush. But public opinion and common sense have moved on. Who can deny that without the JP Morgan Chase guarantee of Bear Stearns, backed up by a Federal Reserve line of credit totaling \$30 billion, chaos would have descended on the markets St. Patrick’s Day 2008?



There is more work to be done. While the immediate problem was the financial market seizure, the issues grew out of and remain in the housing market. Currently, there are a number of ideas being floated to address what can easily become an anti-bubble in housing prices. By that I mean prices could not only correct but fall far further than fundamentals would require. The trick to crafting a solution is to separate those who entered the market to find a place to live from those who sought to speculate, helping as many of the former and as few of the latter as possible. Also, we must mitigate the damage to innocent bystanders when foreclosures occur.

Two of the best ideas I have seen come from different ends of the political spectrum. Both intend a heavy dose of intervention directed at owner-occupied homes with too much debt.

Martin Feldstein, a former Reagan economic advisor, wrote in the *Wall Street Journal* suggesting that the government offer homeowners the option of borrowing 20% of their current mortgage for 15 years at a rate that floats but is equal to the two-year Treasury (1.5%). These funds go to pay down the *(continued on page 3)*

Commentary (continued) . . .

current mortgage, creating equity for the homeowner against the new lower mortgage amount. This would make the mortgages more secure for lenders and result in an immediate reduced rate for homeowners. The risk of foreclosure drops as homeowners have an incentive to keep paying on the mortgage.

Congressman Barney Frank has been working on a plan that would ask lenders to write off a portion of the mortgages they hold to restore a reasonable LTV in return for a government agency guaranteeing the lower balance. Once again, foreclosures are avoided; people

who are serious about staying in their homes are offered a lifeline to do so.

The last piece of the puzzle is what to do with the homes that are foreclosed. Here the best suggestion I have seen is to provide dollars to the states to buy the homes and rent them out so that neighborhoods do not go dark.

Note the paradigm shift. No longer are the solutions driven by free-market fundamentalists but rather by common sense. Thank you black swan. III

Market View . . .

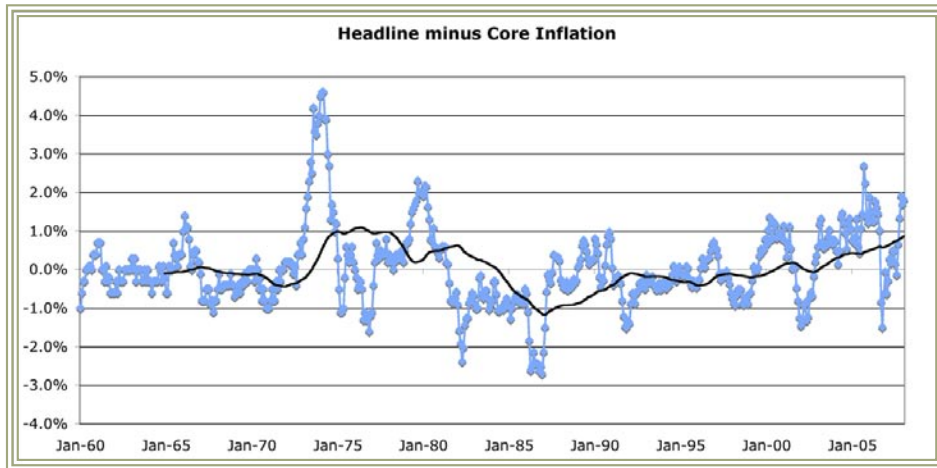
A politically motivated Fed Chairman from an earlier era, Arthur Burns, once asked his staff if there was a way he could cover up what was happening with inflation. Thus was born the core inflation rate, excluding the impact of food and energy.

The theoretical justification: food and energy prices were volatile, but volatile in both directions. Eventually, they returned to trend and so to smooth out the peaks and valleys, it made sense to exclude them. This idea is

actually a sound one if the original premise holds. The chart accompanying this article shows that there have been long stretches when this idea was tenable.

However, there were three times when the five-year average difference between headline and core inflation approached 1%. The first was during the initial oil crisis

in the early to mid-1970s which prompted Chairman Burns to look for a way to obscure the true state of affairs. The second was during the late 1980s when Paul Volcker broke the back of inflation with punishingly high real interest rates. The third is the most recent period since the beginning of the 21st century.



When the headline rate was significantly above the core for the 1970s and early 1980s, the average inflation rate was high (above

4% on a five-year average) but since then it has been low (below 4%). I believe that the implications are obvious. When a period of supposed cyclical inflation in food and energy turns secular, it leaks into the general inflation rate. This is especially the case when the supply of money is growing strongly like it is today (M2 up over 10% annualized (continued on page 4)

Market View (continued) . . .

over the last three months). The cash validates higher prices.

Furthermore, the structural support to prices is provided by billions of newly affluent consumers in China, India, Brazil, etc. who are trading bicycles for cars, rice for pork. Both food and energy trends are secular, not cyclical, in nature.

Today we have a Federal Reserve clearly focused on stabilizing the system by lowering rates and providing plenty of money to grease the wheels of commerce. Inflation is already accelerating, and not just in the US. China's annual rate is over 8%.

In this environment, it is hard to buy fixed-income securities. In fact, the one fixed-income security with an explicit promise to cover inflation with a higher return, TIPS, has rates near zero for terms up to five years. Once the Fed gets control of the situation, investors are going to look around, see a ten-year Treasury at

3.5% with inflation at 4%, and wonder what they were thinking. Stay away from longer-term bonds.

Commodities and real estate have been the traditional ways to play higher inflation. However, the former have had an amazing run-up while the latter are plagued with obvious problems. It's probably too late to buy commodities until a significant correction sets in, and it's clearly too early to buy real estate. Gold is interesting for traders looking for a blow-off rally.

That leaves only cash and stocks. Cash is a safe choice, but with rates on a downward path, the returns are low and likely to go lower yet. Stocks have been hit but seem to be finding a bottom as the Dow Jones has bounced off 11,800 a few times recently. That is no guarantee, but it does offer some hope we are close to the end of the drop if the Fed is successful. I believe that is worth a bet and would focus dollars on bigger names that have exposure to foreign economies, especially those involved with supplying capital goods. ¶

Editor's Note . . .

In chatting with a client earlier this week, the conversation turned to fiddling while Rome burned. I noted the obvious parallels with the current imperial occupant of the White House. Then, an epiphany in the form of the old letter transfer game appeared unbidden. The cosmic connection contains only eight simple steps. Plus, the words closest to each principal are descriptive as well.

COSMIC CONNECTION

NERO
NERD
HERD
HEAD
BEAD
BEAT
BEST
BUST
BUSH



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