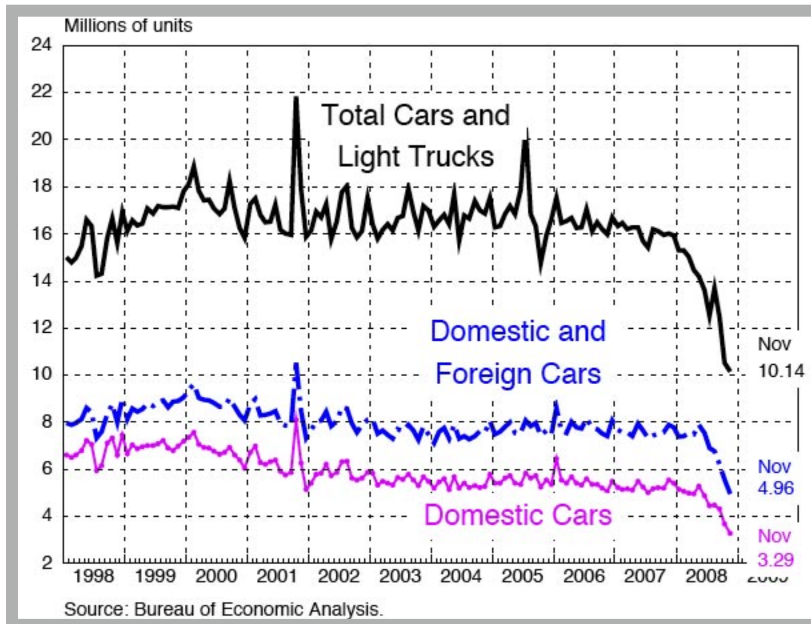
Winter 2008

Jamesson Associates

Recent Economic Events • • •

It's official! The recession started in late 2007 and is likely to last well into 2009. GDP is accelerating on the downside led by a collapse in consumer spending as the unrelenting bad news on employment continues apace. Housing remains weak as well, and the one silver lining — exports — has taken a tumble as the slowdown spreads globally. The good news: oil prices are down just in time for winter.

The National Bureau of Economic Research, the official arbiter of recessions, bases their assessment on a broad range of economic statistics rather than the quick rule of thumb of two consecutive quarters of negative GDP. Taking into account the long stretch of declining employment, weak industrial production, and punk retail sales, they opined that the recession began in December 2007. Were this a normal recession lasting the average of ten months, the declaration would be good news because we would be near the end of it. This, however, is not a garden-variety slowdown. The initial weakness in the housing markets has now spread to a much wider swath of the economy, transmitted by the fragility of the financial system and its increasing reluctance to lend money.



The most disheartening indicator of economic weakness is the unemployment rate. It jumped to 6.7% in November driven by a colossal decrease in jobs of 533,000. This brings the job loss figure to almost 2 million since the end of 2007. And unfortunately, this figure does not fully tell the story. If we were to add those people who would take a job if one were offered, but did not look for one during the survey period, and those working part-time who want to work full time, the slack in the US labor market totals 12.5% or 19.5 million workers.

Accelerating job losses are impacting consumer spending. Retail sales, led by abysmal auto sales, have fallen for four months in a row into October (November is not likely to show a reversal) and are now 4.1% below year-ago levels. With car sales scraping along at multi-decade lows, it's no wonder that the Big Three are looking for a government bailout.

The housing market had shown some signs of stabilizing in the late summer, but the Lehman Brothers bankruptcy and subsequent lending market seizure put an end to that. Housing prices are down a record 17.4% from a year ago and both sales and starts remain depressed.

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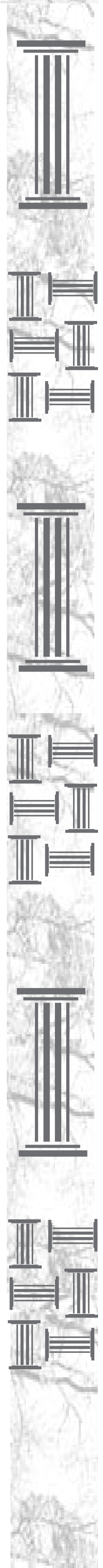


Recent Economic Events (continued) • • •

I had consistently pointed to the strength in US exports as helping to keep the economy stronger than it otherwise would have been. That bloom is now off the rose. Exports fell for the third month in a row in October, down by 2.2% after similar declines in September and August. Falling oil prices and weak domestic demand helped the overall trade deficit, but that is a sign of weakness, not strength.

Falling oil prices had another beneficial effect. Consumer prices fell by 1% in October, the largest one month decline since reporting began in 1947. The drop in prices brought the change since a year ago to 3.7%. With continued good news at the gas pump, it is likely that we will see further declines in the index.

The American economy is in recession. Virtually no economic statistics are showing any strength. This has set the table for massive stimulus in the form of both monetary easing and government spending. The former has already begun, and Congress, along with the President-elect, is strongly signaling that the latter will be the top priority come January. Normally, when a problem is known and action begins, the worst is over. It is my fervent holiday wish that this is the case.

Commentary • • •

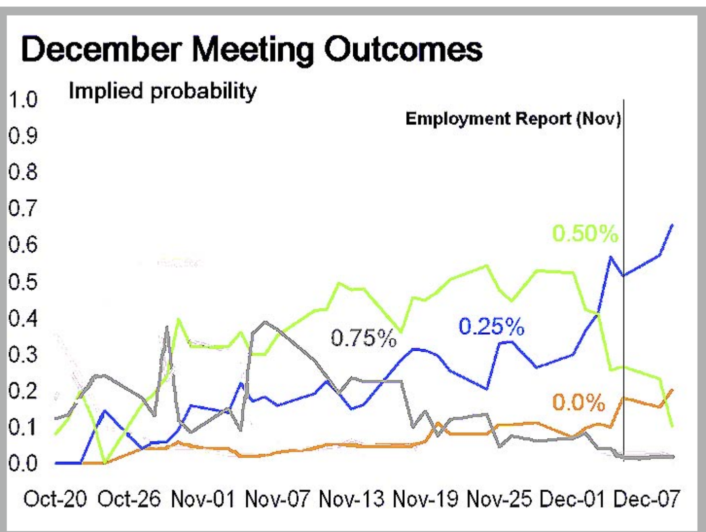
Saved By Zero?

On Tuesday, December 9, 2008, the interest rate on Treasury bills turned negative. Current expectations for Federal Funds put a decent chance on that rate falling to zero at this or the next Fed meeting. Far from being a vote of confidence in the fiscal stewardship of George W. Bush, this signals failure. It is no secret that the US Treasury will have to borrow $1 trillion or more over the next year to fund its various stimulus programs. And yet, the rates on Treasury securities are at multi-decade (if not all-time) lows. These two facts are hard to reconcile, but let's try.

There are two necessary ingredients for a healthy economy: confidence and resources. No matter how optimistic you may be, if you have no surplus to invest for the future, you will be consigned to a subsistence existence. And if you have plenty of resources but hide them in the mattress, no benefit will come of it. The American economy now suffers from a shortfall of both ingredients.

Confidence is in the tank. At the earliest, it will not be replenished before President-elect Obama takes the oath of office. Wall Street has no credibility; the Bush Administration has no credibility. Investors are scared to take any risk at all and are placing funds in the proverbial mattress by acquiring Treasury securities at a zero return. The system will need a catalyst to restore what Keynes labeled, "animal spirits."

But a restoration of confidence may not be enough. Although resources are usually thought of as physical plant and equipment, the key resources of a modern economy are information and credit. It is the latter resource that has been decimated. (continued on page 3)



Commentary (continued) • • •

Both banks and market participants have taken huge losses as over-leverage has led to the inability of borowers to pay their loans. Remember also, lenders themselves are leveraged, banks at around 10 to 15 times their capital and market lenders (securitization) at double or triple those levels. So, when $500 billion (and maybe a lot more) in losses hits the system, it is not hard to see what the drop in lending capacity will be. I estimate that the decline is at least $5 trillion. This is not an insignificant sum.

While not everyone fully utilized all of their borrowing capacity, the change in credit availability has constrained spending and will continue to do so. Make no mistake, credit has powered the American economy over the past few decades and unless borrowing is restarted, confidence will not provide enough of a boost to restore healthy growth.

Whether we like it or not, the government is going to have to start spending money to get the economy moving again. The alternative is the decades-long lethargy that has dogged Japan since the early 1990s.

Roosevelt contended that Americans had nothing to fear but fear itself; I would argue that what we have to fear today is an insufficient appreciation of the private market credit resources that have been destroyed. A stimulus package smaller than $500 billion will not be enough. Yes, there will be waste; yes, there will be some fraud. But without significant governmental stimulus efforts, there will not be a recovery for a very long time.

When markets fail, only the government can set things right in a reasonable period of time. Mr. Obama may go a long way toward restoring optimism, but only actual spending can restore the lost credit resources.

Market View • • •

A client recently sent me a chart which plotted both the price of an ounce of gold and the Standard & Poor's 500 (SP500) index on the same scale. He pointed out that in the early 1970s, the price of gold exceeded the SP500 and stayed higher all the way until the end of the stock bear market in the early 1980s. Since then stocks have been higher, but gold is once again threatening to take the lead. His question: are we in for another long-term bear market?

Before I address that issue, I want to point out another long-term relationship. The dividend yield on stocks had historically been above that on the ten-year Treasury up until the late 1950s. Investors had believed that with stocks being riskier than Treasury bonds, the yield should be higher. However, once shareholders became comfortable with earnings disclosures instead of cold hard cash in the form of dividends, prices rose to the point where dividend yields fell well below Treasury rates. By the late 1990s, we even had earnings yields below Treasury rates. I guess that really was "irrational exuberance". In the last month, dividend yields have once again exceeded the ten-year Treasury. The question here is whether we are in for an extended period of time where stock dividends exceed Treasury rates.

The last data point to consider is whether the market is properly discounting value. In normal times, investors consider the prospects for companies and buy or sell based on these assessments. Prices tend to move back and forth around a long-term trend. When markets break down, as they have this year, the back and forth takes precedence. In other words, volatility driven by emotion rather than calculation dominates the market. At these times, it is wise to step aside.

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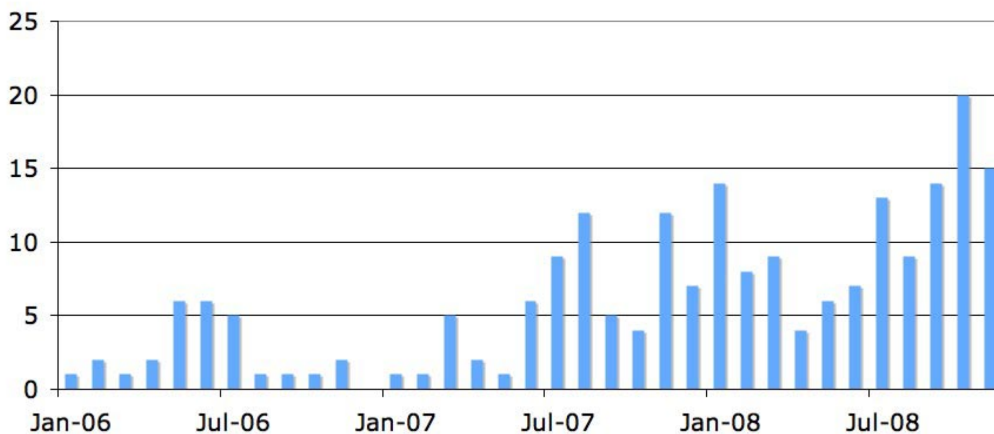
Market View (continued) • • •

Note the chart that shows the days per month that the SP500 has changed in value by more than 1% (its long-term average volatility). Markets focused on fundamentals typically have fewer than five trading days a month with big moves. Markets driven by emotion have far more. October printed 20 such days and November 15. So far, December is batting 1000.

Putting the conflicting data together, I conclude that current valuation is low enough to reenter the market but that appreciation is not likely to occur. Dividends pay you to wait, and wait you will, in my opinion.



Gold is likely to outrun stocks over the next few years as it ultimately reflects the sea of liquidity that is being provided to prop up the economy. Inflation is low today, but the seeds for an increase have been planted, fertilized, and watered. For those looking for more certainty, keeping money in safe, short-term alternatives does not seem to give up much. Furthermore, it offers the opportunity to enter the market at lower levels if the volatility continues. The patient way to play the stock market is to wait for volatility to settle down for a few months and then buy. This suggests a springtime entry at the earliest.

Fixed income options are numerous. High quality municipals offer the best value while corporate securities of the best companies are also quite cheap. My fear of inflation suggests that maturities should be kept within ten years. For those of more adventurous spirits, the double-digit yields on private label MBS or the 20% yields on junk bonds offer a good risk/reward tradeoff. Some babies have been thrown out with the bathwater.

Editor's Note • • •

My youngest son, Susan, and I had the opportunity to steal away for a vacation to France over the Thanksgiving holiday week. We found the French unfailingly stylish (clothes, food presentation, small design notes), quite helpful with language and directions to clueless Americans, and fiercely loyal to their lifestyle — eating outdoors even in 40° weather. But I have not been entirely seduced. The Mediterranean way has much to recommend it (cheap wine and crusty bread), but the proliferation of unintelligible maps, ubiquitous traffic rotaries, and mountain roads wide enough for precisely one and one-half cars gives pause. Apparently, the French balance their budget by eschewing guardrails on all hairpin turns. Ten days may be my limit for non-US locales. As Dorothy said, "There's no place like home."

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