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Jamesson Associates

Recent Economic Events

There are signs that the worst of the Great Recession is behind us. Although we have not yet encountered GDP growth, rising employment, nor sustainable increases in sales, the freefall declines in these measures have stopped. Globally, there are indications of growth which have translated into initial signs of export demand. Of course, a recovery that begins elsewhere will have only a limited impact on US activity while it might have a large impact on the demand for resources.

According to the second quarter real GDP figures, the US economy continued to shrink. But the reported 1% decline was far less than the average 6% decline in the previous two quarters and close enough to the zero point to give hope for the third quarter. The economy has contracted by about 4% from its late 2007 peak, the largest reversal since the 1930s. The recession has taken a terrible toll on economic fortunes and has truly earned the sobriquet "The Great Recession." However, note the use of an "R" and not a "D".

Employment is no longer falling at nearly the pace we saw in the early part of the year, but is still falling. August figures revealed that the US lost an additional 216,000 jobs and that the unemployment rate jumped to a 26-year high of 9.7%. I am afraid that the momentum of job loss and the natural growth of the labor force will push the rate above 10% before we see a sustainable decline. If we add in those people who have given up looking for jobs, those who would take any job if one were offered, and those working part-time who really would like a full-time position, the statistic balloons to 16.8%, representing over 26 million Americans.

Retail sales have been distorted by the "Cash for Clunkers" program. Both June and July experienced overall declines of about .1%. It appears that the money used for new cars was simply shifted from other purchases rather than representing new demand. Nevertheless, annualized that is roughly a 1% decline versus the actual 10% year-on-year decline we saw a few months ago.

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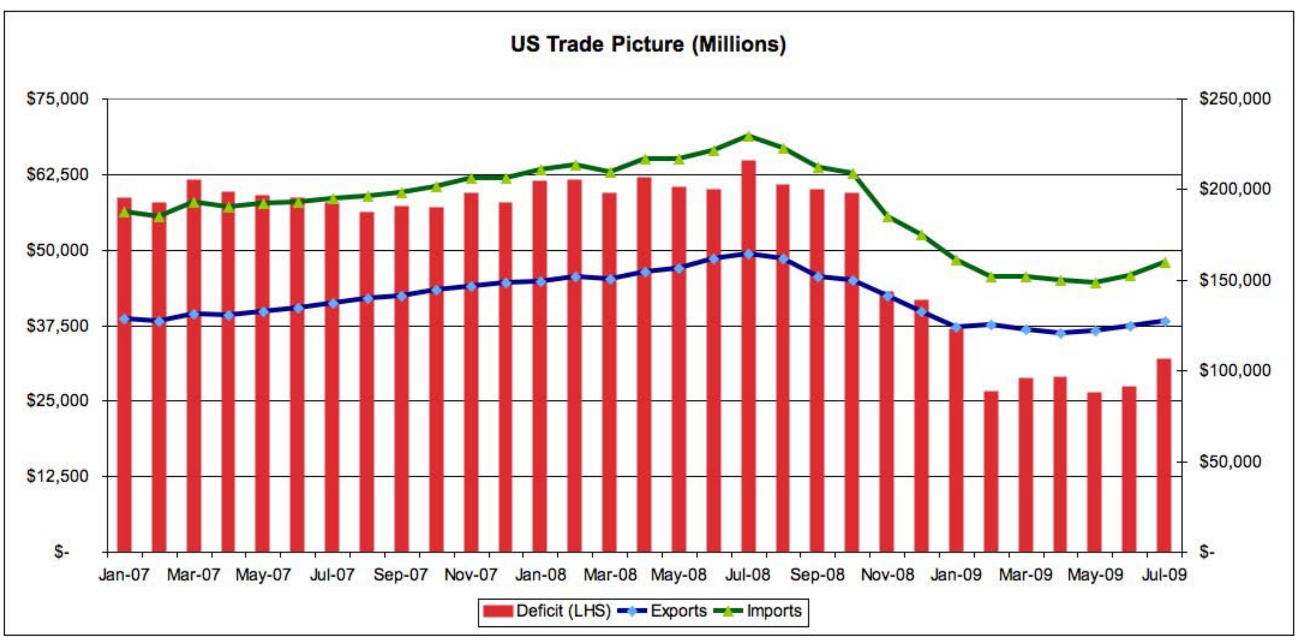

Recent Economic Events (continued)

If this news is simply less bad, is there something we can point to that is undeniably good? Well, there is. Recent statistics from Asia (China and India as leaders but also growth in Japan), South America (Brazil leading the way), and even Europe (France and Germany grew in the second quarter) suggest that the engine of global growth has changed zip codes. You may ask, what's in this for America?

The answer is reflected in our trade balance. Whereas as recently as two years ago, the United States was importing about $65 billion more per month than we were exporting, the July trade figures put the shortfall at $32 billion. This improvement was initially due to the dramatic drop in imports (foreign producers bore a significant share of our consumption retrenchment). More recently, our exports have firmed up as we are sending both capital goods and agricultural products to faster growing nations.

If there is a silver lining in the economic picture, this is it. While the American consumer continues her new frugality, exports promise to put some demand back into our system. Were it not for the positive contribution of net exports in the second-quarter GDP figures, the decline would have been a more troubling 2.5% instead of the 1% reported.

While we can take some comfort in the benefits to be gained by exporting goods and services, the offset may be a loss of economic hegemony. It cannot have escaped the notice of anyone with an automobile that the price of gasoline is up from six months ago. How can this be the case when car sales are down and gasoline (and jet fuel) usage is down? The reason is simple: US car sales in 2009 are estimated to be 10-11 million (down from 16-18 million a couple years ago) while Chinese auto sales are expected to top 12 million, over double that of 2007.

It will no longer be possible to predict the course of commodity prices by looking solely at US economic performance. Whereas the bulk of the growth in the global economy was driven by the US consumer in the run-up to the 2007-09 recession, that is not the case now, nor will it be so in the future. Welcome to a brave new world.

Commentary

Central bankers recently met for their annual confab in Jackson Hole. Far from the self-congratulatory mood of a mere few years ago, the prevailing conclusion was that a great error in judgment had contributed (if not caused) the financial meltdown we have been experiencing. The Greenspan idea of pumping up the system, letting bubbles explode, and then picking up the pieces has been thoroughly discredited. Bankers admitted that a need to lean against asset bubbles was perhaps just as important as the time-old charge to lean against inflationary pressures in goods and services. It seems that central bankers have discovered that all money is green.

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One old line about economists is that, "Of course, that works in practice, but it could never work in theory." It apparently has taken the most significant global economic crisis of our lifetimes to convince central bankers (and hopefully their academic sycophants) that the idea that money can be kept in one arena and not leak into others is not tenable. The distinction between money markets and capital markets may be all well and good in an economic textbook or when a Fed Chairman is consciously trying to obfuscate in front of Congress, but when easy money prevails, someone will figure out how to get it in the hands of borrowers. With more cash than sense, these borrowers bid up the price

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Commentary (continued)

of assets instead of the price of goods and services. And voila, a bubble is created.

Hyman Minsky, a previously little-known or respected economic theorist, is enjoying his fifteen minutes of fame (albeit posthumously). His idea reflected a simple, yet powerful observation about human nature. To wit: if authorities take actions to protect economic participants from risk by expertly moderating the economy, participants will quite logically increase their risk, believing that they can handle the increase in leverage implied. Sound familiar?

Now it is one thing to admit the errors of the past, but quite another to take real actions to address future concerns. Some initial steps have been proposed this past weekend in the G-20 finance ministers meeting, but without follow-on efforts, the opportunity may be lost.

Some of the outlines are coming into focus, but I believe that any regulatory regime that does not include the following items at the minimum will be destined for failure. And if we have a failure the next time, we will not have any entity big or credible enough to stop the meltdown. After all, who is it that can bail out the US Government?

My recipe:

• Consistent regulation by risk rather than by structure. If an entity can avoid regulation by changing its legal structure, it will.

• Real costs to becoming too big to fail. Whether this is a higher level of capital or pay limits on those who work for these companies is immaterial. (By the way, the most effective way to stop a financial company from becoming too big to fail is to limit pay for all employees of any company deemed too big to fail to a pay scale consistent with that of the host government. This will cause internal pressure to become smaller and less risky.) The incentive to become large must be offset by some arbitrary cost. If it is not, the desire to bet big for private gain will eventually lead to a loss at public expense.

• Financial innovation only if it creates a real benefit. The days of relying on the insidious assumption that the free market knows best must end.

It is the last of these points that will be the hardest to implement. Even in the face of a huge financial and economic calamity, there are still apologists for the free market contending it knows best. However, it is clear to all but economists that free markets can and do go haywire at great public cost. It is time for this myth to be consigned to the same dustbin of history that swallowed other intellectual dogmas.

Market View

The financial markets have clearly run ahead of the economy over the past six months. This is the normal course of events. However, now is an excellent time to try to discern the shape of things to come. In other words, what course will the recovery take, and what is the best choice of investments in the different possible scenarios? The table on the back page tries to put everything in one handy place.

Of course, knowing what to choose if you know the shape of the recovery is not advice of particularly high value. The value added in the advice game is to identify the shape of the recovery and then plug in the investments that make the most sense.

Here goes. The case for a "V" recovery is that the contraction was so steep that the bounce-back must be as well. The "U" is predicated on the idea that the consumer is unlikely to return to spending with abandon and that therefore, hiring will be very cautious. The normal self-reinforcing aspect of a recovery will be muted. A "W" recovery is a "V" that gets over-extended and is brought low by debt and the end of the government's stimulus program. An "L" recovery is basically a less optimistic version of the "U" which labors under an extended period of consumer retrenchment.

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Market View (continued)

My guess is that we are in a "U" shaped recovery in the United States while the global economy is closer to a "V" shape. So, we should focus on the top two lines of the below table. Against expectations, this suggests that the domestic stock market and those in emerging nations still have some room to run. Also, riding the yield curve in the US bond market makes sense, as does staying with the run in commodities. This is a decidedly contrarian position, but it makes me comfortable.

Recovery Shape	Fixed Income	Equities	Commodities
V	Cash/TIPS	Cyclicals	Industrial/Precious
U	Medium Quality Intermediate	Growth	Avoid
W	Cash then High Quality Long	Go Short Low Quality	Avoid
L	High Quality Long	Special Situations	Avoid

Editor's Note

After dropping our youngest son at New York University a week ago Sunday, Susan and I spent a few days working our way up the Hudson and through the Finger Lakes, returning home on Wednesday, September 2nd. Having sated ourselves on good food during our trip, we decided to eat simply. We found some Greek sausage in the freezer, and about 7 PM, I started the charcoal fire outside to cook it. Fifteen or twenty minutes later, when the fire was ready, I went out to put the sausage on the grill. As I did, I began to hear some high-pitched beeping. It was loud and didn't stop. Investigating, I determined it wasn't coming from the house, so I walked across the street to my office where the sound was even louder. (Digression: a few weeks earlier my air conditioner had been condensing water into the garage, as the drain valve was plugged. I had it serviced.) As I entered the office, it was obvious the smoke alarm in the garage was the source of the sound. I looked in and saw smoke. Figuring it was the air conditioner, I ran upstairs to turn it off and then went back to the garage. Here I saw an electrical fire caused by a plug that had fallen into the water on the floor. Fortunately, I was able to pull the plug and the flames subsided. I pondered the impact of luck in one's life (easily extended to markets as well). If the fire had started at any time over the previous five days, or I had decided to cook indoors, or even at a different time the same night, I suspect the office would have burned to the ground. Luck, Kismet, Fate, whatever was working in my favor. This is no excuse for not educating yourself and working hard to achieve success, but if you ever have to choose between lucky and smart, take lucky.

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