JAMESSON ASSOCIATES
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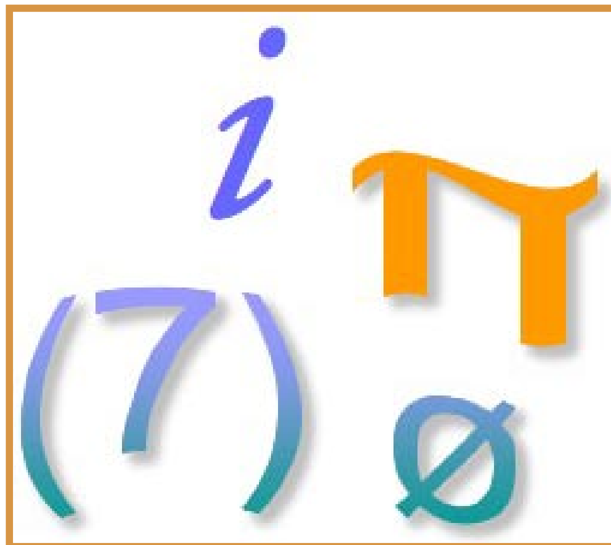
Recent Economic Events

The history of mathematics includes many significant milestones, among them the idea of zero and the discovery of negative, imaginary, and irrational numbers. All of these concepts have recently seeped into the world of economic statistics.

Growth in the American economy was revised downward in the period encompassing the 2007-09 recession and up to the first half of 2011. The recession was judged to be more severe than originally reported, and the US economy, as measured by GDP, grew by less than 1% in real terms over the first six months of the year.

This dismal performance partially explains the deterioration in the employment market from the spring to the summer. During the month of August, employment growth ground to a halt as zero new jobs were created. Only because the labor force has been shrinking has this not turned into an increase in the official unemployment rate, which remains stuck at 9.1%.



Zero growth was also the headline on retail sales in August, as consumers finally surrendered to weak employment and income growth. While total retail sales are higher than they were before the recession began four years ago, that is only because inflation and population growth skew the figures. Adjusting for both, real per capita retail sales in the US are lower than they were at the turn of the century.

Negative numbers abound in the economic statistics. Real median household income fell to below $50,000 in 2010, a level lower than it was in the late 1990s. Housing prices are down from a year ago, and housing sales and starts continue to bump along a bottom. The only reason that the most common measures of consumer confidence are not negative is that the scale is calibrated to be neutral at 100 rather than at zero. Confidence levels are consistent with recession.

Imaginary numbers hit center stage in the European sovereign debt crisis. Bonds changing hands at 50¢ on the dollar or below are accepted for borrowing at full value. It seems that this has caused a quiet run on the banks of the European Union that loaded up their balance sheets with issues of some of the weaker members. These funds have been repatriated by big investors like money market funds and deposited in the US banking system.

Consequences? You bet.

First, the irrational made its appearance in the form of a new fee from Bank of New York. They decided to charge large depositors (over $50 million) for safekeeping their money. Seems as those folks would have been better off with a king-size mattress.

Second, the crisis in Europe has chased funds out of the Euro and into both gold and the US dollar. The fear of market contagion on the order of that caused by the Lehman Brothers failure in 2008 has created uncertainty and caused many

Recent Economic Events (continued)

decision-makers to go on hold. It is this uncertainty that is now threatening to sink an economy that was none too healthy to begin with.

The Federal Reserve has also jumped into the game by committing to keep short rates near zero for the next two years and agreeing to swap short-term bonds for long-term to push down rates all along the yield curve. The US economy is currently struggling with more than mathematics; it has stalled, raising the prospect that we may slip back into recession or, as my high school math teacher would term it, less than zero growth.

Commentary

About time. Populism from the left to counter populism from the right.

President Obama has finally decided to present his view of what the Federal government stands for and to fight for it. After being beaten up by the Tea Party during the debt ceiling debacle, and sandwiching in his speech to Congress just before the NFL season-opener so as not to conflict with the Republican contender debate, he proposed a jobs bill and then followed up with a long-term deficit reduction package. And instead of acceding to the demands of a vocal minority of ideologues who have a rigid view of tax policy, he presented an approach that is positively mainstream. The other key point: it was much larger than anyone expected. This is truly throwing down the gauntlet.

So the class warfare that the Republicans have been winning without much resistance from Democrats is set to get more interesting. The facts seem to be on the side of the President insofar as the middle class and below has lost out to the top 5%, and even they to the top 1%. The number of Americans in poverty hit an all-time high last year, and real median family income has made no progress since the late 1990s.

The President has finally picked up on the fact that Americans are angry at the lack of middle-class progress over the past few decades. The Tea Party was able to harness this emotion in 2010, voting out Democrats across the board. But they went too far during the debt ceiling circus, and their approval rating along with that of Congress as a whole plunged into the low teens. Surprisingly, the President seems to have both far better approval ratings and a plan that puts the Republicans on the defensive.

The proposals have little chance of being enacted by the current Congress, but the $450 billion jobs bill and the $3.6 trillion deficit reduction package establish a clear contrast to Republican plans. Leaving jobs to a deregulated and even less taxed corporate sector and reducing the deficit by dismantling the social safety net as enacted by House Republicans earlier this year, sets up the 2012 election as much different from the last presidential battle. While 2008 was primarily a choice between old and new, with few really well-defined policy contrasts, the upcoming election offers clear differences on the size and scope of the Federal government.

> Leave me alone.... that's not fair.

The United States has two guiding political principles that can be stated succinctly and are frequently in conflict. They are, "Leave me alone." and "That's not fair."

These two principles joined at the nation's founding when the unfairness of "taxation without representation" and the "inalienable right of life, liberty, and the pursuit of happiness" precipitated the Revolution. Since then, political movements have been driven by back and forth swings of emphasis.

The Bill of Rights enshrined the idea of limits to government while the Civil War and Reconstruction established that the Federal government stood for

Commentary (continued)

equality for all under the law. Women's suffrage and the Civil Rights movement extended fairness further, while the repeal of Prohibition showed that unreasonable laws would be dissolved in favor of individual choice. And while the social safety net created from New Deal through the Great Society emphasized liberal use of the fairness issue, it is not an easy left/right distinction.

The abortion debate pits "leave me alone" pro-choice liberals against "that's not fair (to the unborn)" pro-life conservatives.

Make no mistake, the 2012 election has begun, and contrary to expectations a month or so ago, it looks like both sides will be fighting on populist grounds.

Market View

The Bond Bubble crowd is out again. The problem is that there is no definition of a bubble, just an assertion. In the interests of bringing some level of precision to the discussion, I decided to identify three psychological and two financial signs of a bubble and then compare the current ten-year Treasury to check for similarities.

The three psychological markers of a bubble include:

1) Near-universal belief in the merits of the investment class (Japanese Century)
2) Purchases made with the intention of selling for a higher price (dot.com IPO fever)
3) New metrics to keep buyers coming (sub-prime teaser ARMs as AAA securities)

Currently, I am unaware of any major bank or Wall Street firm that is predicting falling interest rates over the next year or two. Furthermore, the yield curve retains a positive slope. This means rates are expected to rise, not fall, by those putting their own money on the line. If there is universal belief in low rates, it remains well hidden.

Bonds are debt that is purchased with the explicit expectation that the issuer will return the original principal to the buyer at a date in the future. The market is huge and largely fungible. Buyers do not hold a scarce resource since issuers can create more. There are no shows on cable entitled, "Flip That Treasury."

Yield and/or spread are the only metrics to judge bonds that I am aware of, and although I hesitate to admit it, I have been in the business for over 35 years. No new math can turn a holding with a 1% yield into a 10% return.

When looking at the financial signs of a bubble, there are two to focus on. First, is the price more than two standard deviations away from its long-term average? Second, what would the situation look like if the price fell by the typical amount that an asset falls after a bubble bursts?

The yield on a ten-year Treasury since the end of World War II has averaged about 5.50%. In price terms, the standard deviation of a note with that coupon has been about 19 points. Using this average coupon, the current sub-2% ten-year would price to 133. This is over one standard deviation above the average price, but not two. We need a yield below 1.50% to hit two standard deviations and trigger a bubble watch.

When bubbles burst, the typical drop in price is around 75%. Note that the 1929 stock crash bottomed at about 90%, the 1990s Nikkei down about 80%, both gold in the 1980s and the NASDAQ in the 2000s around 75%. I left out the housing bubble because it may not be over yet. For the current ten-year to recede in price by 75% requires a yield of 23%. To be consistent, the Bond Bubble crowd would have to contend that when the bubble bursts rates will head to this level.

Market View (continued)

Even if bonds are not in a bubble, they may be overpriced. One way to look at this is to ask what the benefits are of buying a bond versus alternatives. This is where the forward or breakeven yield can help us. Note the nearby table.

Treasuries	June 2011	Breakeven Yield	September 2011	Breakeven Yield
One-year	.10%	N/A	.10%	N/A
Two-year	.40%	.70%	.20%	.30%
Five-year	1.60%	2.40%	.80%	1.20%
Ten-year	3.00%	4.40%	1.80%	2.80%

The breakeven yield here is what rate you would have to get if you chose the shorter option and then had to reinvest to the end of the next longer term. Back in June, the breakevens to match either the five-year or the ten-year were close to or above longer-term averages. Today they are not.

There is another factor to consider. Japanese ten-year rates fell below 3% in late 1996; they have not been above that level since. If 3% is the marker of a changed environment, then the ten-year may still make sense.

So what's my view? Bonds are not in a bubble, but they are probably overpriced. Problem is, there is a good reason. Both the Fed's actions and the possibility of a Japanese "lost decade" means rates are not going up and that you need to hold your nose and buy something. The best bets: high quality corporate or municipal bonds with maturities around seven years. Stocks are very treacherous. Don't trade. Buy only those companies you are comfortable holding for five years or more and that pay a dividend while you wait. Better yet, wait until the Dow drops below 10,000 (or even 9,000). Gold is a hold as a hedge but no longer a buy as the dollar is developing upside momentum. Other commodities, with the exception of agricultural products, should be avoided until there is more clarity on the economic front.

Editor's Note

In the midst of summer, Susan and I traveled to New York to celebrate our anniversary. Because we like to stay in different parts of the city for a change of pace and to experience the varied neighborhoods, we chose a new hotel in Chelsea. Since they were in their soft opening period, we were able to get the room at about half the regular rate which nevertheless was plenty high enough. We managed to book our two-day stay between the passage of the same-sex marriage bill in Albany and the Gay Pride parade. Needless to say, we "experienced the varied neighborhood." Because our son Philip was spending the summer in the city, we wanted to get together for dinner. So, he met us at our hotel beforehand. Not three steps inside he looked around, then at me, and announced, "You're not cool enough to stay here." Caught somewhat off-guard by this, I pondered his pronouncement but then decided that I was. What do you think?