JAMESSON ASSOCIATES
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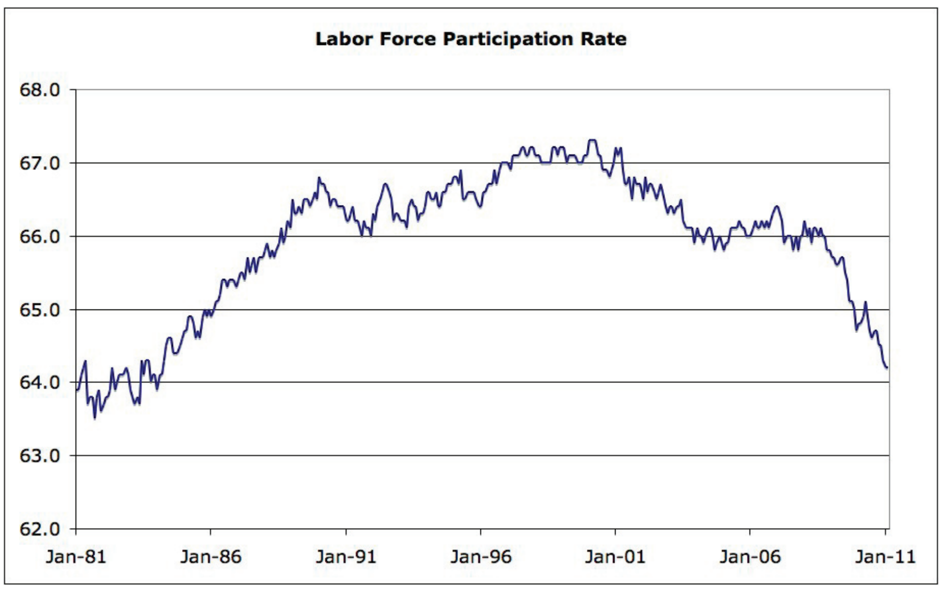
RECENT ECONOMIC EVENTS

Events have overtaken the historical economic reports. While late 2010 economic momentum seems to have carried over into 2011, recent geopolitical upheavals and natural disasters have the potential to stymie the consumer once again. Positive developments include solid retail sales and a somewhat stronger employment picture. The headwinds represented by ongoing housing troubles are now joined by jumping food and energy prices. And the loss of life and habitat in New Zealand and Japan has reminded us all of the potential fragility of human accomplishment.

GDP advanced by 2.8% in the fourth quarter of 2010, a bit faster than the third-quarter gain of 2.6%. This pushed overall economic activity to a new high, finally surpassing the peak set in the last quarter of 2007. Needless to say, this is good news. But is it good enough?



The consumer responded to Christmas markdowns and continued the spending spree in early 2001. Retail sales have posted solid increases: February up 1% over January and roughly 9% from one year ago. Auto sales have been a key driver. Total vehicle sales reached 13.5 million annualized in February, the highest level since mid-2008 except for the one-month bump from the "Cash for Clunkers" incentive. Keeping in mind that sales bottomed out in the 9 million range in Spring 2009, the increase is a very healthy 50%.

Private sector employment totaled a strong 222,000 in February, but government layoffs reduced the net figure to 192,000. The unemployment rate fell to 8.9%. However, a good deal of the improvement in this figure since late 2010 is due to the fact that about 700,000 people have left the labor force. Meanwhile, the percentage of working-age Americans in the labor force has dropped sharply, creating the only three-year decline in the labor force in the postwar period. Furthermore, wages are hardly budging and the workweek seems to have stopped growing. To put sustainable income gains in workers' pockets, both of these latter factors need to improve.

Housing continues to weigh on the economy. Home prices as measured by the Case-Shiller Index dropped for the fifth month in a row based on the latest release covering December 2010. Other price indices confirm the downward movement. Sales of new homes are mired at multi-decade lows and existing home sales have only bounced modestly off their bottom. Since housing represents the lion's share of most American households' assets, the anemic recovery in home values has kept a normally optimistic and mobile American population stuck in their current residences. This is not good — either for general mood or for the flexibility workers need to move wherever better job prospects beckon.

Although it appeared that the improving stock market and employment picture was *(continued on page 2)*

Recent Economic Events (cont.)

boosting consumer confidence through February, recent increases in gasoline prices (courtesy of Middle East upheaval) and food prices (tight supplies coupled with increasing demand from emerging nations) have turned the situation around. The University of Michigan Consumer Sentiment Index had risen from below 70 to the mid-70's range during the November-January shopping period. It then jumped to 77.5 in February, only to plunge to 68.2 in early March. This index normally registers between 90 and 100 when the economy is expanding properly.

The earthquakes in New Zealand and Japan have focused our attention on the power of nature. While many economists and pundits assure us that the devastation will be temporary, we cannot as human beings ignore the impact. It is another sign of uncertainty to add to the virus of revolution in the Middle East. Domestic economic developments had been positive, albeit only modestly; now, global considerations threaten to negate the progress.

Commentary

Who should we be rooting for in the Middle East?

The pragmatic answer is, "For anyone who agrees with our foreign policy goals and will sell us oil." This option has had us supporting some pretty unsavory characters over the years and leaves us open to real problems when regimes fall.

The idealistic answer is, "America should always support freedom and side with youthful protesters when they are joined by the middle class." The risks: the revolutionaries will be anti-American, or a legitimate democratic uprising will be co-opted by radical Islamists or even worse tyrants, producing a new state that is hostile to our interests.

The cynical answer is, "We should support whoever wins." The problem with this is the same one posed by Will Rogers' investment advice: "Buy a stock and sell it when it goes up. If it doesn't go up, don't buy it."

Since my time machine is in the shop, I believe that the United States should live by its principles and support those regimes that derive power legitimately from their own citizens. Let's make it known that we will not support those which do not. Progress has been stalled by the bane of natural resources in the Middle East. Rather than have to work for their livelihood and ultimately provide property rights and freedom to their citizens, countries cursed with easy oil riches have become corrupt hierarchies of paternalism. It's not what you know or how hard you work, but who you know, that gets you ahead.

But won't an overthrow of our erstwhile friends in the Middle East cause the United States pain? Suppose Saudi Arabia goes by the boards?

Oil demand is inelastic in the short run. If we lost a few million barrels a day of production, prices would spike up further. Since the US uses about 20 million barrels a day (importing a little more than half), an increase of as little as $10 per barrel works out to big bucks. Doubling the price to $200 per barrel in the wake of a Saudi overthrow would initially move about 5% of GDP out of consumer's pockets to producers. The price of gasoline would jump to at least $6 a gallon and could easily soar higher.

It is highly likely that a recession would result, causing consumption to drop sharply. But wait—why is it that Europe can stand $7, $8, or higher gasoline prices and still grow? After a wrenching readjustment, the US would begin to substitute alternatives to *(continued on page 3)*

COMMENTARY (CONT..)

oil. Maybe we would actually develop a robust energy policy. But perchance I dream too much.

The current lack of an American energy policy is a testament to political spinelessness driven by the pampered state of American voters. When it comes to energy, Americans are like newborn babies. If the price of gas goes up, we cry until daddy comes up with a rebate. Then we reward him with a smile (re-election). But as any good parent knows, if you run to the crib every time you hear crying, you will never get any sleep and eventually will exhaust yourself. This is the very situation this country finds itself facing after years of bipartisan energy cowardice.

The best thing that could happen is for the Saudis to be overthrown and oil prices to jump, forcing the US to make painful substitutions that set us upon a firmer foundation for the future. This would also allow us to pull out of the Middle East and reduce military expenditures. Second best would be a significant gasoline tax, say $3 a gallon, phased in over the next two or three years. Bribe the American public, and they will become energy-conscious overnight.

MARKET VIEW

Grantland Rice spotted the Four Horsemen of the Apocalypse roaming the gridiron for Notre Dame. We may have another sighting.

Known as Strife, War, Famine, and Pestilence, a case can be made that all have reappeared. Although I am normally not persuaded by the socioeconomics analysis of the Elliot Wave theorists, it does seem that something is in the air.

Strife is represented by the revolutions in the Middle East. They started in Tunisia, spread to Egypt and states around the Persian Gulf, and are now in full force in Libya. For War, we need look no farther than Afghanistan, which now heads the list of longest US wars (nine years five months and counting). Famine is hard to validate, but the record prices for food according to the UN Global Index qualify in my mind. And then we have Pestilence. This one was more difficult to fit into the rubric, but being the clever fellow that I am, I had an epiphany. Environmental degradation in general and radioactive leaks from damaged nuclear reactors in Japan fit the bill.

Now, a quick look at my King James Version Bible suggests that if the Horsemen are really in the saddle, many of us could be heading toward a bad end, while a lucky few will be saved. However, as my son pointed out to me with impeccable logic, it never makes sense to bet on the end of the world. If you win, you really can't collect.

In that vein, I feel that there are some sensible ways to invest, even in the face of a rather grim backdrop.

A higher level of uncertainty and risk should be associated with higher prospective returns. This is only the case if prices have fallen sufficiently to reflect the new situation, and if the situation has not permanently changed. There has been a clear increase in volatility, and markets have reacted by marking down risky assets. "Flight to quality" is once again (continued on page 4)

MARKET VIEW (CONT.)

tripping off analysts' lips. With all of the uncertainty, there are lots of areas that need to be considered.

Let's start with energy. Oil prices were rising in late 2010 based on a strengthening global economy; they rose further in response to the Middle East upheaval, and then retreated as the crisis was pushed off the front pages by the Japanese earthquake, tsunami, and nuclear plant damage. There is every reason to expect that oil prices are going higher. The world economy needs oil to operate, and current oil prices do not seem to be an impediment to growth. In fact, the tragedy in Japan may result in even more demand for oil (and gas) as nuclear capacity is either taken off line or not built at all.

ALTERNATIVE ENERGY MAY HAVE ITS DAY IN THE SUN.

Uranium had been a stellar performer that got ahead of itself in 2007 (topping above $130) and fell to $40 over the next few years. 2010 saw a rebound that pushed the price to over $70 just before the Japanese disaster. A pullback to the high $60-range does not seem enough to me to warrant entry. Below $50 seems reasonable.

Gold and silver initially jumped on all the calamities but have since retreated as the dollar has experienced safe-haven buying. I would look to scale into new precious metals positions and leave the dollar.

Until March, stocks were riding the sea of liquidity provided by the Federal Reserve. But now a correction is in process, and there are plenty of reasons for it to continue for a while. Buying export-oriented, dividend-paying equities on weakness should pay off nicely. For those who have higher risk tolerance, alternative energy may have its day in the sun.

Fixed income is presently the most difficult market to gauge. Paradoxically, history shows that rates rise during Quantitative Easing and fall after a program ends. QE II will end in June. However, the recent flight to quality in Treasuries may have upended the timetable. Discretion being the better part of valor here, I would stay with items in the three- to five-year range as the best risk/reward tradeoff, given the steep yield curve. While taxable investments make sense, high-quality general obligation municipals still seem to offer extra value.

EDITOR'S NOTE

I normally end my newsletter with a personal story including some self-deprecating humor. The events of the past few weeks suggest this would be a shallow exercise this time around. I, like many of you, had a visceral reaction to the yearning for freedom in the Middle East. It brought tears (happy) to my eyes. Tears (sad) overcame me as I read about the terrible loss of life in Japan. We Americans are lucky in escaping brutal crackdowns by power-mad tyrants who call thugs into the streets to abuse their own. We Americans are lucky that neither devastating earthquakes, nor tsunamis, nor radioactive fallout have come to our shores. But we Americans are also members of the global community, and being lucky comes a poor second to being human. Let's keep these people in our thoughts and help however we can.

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