Jamesson Associates

12.2011 NEWSLETTER

Recent Economic Events

The story that will not die is the on-again/off-again meltdown of the Eurozone. The daily soap opera of European events obscures what is a stabilizing set of economic figures in the United States. While third-quarter GDP was anemic, it was positive, and expectations for the fourth quarter have been upgraded. Employment continues to advance, albeit at a glacial pace. This, combined with moderating prices, has supported some bright spots in retail sales. Exports, especially energy exports, have also remained strong. On a more sober note, housing is still in distress.

Anything that I write in connection with the crisis in Europe will be out of date by the time this issue hits your desk. Consequently, I'm going to ignore the gorilla in the room and focus on what is happening in the United States.

Third-quarter GDP showed a pickup from the second quarter, but after revisions it still totaled only 2.0%. This rate is insufficient to make up the ground lost during the recession in any reasonable length of time. Nevertheless, it is positive, and it appears that there is some momentum pushing the economy towards a possible 2.5% to 3% figure for the current quarter.

Monthly job growth has averaged about 115,000 over the last six months (+130,000 private, -15,000 public). This, while not good news for government employees, suggests a healthy restructuring between public and private employment. New claims for unemployment have broken below 400,000/week, meaning that lay-offs have slowed quite a bit. Finally, the headline unemployment rate has declined to 8.6%. Although some of the reason for this improvement is that workers are leaving the labor force, there has been a steady increase (up .4% from July's low) in the percentage of working-age people who have a job.

Inflation has stabilized, with the CPI falling by .1% in October and turning back from its assault on 4% on an annual basis. The core CPI rate remains well controlled: up .1% in October and hovering around a 2% annual increase from a year ago.

Consumers seem to have caught the holiday spirit, with Black Friday and Cyber Monday sales up sharply both in stores and online. And sales of domestically-produced motor vehicles are demonstrating a phoenix-like recovery. For the second month in a row, sales by American producers exceeded 10 million annualized. It

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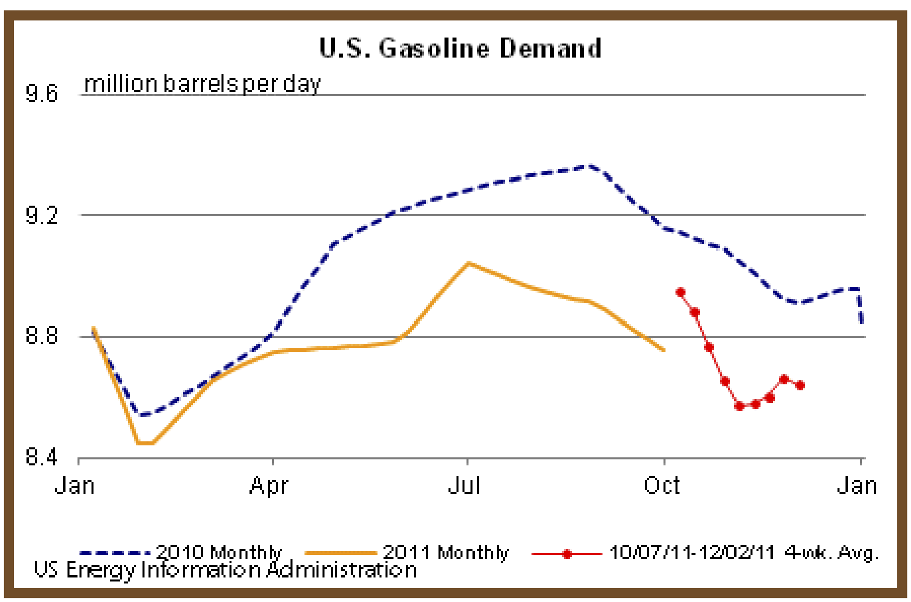

Recent Economic Events (continued)

appears that domestic productivity has recovered and is helping to power manufacturing forward.

One of the biggest surprises in the economy this year is the rapid turn in the country's energy picture. Two facts are key. Gasoline usage in the US is down year-over-year by around 400,000 barrels a day (see chart on page 1 from the U.S. Energy Information Administration) and remains nearly 1 million barrels a day less than it was prior to the recession. On top of this, we are producing more. The United States is now a net exporter of finished petroleum products—not oil itself, mind you, but the products of refining oil. This is a big part of the country's improving trade picture. The most recent trade deficit totaled $43.5 billion, down both because of near-record exports and a modest softening in energy imports.

While most economic indicators are showing modest improvement, nobody invited housing to the recovery. Prices are again falling, and sales remain depressed.

It would be hard to conclude that all is rosy in the US economy, but considering the headwinds, we are doing reasonably well. If Europe can avoid a financial meltdown and severe recession (a big "if"), domestic US strength should build. Even if it doesn't, the American economy is looking more and more like the best of a globally weak lot.

Commentary

"War is the continuation of policy by other means." Carl von Clausewitz (1780-1831), Prussian military theorist

It appears that the Germans have turned this quote on its head. Its economic policy is a continuation of two twentieth-century World Wars. Germany has conquered Europe through the back door of a common market.

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The outlines of a deal to address the financial and economic crisis in the heart of Europe are in place, with only London declining to accept the discipline of Berlin in monetary and fiscal policy. Other countries are giving up a measure of domestic financial sovereignty in return for the promise of Germany's largesse. Wasn't it Benjamin Franklin who said, "Those who sacrifice liberty for security deserve neither"?

The Germans may win this game through a combination of bullying and inaccurate analysis of the problem by those being bullied. The biggest beneficiary of the Euro and the free trade zone it covers has been the German economy.

On its own, Germany is not large enough to provide a market for goods made by its leading companies. Its domestic economies of scale cannot match those of the United States or much more populous emerging nations. Hence, the Germans need the extended market of the Eurozone to be globally competitive.

The second ingredient in the Teutonic arsenal is currency manipulation. Germany with its own currency, even with a larger market, found that a strong Deutschmark eroded its ability to export, ultimately offsetting a good deal of the benefits of scale. Enter the Euro, which guarantees

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Commentary (continued)

no currency appreciation within Europe itself. And since a good chunk of the common market includes far less efficient countries (read: Southern Europe), the external value of the Euro was held back by its weakest players.

The last piece of the puzzle is debt. The German banks lend money to the countries with chronic trade deficits so they can continue to purchase German goods. Now that the jig is up, we find that the debtor countries will need to visit austerity on their publics in order to repay the debt. And to do that, the solution is to make the governments in the periphery subsidiaries of the Bundestag.

Game, set, match.

Previous "solutions" to the Euro crisis have proven insufficient, as this version may. The market will be the ultimate arbiter. However, I fear that even if Europe's financial and economic stability are restored, the longer-term political ramifications may be far darker. Sooner or later, some of the countries made subservient in the Eurozone will elect governments that try to reassert national pride. And if nationalism is loosed in Europe, the reasons underlying the cataclysm of two World Wars become, once again, a concern for us all.

Market View

Let's talk stocks, let's talk bonds.

On equities, three points on US financial markets are hard to deny:

1) Stocks are in a secular bear market
2) Central banks have flooded the markets with unprecedented liquidity
3) Unpredictable events are driving day-to-day market direction in an environment of extreme volatility and high correlation

When each of these facts is considered, it becomes obvious that many of the "truths" of investing are more akin to myth than they are to good investment advice.

Let's fill in the blanks. Consider that from 1870 to 1901, the US stock market advanced by over 80% in real inflation-adjusted terms. It wasn't until the 1920s that it regained that level. Then the 1929 peak held as the high water mark until 1959. The market's 1966 high was not breached until the early 1990s. And finally, the peak in 2000 is well above current levels. History suggests that it takes two decades after a bust for the stock market to surpass its bubble high. In the meantime, there are ups and downs of significance, but no real progress.

Realizing that things are not good, monetary authorities in the developed world are trying to shore up confidence by providing cheap money in the hope is that it will be used to invest in opportunities with a positive expected return. When the cost of participating is zero, any scheme with a positive return becomes a winner.

Normally, this infusion of liquidity would lift markets and generate enough confidence to bring real-world economies into a growth mode. There is a spanner in the works, however. Information has become almost free, allowing all investors to process new events at the same time. This means that new consensus develops quite rapidly. Rather than prices moving over the course of time to incorporate new data, they move instantaneously. These discontinuous jumps or drops in prices reinforce a volatile disequilibrium where all players realize that any price is only provisional. The next day, new information can drive prices to completely different levels.

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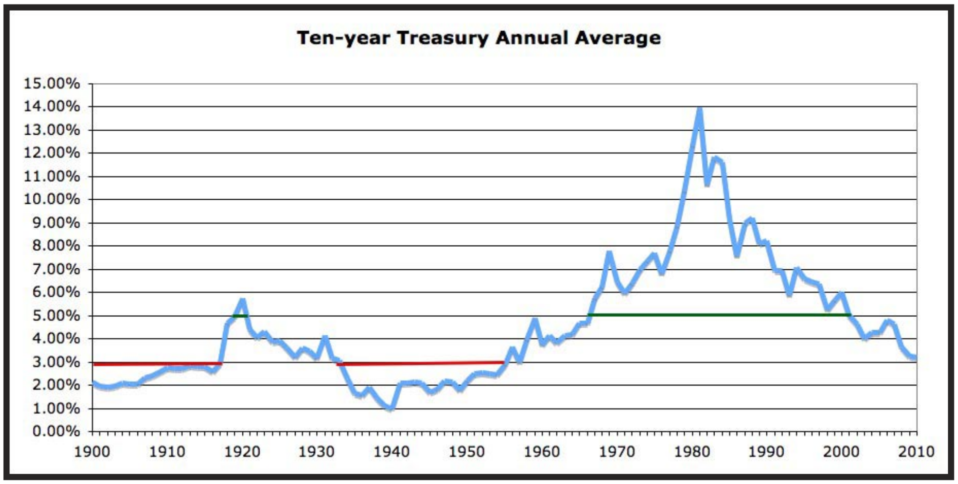
Market View (continued)

With events unpredictable or subject to vastly opposite outcomes of equal (or close to equal) probabilities, markets become bipolar and bounce between extremes rather than settling into a consensus. To operate in such markets, long-term strategies do not work. We are in the realm of a traders' market, which puts the premium on flexibility.



It is time to fully embrace the market's schizophrenia. Identify those assets that you want to own and use scary market plunges to buy when the price hits your target. It is important to pick your entry point well beforehand so emotion doesn't keep you frozen at the switch. I suggest selecting half a dozen high-quality dividend-paying stocks and setting buy points consistent with a Dow falling to 10,000. The flip side of this is to sell if the market approaches 13,000.

Now bonds. Consider that the 10-year Treasury has averaged below 3% during 40 years since 1900. What is remarkable is that the years with rates below 3% came in two long stretches — from 1900 to 1917 and from 1934 to 1955. Once rates fall below the threshold, they stay there in the following year 95% of the time. On the other side, rates above 5% have a 94% persistence. The chart shows that it is a very good bet to hold bonds when rates fall below 3% or sell them when they rise above 5%. It is also a good idea to reverse course when rates do the unexpected and don't follow the path of most persistence. Unless rates vault upward in the last few weeks of the year, they will have averaged below 3% for the first time since I was a toddler.

Editor's Note

Our over 25-year-old refrigerator recently expired. Fortunately, the (equally old) backup fridge in our pantry allowed us to get along for a month or so while we winnowed choices by transferring items and buying fewer extra reserves. We ultimately settled on a new refrigerator with a huge pull-out freezer, and once it was installed, we filled both freezers to capacity. The other day, during our extended Indian Summer, I had a hankering for a grilled steak. Off to the freezers I went. I found venison, ground bison, duck breasts, quail, Cornish game hens, all manner of ethnic sausages, veal sweetbreads, leg of and ground lamb, and even kangaroo. (No PETA meeting at my house.) Beef, however, was MIA. If it is true that people with a somewhat idiosyncratic view of the world can better point out the opportunities and dangers of investment markets, your editor may have passed to the next level. Note my words carefully, and if there are any Australian readers, we should talk, mate.

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