Jamesson Associates

03.2012 Newsletter

Recent Economic Events

The Untied States economy is on a roll. GDP has accelerated to potential; jobs are growing at the best rate in years; new car sales, especially domestic marks, are jumping. And then there is the rest of the world — Europe is playing games with debt and austerity; Brazil, India, and China (most of the BRICs) are posting their weakest results in years; and the Middle East is, well, the Middle East.

The American economy grew at a 3% real rate in the fourth quarter of 2011, and more recent economic statistics suggest that the momentum carried over into the new year. The most important of these statistics is job growth. According to the establishment survey, there were 227,000 jobs created in February, marking the third consecutive month of gains over 200,000 and the 17th month in a row with a positive report. If we turn to the household survey, we find unemployment held at 8.3% in February, but that is down from over 9% as recently as last summer. For technical junkies, the growth rate in jobs according to the household survey has been well above that of the establishment survey for the last year (difference about 500,000). At turning points in the economic cycle, the household survey may have more value, as the establishment survey is adjusted (based on recent history) to account for the birth/death of businesses. If things are really getting better, the estimate of new businesses may be lagging.

No man is an island entire of itself;
every man is a piece of the continent,
a part of the main;
if a clod be washed away by the sea,
Europe is the less,
as well as if a promontory were,
as well as a manor of thy friends
or of thine own were;
any man's death diminishes me,
because I am involved in mankind.
And therefore never send to know
for whom the bell tolls;
it tolls for thee.
John Donne

It appears that improving job prospects are infecting people's psyche and leading to more confident big-ticket purchases. Total vehicle sales topped 15 million on an annualized basis in February. Domestic producers led the pack with the first month over 11 million in annualized sales in four years. An interesting factoid is that the percentage of truck sales in the total is falling towards 50%, most likely reflecting the recent increase in gasoline prices. The move towards more efficient vehicles has contributed strongly to the decline in gasoline consumption (down over 700,000 barrels a day from last year) in the United States. On top of this, the Energy Information Agency recently reported that household expenditures on natural gas during the winter are expected to be the lowest since the 2002-03 season.

If that were the whole story, the news would be positive indeed. However, all is not well with the global economy. Greece and the Eurozone appear to have pulled off a minor miracle in removing over €100 billion in debt from the former's balance sheet, but the weak Greek economy along with chronic poor productivity will bring the debt issue back again. This, of course, did nothing to resolve the problems in the rest of Southern Europe, and it is most likely that recession is spreading throughout the continent.

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RECENT ECONOMIC EVENTS (CONT.)

China announced that its new growth target is 7.5%, which merely validated the market's lower expectations. Both India and Brazil, the other emerging economies with real heft, reported much slower growth. Resting hope on these countries to rescue global growth appears to be wishful thinking.

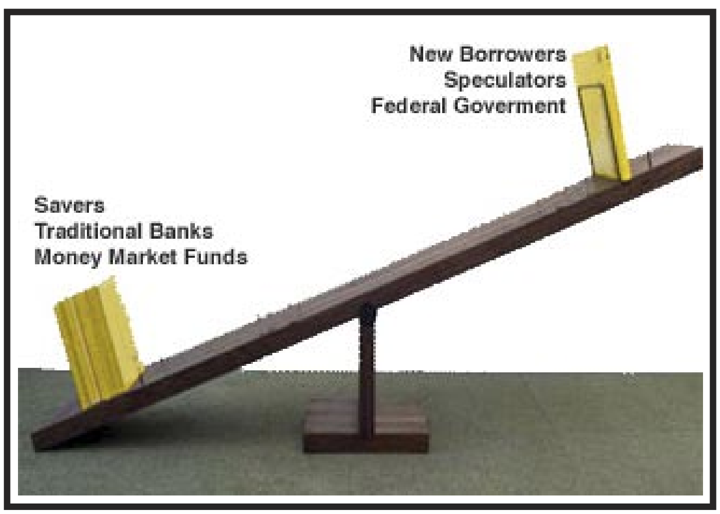
With much of the world slowing, you would think that commodity prices would be in a tailspin. In many cases, commodities have receded from highs, but oil is not following the script. To understand why, one only has to look to the Middle East, where geopolitical tensions have taken over the headlines. Concerns over oil supplies in the event of a Syrian government collapse or an attack on Iranian nuclear assets has sent precautionary oil buying into hyper-drive.

The United States cannot escape the rest of the world. For proof consider that our January trade deficit totaled $52.6 billion, the largest shortfall since October 2008. The fear at this point is that America has regained its position as the one engine of economic growth in the global economy.

John Donne was prophetic. The United States is part of the main and cannot escape a slowdown in the global economy. Once again, we are doing better than most, our recovery seems solid if sluggish, but we remain at risk if the bell tolls for Europe and the emerging economies.

COMMENTARY

The ideal of a united American polity is taking a beating. Everywhere we turn, it seems as though one group is being pitted against another. The prism of partisan politics has brought many of these differences into sharp relief, but is the impact of low interest rates another such battleground?



Before I go there, two questions. First, is the Fed keeping rates down, or is it simply following the market? Second, if it is manipulating the rates, who are the winners and losers?

Let's tackle first things first. If the Fed is keeping rates artificially low, wouldn't we see a huge demand for the cheap money? Anyone with cash would quickly spend or invest it if they felt that the returns (psychic or fiscal) outweighed the cost. But guess what? Short-term holdings in bank deposits are growing like mad and the velocity of money (rate of spending available cash) is plunging. I contend the Fed is a follower not a leader.

But assume I am wrong (it happens), and let's look at this from a winner/loser perspective.

The most obvious winners are new borrowers who can take advantage of the lowest rates in decades. Note that the benefit does not accrue to borrowers who have existing loans (except to the extent that they are tied to an index such as Prime) unless they are able to refinance. Over 11 million mortgages exceed the value of the underlying home and an additional 7 million have less equity than needed to qualify for a traditional loan at 80% loan-to-value. Given that, the benefits *(continued on page 3)*

COMMENTARY (CONT.)

of low rates to many existing homeowners are more theoretical than real.

Winners that are truly benefiting are a different group. They include people (and yes corporations are people too), especially those with a high risk appetite. This means stockholders, commodity producers, holders of high-yield bonds, and leveraged buy-out mavens. Mitt Romney's partners at Bain Capital are big beneficiaries. And of course, the Federal Government is number one on the list as a result of the huge new and renewed debt they issue each and every week.

When we look at the list of the losers, we will find considerably less politically connected individuals. They include, first and foremost, savers. Anyone who spent their working years setting aside money to be able to enjoy retirement with fewer money worries is now facing a future with a lot less potential income. In addition, the two most prominent industry groups that helped savers are under duress as well. These include traditional banks (not the trading behemoths of Wall Street) and money market funds.

Traditional banks have been crushed. Their basic business of gathering small deposits from a wide variety of customers is no longer profitable at current interest rates, forcing them to consider charging fees in order to cover costs. Money market funds thrived by doing essentially the same thing as traditional banks, but without branches. Today they find that even their lower costs gobble up what income they can obtain. Yields for traditional bank accounts and money market funds are now measured in basis points, not percentage points.

Savers who expected to garner a rate at or a little above inflation on their nest eggs, now must settle for one a couple of percentage points below. They are losing their life savings in the same manner that termites eat away at the foundation of a home, silently but steadily.

Economic statistics suggest that the market has produced the Fed's low rate stance, and rather than admit that they have no power to resist, they announce one plan after another to "get the economy going". Politics, however, suggests that certain groups are benefiting in a huge wealth transfer away from conservative savers.

A modest suggestion: let's eliminate the tax deduction for interest *costs* and make interest *income* (up to a reasonable limit per person) tax-free. Neither the Fed nor the Federal Government can overcome the market-driven interest rate environment, but we can try to level the playing field between savers and speculators.

MARKET VIEW

Interest rates can't seem to break out of their range even with the positive economic information common of late. This suggests to me that there is plenty of money that is looking not for a return, but for safety. Neither the Federal Reserve nor the European Central Bank is cutting back on liquidity. In fact, the latter has pumped over €1 trillion of three-year money into the European banking system at a 1% rate in the last few months. Money to support markets is not in short supply.

At the same time, corporate profits are showing signs of a slowdown. Although valuations seem reasonable, a reversion to the mean in profit margins could place ongoing pressure on the stock market.

Emerging nations' economies have given commodities a tailwind, with the large exception of oil. It continues to stay stronger than economic fundamentals warrant due to potential geopolitical events. However, the Iranian nuclear issue is likely to be resolved similar to the Greek debt crisis (which wasn't really resolved as much as it simply wore out its news cycle). When it is, oil will revert to fundamentals, suggesting a price in the \$60-\$80 range.

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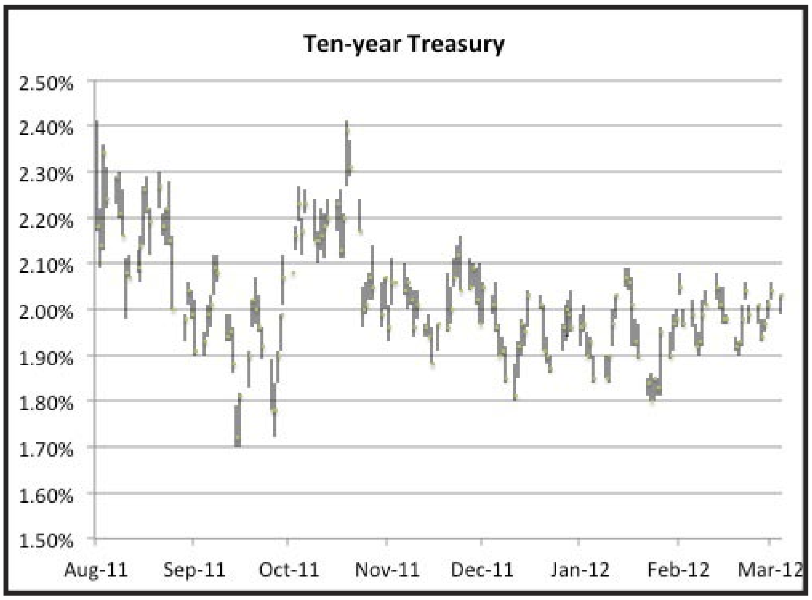
MARKET VIEW (CONT.)

The ten-year Treasury has stayed within 30-40 basis points of 2% since the debt-ceiling circus ended last August. This is remarkable, given that since then, monthly employment growth has roughly doubled, the stock market has gained about 10%, and oil has consistently traded over $100 a barrel. Liquidity is trumping fundamentals, and I expect it to continue. The best spot in the market is five to seven years for taxable investments and about five years longer for municipals. For those with a somewhat higher risk appetite, high-yield bonds have a pretty good risk/reward.



Stocks have surprised me to the upside, but they are approaching a key resistance area. I would be cautious and lean towards quality and dividends. REITs, utilities, and MLPs can offer good yields with some upside to grow over the next few years. I believe homebuilders have gotten ahead of the housing market as there are still huge price and psychological barriers to a full recovery there.

I would avoid commodities, especially oil. At present prices, gold and other precious metals are fairly priced and offer little in increased insurance against calamity.

Avoid cash as an alternative to investment. Keeping a small reserve for living expenses is one thing, but expecting to profit from market timing is a losing game.

EDITOR'S NOTE

In late November, I got a haircut, and by New Year's day, I was beginning to look a bit shaggy. However, the New York Giants had embarked on a somewhat lucky and surreal trip to the playoffs, and with each win, I vowed to let the locks grow. I wasn't entirely convinced that the power of Samson had flowed from my head to "Big Blue", but I wasn't about to mess with success. While I can hardly take credit for the drubbing of the Falcons, the dominating victory over the Packers was something else. Then, an overtime win against San Francisco on two fumbled punts steeled my resolve. One day before the champagne flowed in Indianapolis, something even stranger occurred — the Knicks began an eight game winning streak, sparked by a heretofore unknown guard named Jeremy Lin. The next two weeks saw me consider dreadlocks, but the spell was broken, and I went under the clippers. The story has a coda. Sal, my NYC barber, admitted to me that he was self-taught and had been cutting hair for 38 years. When he first started, he traveled to Germany to work in a small-town shop. The owner was impressed and offered to give him the shop and a house if only he would marry his daughter. In Sal's words, "she was a champion beer drinker and as big as an elephant." He left Germany without making the deal, and judging by my head, not getting any professional training.

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