JAMESSON ASSOCIATES

FALL 2015

QUARTERLY NEWSLETTER

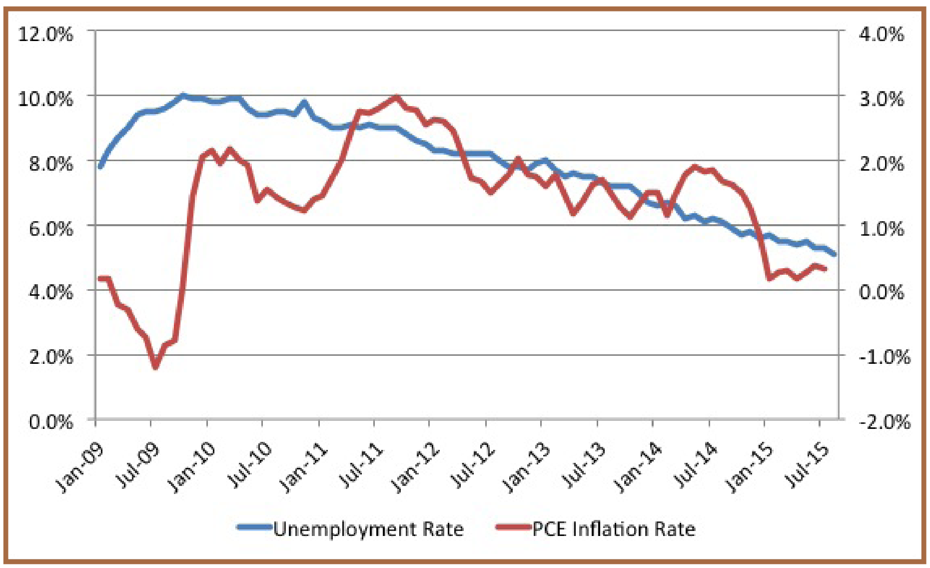
Recent Economic Events

Since my June newsletter, the folks at the Commerce Department have been busy revising past GDP releases. Now, things are coming up roses. The Federal Reserve remains perched on the horns of a dilemma that they themselves have created. Unemployment fell to a post-recovery low while inflation threatens to do the same. After an extended period of weakness, housing is finally showing positive momentum. And confounding economic pundits everywhere, the trade deficit is falling even in the face of a strong dollar.

Perry White, known for screaming at Jimmy Olsen, "Get me rewrite", may have taken a job at the Commerce Department. Earlier in the year, private economists pointed out the consistent weakness in first quarter GDP figures versus those for the ensuing three calendar quarters. After denying that there was a problem, the government statisticians issued a revision of figures going back four years. Lo and behold, the first quarter slowdown disappeared. However, at the same time overall growth since 2011 was downgraded to 2% instead of the original 2.3%. So, the economy was actually growing more slowly than we had thought. "Never mind," said the bean-counters; the second quarter grew at a strong 3.7% (revised up from 2.3%). The change from one year ago was pegged at 2.7%, one of the strongest four-quarter streaks since the recession ended. Re-read that last sentence, and you will get a flavor for the current state of economic growth.

What's a Fed Chair to do? After revising their own criteria for a rate hike numerous times in the last few years, the Fed decided to become "data dependent". They were hoping that a consistent stream of positive statistics would give them cover to raise rates. Well, it hasn't turned out that way so far.

The August employment report indicated job growth of 173,000, less than expectations, but pretty good given revisions in both June and July. The unemployment rate fell to a new post-recession low of 5.1% as did the labor force participation rate, but wage gains are still stuck in the low 2% range. A big plus for consumers is the soft inflation rate (up only 0.2% YOY), driven by falling energy prices. In fact, AAA reported that Americans traveling for Labor Day festivities experienced the lowest gas prices in 11 years. Those low gas prices are fueling auto sales which are close to 18 million on an annual basis, and the appetite for light trucks/SUVs is nearing 60% of the total.



The lack of inflation is clearly bedeviling the Fed. Headline inflation figures are being held to practically zero by the collapse in commodity prices, especially energy. But even if we exclude food and energy from the calculation, we find core CPI up only 1.8% and core PCE up a miniscule 1.2%. These indices are

Recent Economic Events *(continued)*

not moving in the Fed's preferred direction and may be a key reason they hold off on increasing interest rates at their September meeting.

Housing has become a real positive in the economic landscape. Both new and existing home sales are in a strong upward trend and inventories are tight. This bodes well for new construction and for the follow-on sales of home furnishings.

Speculation that the Fed will be raising rates while other central banks around the world are easing has led to a dollar rally, but paradoxically a stronger dollar may cause the Fed to hold back. The concern: a stronger dollar will cause trade problems, weakening the economy. However, a funny thing happened on the way to bigger trade deficits. The deficit is shrinking. July's trade deficit of $41.9 billion was the smallest in five months and has shown no sustained sign of rising even as the global economy slows and the dollar stays strong. It appears that reduced oil imports (both physical and in dollar terms) are offsetting the factors arguing for a wider trade deficit.

At the risk of missing developments entirely (they could be revised), I would categorize the current economic situation as domestically good but not great, internationally dicey with a good chance of financial market volatility, and asymmetrically risky because of too-low inflation. Should the Fed tighten next week? I would lean against, but I understand their credibility predicament. With things this close to call, the more important question is what the data are likely to show after the Fed meeting and into 2016.

Commentary

China has been on the minds of many investors recently as its buoyant stock market (which more than doubled YOY into early June) has reversed into a crash, falling by over 40% with little respite in sight. The danger here is less the stock market itself than what it signifies for the credibility of the Chinese elite.

> Bubble + Crash ≒ Mandate of Heaven
>
> Pàomò + Bēngkuì ≒ Tiān jiàng dàrèn

Some quick history — top-down to bottoms up. The Chinese economy was rocked by the global financial meltdown in 2007-8 as many export markets cratered. The authorities responded by launching a massive infrastructure investment program (top-down). Realizing that this was not a long-term solution, but that the domestic Chinese consumer would have to pick up the slack (bottoms up), the powers that be pondered how to encourage increased consumption. First, they turned a blind eye to shadow banking and its support of real estate speculation, figuring that if consumers felt wealthy from increased housing values, they would spend some of their paper wealth. Not only did this not work, it ultimately ended in a decline in real estate values and a plethora of half-finished apartment buildings.

On to Plan B. There is a strong gambling culture in China. This is why Macao sports the most lucrative gaming revenues in the world. The Chinese stock market is viewed by "investors" as a casino much more than a true investment vehicle. It is no surprise that gambling revenues in Macao fell at roughly the same rate that the stock market appreciated from 2014 to the middle of 2015. The last upward surge was driven by a *People's Daily* article touting the benefits of stock market speculation. Newly opened brokerage accounts jumped from fewer than 1 million a month to over 12 million.

These attempts to manipulate the markets and the economy through the supposed wealth effect ominously

Commentary *(continued)*

echo Federal Reserve policy. They were as effective there as they were here. In other words, not very.

The new Chinese leader Xi Jinping decreed that growth would be 7%, so 7% is what the official rate has averaged for the first half of 2015. As Arsenio might have commented, "Hmmmm". No one believes the figures, adding to uncertainty.

Surprisingly enough, the business cycle is immune to ethnicity and ideology. Booms and busts hew to their own rules, not the rules of government bureaucrats, no matter which side of the Pacific they call home. However, there is a great deal of cultural difference between the US, which expects these things to occur from time to time and the Chinese, who look to their leaders for stability and prosperity. Chinese history reveals long stretches of good times punctuated by periods of war and chaos. It is only when new rulers bring stability that they assume the "Mandate of Heaven" confirming their legitimacy. The thirst for order is what ultimately doomed the Tiananmen Square uprising, instituting the deal between the Chinese public and the Communist party: make money but stay out of politics.

The real danger I see in the inability to control the stock market is that it is a symptom of the failure of the Communist party to hold up its end of the bargain as the economy transitions from top-down to bottoms up. If the economy continues to slow and the public begins to question the Mandate of Heaven, the recent volatility in China will look like a picnic in the park.

Market View

The financial markets have been on quite a rollercoaster ride this summer, fulfilling my prophecy of increased volatility. Whereas we hadn't had a 10% correction in the stock market since late 2011, we experienced 15% or more in both the Dow and S & P, and the NASDAQ dropped over 20%, technically ushering in a bear market. But though the plunges were scary, we have had a nice rebound from the lows. Oil prices have followed the script as well, cascading down from over $60 to under $40 and then staging a violent rally back to almost $50. It's clear that these markets are not for the faint of heart.

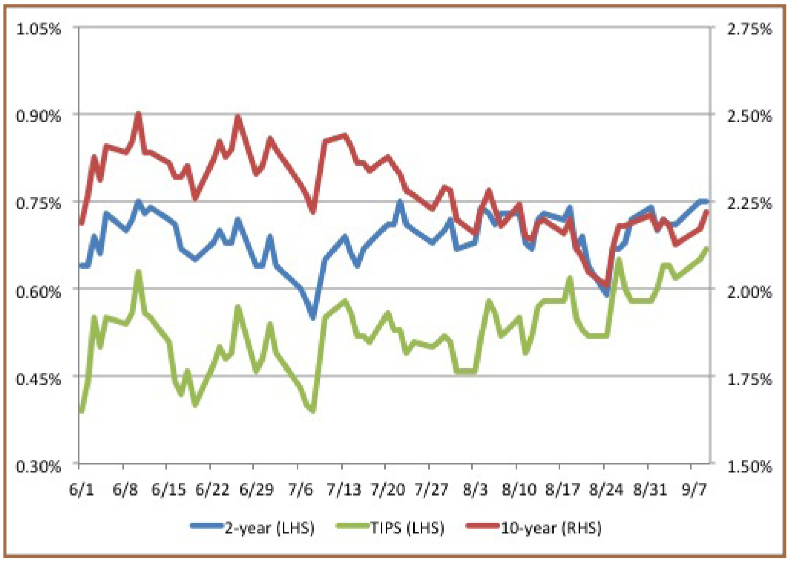
In contrast with equity and commodities markets, the Treasury market has quietly established a directional trend. However, the direction was quite dependent on the term of the note involved. The divergence since early June between the ten-year and two-year note couldn't be starker. The latter has increased by about 15 basis points from roughly .60% to .75%, while the ten-year has dropped about 25 basis points from 2.45% to 2.20%. Even though the data-dependent Fed has sent plenty of conflicting signals on its plans, the market has concluded that short rates must rise in anticipation of a tightening cycle.

However, the ten-year is not cooperating, and this is significant. Historically, in the months before a Federal Reserve increase in rates, the ten-year will rise by more than short rates, steepening the yield curve as it tries to get to where the Fed is going before the Fed gets there itself. After the move, the long rate either holds (if the market believes it has the end point correct) or rises by less than the increase in Fed Funds (as it readjusts it expectations). In either case, the curve flattens during the tightening cycle.

So what to make of the anomalous movement? First, it doesn't appear that we are seeing knee-jerk flight to quality. I say that because the spread between regular ten-year rates and rates on TIPS has narrowed, signifying that buyers are looking for nominal yield, not inflation protection. From early June, the ten-year TIPS has increased from .45% to .65%. This means market participants who were expecting inflation to run 2.00% in early June are now expecting it to be closer to 1.55%.

Market View *(continued)*

Note that from December through February when the market was in a tizzy from the Greek crisis (remember that?) nominal rates fell from 2.30% to 1.80% while TIPS were falling from .55% to .10%. Everything moving in the same direction: that's a flight to quality.



I believe that the risk of deflation is animating the demand for longer-term Treasuries and that the Fed could be making a big mistake if it raises rates. The proof will be easy to detect. If the Fed increases the Fed Funds rate and ten-year Treasury rates rise a bit, it will be a vote of confidence. If instead they fall, especially if it is the nominal rates that fall the fastest, it will be a market signal that deflation is far more a of threat.

There is little doubt where I come down on the question. Commodity prices are not only on a downtrend, I believe that they are resuming their long-term secular decline.

Recall that predicting the general level of commodity prices over long stretches of time comes down to identifying the marginal cost of production. Further recall that the marginal cost of production invariably declines over time (adjusted for the general price level) because of ongoing improvements in technology. Over the last twenty or thirty years, the difference has been the one-time secular change of emerging nations entering the global economy upon deciding that material well-being trumps ideological rigor.

With this process reaching maturity, I expect ongoing downward pressure on commodities and interest rates. The latter may not actually decline, but I see little risk that they will rise by much. Stock prices will be buffeted by the data release de jour, but since I don't expect a recession, I would use weakness to buy good quality companies with superior growth prospects.

Editor's Note

I have always been proud of my status as an omnibibe (one who drinks everything). Beer at a baseball game, bourbon when in Kentucky, wine with meals that start after noon, Iced tea at the church supper, water after brushing my teeth, but rum has been a generally hard swallow. Don't ask me why, but Susan and I decided to celebrate our 33rd Anniversary in Bermuda in late June/early July. The temperature was consistently in the upper-80° range, and it was decidedly not "dry heat". If there is anyplace that humidity can be over 100%, it's in Bermuda. All movement from indoors to outdoors was met by a blast of hot, humid air which challenged our supply of clean, dry garments. It is unlikely that rum drinks are the scientifically proper counter to this weather; I might argue for 3.2 beer. Nevertheless, ubiquitous was the Rum Swizzle (served in every bar we visited but never using the same recipe) which I am convinced got its name from a patron who slurred out an order after downing one too many. They go down easy, so it's a very good thing that I'm back on the mainland where rum is off the agenda.

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