JAMESSON ASSOCIATES

06.2015 NEWSLETTER

RECENT ECONOMIC EVENTS

June gloom lifted with the release of the May employment report. And gloom there had been, due to the dismal first-quarter GDP report along with decidedly weak retail sales figures in April. Consumers appeared to be stashing away their gasoline savings rather than spending them. Inflation remained benign, and while oil prices bounced back, they seem to have stalled in the low $60 range. And the strong dollar finally had its say on exports and industrial production.

At the end of May, the government reported that first-quarter GDP growth registered a negative (0.7%). This was the second negative first quarter in a row, cementing the idea that first quarters in general perform much worse than subsequent ones. Nevertheless, government bean-counters are standing by their calculation that the growth numbers were simply lousy. While many private forecasters believed that things were not as bad as reported, they had little to hang their hat on.

Not only did monthly job growth jump to 280,000, the report also showed a 0.3% advance in wages, boosting year-over-year gains to 2.3%

Employment, which had been a real positive for the economy late last year and into the early part of 2015, took a weaker turn in March, and April's recovery convinced few that we were back on track. That is why the very positive May report, released early in June, was so important. Not only did monthly job growth jump to 280,000, the report also showed a 0.3% advance in wages, boosting year-over-year gains to 2.3%. Given that annual inflation is essentially zero, this means a very nice increase in real income for American workers. Even the uptick in the unemployment rate from a post-recession low of 5.4% to 5.5% was good news, as it represented a welcome rebound in labor force participation.

You would think that all these positives would translate into increased retail sales. If you did, you would be wrong. Consumers appear to be saving at an elevated rate, perhaps believing that the decline in oil prices, and hence gasoline prices, will not hold. Admittedly, since mid-March, oil has recovered from the low $40 range to top $60, adding about 50¢ a gallon to the cost of gasoline and encouraging the "I told you so" lobby. However, the gain in oil prices that promised to continue to the $75 dollar area has stalled in the last few weeks, suggesting that the upward spike has been exhausted. Record production in Saudi Arabia and no real decline in American production, along with close to all-time highs in oil storage (in tankers, in above-ground storage tanks, and in fracked wells drilled but not completed) argues for the next major move in oil prices to be down, not up. If so, deflation worries will be revived.

From mid-2014 to early this year, the US dollar rose almost as much as oil collapsed. Many wondered why the roughly 25% increase had not impacted the American trade deficit. Well, in March the mystery cleared with a figure in excess of $50 billion. This figure was probably distorted by the reversal of the effects of the west coast dock strike earlier in the year, but April's deficit topped $40 billion as exports languished. On a monthly basis, exports are down about $10 billion from a year ago, offsetting the decline in our oil imports.

It is likely that the negative impact of the strong dollar has not been fully realized either. Estimates suggest it may take as long as three years for currency changes to be incorporated into the real economy. Furthermore, the ongoing weakness in Industrial Production (five

(continued on page 2)

RECENT ECONOMIC EVENTS (CONT.)

months running) is evidence that the strong dollar challenge is still with us.

The super May employment report served to lift spirits after some disappointing first-quarter and early second-quarter economic releases. Wage gains are finally coming into view, and the stall in rising oil prices will hopefully put the consumer in a better mood. With a strong dollar and a generally weaker global economic picture, it had better, because it will be up to the American consumer to keep the economy moving forward at this point.

COMMENTARY

Big data vs. Narrative. Algorithms and computers operate differently from a human mind. The machine looks for correlations and constantly refines its conclusions based on levels of data input beyond the ability of humans to process. Humans utilize heuristic strategies that try to pick out the story in the data, excluding pieces deemed irrelevant so as not to lose the forest for the trees.

As human beings, we can quickly reposition our body and hands to catch a football, while a machine would need many sensors and a specialized database to even try. Conversely, a computer can sample a few seconds of a song and then compare the snippet to the full library in its memory banks to immediately identify it and all of the production facts. Although we cannot recall the issue date of every one of the Beatles' songs, Shazam has no chance of scoring a touchdown. Different strokes …

I wonder, however, if we are near a technology tipping point — a point where raw computing power, coupled with algorithms that learn, will accelerate the abilities of machines to do heretofore-unimaginable things. We may be close to validating the promise of Kraftwerk's 1978 album which featured the haunting lyrics, "we are the robots, we are the robots…."

Areas thought immune to machine learning are becoming fewer and fewer by the day. Artificial intelligence has conquered chess and Jeopardy, and is now common in day-to-day sports and financial reporting. Voice recognition has clearly moved into the mainstream. Facial recognition is close. These endeavors can be thought of as open to rules and comparison to known facts. What about artistic arenas or high-level decision-making? Doesn't that require creating something that machines cannot find in their databases? I am not so sure.

There is a debate bubbling up in the economic blogosphere on just this point. The Federal Reserve Bank of Atlanta uses a GDPNow model which gathers economic statistics as they are released and then uses the information to produce an estimate of GDP growth. How good is the estimate? Well, in the first quarter, it was quite close to the initial release, while the consensus of economists missed by a good *(continued on page 3)*

Commentary (cont.)

deal. However, over time, it appears that the model is currently no better than the economic consensus.

But here's something to consider: humans carry their biases with them, while machines are a lot like Joe Friday: "Just the facts, ma'am."

Information comes to us in a very organic way with plenty of noise. It is generally a wise idea to disregard data that seems inconsistent with the ongoing trend, as in most cases, the outlier is just that. However, sometimes the oddball statistic is the signal within the noise and is discarded inappropriately. That is why virtually all human projections extrapolate from the recent past, and why they are wrong when the trend is changing.

This suggests a way to use the different approaches. The stronger and younger a trend is, the more we should hew to a consensus and disregard outlying data. However, as a trend lengthens in time or becomes weaker, paying attention (in a systemic way) to all the data becomes more and more appropriate.

That brings us full circle to the current projections of GDP growth for the second quarter. The consensus of economists suggests growth of about 2.5%, a nice bounce-back from the first quarter contraction. The GDPNow model is tracking a level near 1%. While one quarter will not decide the question of which approach is more accurate, it will be interesting to see whether the machines can conquer the world of economic forecasting as they have other realms.

Market View

The Federal Reserve has announced that future interest rate policy will be "data dependent". This means that they will look at the incoming economic statistics and make decisions on moving the Federal Funds rate based on the evidence at hand. While this sounds eminently reasonable, it is a far cry from the SOP since the financial meltdown in 2008. Lack of forward guidance along with the vagaries of daily economic releases suggests that we are in for increased volatility.

In my opinion, market volatility comes in two flavors — short and long. There is the day-to-day or week-to-week volatility that is primarily determined by reaction to new information and market liquidity. In other words, the more out of consensus new information is and the fewer the counter-parties willing to make markets, the more violent the price reaction will be. Sometimes the market's internal dynamics can trigger outsized market reactions like the May 2010 "Flash Crash" and the huge Treasury yield collapse on October 15, 2015.

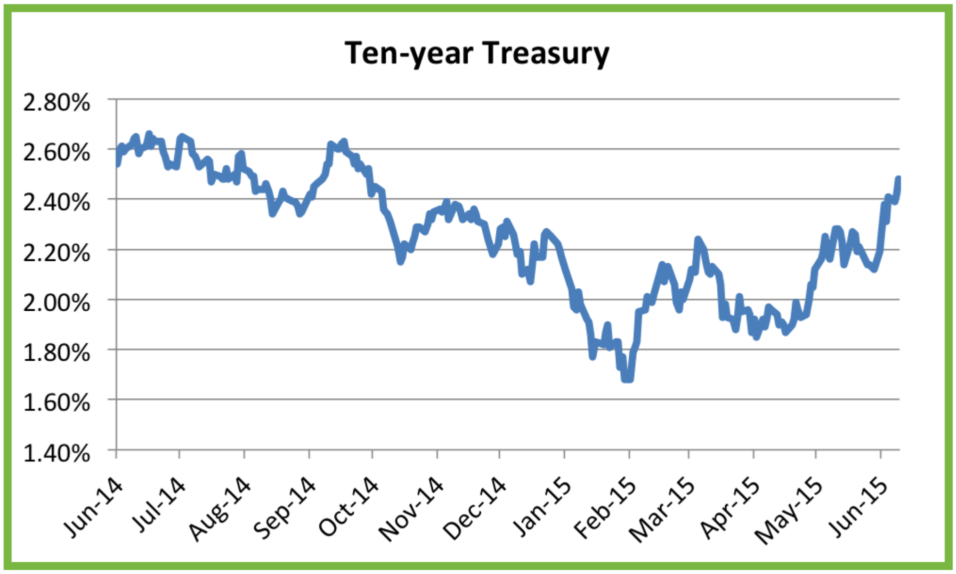
However, looking at markets through a wider lens suggests that prices have been remarkably stable. The stock market has not had a 10% correction on a closing basis since late 2011, and even with at least eight swings of 25 basis points or more in the 10-year Treasury over the last year, we are still within 25 basis points of where we were in June 2014.

We have been dealing with micro-volatility and macro-stability. With the Fed now moving further into the arena of data dependence, I am afraid we will lose the macro-stability. What does this mean for investors?

Well, it means that buying options may make more sense than selling them, and that nimbleness and flexibility are likely to be a better approach than steadfast perseverance. On a practical basis, don't get wedded to your portfolio. While it may take more time and effort, a regular review and assessment will pay off. The tried-and-true, buy and hold strategy is not well designed for the expected *(continued on page 4)*

Market View (cont.)

environment. This doesn't mean constant in and out trading, but it does mean playing against the crowd.



So where is the crowd now? The market has become more and more convinced that the Federal Reserve will be raising rates this year and that the knock-on effects will be to boost longer-term rates as well. The ten-year Treasury has already moved from the low 2% to the mid-2% area. It may be time for a counter move in term interest rates. While I use the ten-year as a handy proxy for value, I would concentrate purchases in the shorter three to five-year area for taxable investments. With the annual rush to issue by municipalities in full swing here in June, I continue to believe that there is extra value in the tax-exempt market. Here I like the seven to ten-year range.

The stock market has recently battled between a record-setting Dow Jones Industrial Average and a Dow Jones Transportation Average that is well below its highpoint. Perhaps both have been reacting to the rebound in oil prices, suggesting to me that it is time for the focus to shift to those companies that will benefit most if oil does soften. While much of the market has been supported by liquidity, as opposed to organic earnings growth, I believe that the next stage will be dominated by those companies that can increase earnings as opposed to those that depend on an increasing P/E ratio. Growth is poised to outperform value.

Editor's Note

Over the last few months, my goatee has been a conversation starter. Comments range from, "You look like a refugee from the sixties." (not so far off), to the classic, "Oh, how long have you had that?" and on to the time worthy, "Why did you decide to grow a beard?" The short answer: I hate to shave. Those of you who have seen me on any day when I don't have to visit clients or board an airplane know I can get quite scraggly. I have, however, found that many folks have commented that I look younger with the facial hair than I did clean-shaven. I am not sure whether this signifies deteriorating eyesight amongst the public or whether it reflects the fact that I am simply associating with older people. However, it leads me to the following strategy. I will keep the beard long enough for people to recognize it as my normal look, and then I will shave it off. I am fully convinced that the first comment I will hear is, "You look much younger without the beard." A couple of cycles of this process, and I will be back to the sixties.

Michael Jamesson
Jamesson Associates
Scottsville, NY
(585) 889-8090

Mjamesson@aol.com
Michael@JamessonAssociates.com