JAMESSON ASSOCIATES

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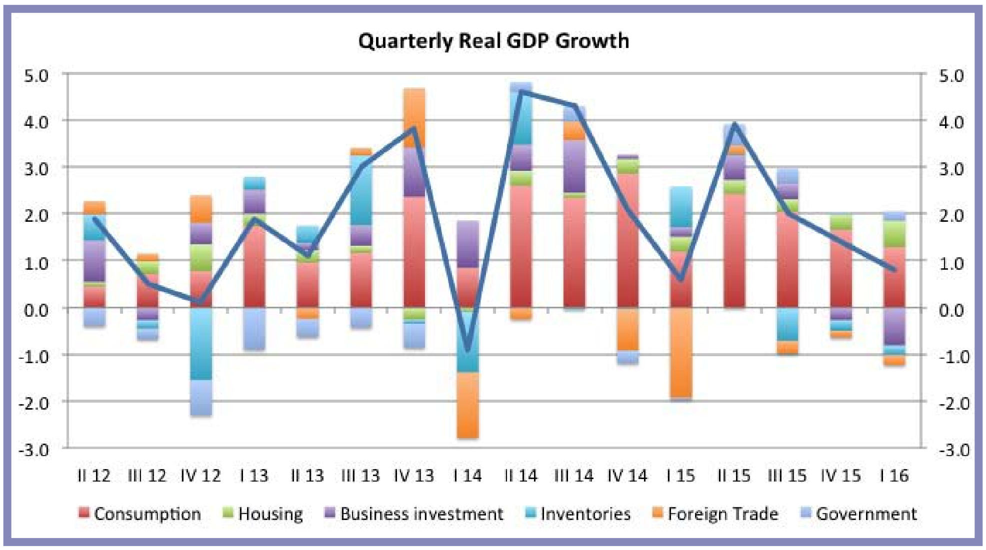
QUARTERLY NEWSLETTER

Recent Economic Events

The results are in: the American economy was not strong enough to withstand the 25 basis point tightening executed by the Federal Reserve in December. First-quarter GDP slowed from the already weak fourth quarter last year. Employment growth has clearly decelerated to a pace more consistent with a pre-recessionary environment than with an economy gaining traction. All of this has discouraged US businesses from spending on the future. Governments are also reluctant to take advantage of historically low interest rates to borrow funds for capital improvement. Consequently, the fate of the recovery is in the hands of the American consumer — supported by a welcome uptick in wage gains and still-low inflation, but challenged by debt and monetary policy more focused on retarding growth than boosting it.



First quarter GDP was revised upward from an anemic .5% to a still-weak .8%. This represented a three-quarter sequential slowdown. If not for the consumer/ homebuyer, we would have had a contraction rather than growth. Reviewing the details of the report, we find that consumption (1.3%) and housing (.6%) were "strong" enough to offset business investment (-1.1%) and net exports (-.2%). Government rounded out the net number by adding .2%. The recovery is getting tired.

Employment and wage growth are the life's blood of healthy consumer spending. On that score, there is good news and bad news. The bad news is that employment growth has clearly slowed. Private jobs created in the month of May totaled only 25,000. Although the Verizon work strike contributed to this, it represented the weakest monthly gain in some six years. It also doesn't look like an outlier, as both March and April were revised lower, bringing the three-month moving average to a little over 100,000 against a late 2015 figure over 200,000. The good news in the release from the BLS was that annual wage gains have maintained their highest post-recession level of 2.5%. The acceleration from the 2% range is quite welcome.

Faced with lethargic growth, businesses have retreated from investing in plant and equipment. In fact, total fixed investment by businesses is lower today than it was a year ago. Government has hardly picked up the slack. One would think that historically low rates would represent a great opportunity to fix our dilapidated roads, bridges, airports, water mains, etc. The inability to distinguish between capital expenditures and expenses, along with misguided austerity in Washington and many state capitals, has saddled America with third-world infrastructure.

With all other parties AWOL, it falls to the American consumer to drive the economy. Annual wage growth, as noted, is finally up to 2.5% against an inflation rate as measured by the CPI of 1.1%. This modest gain has been helped by the lowest gasoline prices in years, down about 40¢ from last Memorial Day. The challenge to the consumer is how much spending can be financed with borrowing. Auto debt has powered

Recent Economic Events (cont.)

ahead and now tops $1 trillion, while student loans exceed $1.2 trillion. Even credit card borrowing, after seeing some welcome reduction, is on the upswing again. While cars and education are legitimate uses of credit as they provide benefits over time, credit cards most likely serve as the plug figure between income and regular expenses.

It remains to be seen whether the Federal Reserve will throttle the consumer with higher interest rates. They seemed bent on repeating their mistaken rate increase until the release of the May employment report. Only ideology can justify a tightening cycle when confronted with a slowing economy and little, if any, price pressure. As John Maynard Keynes said, "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist." I hope Ms. Yellen can break free.

Commentary

Human beings are hierarchical animals. We tend to establish a pecking order pretty quickly in our business dealings and in our social interactions. Sometimes these structures are informal and temporary, but sometimes they are made more concrete and permanent by corporate or governmental lines of authority, reinforced by monetary or legal means. However, at certain junctures of history, individuals realize it is time to blow up the hierarchy. 2016 appears to be just such a time.

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The European Union was perhaps on the cutting edge of this movement a few years ago when Grexit entered the lexicon. With all due respect to my Greek heritage, this was never going to be a significant economic event but rather a harbinger of future dissolution movements. Now, with the upcoming vote in Great Britain over remaining in or leaving the Eurozone, the issue has real economic import.

London is the foremost financial center in Europe and possibly eclipses New York on the world stage. If the Brexit forces win the vote on June 23rd, there will be significant upheaval in the world of finance. Trillions ($, €, £) or even billions of financial transactions which facilitate trade, asset purchases, etc. will enter limbo. This is why investment banks in London have been key funders and supporters of the "Remain" camp. In fact, it is a "Who's Who" of prominent UK business and political leaders driving the campaign to stay. That, of course, raises the question of who is supporting the "Leave" initiative. Turns out it is the everyday British citizen. Does this divide remind you of anything closer to home?

Before I turn to our topsy-turvy political scene, I want to discuss the battle between the Federal Reserve and the markets. As many will remember, the Fed told us a few years ago that they would be moving off their ZIRP, heading towards a presumed equilibrium rate of over 4% on Federal Funds. The market disagreed. Even as recently as December, when rates were increased by 25 basis points, our lords at the FOMC suggested that there would be four more rate hikes in 2016. The market disagreed. And a few weeks ago, in the wake of a somewhat troubling CPI report (driven mostly by energy prices), a number of Fed Governors were publicly calling for a rate increase in June. The market disagreed, placing the odds no higher than one-third. With the punk employment report for May, the market won again. And, I might add, so did the American economy, which is hardly strong enough for misguided rate increases.

Contrast this denouement with the awe with which the market regarded Paul Volcker as Fed Chairman. The phrase, "don't fight the Fed" was appropriate then and during most of the reign of Alan Greenspan. It is now the market which the Fed doesn't want to fight.

Commentary (cont.)

The American political scene mirrors that of Britain and the travails of the Fed. The elites are on the run. The most surprising political event of 2016 has been the rise of Donald Trump and the collapse of the other 16 Republican hopefuls. While a couple of those folks could be termed outsiders, the original field had nine governors or ex-governors, and five senators or ex-senators. Surely, the establishment could have coalesced behind one of their own. The base disagreed.

And over on the Democratic side, who would have guessed that Bernie Sanders, democratic socialist from Vermont, would be so successful in delaying Hillary Clinton's march to the nomination? Senator Sanders has given voice to a Democratic base that is far more interested in income inequality, trade fairness, and reducing military commitments than expected. He has pulled Secretary Clinton to the left and will leave an indelible mark on the party's platform.

So, we are facing a choice between the Democratic Party's answer to Dick Nixon and the Republican Party's embrace of know-nothingism. Mr. Trump is clearly unqualified to be President, lacking the temperament, the governmental experience, and the intellectual curiosity to dive into complex policy problems. The voters may disagree.

Market View

Boy, was I off base on oil. While I tagged the bottom, I figured it would be tested and that the price would not enter a solid upturn. Only if I can argue that a move from the mid-$20 range to the cusp of $51 is not a solid upturn can I wipe the egg from my face. Clearly, oil has confounded me once again. In my defense, it appears that some temporary factors provided a tailwind for oil beyond my expectations. Given the fact that geopolitical factors and accidents are always lurking in the oil market, I should have known better.

Libya, Nigeria, and Canada have been the culprits in the upswing that carried oil beyond my upper-end target of $45. Few would lump our milquetoast northern neighbor with Libya and Nigeria, countries that have a history of poor governance and armed militias. It wasn't unrestrained violence that hit Canada's production; it was wildfires. All together, the "temporary" supply disruption took enough daily production off line to swing the global net oil balance into deficit. Between temporary factors reversing, seasonality, and a marketshare war by OPEC, I see oil with a downward bias.

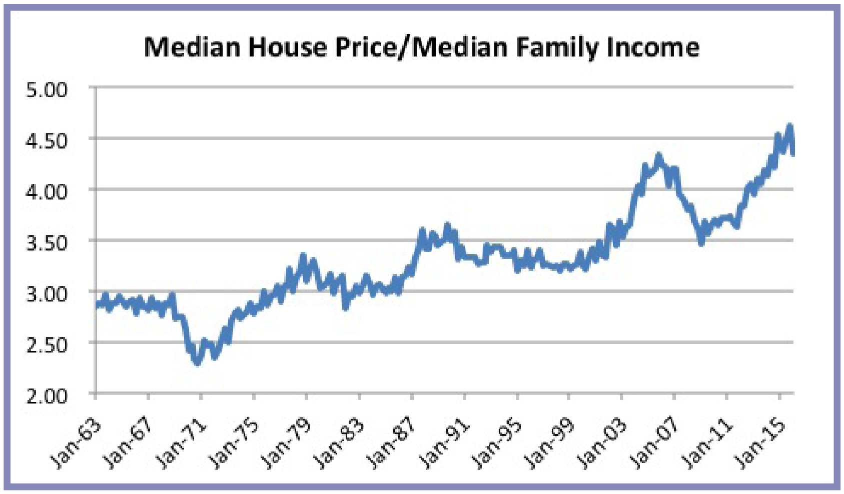
Turning to other commodities, it appears that industrial metals prices fit with my expectation of bottoming but not entering a new bull market. Agricultural prices are more mixed — clearly up but not booming. With a domestic and global economy that is showing middling growth rather than an acceleration, I believe that commodity prices are likely to stay in a range.

The stock market has fooled most prognosticators in threatening all-time highs in the face of earnings that are on a downward path. Earnings down, prices up: the only way this happens is delusion or the lack of alternatives. While the Federal Reserve has embarked on a painfully slow tightening cycle, the money supply is still growing more quickly than the economy. The extra money is finding its way into both financial and real estate assets.

The stock market as measured by the S & P 500 is trading at a Price/Earnings Ratio of 24x versus 21x a year ago. Its level was roughly 2100 in both cases: consequently the earnings associated with the index have fallen from roughly $100 to $88. At the same time, housing prices have continued to advance by about double the rate of wage gains in the economy. As a result, the ratio of housing prices to median income is actually higher than it was in the housing bubble period 2005-2006.

Market View (cont.)

There are two ways to look at this situation. The positive spin is that with future returns likely to be lower than history suggests, current values need to adjust. In other words, while I used to be able to buy stocks at an annual return of 6% to 7% (implied P/E Ratio of about 15x), I now have to settle for a return of about 4%. So the move from historical to current valuations is valid, but any further appreciation is dependent on even lower expected returns. The upside is that values are reasonable; the downside is that future returns will be disappointing.



The less attractive view is that asset prices are simply way too high and will have to adjust. The bad news is a market crash; the good news is buying opportunity for those with cash.

My view is that future returns will be lower because of reduced growth opportunities in both the domestic and global economies. The surfeitofsavingschasing the limited number of those opportunities has pushed valuations upward, and we are just going to have to live with lower future returns. This has plenty of implications that I don't have time to discuss now, but may return to in the upcoming newsletters.

Let me finish with some thoughts on the bond market. US Treasury rates are not playing ball with the Fed. The ten-year has held under 2% since early February, both when it looked like there would be no more tightening this year and when it appeared the Fed was ready to move multiple times. This says to me that something else is driving long-term bond rates. That something else is the pull of negative interest rates around the world. The US has the highest note and bond rates in the developed world. That should keep steady demand for our debt and hold down the rates the Treasury pays for funding.

Editor's Note

Since I last wrote, rodents and global warming have been the bane of my existence. Susan and I headed to New Orleans in mid-February and spent most of the next two and one-half months there. Things were fine in March, but in April, we discovered that the air conditioner in my car went on strike every time the temperature exceeded 75°. Boy was that fun. We would head out on an errand and soon would feel warm, humid air coming through the vents. Down went the window, and there went my carefully combed coif. After an hour or so of this, my hair resembled that of Medusa. When we returned to Scottsville in May, I had the air conditioner replaced. Not long after this, a familiar gust of warm, humid air was apparent in the house. Turns out opening the windows when stationary is not as effective as when you are traveling 55 MPH. The home repair was fortunately less expensive than that for my car because it was caused by chipmunks eating through the wires to the fan on the condenser unit. I'm kicking myself for not asking the car dealer whether there were any teeth marks in the engine compartment.

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