JAMESSON ASSOCIATES
SPRING 2017
QUARTERLY NEWSLETTER

Recent Economic Events

The Federal Reserve accelerated its tightening cycle in an opportunistic attempt to raise rates. Although recent inflation and employment releases and increases in optimism support the action, corroborating statistics are hard to find. This is especially so when looking at the divergence between consumer confidence vs. actual spending and small business expectations vs. actions. Unless there is a quick reversal toward better hard economic statistics, first quarter GDP could easily fail to surpass 1%. That would mark a particularly inauspicious start to President Trump's term.

On the Ides of March, Janet Yellen announced an increase to 1% in the overnight interest rate, but she reaffirmed the FOMC's gradual approach to rate increases in the post-meeting press conference. The "dot plot" continues to project only three increases for all of calendar year 2017. It appears that the Fed used the recent jump in consumer prices as an excuse to raise rates sooner than they had previously targeted. However, that jump in prices is not likely to continue, as it has more to do with 2016 activity than it does with more recent movement. Here's why.

The February Consumer Price Index was up only .1%, a sharp drop from January's .6% increase, but the annual rate rose from 2.5% to 2.7%. The contrary movement is due to early 2016's collapse in oil prices. Because the base hit its low point in February 2016, the annual increase this year appears large. Note that oil prices have been going in reverse this year, so as the historical price catches up to present levels, the CPI is destined to slow or even decline.

Employment growth has continued at a healthy pace, with February producing 235,000 new jobs and knocking the unemployment rate down to 4.7%. Unfortunately, the good news on job numbers was not matched by wage gains. Weekly median wages were up .2% in February and now stand 2.5% above their level a year ago. This leaves real buying power down by roughly .2% (wages less CPI).

Despite declines in real income, consumer confidence has increased smartly since the election. However, in the battle between animal spirits and cold hard cash, the cash is winning. Consumer spending took a header in January. It fell .3%, with particular weakness in utilities (thanks to a warm winter) and durable goods (mainly auto sales). Things are now quite dicey in the car market, with manufacturer incentives running over $3,000 per vehicle — an amount that exceeds the labor cost of building the cars. Auto inventories register over 80 days as opposed to the ideal 60-day level.

On the Ides of March, Janet Yellen announced an increase to 1% in the overnight interest rate, but she reaffirmed the FOMC's gradual approach to rate increases...

Traditional retail establishments have fallen on hard times, with numerous store closings because Christmas season sales were not enough to offset the ongoing move toward online shopping. Malls are really suffering, with sales below a year ago. Plus, restaurant sales have been weak for long enough that the restaurant association boasted that "flat sales are a welcome change". Restaurants really don't compete with online, so it's hard to reconcile their weak sales with big jumps in consumer confidence.

Recent Economic Events *(continued)*

Small business optimism practically jumped off the charts in December and held its high level earlier this year. Promises of lower taxes, less regulation, and fiscal stimulus were the key drivers. However, plans for new spending and employment are lagging, just like consumer spending.

Looking at the big picture on GDP, we find that last year's weak fourth quarter (up only 1.9%) is more than double the FRB of Atlanta GDPNOW projection of < 1% growth for Q1 2017. That would clearly be a cold dose of reality for Mr. Trump. Winter storm Stella will pale beside the President's Twitter-storm if the projection proves accurate.

Commentary

Dispatches from the Technological Frontier

Notwithstanding the President's vow to bring jobs back to America, the biggest culprit in the loss of good-paying jobs in the US is the onrushing tide of the digital revolution. Here are some stories from just this year.

Dateline: Inauguration Day

POTUS talking past the press pool
directly to the people

FDR: Radio
Reagan: TV
Trump: Twitter

Progress or peril in precisely 140 stokes?

Dateline: Super-Bowl Sunday

It's tax season, and H & R Block is running commercials hoping to gin up business for their nationwide network of offices. The commercials feature the typical guarantee of the maximum tax refund but do so while showing off their newest tax preparer — IBM's Watson super-computer. It doesn't take a Jeopardy champion to come up with the question that matches the answer, "A lot fewer". (That would be, "How many tax professionals will H & R Block need in three years?") It's likely that the workers to be displaced by Watson are not only college graduates, but probably MBA degree holders as well. Furthermore, they need to take continuing education courses and be licensed in most states. And if you think Watson will stop with tax professionals, think again. What happens when even highly trained specialists end up being replaced by automation?

> CPAs for $400: "A lot fewer"
> Jeopardy question: "How many tax professionals will H & R Block need in three years?"

Dateline: March 2, 2017

In early March, the price of a Bitcoin ($1,262) exceeded that of an ounce of gold ($1,233). While subsequent market movement restored gold's preeminence for a while, this is but a further example of clicks triumphing over bricks, in this case gold bricks. The investment appeal of gold has depended on its near-indestructibility and long history of value preservation. Bitcoin is a computer algorithm less than ten years old. When those fearful of government-created money fully understand what has happened, gold miners will lose out to Bitcoin miners.

Dateline: March 8, 2017

Oil and gas executives convene in Houston to discuss the state of the oil industry. Speaker after speaker

Commentary

reports on drilling cost reductions due to improved shale technology. The improvements include more flexible drilling rigs, improved data on where to drill, and refinements in technique relating to just what kind and amount of drilling compounds to use to maximize output. And it is all being done without increasing employment back to the levels that were in place with $100 oil. The results of these gains show up in falling break-evens (many down below $40/barrel) and the entré of mega-companies (Exxon, etc.), complete with huge investments, into the space. OPEC messed up; fracking has come of age.

Dateline: March 13, 2017

American Banker headline: "Bank of America Gives Itself Five Years to Save Branch Banking". The bank is pioneering virtual banking centers with no humans on premises. The locations, in Denver and Minneapolis, include ATMs and videoconference rooms where customers can use digital communication to discuss issues with bank specialists. The initiative is driven by the fact that customers use ATMs (50%) and mobile devices (20%) instead of tellers (30%) to make deposits. Millennials skew these figures even more toward the digital.

There is no escaping the onslaught of technology, and as the snippets above indicate, jobs, rather than being created by the changes (except perhaps more fact-checkers on the President), are being eliminated. That is what capitalism does with technology — make things cheaper by cutting out the cost of labor.

Market View

Some prominent bond investors have offered opinions on how to determine the end of the secular bull market in fixed income. The old Bond King, Bill Gross, has suggested that if the ten-year Treasury were to clearly break through the 2.60% level, a bond bear market would be in place. Jeff Gundlach, the new Bond King, believes 3% is the determining level. At the risk of contradicting those with more standing (I'm more of a Bond Baron than a King), I don't think we can bury the bond bull market until the next recession causes rates to fall again. I base my contention on the demise of the bond bear market which may have occurred in 1981, but which could not be confirmed as having done so until 1984. Let me explain.

Ten-year Treasury rates were in a long-term decline from the 1930s through the 1940s as a result of the Great Depression. In the late 1940s and accelerating in the 1950s, rates began to rise. They crossed 4% in

Market View *(continued)*

1959, neared 8% in 1970 and pierced this level in late 1974. The 12% barrier fell in 1980 and the yield topped out near 16% in 1981. However, until this final peak, rates retreated before resuming their rise to record levels. Contemporaneously, any one of the high points could have been dubbed the end of the bear market. But it wasn't until 1984, when the next peak in rates fell short of 14%, that one could confidently report that the bear had been broken. Until that point, the profits were on the side of being short.

By analogy, it isn't the high point in rates that will determine the end of the bull market, but rather the next low point. The recent low was 1.37% in the wake of the Brexit vote last summer. While we are right to be cautious if rates move up to or through 3%, I am not ready to bury the bull until the economy weakens and rates start to fall again.

Without going into the same level of detail on oil prices, I would contend we are in a bear market, as the 2008 low following the peak over $140 was near $45 and the recent low after the 2011 peak over $100 was a lower $27. When the next global slowdown hits, the key question on oil will be whether the price falls below $27 or holds above it.

That's enough history and theory for one newsletter. The more immediate question is what to do with investment dollars in March 2017. Uncertainty is high; equity valuations are stretched; commodities have bought into the reflation narrative that has yet to deliver; and even though rates have moved up somewhat, they are by no means compelling enough to fully overcome concerns about a Fed tightening cycle.

The stock market calls for trimming positions, but not wholesale liquidation. Focus on those stocks which have P/E ratios that have jumped since the election and either sell a portion of your holdings or set trailing stops to take you out if weakness begins. These strategies will take emotion out of your decision. Commodities are dependent on inflation gaining solid momentum, which is unlikely given the punk growth in the economy along with a Federal Reserve that will step in if prices begin to soar. If you can invest in bonds with rates tied to Prime or LIBOR, you can ride upward as the Fed tightens. Another approach is to purchase Treasury Inflation Protection Securities (TIPS). These will reward you regardless of whether inflation accelerates or holds around present levels. Finally, buying longer bonds on weakness makes sense, especially if the 10-year Treasury yield moves towards 3%.

Editor's Note

For those of you who have not experienced it, Mardi Gras in New Orleans is a multi-week, multi-parade celebration. The inventiveness and variety of the floats truly impresses. However, one constant is the source of the various "throws" that are lavished on the crowds lining the parade routes. Virtually all are made in China, and judging by the volume, we could crash the Chinese economy with a one-year cancellation of Mardi Gras. Mr. Trump may consider this as an option, but it's clear that a lifetime teetotaler is not in sync with the party atmosphere of my adopted city. On the other hand, I saw plenty of folks stumbling around with orange hair during the festivities, so I may be mistaken.

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

Mjamesson@aol.com
Michael@JamessonAssociates.com