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associates

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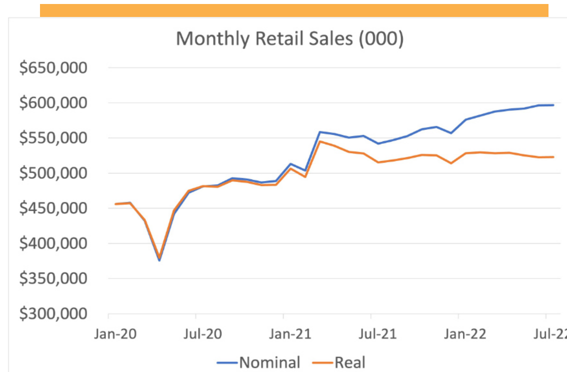
Recent Economic Events

The American economy shrank for a second consecutive quarter according to GDP figures, but most of the corroborating statistics failed to confirm a recession. Job growth continued to surprise on the upside, and consumers kept buying. In contrast, the housing market is clearly in retreat. So far, the slowdown has had only a marginal impact on the inflation statistics. This means that the Federal Reserve can't soften its hawkish rhetoric, step back from outsized boosts in short-term interest rates, or suspend quantitative tightening. They need to keep a foot on the brake for as long as it takes to slow inflation to the 2% target and restore their credibility. It's hard to see how that will happen before a real recession occurs.

Second quarter GDP posted a 0.6% decline on the heels of a 1.6% shrinkage during the first quarter. The culprit this time was inventories. It should be noted that consumer spending held up, albeit at a slower pace than in 2021 or earlier this year. In fact, an alternative measure of the American economy known as GDI (Gross Domestic Income) grew in both the first and second quarter. Since the two measures should be equal, there is a suspicion that something is missing from the traditional GDP figure. In any event, the American economy is far too large and complex to be reduced to one number, especially when the number is adjusted to remove the impact of inflation. Unless other economic statistics validate the decline in GDP (which might be revised upward to positive territory anyway), I'll delay the recession call.

The most significant counter to such a pronouncement is the ongoing labor market strength. August job gains totaled 315,000, once again beating expectations. Perhaps the most telling figure in the report was the unexpected jump in the labor force. After much handwringing over the decline in the participation rate (those people over 16 years old who are either working or looking for work compared to the total over-16 population), August produced a .3% increase, as close-to-record job openings, higher posted wages, and greater job flexibility drew folks in. The influx caused the unemployment rate to rise to 3.7%, but that level implies tightness, not slack. In fact, there are almost two job openings for every unemployed person in the United States.

Although retail sales in nominal terms have remained strong, they have plateaued when adjusted for inflation: the American consumer has increased spending but is receiving no more for her dollars. Frustration with seeing higher wages eaten up by even-higher prices has led to a sour mood according to the consumer sentiment measures. Inflation has overtaken all the other economic statistics in importance. It has even made the funny pages, with both Ziggy and Blondie, among others, taking note.



It's not surprising that inflation has everyone's attention. Earlier this year, the Consumer Price Index was rising at an annual rate of 9.1% while the core rate was increasing 5.9%. July headline figures were considerably better at 8.5%, but the core stalled at 5.9%. The PCE price index showed

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somewhat less virulent increases at 6.3% and 4.6%. However, these levels are far above the Federal Reserve target of 2%.

To regain the confidence of the markets and the American public as well, the Federal Reserve needs to get inflation under control, allowing the comics to return to other themes. In a remarkably blunt 8-minute speech at the annual Jackson Hole confab, Chairman Powell dashed water on the expectation that the Fed would be pausing its tightening cycle anytime soon. In fact, he stated, "Bringing down inflation will cause pain to households and businesses." This is about as close to predicting a recession as a government official can get.

The American economy has clearly slowed from its strong pace emerging from the pandemic recession. Its anemic performance in the first half of the year is disappointing, but not enough to officially be called a recession — the key reason being a strong labor market supporting consumer spending. However, the elevated level of inflation will cause the Federal Reserve to further tighten the screws on interest rates. In their quest to regain credibility as guardians of price stability, they need to reduce demand. To reduce demand, I am afraid they will cause a recession, but the strength of the labor market promises to make the hit worse on Wall Street than it will be on Main Street.

Commentary

I noted in the summer edition of this newsletter that our government seemed broken and unable to act on priorities that significant majorities of Americans supported.

What a difference a few months make. We have seen a popular repudiation of the Supreme Court's reversal of Roe v. Wade in conservative Kansas, where approximately 60% of voters rejected the extreme anti-abortion amendment to the state constitution. In addition, polls suggested all but a handful of states would have voted as did Kansas.

Congress too has transformed itself from dysfunctional to functional. Bipartisan majorities passed the first gun safety law in ages and came together to add medical benefits for veterans who had been exposed to toxic gases while serving overseas. Military support for Ukraine and the CHIPS bill, which Creates Helpful Incentives to Produce Semiconductors, also passed with both Republican and Democratic support. While the Inflation Reduction Act (George Orwell must be smiling) gained not one Republican vote, it showed that America was finally being serious about climate change, and in a real break with business as usual, raised revenue to more than pay for the outlays.

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Contrast this with the messes in China and Russia. While Xi and Putin may have aced their finals in authoritarianism, they clearly flunked economics.

China's problems are so numerous that it is hard to know where to begin. Let's start with the Chinese real estate market, the largest in the world. It is in freefall. A process that relies on pre-sales of apartments to finance construction, allowing early buyers to flip their unit for a profit on completion, works great when the market is rising. It implodes when prices fall — and prices are falling. Couple this with the fact that many of the apartment projects are not completed even years after the sale, and it's no wonder that buyers

Commentary -continued

are balking at paying their mortgages. The refusal to pay has spread nationwide to over 300 projects and counting. Keep in mind we are talking about a country with an intrusive surveillance apparatus and a "citizen rating" that essentially determines your ability to succeed in the economy.

Were this the only economic issue, the government could probably find a solution. But it isn't. The zero-Covid policy which locks down cities (recently representing 30% of productive capacity) when there are only a few positive cases is crippling both production and consumption. Official statistics suggest practically no GDP growth in the second quarter, but those statistics are famously massaged. More tellingly, youth unemployment is now near 20%.

Climate change has resulted in a severe drought throughout China's most productive agricultural area. Perhaps more importantly, it has reduced water levels in rivers to the point where hydroelectric generation has been curtailed.

Given these challenges, it is no surprise that marriage rates are on a downswing, and births are still languishing even as the one-child policy has been rescinded. The United Nations now projects that India will be the most populous nation on earth come next year. On top of that, the working age population in China has peaked and is likely to fall by close to half over the remainder of this century. And that is the optimistic view, as private forecasters suggest that America's working age population may exceed that of China by 2100.

Russia figured that its Ukraine invasion would be quick and easy because of its hold over energy supplies to Europe. It has been anything but. The presumed might of the Russian army has been shown to be overrated. Sanctions have forced the Kremlin to source military supplies from North Korea. Moscow's cutoff of gas to Germany will eventually wean Europe off Russian suppliers, forcing gas wells to be shut and pipeline investments to be abandoned. Russian population trends are even worse than China's, and the exodus of young professionals is gaining steam. The best case is that Russia will become a vassal of China, and as I indicated above, that is a long-term losing game.

We have our problems in the United States, but this summer's events have been far more positive than those in our two most important global rivals. The world remains a dangerous place and countries facing significant internal stresses can easily decide to lash out, as has Russia in Ukraine and China with military exercises near Taiwan. However, these are signs of weakness, not strength. I am willing to bet on America and its allies as the long-term winners — economically and geopolitically.

Market View

The passage of the Inflation Reduction Act created a nice uptick in stocks of companies focused on renewables, which, plus traditional energy stocks, were about the only areas of positive performance since my last missive. Both stocks and bonds rebounded from the June low but have since retreated. The market has finally processed the fact that the Federal Reserve is serious about containing inflation and has reconciled itself to the risk of recession.

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Liquidity is the lifeblood of markets. When the Federal Reserve is adding dollars to the economy by keeping rates low and buying government bonds, the money created goes wherever the narrative takes it. The Fed cannot really control whether dollars will bid up the price of goods and services (traditional inflation) or real estate, stocks, bonds, or collectibles (asset inflation). As the Fed drains liquidity, the hope is that it will dampen demand

Market View -continued

for goods and services, but their actions are more blunt instrument than surgical scalpel. Money and water are more alike than not. And when water is scarce, crops wither, rivers dry up, and wildfires rage. The current money forecast is more drought than nourishing showers.

The best investment option in a tight liquidity environment is cash. The overnight rate will be close to 3%, if not over it, after the Fed next meets. This means that short-term Treasury Bills should near that level and Money Market Funds will return well over 2%. You get paid while you wait, and shifting to other investment options can be accomplished quickly.

For those who prefer stocks, a review is timely. Make sure your holdings present a solid long-term investment thesis. More likely than not, stocks will continue to fall before they find a solid bottom. If you have faith in the company's business, you can ride out the storm. If there is a well-protected dividend, even better. But now is not the time for speculation in stocks. When money is at a premium, it's devil take the hindmost.

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Fixed income presents a dilemma. Although term rates are higher than they have been in years, they are still below the rate of inflation, not much higher than cash returns, and could easily go higher as the Fed tightens. I continue to believe we saw the peak in the ten-year Treasury in June at 3.50%. We are close to that level now, so those with strong stomachs can begin to buy. If you feel the Fed will lose the inflation battle, TIPS can be real winners.

Most commodities will suffer as the extent of the coming recession comes into focus. If you want an allocation to commodities, try to zero in on those with bright longer-term prospects. This would include copper and silver (Green Revolution) and water (climate change).

Gold and crypto-currencies should be avoided, as reduced liquidity leaves little room for them to prosper.

Editor's Note

Jamesson Associates was founded in 1991, and Susan made the case that I still had boxes of files from the year of its genesis. She was right. As a result, we set aside a day to reduce the clutter. I would estimate at least a ton of items moved from my office to the recycling center and/or the landfill. Amongst the hoard, we found memos to banks that merged last century, scores of digital media for defunct software programs, and of course, the ecologically unsound packing material they came in. There were even printed software manuals (something that younger readers may feel is the stuff of legend). However, I did uncover a few gems — the most prized of which was a floppy disk with a copy of VisiCalc, the program that launched the PC revolution. I wish I could report that Marie Kondo would be proud of the post-clean-up results. Alas, that isn't the case. While my storeroom floor is now visible, the bookshelves remain chock-a-block and any horizontal space commands Tokyo-level real estate value.

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