JAMESSON ASSOCIATES

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QUARTERLY NEWSLETTER

Recent Economic Events

America's labor market continues to be super-strong; job openings are at record levels, as are those quitting for other opportunities. Wages are increasing faster than productivity although more slowly than prices. In fact, inflation remains the key economic factor driving Federal Reserve words and actions. GDP growth, which had been very strong at year end 2021, turned negative early this year. The culprits were a record-large trade deficit and building inventories. It is those inventory gains that are likely to cause indigestion for many businesses over the course of the next few months. When we put all this together with fiscal restraint from lower Federal deficits, odds are that a recession is in our future. The hope is that the strong job market will make it a mild one.

May payrolls in the United States grew by 390,000, keeping the unemployment rate at 3.5%. Job openings (11.4 million) continue to run almost double that of officially unemployed Americans (6 million). This resulted in record-low layoffs (1.2 million) and near record-high quits (4.4 million). Although seemingly nirvana for American workers, there are two caveats. First, wages, while increasing nicely, have lagged the much more virulent increase in overall consumer prices. Workers' hourly pay posted gains of 5.2% year-over-year in May while the monthly increase was only .3%. Second, productivity plunged by 7.3% in the first quarter. This led to a massive 12.6% jump in unit labor costs, suggesting that businesses will be much more careful in adding employees from this point forward. There are now stories of worker cuts at well-known companies, especially those which are seeing weakening demand (retail stores) or simply got ahead of themselves (unprofitable IT firms).

Inflation may have peaked, but it is still running at an elevated rate. The April PCE inflation rate on a year-over-year basis registered 6.3% headline and 4.9% core. The good news is that these rates are down from March, and the monthly rates have slowed even more. The bad news is that the biggest price increases are for food and energy. With more money going into the gas tank and the grocery cart, there is less left over for discretionary purchases. That explains the collapsing consumer confidence figures and the foreboding mood of small businesses.

It's no wonder that the Federal Reserve needs to pursue all options to try to tame inflation. Even prior to actually raising interest rates in March and May and beginning to shrink its balance sheet in June, it traded in its dovish words for extremely hawkish ones. I believe that the Fed is pursuing a very sophisticated, and largely successful, messaging campaign to try to get the market to do much of the dirty work for it. Financial conditions have swung from accommodation to constraint, led by falling stock and bond prices and ballooning credit spreads. Consequently, the price of and access to capital has become more challenging. The economy now enters a critical phase where we will learn whether the change in monetary conditions will be enough to weaken price pressures without causing a recession.

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We have already seen some weakening. Instead of the heady fourth-quarter 2021 growth, this year's first quarter posted a decline of 1.5%. Consumer spending held up relatively well, but much of the demand was met through record imports. Inventory growth slowed in the first quarter, and given the curious math of GDP calculations, this also subtracted from growth. However, two quarters in a row of near-record inventory building has filled warehouse and store shelves just when the consumer is seeing maximum pressure on the pocketbook.

Recent Economic Events (cont.)

Inventory clearance sales are likely to become prevalent this summer.

The US economy is now facing significant headwinds. The deluge of fiscal largesse which kept the Covid recession from devolving into something even worse is reversing. This year's (October 2021 start date) Federal deficit through April was $360 billion, down from $1.9 trillion the previous year. That, along with monetary restraint, represents a huge drag. Then we have prices outrunning wages, which results in falling real income for the consumer. America will have to use up all of its good luck tokens to avoid a recession in the next few quarters. If we don't get lucky, the job market will determine whether the downturn is mild or severe.

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Commentary

Is America a failed state? This is a question that I could not have conceived of asking as recently as a few years ago. I would hasten to add that I lived through the upheaval of the 1960s and 1970s: the fight for civil rights and its backlash, the debacle of the Vietnam war with its generational tensions, and the inflationary spiral unleashed by oil embargos, loose money, and the end of the gold standard. An American President, elected in a landslide, resigned rather than face certain impeachment and ouster. While the convulsions of that period were life-defining, there remained in the United States an attitude of optimism. Things could be righted, and they were. Tie-dyes and bell-bottoms gave way to button-downs and Brooks Brothers suits. Ronald Reagan proclaimed, "Morning in America", and people believed it.

Today, I'm not so sure. Americans seem to be talking past each other, living in separate worlds. Trust and compromise seem quaint relics of the past. Politics have always been rough and tumble, but until recently there were clear lines that were respected. No more. The hypocrisy that resulted in the current make-up of the Supreme Court is waved away by Republicans because they won. That court seems oblivious to the social upheaval that they are producing with their partisan decisions, upending longtime precedents.

The leaked opinion overturning Roe v. Wade promises even more disruption. America will become a patchwork of differing state rules on abortion, and if some of the neo-puritans are to be believed, contraception as well.

It's one thing to protect minority rights, it's quite another to enshrine minority rule. There are plenty of issues that extremists have captured, thwarting both common sense and the majority.

Guns. While significant majorities of Americans are in favor of reasonable restrictions on guns, a vocal minority stymies any talk of reform. The recent spate of mass murders has done little to change the discussion. One might ask why Americans are willing to live with the fact that more young people (ages up to 20) die of gunshots than any other cause.

Gender. Apparently, "he" and "she" are not enough anymore. The speech police are on the job to make sure that you use the right pronoun, even if that pronoun is made up. Then there is the issue of whether transexual females should be allowed to compete in women's sports. I have no problem with unisex bathrooms, my house has three of them, but at a certain point, differences are real, and no amount of wordsmithing will change the facts.

Commentary (cont.)

Contrary to the optimism that characterized my formative years, everyone seems to be depressed. Some of this is due to the pandemic isolation of the last few years, but not all of it. Gridlock in Congress reinforces our belief that government is broken and cannot solve our problems. And gridlock is bolstered by partisan gerrymandering which creates congressional districts which are so heavily weighted for one party that extremism is rewarded.

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Up until now, minority rule has been tolerated by the majority, and our institutions have held. While both the 2000 and 2016 elections resulted in the "winner" collecting fewer votes that the "loser", power was transferred without incident, not so in 2020. It isn't beyond belief that another popular vote loser will win the electoral vote in 2024. Even if that occurs without interference in state vote certification, it could be seen as illegitimate by some. However, if state popular vote totals are overturned by legislatures, we will have a true constitutional crisis. At that point, my initial question will have been answered in the affirmative.

Market View

2022 has not been kind to financial assets. Both stocks and bonds have fallen by significant amounts, producing losses not seen in decades. Had you hoped that the fixed income portion of your holdings would act as a hedge against equities, you would have been sorely disappointed. In contrast to financial assets, commodities have shown positive returns this year. To see what the future may hold, it is important to identify the factors contributing to the recent performance.

The biggest influence on financial market prices this year has been the dramatic turn towards hawkishness by the Federal Reserve. The change from "inflation is transitory" to "we'll keep raising rates until inflation recedes" has been extraordinary. It convinced the market that the overnight rate is likely to approach 3.5% in this cycle rather than the New Year's Eve expectation that 1.5% would be the peak. Discounting financial assets at substantially higher interest rates dramatically reduces their value. The longer the duration of the expected cash flows, the bigger the decline. Through May, the Dow was down 9.2%, the SP 500 13.3%, but the Nasdaq had plunged 22.8%. This is true for fixed income as well. 30-year bond total return is negative 22% year-to-date through the end of May, while 2-year notes have returned a less stomach-churning negative 2.5%. This is true even as 2-year rates have jumped by 1.8% and 30-year rates have increased by "only" 1.1%. So much for the idea that "cash is trash".

The only area of the stock market that has performed well is the energy complex. It had been boosted by the combination of tighter supply resulting from years of underinvestment and stronger demand as the global economy shook off Covid lockdowns. Not surprisingly, oil prices were then turbocharged by the Russian invasion of Ukraine. On top of the increase in the price of oil and its alternatives, refineries are capturing super-high margins to turn the raw material into the various fuels needed. Divide $120 a barrel by 42 gallons and you get less than $3, add something for taxes and you still get a big profit at $4.85 for gasoline, $6.50 for diesel, and $6.30 for jet fuel. Vacations are going to cost a lot more this summer.

Market View (cont.)

All of the above ignores the elephant in the room. The risk of recession has also been a factor in the decline of those assets sensitive to economic health. Spreads on investment-grade corporate bonds have widened by 50 or 60 basis points while junk bond spreads have expanded by 150 basis points or more.

> THE STOCK MARKET WILL HAVE A HARD TIME MAKING ANY PRORESS UNTIL THE FED STOPS THE TIGHTENING CYCLE.

So, the key question is which of these trends have plateaued and which ones are likely to continue. My view:

- The Fed is serious and will raise rates until it is clear that inflation is heading down, but they will stop if unemployment tops 5%.
- Avoiding a recession has lower odds than filling an inside straight, but the real economy will fare better than the financial markets.
- Putin has no reasonable off-ramp, and Ukraine will not give up territory.
- Energy supply will continue to lag demand, but operating margins will revert to the mean.

Consequently, the stock market will have a hard time making any progress until the Fed stops the tightening cycle. At the very least, that won't happen until late fall or early winter. Stay with high-quality stocks with a focus on dividend-paying companies; trim holdings that aren't core. Energy stocks should be considered more as trading vehicles than investments because at some point they will hold stranded assets. The transition to renewables is a durable secular trend, so price drops offer entry point opportunities.

Longer-term interest rates will fall in either a slowdown or a recession. However, the 40-year bull market in bonds is behind us. As the global economy becomes less integrated with more potential threats to the supply chain, resilience will rise in importance. This will increase costs. The long-term forces of demographics — older people save more and spend less — and technology will serve to limit these costs, creating a trading range for inflation and interest rates. For investors, patience in adding to bond positions will pay off as summer turns to fall.

Non-energy commodities should benefit, but volatility will be evident in these markets as well.

Editor's Note

On our trip north in early May, Susan and I stopped just north of Montgomery for the night at a hotel that had a charger for the car. While billed as a fancy golf resort, the first room they provided had not been cleaned, only one of the two chargers worked, and the restaurant was a glorified sports bar. Seeking a less corporate option, we ventured into the nearby town and found a local eatery where the food was good, the wine was surprisingly tasty, and live music was on tap. A local singer with a guitar was performing Baby Boomer songs for the locals and was mostly being paid in bottles of beer from the bar crowd. Since I wasn't a local, I decided cash would be better and put some money in his tip jar while asking if he could play a David Bowie song. He looked at me as if I were Ziggy Stardust himself. As an alternative, we settled on Jim Croce's Big Bad Leroy Brown, which he did with gusto. We stayed for another hour, enjoying songs of our youth and remarking on how we all have been robbed of simple experiences like this by Covid.

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