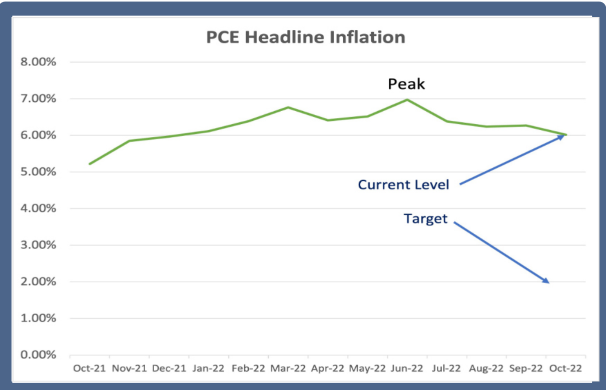
Winter 2022

JAMESSON associates

Recent Economic Events

The American economy showed its resilience by returning to growth in the third quarter even as the Federal Reserve continued to boost interest rates. Growth was supported by consumer purchases, business investment, and a positive turn in trade. Employment remains a key pillar of the economy even though there are signs that the job market is less heated than it was earlier this year. To get inflation under control, wage gains will need to slow, but there are few signs of that. In fact, even though interest rates are up sharply this year, only the housing market seems to have noticed. While inflation may well have peaked, it remains at troublesome levels, suggesting that the Fed will keep its foot on the monetary brake.



After two quarters of declining GDP, the United States posted solid 2.9% real growth in the third quarter. This pushed the year-to-date figure into positive territory. The consumer was a key reason. Job and income momentum, along with remaining savings balances from pandemic times, allowed the consumer to keep spending. Business investment was another positive during the quarter with a focus on building capacity for advanced manufacturing (chips, EV batteries, renewable energy components, etc.). These investments will pay dividends for years to come as domestic production recoups market share from overseas factories. America already realized a trade benefit in the third quarter reports. As supply chains normalized earlier in the year, businesses found that their inventories were more than ample. Reduced orders for foreign goods coupled with record exports of LNG to Europe (replacing Russian gas) led to a sharp improvement in our net export position.

The labor market has weakened since the beginning of the year when job gains were running nearly 500,000 per month. However, the unemployment rate is still below 4% and job openings total over 10 million, which represents about 1.7 jobs for each unemployed worker. November job gains equaled 263,000 and average wages were up 5.1% from a year ago, having accelerated to a monthly rate of 0.6% (7.2% annualized) in November. Neither the annual gain nor the annualized monthly increase is anywhere near the Fed's target of 2%.

Mortgage rates at or near 7% have dramatically reduced the affordability of homes in the United States. This has trapped current homeowners who find it too expensive to pay up for a bigger home with a higher mortgage rate and stymied potential first-time homebuyers who are priced out of the market altogether. Existing home sales are down nearly 30% from a year ago. Paradoxically, the Federal Reserve's success in slowing the home purchase market has boosted inflation. Unable to buy, potential first-time homeowners are forced to crowd into the rental market, lifting demand beyond available supply. The result: higher rents.

The most recent report on PCE inflation, the Federal Reserve's preferred measure, was somewhat heartening. The annual headline rate registered 6.0% while the core rate was 5.0%. These were down from the 2022 peaks of 7.0% and 5.4%, respectively. However, neither level is low enough

Recent Economic Events-continued

for the Fed. Furthermore, the improvement we have seen is centered in food, energy, and core goods, items that are mostly outside the Fed's abilities to control. While those prices are losing momentum or even falling, core service prices are moving in the opposite direction. Besides the abovementioned shelter cost increases, services such as medical care, restaurants, and travel are highly labor-intensive. Unless and until wage gains moderate, it will be hard for services prices to slow their ascent.

You would have thought the kinds of increases in inflation and interest rates we have seen this year would sink the American economy. They haven't. Aside from the housing market and the collapse of FTX and other crypto-currency participants, signs of weakness are hard to find. Job gains and solid wage growth have buoyed consumer spending; record exports of LNG along with reshoring manufacturing has improved our trade picture and set the stage for future domestic production.

Ironically, inflation has bolstered government revenues at all levels, allowing increased spending to be taken in stride. It is in the face of this resilience that the Federal Reserve is trying to slow the economy just enough to reduce inflation to its target without causing a severe recession. Unfortunately, it is precisely this resilience which forces the Fed to keep tightening and risk having gone too far.

Commentary

A narrative is developing among market pundits that many Americans need to lose their jobs for inflation to be brought under control, and that this is a good thing. Signs are that it is taking hold at the Federal Reserve as well. Few of those espousing this view expect to be among the future unemployed.

There has always been a battle between labor and capital, but for most of the time, capital has had the upper hand. We see it in how the labor market is covered. Doing the job you've been hired for is characterized as "quiet quitting" while Elon Musk is lauded for asking Twitter employees to give up their lives to work for the company. However, the world is changing.

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The reason: There are simply not as many workers available as there were pre-pandemic. In fact, labor demand stayed strong in early 2022 even as GDP was shrinking. Given near-record job openings, a much more severe slowdown may be necessary to raise unemployment — one that may not survive political pressure.

It has long been known that Baby Boomers are entering retirement age. The initial stages of Covid accelerated early retirement as businesses offered enhanced packages to reduce their labor force and individuals concluded that life could easily be cut short. The surprise is that the pace of retirements hasn't reverted to the old trend but instead has remained elevated. Since early retirees from 2020 are now almost three years older and have adopted a new lifestyle, it's hard to see this changing.

Millennials have also had an impact on labor availability, but it's not from retirement. The pandemic so disrupted the normal functioning of the economy that many people had time to question their work/life balance. Remote work options have freed individuals from geographic constraints, which should theoretically boost the potential worker pool for companies. However, in order to take advantage of that,

Commentary-continued

businesses must be open to remote work. Many are not or cannot. Plus, the ability to work remotely allows individuals to more easily switch jobs or to simply drop out of the labor force for a period of time.

There have been far fewer immigrants coming into the United States in the last few years. The shortfall could be as many as 2 million foreign-born individuals today versus longer-term trends — a major factor in the lack of entry-level workers and seasonal help.

However, the most significant shortfall in workers may result from supply chain disruption in developing countries. In pre-pandemic times, these workers were effectively extensions of the domestic labor supply. When companies considered where they could source workers, overseas locations were part of the mix. The upheaval in supply chains that we saw when the pandemic hit and the recent strikes in China due to overly aggressive lockdowns have made that option less inviting. Reshoring of production effectively reduces the potential labor available to American companies while simultaneously increasing demand.

Demographics, changes in work/life desires, and fewer foreign workers, both domestically and in their home countries, have all contributed to a much tighter labor supply. Given the large number of unfilled jobs and the secular nature of the labor shortage, the expected economic slowdown would have to counter both cyclical and structural trends. At some point, the politicians will ask the same question that I am posing: “Why crush the worker in pursuit of advantage for the employer”?

Market View

The investing world today is a much different place than it was one year ago. Since then, stocks and bonds have entered bear markets, making a mockery of the traditional 60/40 investment approach. Inflation and the attempt to fight it have caused interest rates to rise dramatically. Commodities, a traditional hedge against inflation, have given up their gains as well. Crypto-currencies have been marked by spectacular collapses instead of outsized returns. Risk is elevated, and even cash appears to be a lousy place to hide, since short-term rates are still well below the pace of inflation.

Times like these reward long-term investors, not short-term traders. But make no mistake, the investing environment is challenging on both fundamental and psychological grounds.

Fundamentally, the Federal Reserve is on a mission to reduce liquidity in pursuit of lower inflation. Buying while the Fed is selling is generally not a successful strategy. Liquidity is a critical component of healthy financial markets and removing liquidity always pressures valuations. If earnings could be expected to grow fast enough to offset a lower multiple on those earnings, a case could be made for stocks. However, it’s likely that higher interest rates and less market liquidity will end up reducing earnings, creating a double whammy. The fundamentals of fixed income investing are equally problematic. Inflation eats away at the principal of any bond investment and even produces negative real returns on cash.

...Buying while the Fed is selling is generally not a successful strategy

Market View-continued

Real estate, residential or commercial, has similar obstacles to appreciation. It is estimated that the jump this year in residential mortgage rates (and thus mortgage payments) has reduced the effective home price a traditional buyer can pay by roughly one-third. Income will catch up over time, but prices are likely to fall as well. Capitalization rates on commercial real estate are closely tied to longer-term interest rates. Because most commercial real estate is financed with longer-term borrowings, the price impact may be delayed, but whether you sell or hold on until the borrowing turns over, value will adjust.

The fundamental background for investing is not promising. This is where the biggest risk comes into play: human psychology. The prevailing narrative generally overwhelms the fundamentals. Human beings are quite adept at rationalizing outrageous prices with novel arguments. When prices are rising, forget the reason, the fear of missing out (FOMO) becomes difficult to resist. Similarly, when prices are headed downward, FOMO simply becomes fear.

This brings us to the current juncture. The stock market has rallied from early October lows while Treasury bonds have risen sharply since then as well. Should you jump aboard or should you reduce exposure? I'm afraid that we have one more downdraft before a durable bottom is in.

If you don't need the money and won't look at your financial statements for a few quarters, pare weak holdings, put the proceeds in cash, and set your alarm for Independence Day. If you don't have that discipline, sell stocks into strength, refrain from chasing even when markets are rallying. Be patient on purchases of real estate; prices will be lower a year or so from now. Until the Fed both stops raising rates, and more importantly, stops shrinking its balance sheet, the odds are that prices for all types of investments will be under pressure.

2022 Scorecard

	Year-to-Date	Since September
Stocks	-17.5%	+9.7%
Long-term Bonds	-28.2%	+3.8%
Oil	-2.3%	-13.4%
Bitcoin	-62.9%	-11.6%
Housing	+6.2% *	-5.2% **

* October YOY
** July to October

Editor's Notes

Susan and I made our fourth trip to Spain late October/early November. We landed in Madrid and after a few days there, rented a car and headed south. We stayed two nights in a medieval tower built in the 8th century but ecologically renovated to use minimal energy. That's if you don't count the energy we expended walking up steep steps to the third floor bedroom. We, of course, left few plates of food or bottles of wine unexplored but actually lost weight due to the extensive walking and climbing necessary to tour the sites we visited. Driving in Spain is uneventful, but parking is another matter. Mountaintop towns designed for animal-powered carts are not well supplied with parking lots. Our timing proved fortuitous. The Euro was worth less than a dollar during our visit, and we returned to the US late on election day. Experiencing something new at attractive prices, eating well while losing weight, and avoiding politics: all in all, the perfect vacation.

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