The CJ Investment Newsletter
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Dominos Falling

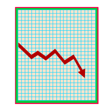
Purpose

The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

Quick Look

Market	**Next Expected Move**
	

- The underpinnings of the US economy are falling as dominos stood in a row.
- Recession looms. The question is, "How bad a recession?"

Dominos Falling

Being the bearer of bad news is never fun. However, what I'm going to say is really not "news," although it is bad. I should also warn you that many people, some of them intellectually honest, disagree with the assumptions and conclusions that follow. There's really only one good response to their differences of opinion: "Time will tell who is right and who is wrong." Simple. My conclusions will be proved right or wrong by the passage of time, not by how many agree or disagree with me or whether their qualifications are "superior" or "inferior" to mine. I will avoid focusing on statistics as much as possible in order to put attention on the concepts and logic involved.

I believe the US economy is headed into recession, likely within the next 3 quarters. Of course, if it happens in the 3rd of those

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3 quarters, we will not know until a year from now or better, when the economic data is accumulated and released.

There are many reasons for my conclusion. However, the primary ones are:

- The decline of the housing market
- The inversion of the yield curve
- The increasing likelihood of our withdrawal from Iraq, and perhaps the entire Middle East

There is also the distinct possibility that the Republicans will lose one or both houses of Congress in the fall election. If so, the *traditionally* less business-friendly Democratic Party ***may*** implement policies that accelerate the occurrence of or exacerbate the deepness of the recession. They may not, either, depending upon where the economy is at the time they assume power, if they do.

The Decline of the US Housing Market

The housing market decline is probably the most serious of the causal factors at work. One of the primary reasons is that the housing market has been overheated almost from the time the Fed dropped the Fed Funds rate from over 6% to about 1.25% in 2001. For the past several years, the housing market has:

- been much more affordable
- creating higher housing demand
- creating higher housing prices
- creating more housing to be built and
- causing people to refinance their homes at lower rates while extracting equity from them.

The net effects are that the housing market is overbuilt and the consumer is fully mortgaged, after tapping the "equity" from their homes to support a lifestyle beyond their earned incomes. Now that rates are "normalizing," it is reasonable to expect the above effects to unwind. Effectively, the consumer finds him/herself in a home fully mortgaged in a rising interest rate environment where the owner may or may not be able to pay the higher house payments when their ARM's adjust upward.

The housing market is overbuilt, just as interest rates are rising to make housing less affordable. These conditions are not conducive to housing prices continuing to rise or, even, maintain their current levels. It's quite likely housing prices will drop, putting many consumers in "upside-down" positions between their home values and their mortgages.

As if that wasn't enough, I've read numbers indicating that at much as 30% of new job growth and a significant percentage of GNP growth in the last few years has been housing related. As the homebuilders continue to accumulate inventory (unsold houses), it is likely that many of those jobs will disappear, also taking jobs from the supporting vendors with them. The collapse of homebuilders stocks began in the summer of 2005 and continues today.

Is it any wonder many folks think the American consumer will be unable to sustain the spending pace that has supported the world economy for years? Imagine the impact of the US consumer pulling in his/her horns and consuming less, maybe even much less. While not as true as in years past, it is still true that if the US economy sneezes, the rest of the world catches cold. The recession will not be limited to the US.

The Inversion of the Yield Curve

We have discussed the inversion of the yield curve as a time-honored predictor of an upcoming recession many times in the *CJ Newsletter*. Earlier this year (7/06 *CJ*), we also laid out the case for the Fed having inverted the curve with its combination of edicted short-term interest rate hikes and easy credit policy as evidenced by the massive growth of the money supply as shown by the growth of MZM, the Monetary Base, and (until they stopped reporting it) M3.

The relevant point in this discussion is that the inverted yield curve helps to predict recessions because it reveals imbalances in the credit markets. Specifically, it shows that the Carry Trade is or will soon shrink. The Carry Trade is a name for institutional and individual investors who will borrow short-term money and invest it in long-term instruments, pocketing the spread in interest rates.

The Carry Trade provides a great deal of needed liquidity to the markets. An inverted yield curve makes the interest rate spread negative, so the Carry Trade unwinds. As it does so, liquidity is removed from the markets and the markets normally decline in response. Lower liquidity often serves to make money more expensive, as there is less money flowing through the credit markets. While this tends to be self-correcting (*i.e.* righting the yield curve), it also makes borrowing more expensive for business. This would tend to reduce the willingness of business to undertake borrowing for potential expansion, reducing job creation on many fronts. I doubt the Fed can counteract this effect without lowering short-term

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interest rates, which, of course would tend to be inflationary – a problem they are supposedly fighting.

Withdrawal from the Middle East

The pressure from the American press and much of the American populace (not the least of which are opportunistic politicians in an election season) makes it increasingly likely that we will at least partially withdraw from Iraq and other places in the Middle East, regardless of whether it would be harmful to the places we would withdraw from or to us, for that matter.

While it is not normally considered, the multiple billions of US$ spent on the military actions in the Middle East do actually translate into jobs in America. The withdrawal of military activities, while saving billions in taxpayer US$ also removes that level of economic stimulus for the production of clothes, equipment and other items expended or destroyed in the conduct of a war. *Caution: I am not in any way suggesting that a war should be conducted for economic purposes. That is clearly and obviously immoral in every way imaginable. Nor am I suggesting that any such thing has ever been done by any politician in the history of this country.* Still, the loss of such a large economic stimulus, especially in light of the other items discussed above, could easily provide the impetus to push the US into a recession. It's no reason to continue fighting, but it may be a "hidden" cost of stopping the war.

The bright side is that if the federal government could get its act together enough to redirect the war funds into badly needed infrastructure improvements and energy research, among others, the stimulus would not have to go away and exacerbate the recession.