The CJ Investment Newsletter

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Crunch

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
?	?

- Several major indices hit new highs on 7/19/07. The DJI closed over 14000 for the first time. Since then, the markets are down precipitously, but the technical damage doesn't appear serious - yet.
- The US$X hit a new low in 7/07, barely staying above 80 this month. It is still below 81 currently.
- The yield curve has re-inverted.
- Is the sub-prime meltdown becoming a "credit crunch?"

Crunch?

For months now, B-B-B –Benny and the Feds, other government officials and some financial market pundits have been telling us that the sub-prime meltdown is "well contained" and "does not appear to be affecting other areas of the economy." My opinion is that most of these folks have no way to quantify the future impact of the sub-prime meltdown (nor do I), so they are trying to put the best face on what is happening. That way, what happens will be the actual result of the meltdown, rather than the result of panic psychology becoming a self-fulfilling prophesy. Still, positive,

(Continued on page 2)

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(Continued from page 1)
but misleading, statements made without factual basis is, at best, disingenuous and, at worst, dangerous. How many poor investment decisions have been/will be made because of "putting lipstick on this pig?" How many investors will incur losses by investing when they shouldn't based upon misleading statements from officials and pundits?

As I said above, I have no way to quantify the full extent of the damage that will be done from the sub-prime meltdown, either. However, it wasn't too long ago that we were hearing from the same people that the real estate and housing industries were driving our economy though job creation and home appreciation (from which many consumers were augmenting their incomes via Mortgage Equity Withdrawals – MEW's). You can't have it both ways. If our economy was being driven by housing, why would it not now contract as the homebuilders and housing markets are collapsing?

I have been watching the money supply figures for signs of contraction in any of the most common and important money supply figures. My two favorites, MZM and M3, are expanding much faster than the GDP. Eventually, that means inflation, or worse. Interestingly, it appears the Fed is not the driving force behind the money supply expansion. Both currency and the monetary base, which are the only measures I know of the Fed can completely control, are at or near all-time highs, but they have been growing very slowly, if at all, for many months now. Therefore, the money supply expansion beyond the insignificant amount provided by the Fed is being driven by demand, not supply.

Recently, it has become more difficult to float corporate bond issues, as the buyers have suddenly become wary of credit risk. The underwriters were unable to sell all of the bonds necessary for Chrysler to be purchased from Daimler. Banks have started using much more stringent credit criteria for new loans of any type, but especially for home loans. These are early indications of a potential credit crunch, but as long as the upper layers of money supply are still expanding without the Fed feeding the expansion, it's difficult to assert that credit is hard to acquire. Still, that will be an important marker in determining if the markets and economy will continue to be healthy or if a recession looms in the near future.

The Yield Curve

In spite of the above, the yield curve has recently re-inverted. Actually, it's only technically inverted. It is more flat than inverted. Still, this does not present an incentive for banks to participate in the US$ carry trade, since they cannot loan long and borrow short for a sufficient yield spread. Especially in light of the recent meltdown in sub-prime, why would banks want to take on any significant risk for a potentially insignificant return? This would certainly lead one to believe a credit crunch is upcoming.

The yield curve re-inverting tells me the same story that the large cap stock indices outperforming the broader indices tell. There is a significant amount of "flight-to-quality" in today's markets. Surprisingly, this flight has not yet expressed itself in the precious metals markets or in the precious metal miners. Historically, the "ultimate" flight-to-quality is to gold and gold equities. Currently, though, the demand for safety associated with US government debt is creating a demand for US treasuries and driving down the yield throughout the yield curve.

My guess is that when the credit crunch manifests itself, the markets may decline quickly as liquidations need to be made to service the overwhelming amount of debt in the US economy. Will gold appreciate due to flight-to-quality? In the short-term, I think so. Longer term, I'm not so sure. US$ will become very valuable as debt denominated in US$ comes due. Debtors may be forced to liquidate even the best investments in order to service their debt. If people become convinced the market has topped, many will sell sooner than later in order to get the best price they can. This could make for a quick and ugly ride down - and would signal a recession.

The US$ Index (US$X)

Much of the previous scenario is based upon the Fed not changing the Fed Funds interest rate. Right now, the Fed is caught between a rock and a hard place. There is an enormous amount of US$ in reserves overseas due to our continuing trade deficit. Other central banks have been raising their rates while the US has not. Raising rates would "defend" the US$ against foreign currencies somewhat by making the yield relative to other currencies more attractive. This would also entail the Fed reducing the money supply in order to support the higher rates. However, with the housing market crashing and a potential recession on the horizon in an economy carrying record levels of debt, raising rates would certainly seem to become the straw that broke the economy's back, sending it into a recession of uncertain size and length. Therefore, the Fed is in a very tough situation that has bad
(Continued on page 3)

(Continued from page 2)
consequences regardless of their action(s). As I've said before, the Fed would most likely opt to lower rates to stave off a recession before it would raise rates to fight inflation, especially since they are the source of inflation, anyway.

If the Fed chooses to lower rates and increase the money supply in order to stave off or ameliorate an upcoming recession, we could find ourselves reliving the 1970's. That is, a weak economy with large amounts of inflation. Those of us who lived through those years as adults are not nostalgic about that era and we don't want to see it return. Recession would still happen eventually. Given the imbalances in the economy, I'm not sure a recession would be any milder than if the Fed bit the bullet now and defended the US$. In such a scenario, all commodities, but especially precious metals would be extremely lucrative. Painful as it sounds, this scenario would be quite profitable for my clients, the *CJ Model*, and me in the long-term.

Please allow me a comment here. I hope that I'm wrong about my assessment of what is upcoming and about Dr. Bernanke's abilities to deal with the problems that are present. He is reputed by some to be a brilliant economist. Just because I don't see a way out of our problems without people incurring significant pain doesn't mean there isn't one. I hope Bernanke and the Fed know a way to solve these problems and keep our economy expanding with minimal further damage to the US$. However, until I see that solution applied and that my predictions are wrong, my clients and I will continue to remain defensive and positioned as we are currently. This isn't a good time to "swing for the fence."

Market Technicals

While I still assert that major technical damage hasn't been done yet, the DJI reaching the 14000 level and then dropping below June's closing low of 13266 in 8 trading days is somewhat sobering. The TRAN has not yet confirmed this downward move, but it would if it breaks below June's low of 4995 soon. There are three significant levels for the DJI that would indicate serious problems in the markets. Psychologically, breaking below 13000 would be bad, especially so soon after reaching 14000. It also happens that 12990 is a significant retracement level for this move in the DJI. There really isn't any further support until around 12350 after the 12990 level. Finally, breaking 12600 would mean that the DJI's downward move has exceeded 10% of the high. This would prompt questions about whether the markets would continue down to a 20% drop, which is "official" bear market territory. As each of these levels is broken, the confidence in the market's recovery in the near-term would decline.

I don't know if we have begun a bear market. One would certainly think something major is going on after seeing the markets and the *CJ Model* up in double digits on 7/19/07, then watching half of those yearly gains evaporate by month's end. It's possible, but I've been predicting a major downturn for years that hasn't materialized. It's hard to look at the markets with fresh eyes every day. I don't want my previous assessments and biases to keep me from missing something significant. Perhaps the markets were just so overbought and overdue for a 10% correction that it finally happens and the markets appreciate significantly from here. The best thing to do now is to watch the action, see if the DJI markers are met, and see if the TRAN confirms the DJI's downward move. If so, we may close some positions in order to protect profits and/or capital.