The CJ Investment Newsletter

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Jump Off or Keep Riding the Bull?

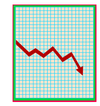
Purpose

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 DJI and most major indices worldwide experienced major declines yesterday. What does it mean?
- Will the Fed raise or lower rates? If so, when?
- We discuss and try to weigh current bullish and bearish arguments.

Wildfire!

Yesterday (2/27/07), after setting records for new highs almost daily, the DJI cracked and fell over 500 points before recovering some and closing down 415 points, a 3%+ decline. The SPX and COMP were down similar percentages. Presumably, this originally precipitated in China. The Shanghai Index was down about 9% in one day due to announcements by the Chinese government regarding the imposition of capital gains taxes on gains from stock sales. When the Asian indices cracked, it carried over to Europe, then America. Or so the story goes. After the Shanghai Index more than doubled in a year, I have a little trouble believing a 9% drop would cause such an enormous worldwide reaction. In my humble opinion,

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this event was more likely the match that lit the forest fire – all the other conditions had to be present before such a wildfire could spread worldwide.

Today (2/28/07), the DJI recovered 52+ points, or about 0.4% of the 3+% it lost yesterday. The COMP recovered 0.3%, while the SPX recovered the most, almost 0.6%. While these are not strong recoveries, the important point is that the markets did not roll over and collapse today. Some will credit Ben Bernanke's televised speech touting the overall strength of the US economy.

Returning to the metaphor above, the wildfire may have been damped somewhat today, but there is still quite a bit of dry brush around just waiting to be ignited.

Boring, but Important Statistics

Let's review some basic value measures:

	P/E	Yield
DJI	20.7	2.16%
SPX	17.7	1.81%
US 10yr T Note		4.75%

(All information is from the 2/26/07 Barron's.) In historical perspective (like the last 100 years or so), the P/E's on the DJI and SPX are much closer to market tops than bear market bottoms. Historical dividend yields have averaged close to 3.5%, and, in fairness, 10 yr T Note yields have been closer to 6%.

In market parlance, "smart money" refers to those (generally rich) folks who make "smart" decisions with their money, like buying when others sell and vice versa. They also tend to be more disciplined and number-driven. Conversely, "dumb money" consists of emotional investors, the types that buy into market tops and sell into market bottoms. Put simply, do you believe that "smart money" is buying DJI or SPX stocks, which have market significant risk due to long run-ups since the spring of 2003, extended P/E's and miniscule yields? Do you think it's more likely that they are buying US T Notes, which have no credit risk and yield over twice as much? Me, too.

Although there are arguments that deal with relative values and other measures that suggest that perhaps the stock markets are not overvalued, I generally do not put much credence in them as compared to the lessons of 100+ years of market history and Dow Theory. For some reason, it appears that the markets do have some relatively hard and fast rules/measures that may be violated in the short term, but not for extended periods. I tend to believe and act on those rules/measures. Let's review a few of these statistics and rules in relation to the market here, in no particular order:

- There have been recent Dow Theory confirmations, including a rare triple confirmation between the DJI, TRAN and UTIL indices. Richard Russell doubts the confirmation, but other Dow Theorists think they are real. This would indicate that the market should continue upward for at least a while. **Bullish**.
- The valuation side of Dow Theory is **bearish**, as described above.
- The VIX (a measure of the price of options, especially puts) has been very low (between 10 and 11) for long time, indicating complacency in the market. This is a contrarian indicator of potential trouble in the market. Yesterday, the VIX rose to a high of 19, closing at just over 17.2. Today the VIX closed at about 15.4. The two-day rise indicates less complacency in the market than before, but is still a low figure. Still **bearish**.
- The abruptness of the drop in the markets yesterday is more indicative of a bull market correction than a bear market move. Corrections of primary and secondary moves tend to be sharper and faster than primary moves, but shallower. **Bullish**.
- The bull hypothesis is somewhat dependent upon the hope that the Fed will lower interest rates and, consequently, loosen the money supply. Since 1/26/07, the US$X has been declining from 85.3 to its current level around 83.5. Actually, the US$X has been plotting out a series of declining tops since its last major top of 92.3 on 11/16/05. This will likely keep the Fed from lowering rates anytime soon. More on this below. **Bearish**.
- The market recovery since 2003 and the economic expansion are getting very old as such things go. Trees don't grow to the sky; markets and economies don't expand forever. **Bearish**.
- More earnings reports, especially in the housing sector (discussed below) are coming in shy of expectations, often with negative or no forward guidance. Declining earnings ~> (~> equals "leads to") slowing economy ~> declining market ~> recession. **Bearish**.
- My technicals for the DJI, SPX and COMP are relatively neutral. Technicals for the TRAN are negative and positive for the UTIL. **Neutral**.

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Bernanke, the Fed and the Truth

New home sales were down 16.6% for 1/07, the largest percentage drop for 13 years and the slowest sales pace for 4 years. Bernanke expressed his opinion that the problems in the housing and real estate industries do not appear to be affecting other parts of the economy. As Harry Shearer used to say on *Saturday Night Live*, "Pardon me for thinking clearly, but..." How can the "engine" that drove our economy for the last few years (by the Fed's own acknowledgement) not affect the economy here? Get real. Hundreds of thousands, maybe millions, of jobs will be affected to the negative. The increase in home prices, which US consumers borrowed against to consume beyond their income means is drying up – fast! Less jobs and less wealth will definitely translate into less consumer demand. This will lead to declining earnings (being seen now, see above), then a slowing economy, then a declining market, and then a recession. How disingenuous of the esteemed Dr. Bernanke. Does being head of the Fed give you a license to lie? Sign me up!

While we're on the subject of the Fed, do not count on Bernanke's Fed being any different from Greenspan's Fed. Only one Fed Chief in the history of our country had the courage and knowledge to hold fast against the firestorm of public opinion and let unemployment and interest rates rise in order to keep inflation in check. Paul Volcker. Regardless of what he's done since with the UN, he casts a giant shadow against other Fed Chairs. Bernanke has already shown himself to be secretive by withholding M3 data (after professing to bring "transparency" to the Fed) and disingenuous (see above). Do not expect such a "man" to be able to step out of Volcker's shadow.

Bernanke will lower rates as soon as he sees the economy really begin to falter, probably by a lot. He will not take the heat of trying to stem inflation at the cost of the unemployment caused by a significant recession. He will do whatever he can to mitigate and postpone the recession that eventually *has* to happen. Expect inflation and lots of it in the future, especially *after* the likely upcoming recession.