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The CJ Investment Newsletter

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See No Evil, …

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
?	?

- Today, the Fed lowered the Fed Funds target by 25 bp (0.25%). The markets' reactions were enthusiastic. Gold rallied dramatically after the announcement, and we may see $800/oz gold tomorrow.
- We discuss the disconnect between the markets' actions and the US economy.

The Never-ending Conflict

Recently, I've been reading my usual pundits, as well as a couple of others, who persist in stating that the circumstances surrounding the subprime meltdown, and the resultant credit crunch and real estate meltdown have to start reigning in consumer spending, and soon. Just *have* to. In fact, Hoisington Management's data can make an excellent case for why we're already in a recession – we just don't know it yet. Their case, and that of John Mauldin's, suggests we have not even begun to see the end of the subprime fallout.

If I might add a bit of accurate, if perhaps

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"The inherent vice of capitalism is the unequal sharing of blessings. The inherent blessing of socialism is the equal sharing of misery." - *Winston Churchill*

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not PC information to their contentions, the job losses in the housing sector have a larger impact than that measured by the government jobs data. Millions of illegal aliens worked in the home construction industry. When they lost their jobs, of course, those losses would not be reflected in the government figures. But, they had to eat, drink, buy gasoline and use a host of other consumables, which are not being purchased now due to their being unemployed – or at least, less richly employed. Whether they remained here or left, the level of their consumption has declined.

In fact, domestic consumption has slowed down, but has been mostly offset (so far) by the increase in exports due to the decline in the value of the US$. One benefit of the decline in the US$ versus foreign currencies is more competitive prices in US goods.

Adding more fuel to the fire (pun intended) is the disconnect between the meteoric rise in oil prices (now at a record $94.53/barrel) and the relatively tame increase in the price of gasoline. My understanding is that the reason gasoline has remained relatively stable is that significant amounts of refining capacity have come on stream recently producing gasoline, keeping gasoline relatively cheap – in the short-term. When that inventory is gone, we're likely to see gasoline prices soar – again. Imagine what that will do to consumption, especially for lower wage earners.

Do you get tired of people looking straight into the camera and stating:

- Inflation is contained.
- The Fed needs to lower the interest rate.
- That it's a mystery why gold, oil and commodities keep rising.

All of these statements are disingenuous at best. What mystery? If you've read me for any length of time at all, do you have any problems understanding the third bullet and knowing the first two are just plain wrong?

Money is supposed to perform two functions:

- Serve as a medium of exchange.
- Be a storehouse of value.

There is no reason to rehash the discussion of inflation in last month's *CJ Newsletter*. Still, isn't it plain that if you keep expanding the money supply beyond the actual expansion rate of the economy you're eventually going to have inflation? We do, despite their claims and manipulation of inflation rates. And we will continue to, until we stop printing so much money. For those who say inflation doesn't matter, how do you think our trading partners feel about holding and continuing to build US$ reserves? Would you want to hold and accumulate a wasting asset? Them either.

The Fed remains committed to destroying our money's ability to be a store of value. I believe Bernanke thinks that if he can mitigate or avoid the recession on the horizon, the Fed can deal with inflation later. *All* Fed Chairman think that. But, the time never comes; they never undo the damage. Only when the situation becomes as dire as it did in the late 1970's and early 1980's does the Fed ever stop electing to deal with the economy and deal with the inflation problem instead. How bad will it have to be before they act this time?

So, there it is. Consumption slowdown. Inflation. Destruction of wealth from the crumbling real estate and credit markets. A very real danger of recession. *And the Fed and the government propose doing more of what got us here in the first place!*

And yet…

The markets tell me I must be wrong. In the face of what I've just laid out, the markets continue to march to new highs. The market loved the Fed's 25 bp interest rate cut today. The DJI closed up 137+ points, at least 100 points being due to the Fed announcement. The markets are a whisper away from new all-time highs and look to break them soon. *Why?*

To revisit an old idea, I think we're experiencing a manifestation of Marshallian K theory. This theory states that when an economy has more money supply than it currently needs for production and purchase of goods, excess funds find their way into the financial markets, creating asset inflation. We clearly have excess funds, judging by the excess growth of money supply measures over GDP growth and by the slowing of monetary velocity in all measures besides M1, a special case. Put more simply, there is a lot of "excess" money to invest and that money has to go *somewhere*. Thus, a rising tide lifts all boats - literally.

Second, we have inflation in tangible assets, too. The most obvious manifestation is in commodities. Less obvious is the revaluation of corporate balance sheets as revalued by the inflated US$. Think those assets might be worth more in the market than on the books? So do many investors. Perhaps we see the return of the corporate raiders soon.

Watch out when the excess money finds its way past the financial markets and into the general economy!

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