The CJ Investment Newsletter
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The Fork in the Road

Purpose

This is a reissue of previously disseminated information.

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
?	?

- On 9/18/07, the Fed lowered both the Fed Funds target and discount rates by 50 bp (0.5%). The markets reacted with a huge upward surge that day and have followed through strongly since.
- Did the "Bernanke Put" replace the "Greenspan Put" on 9/18/07?
- Commodities have rallied particularly strongly since the Fed announcement, notably gold and oil. While still lagging the metal, gold miner equities made strong upward moves this month.
- The implications of the Fed changes and market reactions are discussed, including a look at potential and likely future results.

The Fork in the Road

Yogi Berra, famous for his quotes as well as his baseball talents, once said, "*When you reach a fork in the road, take it*." While undeniably hilarious and worth the space to relay to you on its own merits, this quote seems eerily applicable to me, here. For months Bernanke and other Fed Governors

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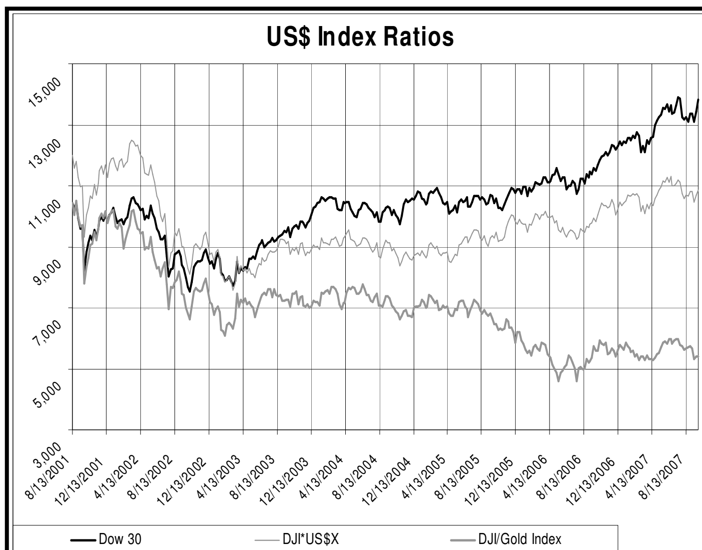

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have been proclaiming the dangers of inflation and holding the Fed target rate at 5.25% in order to "fight" said dangerous inflation. On 9/18/07, B-B-Benny and the Feds made the relatively unexpected (depending upon who you're talking to and how honest they are) move of lowering both the Fed target and discount rates by 50 basis points (0.5%). Apparently, they found a fork in the road and, well, took it.

If you didn't read last month's *CJ Newsletter* or you don't remember it, it would help to review it now for fuller understanding of the material herein.

Obviously, the Fed made a studied judgment that the risk and likely depth of recession to be triggered by the credit crunch and decline in housing prices (and, therefore, homebuilding activity) was considerably worse an outcome, after all, than accelerating inflation, at least for now. He may feel that the recession had the potential of becoming quite painful, perhaps even devastating, on a worldwide scale. He may also believe in the Fed's ability to control inflation without triggering a recession as painful as the one he thinks might happen if he did not make this move.

We may never know whether Bernanke's judgment was right about this. After all, only once in history has the Fed ever willfully and deliberately brought on a recession in order to halt inflation. That began in 1981 under President Reagan and then Fed-Chief Paul Volcker. No other combination of Presidents and Fed Chairmen have had the political will and bravery (mostly Reagan) to withstand the criticism leveled by both the press and the "loyal opposition" party and follow through on their decision until inflation was actually coming under "control." Clearly, neither President Bush nor Chairman Bernanke appear to have that kind of courage and strength.

TCM Reissue

Remembering the Mises quote from last month, Bernanke is truly playing with fire here. Let's examine why:

- Remembering Mises's quote from last month's *CJ Newsletter*, our choices are simple: stop stimulating business activity with artificially low interest rates and overly free credit or face the potential destruction of the US$ as a viable currency. Period. History shows that no fiat currency, other than those currently used have survived. Eventually, they have all been replaced by *other* fiat currencies when people simply would no longer accept the old ones as having value.
- While I'm not yet totally in this camp, many pundits are now talking about the "Bernanke Put." Alan Greenspan was so famous for rescuing markets with enormous injections of liquidity and low interest rates before they could decline seriously that a new term, the "Greenspan Put," was coined. If Bernanke's Fed follows through on this decision in the future, I'll agree that the "Bernanke Put" has indeed been established.
- The upcoming recession will be *deferred*, not eliminated by this policy. The recession, when it finally arrives, will almost certainly be much worse than if we let it happen now.
- The "Bernanke Put," when established will encourage more of the excessive risks taken without proper compensation that got us here originally. Market participants will rely on the "Bernanke Put" to keep them from incurring the losses they most likely should incur.

Inflation

Let's review what inflation actually is and what it does. Most people mistakenly associate inflation with rising prices. Not true. *Inflation is an increase in the size of the money supply*. Simple, huh? Consistent significant inflation can be a major causal factor in rising prices, but is not the only reason for rising prices, especially in the short-term. Rising prices can exist in a non-inflationary economy.

To understand inflation, imagine a set of scales, like the scales of justice. That is, a bar centered on a pivot on a pole, with baskets hanging down from the end of each bar. The baskets weigh the same, so the scale balances the baskets at the same height. Now, imagine that in one basket are all the goods and services of an economy and in the other is economy's money supply. By definition and axiom, they must balance in the long-term. In the short-term, they can wiggle around as changes in either

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Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: ?
Appropriate Current Allocation: DEFENSIVE

Asset Class	Conser-vative	Aggres-sive
Money Market Funds	70-10%	55- 5%
Long Positions:		
Bonds & Bond Funds	30-60%	40-60%
RD Stocks	0-10%	0-10%
Growth Stocks	0%	0%
Gold Equities/Funds	0-20%	10-30%
Bear Market Funds	0- 10%	5-20%
Aggressive Positions:		
Shorts and/or Options	0%	0- 5%

Notes:
Income generating portfolios may not conform to the above guidelines. If income is the primary purpose of a portfolio, income needs are met *first*, then other allocations are made.

Up to 50% of bond/bond fund positions should be in international (non-US) bonds. Such bonds will provide higher interest paid on the face due to the additional *perceived* risk of foreign bonds, as well as providing hedging gains as the dollar declines against foreign currencies due to Fed monetary policies.

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basket are made. Let's assume that the money supply in one basket is $1 million (it's a small economy) in the year 0. Let's also assume that in year 1, the amount of goods and services were *exactly the same*, but the economy's central bank increased the money supply by 10% to $1.1 million. What happens?

After wobbling around, the economy is now valued at $1.1 million even though no additional wealth (goods and services) were produced. Nothing has changed except the *number of units* needed to measure the production. Since it now takes $1.1 million to value what was previously valued at $1 million, the value of the $ have *decreased*. *That* is inflation. If the central bank had *reduced* the measuring units in the money supply, that would be *deflation*, because it would take less units to measure the output. Confusing as it sounds, inflation devalues a currency while deflation increases its value.

Looking at a more concrete example, let's look at gold. (You knew this was coming, didn't you?) An ounce of gold is an ounce of gold. It never changes – literally. An ounce of gold 2,000 years old is identical to an ounce of gold made yesterday. So how can gold go up in price? Actually, it doesn't. It's always worth the same – 1 ounce of gold. *What changes is the amount of monetary units by which it is measured.* Assuming no unusual short-term demand peaks or valleys and no new uses for gold that would permanently increase demand for the yellow metal, gold goes up in price because the value of the measuring units decline – and that is inflation.

Please note the graph on page 2. This graph tracks the value of the DJI as reported since 8/01. It also calculates the value of the DJI as restated for the loss of buying power of the US$ as measured by the US$ Index (US$X). Finally, it restates the value of the DJI with respect to the percentage changes in the price of gold (Gold Index) since 8/01. As of 9/24/07, the values were:

DJI	13820.19
DJI/US$X	10862.67
DJI/Gold Index	5401.64

That's what inflation is and what it does. Is it any wonder people can make $150,000/year and feel poorer than they were a few years ago? Moreover, this study is only 6 years old!

Gold has almost *tripled* (in US$) since 8/01, when it was about $288 per ounce. Gold closed today at $750/oz on the COMEX. Because of earnings leverage, the gold miners have, as a rule, exceeded the performance of gold itself, although they have recently lagged the metal.

TCM Reissue