February, 2008 One Hundred Twenty Second Issue

The CJ Investment Newsletter

Callom B. Jones, V Investment Adviser Representative

Let's Repeal the Law of Gravity, Too

Purpose

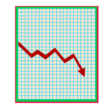
This is a reissue of previously disseminated information.

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**
	

- The Fed made a rare intermeeting fed funds rate cut of 0.75% on 1/22/08. They followed up with another 0.50% rate cut on 1/30/08 when they conducted their regularly scheduled FOMC meeting.
- The Congress and the Administration try to cobble together a relief package to help "salvage" the economy.
- We discuss the policy aspects of the Fed and the "Feds."

"Shocking the Frog," Part II

Many of you may recall an image I used in the 8/02 *CJ* Newsletter (Issue 56) called "Shocking the Frog." The following two paragraphs are lifted directly from that issue.

"Back in the old days when I was in high school, students would have a chance to learn some biology by killing a frog, performing some experiments on it and then dissecting it because its anatomy was similar to that of human beings.

"One of the experiments was to run an

(Continued on page 2)

Trend Capital Management, LLC
9717 W 121 Terrace ▪ Overland Park, KS 66213 ▪ O (913) 897-7576 ▪ C (913) 568-9916
e tcm@trendcapitalmgmt.com ▪ www.trendcapitalmgmt.com

(Continued from page 1)
electric current through the frog and watch its muscles contract, presumably identifying an electrical component to nerve impulses. One would also learn that there was quite a bit of stored chemical energy in those muscles, but not an infinite amount. The first few short shocks would result in mighty muscle contractions, but if you continued the process, the contractions would get weaker and would eventually stop altogether. Why? The frog was *dead*, and unable to replenish its chemical energy stores."

This allegory is somewhat misleading when applied to an economy or a market. Obviously, economies and markets can't die as long as there are people alive interacting in an economic manner. Still, it's a vivid, memorable image and can guide understanding if you consider the *phases* of both markets and economies as life (economic expansion and bull market) and death (recession and bear market). Perhaps the most useful lesson is that, even in death, there is stored energy which can be tapped, but not replaced once exhausted. That is descriptive of the behavior of both recessions and bear markets. They will react to monetary, fiscal and tax stimuli, but in a weaker fashion than in expansion. In addition, stimuli will gradually become less effective when used, eventually becoming ineffective if all of the stored energy is exhausted.

If we are, in fact, in a bear market and/or a recession, keep this image in mind when the politicians and the Fed (*aka* politicians) talk. Perhaps more importantly, keep it in mind when they *act*. Most of all, remember that no matter how much you shock the frog and regardless of whether it responds or not, *it's still dead*.

Keynes Misapplied

Lord John Maynard Keynes was one of the most brilliant and influential economists ever, whether you ascribe to his theories of economics or not. Keynes published The General Theory around 1936, when the Great Depression was in full force. One of his greatest theoretical contributions, if not his greatest contribution, was the idea that there is no *natural* stimulus inherent in an economy in the bottom of a depression that will encourage entrepreneurial activity and, therefore, begin a new business expansion. If there is a theoretical contradiction of this concept, even by the Austrian school (to which I adhere) I am unaware of it.

Naturally, to a world in depression, these were sweet words, because they gave to governments explicit approval to interfere in their economies through interest rate, fiscal and tax stimuli. Prior to the publication of The General Theory, there was almost complete agreement that government interference in the economy would only make matters worse. FDR was also an open admirer of the newly created Soviet Union, which, of course, controlled all economic activity centrally. With these as justifications, FDR began an unprecedented tradition of government interference in the US economy that continues to this day. Even the Republicans can't seem to resist the siren song of trying to control the economy through fiscal and monetary policy, except for perhaps Rep. Ron Paul of Texas, a devout Austrian economist and strict Constitutionalist.

Keynes never intended for governments to become chronically involved in their economies. In fact, he specifically warned against it in The General Theory. Economic stimuli were supposed to be used judiciously, *not constantly*, by governments. Still, once the cat's out of the bag, there's no putting it back in. At least not in the US government since the 1930's.

The Business Cycle Can't Be Repealed, Unless…

Regardless of the reasons, US politicians since the 1970's have been determined (as a group) to repeal the business cycle. More precisely, they are determined to repeal the *recession* portion of the business cycle. The funny thing is, to Austrian economists, at least, the *cause* of the business cycle is a central banking system (the Fed in the US). Of course, ridiculous fiscal policies and overly confiscatory tax policies, sprinkled with a "liberal" (pun intended) dose of deficit spending can make the situation much worse. Sound familiar?

As long as we have a meddling Fed, the business cycle can't be repealed. You can't repeal the "bad" half of the business or market cycles, either. Some politicians and most Fed Governors know this, but in a country where elections occur every 2, 4, and 6 years with politicians that want to be reelected, they continue to try. I guess they think natural laws are like human laws. Hey, let's get them to repeal that annoying gravity law, too. Currently, politicians are truly afraid of not being reelected if they're in office when we have a recession. Here are the facts of life about this:

- The only way to repeal the business cycle is to get rid of the central banking system or to take the human governance out of it.
- Once a phase of the business and/or market cycle is begun, it only stops when it reaches exhaustion. Bull or bear markets, expansions and recessions all run to their conclusions.

(Continued on page 3)

Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: **BEAR**
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.

(Continued from page 2)

Strategies

As I said in the *CJ* Newsletter when he first took over as the Fed Chairman, I feel sorry for Ben Bernanke. I said then and reassert now that he took over an economy that was made very sick by his predecessor, Alan Greenspan. The symptoms were not fully manifested, but you didn't have to be a rocket scientist to see what had to happen because of Greenspan's policies and the government's spendthrift ways. Not that I'd ever be offered the Fed Chairmanship, but I surely wouldn't have taken the job then. If you do the right thing, you'll be excoriated as Volcker was in the early 1980's. If you do the wrong thing and try to minimize the short-term damage, you risk making the long-term damage even worse. It reminds me of a common saying from many years ago: "When you're up to your butt in alligators, it's difficult to remember your original objective was to drain the swamp."

The brilliant John Mauldin, who can be accessed at www.frontlinethoughts.com, recently wrote he thinks the current Fed strategy is designed to steepen the yield curve quickly to allow banks and other financials to earn enough to grow their way out of the credit crisis over time. He also posits that the Fed will cut twice in the next two meetings, making the eventual fed funds rate 2.00%.

While Mauldin may indeed be right about Bernanke's thinking and actions, problems present themselves:

- Under Austrian theory, expansions are brought about by lowering the borrowing rate below the natural interest rate of an economy, creating malinvestments (uneconomic projects) to look economic and be undertaken. The level of malinvestment caused by the artificially low interest rate increases to a climax, after which the recession (correction of the expansion's malinvestment) begins and must run its course. In other words, the three years of 1% fed funds under Greenspan created this crisis. *How in the world can Bernanke implementing the same policy rectify the situation?*
- No one knows if stimulus applied during the recession phase of the business cycle can raise the final level of the bottom of the recession or delay its completion. Keynes only suggested its use at the bottom when it was clear the economy would not recover on its own. My guess under Austrian theory as I understand it is that the level of the bottom would be unaffected, but the potential for delaying the final reckoning could happen. No matter how much you shock it, the frog is still dead. Great! We get to endure the pain for a longer time without lessening the total amount of it.
- While no one knows about the point above, virtually all economically informed persons know that lowering the interest rate requires increasing the money supply, creating inflation, *aka* destroying the value of the dollar. When added to the recession that is almost surely coming, if not already here, these actions create a climate that looks eerily like the "stagflation" of the 1970's and early 1980's.