The CJ Investment Newsletter
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The Price We'll Pay

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

- Due to a death in the family, the *CJ Newsletter* is published late this month. My apologies.
- The price of the "bailout" versus no action by the government is discussed.

Quick Review

This newsletter could probably been called "Not-So-Free Markets? Part II," after the 4/08 *CJ Newsletter*, which explains how we got to this place. I will explain the major ideas presented herein, but I recommend that you re-read the 4/08 *CJ* for a complete understanding of this letter.

The first thing to keep in mind is that federal government and, especially, past and current Fed monetary policy are almost completely responsible for the US markets and economy being in their current condition. Any "bailout" is an attempted correction of *their* past mistakes, not failures of market forces or of capitalism. The Fed's constant over-priming of the economy to try to avoid recession via ultra-low interest rates in the early 2000's set off the chain of events that led the US markets and economy here.

(Continued on page 2)

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(Continued from page 1)

The chain of events:

- Home prices surged from new demand created by low interest rates making home mortgages more affordable. More people qualified for loans than before.
- Existing homeowners took out mortgage equity withdrawals (MEW's), allowing more consumerism without increases in income. The economy becomes more debt-laden.
- Because of the surging home values, home loans were considered less risky because the collateral (the home itself) would increase in value. This, plus government incentives and directives, created a market for "subprime" and "alt-A" loans to less qualified and unqualified buyers. "NINJNA" (no income/no job/no assets) loans become common.
- Lenders bundle up the loans and sell them (RMBS's, see below) into the credit markets, diminishing *their* risk and perpetuating the behavior of loaning to under- and unqualified buyers.
- Low interest rates cause investors to reach for yield. The credit markets develop arcane debt instruments such as asset backed securities (RMBS's, CDO's, and CMO's, among others) to sell as "safe" securities with higher yield. The ratings agencies gave many of these securities AAA ratings via some mathematical magic, further perpetuating the falsehood that these higher yielding securities were safe.
- In order to mitigate risk and remove liabilities from their balance sheets, financial institutions began buying and selling credit default swaps, creating a web of counter-party obligations, tying financial institutions together tighter than ever before. The net effect was to shift individual risk to systemic risk, making the failure of one major player potentially capable of bringing down the entire network.

Finally, a quote from the 4/08 CJ:
"*What the Fed doesn't want you to realize is that they are culpable for the entire problem by lowering the interest rate below 2% and leaving it there for three years.* This could be a textbook example of how (at least in one industry) interest rates below the natural rate of interest create malinvestments, further creating the expansion phase of the business cycle and how capital is destroyed in the recession phase, as theorized by Austrian economics.."

Managing the Pain

It's vital that you remember throughout the following discussion that we are now in a recession and that, under Austrian business cycle theory, the uneconomic capital created in the expansion phase must be destroyed. There is no escaping this. The proper term for the "bust" portion of the trade cycle is *depression*. After the Great Depression, politicians were loathe to call any later phases of this type "depressions," so they made up a new word: recession. After the 1970's, "recession" became anathema, so they coined the term "business slowdown." "Recession" has reentered the lexicon, but all three terms mean the same thing.

The cleanest and fastest way of destroying the capital needed to complete the cycle would be to let the recession take its course. Essentially, this is what happened in the beginning of the Great Depression, but that was not the *cause* of the Great Depression. A depression/recession would have happened, but the *Great* Depression happened because of poor government decisions at the beginning of the depression involving taxes, tariffs and a whole host of other policies that protracted and deepened what might have been a "normal" recession.

The problem is this: "capital destruction" entails the failure of companies and the abandonment of uneconomic projects, both of which involve the destruction of *jobs* and creates a vicious downward spiral reducing consumerism and more destruction of capital and jobs. There is a *human* cost to capital destruction. The correction process inflicts pain, sometimes, great pain, on some of our population. Swift, but not merciful.

Last, it's prudent to keep in mind what many believe to be Lord Keynes's greatest contribution to economics. *He postulated that, at the bottom of a depression, there is no natural force that drives the increase of entrepreneurial activity needed for the economy to expand and recover.* That is why he suggested the use of freer credit and the increase in money supply needed to support it – to spur an increase in entrepreneurial activity that otherwise might not occur. He never envisioned, nor would he approve of, the Fed's near-constant use of this technique to promote faster-than-natural growth and to attempt to repeal the trade cycle. (*CJ* 7/03)

Do you now understand why the government wants a "bailout" plan?

- Altruistically, they are trying to preserve some or all of the jobs that would be destroyed as a recession took its natural course.

(Continued on page 3)

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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)

- Those few that realize they are *culpable* in the creation and depth of the coming recession like to *mitigate* the bad effects as best they can.
- Finally, they can impose *control*, a siren call few politicians can resist, over another few aspects of American lives. Eventually, enough government control gives way to an un-American society and economy – socialism, the ultimate siren call for politicians. Complete control over all aspects of our economy – and our lives.

The Price We'll Pay

The original "bailout" plan involved the government buying up $700 billion of the bad securities at some price, reliquifying the banks and other lenders to unfreeze (hopefully) the credit markets. Whether or not this would work is problematic. Regardless, the losses of capital contained in those loans will be realized and will not be mitigated by an ownership change.

Essentially, any adopted plan will do the following:

- The government buys or insures the securities with losses, transferring the losses from the "bad actor" companies in the finance industry to the government, and, therefore, the taxpayers.
- The government then regulates the bad actors in the future.
- The government may acquire an ownership stake in the bad actors.
- Unrelated "pork" may be added to the plan prior to passage.

Did you notice that no provisions are made for the correction of problems created by credit default swaps? Nothing like missing the 800-pound gorilla in the room…

The price for this "bailout" being adopted will be:

- Higher future taxes needed to fund the losses purchased by the government.
- Higher short-term inflation (given the right conditions) from the huge injections into the money supply to purchase the bad assets.
- Higher inflation longer term from the cowardice of the government to levy enough tax directly to cover the losses, instead using inflation as a "stealth tax" to mitigate the debt.
- Further regulation and intrusion into private industry by the government, hampering the productivity and profitability of previously more capitalistic companies.
- Government ownership of once private companies. They already own 80% each of Fannie Mae and Freddie Mac as part of the "bailouts" of those entities. Ownership by "the people" is the very definition of socialism.
- A very protracted period to work through the losses that must be realized and capital that must be destroyed. Like the Great Depression, it will transform a 2 – 3-year recession into a decade-long or longer recovery period.

Great choices, huh? A "quick" and brutal recession versus a (perhaps) less painful recession over a much longer period with onerous government intrusions taking us much further down the road to socialism. I favor the "plan" 50.1% to 49.9% only because of the innocent citizens that would lose their jobs otherwise and because of Keynes's revelation about the bottom of recessions. I wish *I* could get bigger, richer and more powerful by screwing up, as our government does.

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