The CJ Investment Newsletter
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Do Stocks & Gold have "Legs?"

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.

The CJ Growth Strategy (back page) has been an ongoing aggressive growth model portfolio since 1/98. Its results continue to be tracked herein.

Quick Look

Market	**Next Expected Move**
?	

- The recovery of the stock market since early March, 2009 is unprecedented.
- Gold reaches new all-time highs in early October, 2009. Why?
- Credit creation is far less than what should be required by an economic recovery.
- Money multiplier and velocity statistics indicate deflation, not inflation – a condition associated with recessions, not expansions.
- Unemployment keeps climbing.
- How do the conflicting 1st two and last 3 bullets get resolved?

The Serious Disconnect

From the review of the above bullets, one could conclude that there is a serious disconnect between the economic data and the optimism of investors at this time. The economic data is highly negative and getting worse in some areas. We will review some of this data later. Clearly at odds with the data is the buying behavior of investors, at least since the market lows of early March, 2009. As of today (10/8/09), the DJI is 49.4% above the 3/9/09 low of about 6547.

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"The market can stay irrational longer than you can stay solvent."
- Attributed to Lord John Maynard Keynes

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Some may argue that the market "leads the economy" by 1-3 quarters, so the stock market is foretelling the end of the recession within the next 9 months. All I can say to this is that I hope it's true, although I doubt that it is. In my opinion, our problems have been building up too long and run too deep for such a quick recovery.

The action of gold and gold miners is also a mystery to me in the short term. I have to admit to feeling sheepish about selling client and personal gold miners in August and watching the metal and the miners rally since then. Again, this action is a disconnect from what the underlying economic conditions, as reflected by the statistics, appear to be. Gold rarely rallies in a recession; lacking specific other causes, gold will decline in price like all other non-cash assets during a recession.

Eventually, clients and I will re-enter gold equity positions, but I've never found chasing a rally to be a profitable behavior. Especially in a bear market with an underlying recession, the chance of a sudden reversal causing price declines is higher than usual. The only thing worse than missing this run is to get in and have it reverse, causing capital losses in client accounts. Capital losses are always worse than opportunity losses, at least in my opinion.

Recent Commitment of Traders data from *Barron's Magazine* indicate, that since 9/14/09, commercial hedgers are so short gold contracts that the likelihood of gold peaking soon is higher than usual. This suggests that this recent rally doesn't have much farther to run.

As long as the Fed continues to overprint US$ in a vain attempt to control the economy, commodities are generally a good play – unless you're in a recession. Long-term, gold continues to have future profit potential, once the recession ends and we begin a new expansion.

As laid out in the 5/09 CJ Newsletter, the recovery from the first drop in the great bear market of 1929 – 1932 was 45%, followed by a 38% rebound. The prevailing opinion, even of President Hoover, at that time was that the worst was over and there were "blue skies" ahead. Sound familiar? Listened to CNBC lately? NBC? PBS?

I still can't forget that we have come off a "V" bottom since March. Sorry if I'm repeating too often, but no bear market in history has EVER ended that way. Will this be the first? Perhaps, but it's not a smart bet.

As Richard Russell says, a bear market rally's job is to look better than the "real thing" and to suck in as many people to lose money as possible. Russell also says that the winners in a bear market are those that lose the least. We're aiming for that goal.

The Economy

I'm going to state up-front that I really admire John Mauldin. Long time readers already know this, because I've referred to his e-newsletter many times in the *CJ Newsletter*. His work has introduced me to many concepts that I've explored further on my own that have really helped round out my understanding of financial and economic matters. His data resources are second to none that I know of.

He's truly bright, an excellent writer, and he is exceptional at accumulating and presenting large amounts of information from an incredibly broad group of sources in his weekly e-newsletters. While I don't agree with all of his opinions and conclusions, I know of no one else who is able to accumulate huge amounts of data, assimilate them into a cohesive and reasonable approach and present it to his readers in an understandable form. Should you like to read him for yourself, he will send you his free e-newsletter by signing up at wave@frontlinethoughts.com .

From Mauldin's "Welcome to the New Normal:" "Let's review quickly what I have written about the last four weeks. We have enormous excess capacity - capacity utilization is about 68%. Banks are cutting back on their loans, and consumers and businesses are borrowing less. Housing is likely to be in a funk for at least two years. We are deleveraging, which is causing the velocity of money to slow.

"All of this is very deflationary. Will the Fed print enough money to reflate the economy? You better hope so. Will we have to deal with it later? Of course. We have no good choices. We are in for a long five years, at the least. Yes, there will be opportunities, and new industries will be created. But it won't happen overnight." Here's the reference: http://www.frontlinethoughts.com/article.asp?id=mwo092509.

While it's a considerable amount of reading, all of Mauldin's weekly articles from 9/4/09 through 10/2/09 provide enormous amounts of important, if sobering, information about the economy. They can all be accessed at wave@frontlinethoughts.com .

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Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: **BEAR**
Appropriate Current Allocation: **DEFENSIVE**

Asset Class	**Conservative**	**Aggressive**
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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Among his most salient points:

- The FDIC does not have the resources to cover a significant banking system disaster, which is likely looming. The FDIC currently has reserves capable of covering 0.002 of every US$ insured.
- Credit is still contracting, as banks need to hold more capital to meet legal and survival requirements.
- Unemployment is at record highs since the Depression. It will take 15 MILLION new jobs created from 2010 – 2014 to reemploy recent job losses and to keep up with population growth. That's 250,000 new jobs/month on average, 25,000 more/month than 2006, the best year for job creation ever.
- From "Welcome to the New Normal:" (cited above) "There has never been a period of serious inflation in the US without wage inflation. But real incomes are falling, and there is little reason to believe we will see wage pressures within the next few years. The opposite is likely to be the case."

My own monetary studies (from information provided by the St. Louis Fed) indicate monetary velocity and multipliers just off historic lows. Even when adjusted for a more normal growth pattern for the monetary base, money multipliers are generally in the middle of the range. The only exception is MZM, which is near the top, indicating that large amounts of cash are in the sidelines in money market funds. Free reserves ($547+ billion from 10/5/09 Barron's) are at all-time highs, indicating the Fed is likely out of bullets with which to fight this battle.

The Markets' and Gold's Rises

Where are the indications of expansion that would follow from such a large stock market rally? Where is the inflation that would push the price of gold to its new record highs? What is the underpinning of the recent stock market and gold rallies?

Richard Russell recently mused about how the stock market was surging on a sea of liquidity to which the economy doesn't respond. It appears to me to be a classic application of Marshallian "K" Theory, which states that excess funds the economy doesn't need will find their way into the financial markets, inflating them. While the theory is convenient, it is based upon Marshall's postulation (with others of that era) of equilibrium or movements towards equilibrium in the economy. As an Austrian economist, I don't necessarily believe in the equilibrium postulation.

Perhaps a more sinister explanation for the movements of both gold and the US$ recently is the unloading of US$ reserves through purchases by foreign countries holding such reserves. If the government and the Fed are going to deliberately trash the US$, our trading partners will smartly unload their reserves through purchases of tangible assets and ownership stakes of manufacturers and extractive companies all over the world. In other words, our failure to be responsible with the value of our own currency will hasten its devaluation as our trading partners begin to flood the currency markets with US$. China is surely doing this, and they have stated publicly that they are doing so because we refuse to be responsible.

If the latter is the case, gold will continue to rise when the stock markets fall. In such a case, we will look for an opportune entry point into some form of gold equity investing.