The CJ Investment Newsletter
Callom B. Jones, V   Investment Adviser Representative

May, 2011   *One Hundred Sixty First Issue*

This is STILL America!

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
?	?

- Risk versus return and opportunity loss versus capital loss, including some of the problems with "getting in" right now.
- The criterion that determines a bull market versus a bear market.
- US history as encouragement during tough times.
- Navy Seals kill Osama Bin Laden!
- Why inflation isn't worse - yet.
- What "propping up" the consumer since 2000 has done.

Wow! Is that ALL? Let's get started…

Risk, Return and Losses

With people (including me) seeing the stock markets and precious metals going up almost daily, and, especially after this latest market response to B-B-B-Benny and the Feds' positions regarding QE, it's only natural to want to "be in," to join in on the profits. Me, too.

However, investing is never just about *reward*. It's "evil" sibling, *risk*, is ever-present. "Getting in" gets one in to both reward ***and*** risk. This may seem pathetically obvious, but when you do what I do, you still see folks forgetting about risk

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From the 5/2006 *CJ Newsletter: "It's become clear to darned near everyone that the US$'s value is going to decline during Bernanke's Fed tenure. It's really more a matter of whether the decline is sharp and disruptive or whether it will be slow and controlled."* The closing price of gold on 5/1/2006: $771.50. 4/29/2011: $1556.40. QED

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

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as they (naturally) reach for return. Here's how it should be thought of:

- Higher reward is *not an outcome* of taking greater risk, consequently
- Higher reward is what a smart investor *demands for taking* higher risk.

Perhaps this is best illustrated using bonds or loans, rather that equities. Say you are a loan officer in a bank. You have a certain amount to lend and you have enough to lend to both of two candidates vying for the money. One is a large regional firm with an established business and the other is a start-up business that clearly has significant potential, but is much riskier, as are virtually all start-ups.

A smart loan officer (that wants to keep his/her job) will likely lend to the established business at somewhere between 3% to 4.5% above the bank's borrowing costs – the bank's *prime rate* or maybe a little above. That same loan officer may or may not offer funds to the start-up, but if they are offered at all, they will be offered at as much as 8% or more above the bank's borrowing costs. *More return (interest) is* ***demanded*** *from the riskier loan.*

The same can be demonstrated with the sale in the secondary markets of debt issued by corporations or taxing authorities (bonds). Those securities from issuing entities with less risk do not have to generate the same level of return required of securities issued by more risky issuers. The secondary market will apply premiums or discounts to securities, altering their *yields to maturity* in order to compensate for changes in the risk of the issuer, as well as market interest rate changes. What do you think happened to Chrysler and GM debt in the secondary markets once the risks of their going out of business became widely known?

The same discounting mechanism applies to the equities and commodities markets, although it becomes much more nebulous and difficult to demonstrate. Still, I'll take a stab at an example:

- The yield on a bond in percent can be divided into 100 to determine a P/E for that bond. A 5% yield translates to a P/E of 20.
- These "P/E's" can then be compared to the P/E of equities. A large cap equity may have a P/E of 15.
- Depending upon the relative risk of the bond versus the equity, the equity may appear attractive with the lower P/E.
- Change the assumption for the equity from a P/E of 15 to one of 25, such as after a long bull run in the stock markets.
- Now, the bond may appear more attractive as you are actually paying more for each dollar of income (higher P/E) in the equity and, since bonds are generally less risky than common stock, you are assuming more risk (all other things being equal).

Another factor that should be considered when investing in this environment concerns the difference between *opportunity loss* and *capital loss*. Opportunity loss is the loss of *potential profits* from not purchasing an investment that subsequently produces returns. Capital loss is the *actual loss of capital* from putting capital at risk and having all or part of that risk realized. The difference? With an opportunity loss, you can still "catch the next train leaving the station." Incurring a capital loss means you need to make a return just to get back to your original position. The statistics for this can be daunting:

- A 20% loss requires a 25% gain to break even.
- A 33% loss requires a 50% gain to break even.
- A 50% loss requires a 100% gain to break even.

In a bear market, which I am still afraid we are in, incurring such losses requires a long road back just to break even, if you can even find securites that can get you there. While I may be more aggressive in a bull market, because it is easier to make up losses, *I tend to consistently opt for the opportunity loss in a bear market.*

While there are major uncertainties in the bond, equities and commodities markets now, the recent run-up in equities and commodities would make one think that perhaps the relative reward/risk relationship has changed and should be factored into any current investment thinking.

The dividend yield on the DJI is below 3% again, far below it's long-term historical average of 5%. Historically, this is much more indicative of a market top than a continuing bull market. It also strongly suggests that the SPX will likely be 10% cheaper in a year.

My clients and I are currently in significant amounts of cash and cash flowing securites (interest and dividend payers) that my research indicates are hopefully less volatile than some other choices. The *CJ Model* has been much less active because of the bear market and overall investing environment since 2007. It's also a smaller part of client portfolios than at some times in the past. While the markets have gone up significantly since 3/2009, that has actually tipped the reward/risk balance even more to risk than at 3/2009.

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The Risk of "Getting In" Now

The risk of "getting in" now (both the markets and precious metals) is pretty simple: We've had a HUGE run in both markets for quite a while, much of which I believe is unsupported by an improving economy. Therefore, there is a strong possibility we're at or near a top.

Should we "get in" now, there is a real possibility that we could make money in the short-term, then have the market correct sharply before I could react to the change and get out or determine if it was an actual change in trend or a short-term move we should ride out. If it was a change in trend, the likely result is that it would end up costing both profits and capital. This brings up two thoughts:

- If you have profits and don't sell in time to keep them, you never really made them.
- I'd opt for the opportunity loss, as explained above.

From Richard Russell, one of the greatest Dow Theorists of all time and someone who has studied the markets for 62 years:
"What I've learned (the hard way) is that you ride a primary bull market until the market becomes absolutely outrageous (hysterical) or until your stomach tells you that you've 'had enough.' Then, take your chips and cash them in. Once you exit a bull market, STAY OUT. Ironically, once you're out, a bull market will do everything it can to try to lure you back in. **But don't do it**. Jumping back in can be very costly to your bank account."

I wish I could have said it that well.

The Bull or Bear Market Criterion

People talk about bull and bear markets all the time. How many people do you know who could *really* define what a bull or bear market is? Thanks to John Mauldin's brilliant book Bull's Eye Investing (2004, John Wiley & Sons) you can be one of the few who really knows what constitutes a bull or bear market. Of course, the book is about much more than this concept, but it is *a very important concept*. How are you going to decide where to go if you don't know where you are?

- A bull market is where investors are willing to pay increasingly more for each dollar of income. That is, a period in which *the market experiences a rising P/E ratio*. Conversely,
- A bear market is where investors are progressively less willing to pay for each dollar of income. *The market, therefore, experiences a contraction of the P/E ratio*.

That's it, but the implications/ramifications of the above are hard to overstate. Think about what the concept means for a couple of minutes. It's profound, and explains a great deal about market behavior.

If you wish to be cheeky and say, "I don't believe it; Mauldin's wrong," read the book. Be prepared to read overwhelming evidence supporting his case. Not to mention one of the best books on investing I've read in the 2000's.

This is STILL America, After All

Much of what I have written here (especially recently) is somewhat negative. Although I'd like to be more positive about what's happening market-wise, economically, and politically (as it applies to economics and investing), I've found that looking at conditions in as realistic a fashion as possible is much more profitable and less risky when measured in years, as opposed to days, weeks and months.

But, I'm not saying the world, and certainly America, is coming to an end. Hard times – yeah, maybe. If you feel disheartened, here's what I'd like to say to you:

This is America. This is not an average country, and never has been. Having earned our freedom for us, our forebears provided us with, in my opinion, the unquestionably greatest country in the history of the Earth and, on balance, the greatest force for freedom and human dignity ever. Many of these tasks were performed for NO reward and at great cost to us. After taking our own country, we have purchased, not conquered any additional worldwide properties we own, like Alaska and Hawaii. After we free people, we don't take their property. The world is a much better place for America's existance as a country, in spite of our sometimes glaring faults. We are human, after all, so America will exhibit the mistakes and flaws of being run by people. But, it also exhibits the glory we sometimes show when the best of us comes through.

What's the point of this section? Simply this: What we're going through right now, while bad, is certainly NOT WWII, WWI, the Civil War, or the Great Depression. Some people will initially suffer as we figure out how to fix the problems we are dealing with, especially the ones brought on by our own

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government(s) as they try to control things they:

- don't understand and
- have no business or authority to control in the first place – at least constitutionally.

Eventually, our government will find the right path or WE, THE PEOPLE, WILL MAKE THEM. That is the ultimate secret to America's uniqueness and greatness – the government exists to serve us, not the other way around. If the power-grab by the government becomes too great, we have the God-given and constitutional right to throw them out.

We've gone through worse and come out better in the past. This is STILL America. We will prevail.

I wrote the above on the afternoon of 5/1/2011. President Obama announced that evening that 40 US Navy Seals killed Osama Bin Laden hiding in Pakistan, exacting justice on the 9/11 killer and once again sending a message to the world about the resolve and power of America and her people.

Why Inflation Isn't Worse

This is one of the "geeky" parts of this letter. John Mauldin's "Outside the Box" recently published an article entitled "Charles Plosser and the 50% Contraction in the Fed's Balance Sheet" by John Hussman. Here's the URL: http://www.johnmauldin.com/outsidethebox/charles-plosser-and-the-50-contraction-in-the-feds-balance-sheet.

If you're smarter than I am (a distinct possibility) and you've extensively studied economics and monetary theory, this may be a simple but informative read for you. If not, you should definitely read what I write below before tackling it. This is a brilliant, but tough read. For the record, I don't entirely believe his reference to the relationship between interest yields and liquidity preference because his evidence is purely statistical, rather than causal. However, his work on why the Fed can't increase interest rates without releasing inflation is the first satisfying explanation I've read that meets ***my*** standard of "proof" – supported by solid evidence, logical, causal, and predictive.

As regular readers know, I've been very confused by the massive increase in MO ***not*** being followed by proportionate increases in higher order money supplies and, as a result, massive amounts of inflation. Clearly, there has been inflation in commodity-heavy goods as well as precious metals (especially gold and silver, much to my chagrin), but inflation hasn't "taken hold" of virtually every part of the economy as I would have expected. Especially since the economy has begun a recovery, at least based upon some recent corporate profits and the government's assertion that "We are recovering. Too slowly, but we ARE recovering." Certainly, this assertion is debatable and there are questions regarding its sustainability, but we won't explore this further here, since I'm focusing on inflation.

In order to understand fully what follows, remember my "scale of justice" analogy regarding how inflation works. It's appeared multiple times in my newsletter over the years, but if for any reason, you don't know it or remember it and you want to understand, please call me and we'll go over the concepts.

The key point to remember when trying to understand why the multiplier effect has broken down for higher order money supplies is that the banks have all these money reserves, but they're holding them, most of the time beyond the amount needed to meet their statutory and contractual reserve requirements. Why? Risk, mostly. Banks are justifiably cautious about lending to any but the least risky customers, naturally wanting to defend their newly repaired balance sheets and loan portfolios. *Moreover, at 5/100ths of a percent interest per year, there is virtually no cost to holding these reserves.*

From my notes: "Once the Fed starts charging interest on funds, it becomes expensive to the banks. In order to reduce expense or make profits, banks will begin lending, therefore injecting money into the economy and increasing monetary velocity and the multiplier effect. As velocity increases, more money supply exists at each level. More money at each level without a proportional increase in output equals inflation."

So, if the Fed starts to charge interest, inflation would become rampant, perhaps even to the point of endangering the US$ viability as a currency, *much less the world's reserve currency*. In order to stave this off, the Fed would have to start recalling funds (reducing M0) in order to offset the effects from raising interest rates. According to Hussman, the relationship isn't linear. In order to raise the overnight Fed Funds rate to just 0.25%/year, M0 must drop to $1.92 trillion, down $630 billion (24.7%) from the 4/20/2011 M0 balance of $2.549 trillion. To arrive at a "normal" Fed Funds rate without inducing massive inflation would require reducing M0 to $1.2 trillion – over 52%! In other words, the Fed's policies of accommodation for the

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government's massive overspending in the 2000's (and before) has been to paint all of us into a corner:

- Can't raise interest rates without reducing M0 or introducing massive inflation
- Can't reduce M0 without (very) probably killing the nascent recovery and bringing on a worse recession than the one they tried to avoid with these policies.

Wow! Good thing Bernanke and Geithner were the best we had to run the Fed and the Treasury. Imagine what would have happened if we'd had *less qualified people* in these positions. Of course, that would *never* happen. The government makes sure the folks in those positions *will go along with its agendas*. Otherwise, they would never be nominated, much less confirmed. In fairness to Bernanke, Greenspan started this vicious ball to rolling big-time. But, Bernanke believed in that policy, so he carried on with the same zeal his predecessor did and he is not without his own blame.

The (deficit spending) piper had to be paid sometime. Looks like that time is now, for better or for worse.

What "Propping Up" the Consumer Since 2000 Has Done

Quick review:

- 2000: The "Tech Wreck," a massive market correction. The wealth effect from the 1990's gone. The Republicans continue to control Congress; George W Bush wins the Presidency.
- 2001: Continued market decline. Recession starts. "Bush tax cuts" passed. 9/11. Greenspan reduces Fed Funds rate from about 6 – 6.5% to 1.75%, finishing in Q1 2002. CJ Model invests in first Gold Miner – Homestake.
- 2002 – mid-2004: Fed continues lowering rates, ending at 1%. The distortions in both monetary growth and interest rates create booms in both the real estate market (planned) and precious metals (likely unplanned). The RE boom creates "artificial demand" for consumer products from folks taking cash out of their houses and from artificially boosting the construction industry. The CJ Model increases investments in gold and silver miners.
- 2004 – 2005: The Fed starts raising rates in order to stave off inflation. Bush Reelected.
- 2006: Bernanke becomes Fed Chairman. The Fed stops reporting M3, even though most of us live in that world. (Hmmm) The housing market and economy begin to decline. (Hmmm) The Democrats regain control of both houses of Congress.
- 2007 – 2008: The housing market declines and Bernanke openly states, "The damage appears contained." In mid-2007, the Fed begins reducing rates again, eventually ending between 0-0.25% in late 2008, where rates still are. Market begins large decline, along with an economic recession. Also in late 2008, the Fed begins quantitative easing. Obama elected; Democrats control both houses and the presidency.
- 2009 – 2010: Massive stimulus bill (almost $900 billion) passes in Washington. Market decline ends in 3/09; recession "ends" a couple of months later. Tea Party starts to show itself. Massive health care reform passed in early 2010. Tea party becomes major force in Republican Party. Republicans win 2010 election, assuming control of the House.
- 2011: QE2 begins.

The result of all these manipulations?

- The destruction of the US$:
  - US$X : 7/6/01 – 119.93
    4/29/11 – 72.93
  - Gold/Oz: 7/30/01 – 428.30
    4/29/11 – 1556.40
- Most other commodities up dramatically.
- A tripling or more of US government debt.
- Most major stock indices still below early 2000 peaks.
- Much greater unemployment than at the beginning of the 2000's.
- The consumer seriously hurt by the additional debt load from refinancing homes for disposable income when non-construction jobs were scarce.

For more details on the timeline and events, as well as the predictions of and bases for these results, see the 5/2008, 10/2008, and 10/10 *CJ Newsletters*.

Each time the government "propped up" the consumer, the government simply "kicked the can (our problems) down the road," making the eventual reckoning much more painful. As I said above, the piper has to be paid, eventually. Votes purchased with deficit spending enabled by the Fed's monetary policies put us in this place. Only the pain of the government getting "honest" and admitting this system won't work will get us out. It will be painful fixing this, as it was in the early 1980's, but the results will be equally good if we can keep the government from using inflation to finance expenditures for which they are too cowardly to collect taxes fairly and honestly.

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