The CJ Investment Newsletter

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Reasons Why the US Economy is Stuck

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

- Q3 2011 was not good for the markets. All my benchmark indices are negative for 2011. The *CJ Model* is now outperforming them YTD. See page 4.
- We discuss reasons some markets and economies many not be recovering as quickly as perhaps they could.
- The TCM website now has a blog page called "Current Takes." Please visit it for updates and thoughts/events of note between *CJ Newsletter* publishings. Also, please provide feedback. Thanks.

Money and Economic Exchange

Reviewing a few concepts could be helpful in understanding this discussion:

- *Wealth* is anything owned that has economic value.
- *Capital* is a subset of wealth. It would generally not include consumer goods, except when those goods can be used in the production of other consumer goods.
- *Money* is a medium of exchange that is also a storehouse of economic value. The value of money can change based upon which type of money is addressed and the circumstances involved. There are two basic types of money:

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"There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million can diagnose."

\- Lord John Maynard Keynes

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- *Specie* is money that consists of something that has intrinsic value. The most common forms of specie throughout history are metallic coins or bars, generally made of gold or silver. Historic examples of nonmetallic specie include sea shells, beads, cigarettes and tea (in pressed block form).
- *Fiat money* is money that is not made up of something of intrinsic value. Most commonly, this occurs as paper and/or cloth money. It is declared to have value by government *fiat* (edict).

Actually, there is a hybrid form of these two types that has existed historically. It is paper/cloth money that represents (was backed by) a specific amount of specie held by the issuer and that the holder could redeem for the specie by presenting it to the issuer. The US$ started this way. This type of money is issued for convenience and portability, both of which ease the burden of using specie for large transactions and therfore make commerce a little easier to transact. I am unaware of any *major* currency of this type in the world today.

Money's value as a medium of exchange comes into play when we discuss *arms-length economic transactions*. Such transactions occur between two unrelated (arms-length) parties negotiating an economic exchange. If such an exchange is executed successfully, *both parties* should feel they have improved their economic position through the exchange. This isn't hard to imagine. The farmer who just harvested his wheat almost always has more than enough wheat; what he/she wants to do is to exchange his/her wheat in excess of what he/she needs for some period (savings) for other goods or services he/she needs.

Money provides a medium to make economic exchanges simpler, faster and more precise than bartering. Therefore, it facilitates (lubricates) an economy so that it can provide and distribute goods and services to the participants and allows it to grow larger and more efficient that it otherwise could. There is one huge caveat, however: *if all participants in an exchange do not know the real value of the money at the time of the exchange, one or more participants may not achieve the improvement in their economic condition that they thought.* This almost always works to the detriment of the participants and the economy itself, if the problem is systemic.

Please reread the last paragraph. It is critical to understanding what follows.

Valuing Fiat Currencies

Specie money changes value only as the value of the underlying material(s) change. Specie changes value slowly, if at all.

Fiat money is valued *indirectly* by measuring what it can purchase at a given point in time. Unlike specie, fiat money changes value almost constantly. This is primarily because of governmental manipulation of the money supply and with it, interest rates.

Imagine an old-style weighing scale, like the scales of justice. At the end of year zero, all the goods and services of an economy are in one basket, the total of a particular money supply measure is in the other, and it equals $10 million. By definition, they must balance. Assume the same conditions at the end of year one, except the central bank has lowered the overnight interest rate charged to borrow by increasing the size of the money supply by 10%, or a total of $11 million. The baskets on both sides of the scale wobble as the additional money is absorbed into the economy, but eventually come to rest in balance.

This scenario poses a difficult question: if the amount of goods and services are exactly the same for each year, yet the size of the economy in year zero is $10 million and the same economy the next year is $11 million, how can this be? Because the value of the money in year one is 9% less per unit than the money in year zero. The economy hasn't changed, *the value of the money has*. If the value of money becomes less, it is called *inflation* (because the money supply itself was inflated). The reverse can also happen. Fiat money can become more valuable by reducing the money supply. That is called *deflation*.

Such things can only happen in a fiat money system when a governing agency, generally a central bank, manipulates interest rates or enables the government to do deficit spending through manipulating the size of the money supply, which then changes the value of the currency units themselves.

What Causes the Trade Cycle

Friedrich Hayek won the Nobel Economics Prize by fleshing out the Austrian theory of the Trade (Business) Cycle. The trade cycle is a repeating cycle whereby a capitalistic economy undergoes a period of expansion (boom) that eventually changes to a period of contraction (bust, depression, recession).

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The *uncomplicated* version of Hayek's Austrian Theory of the Trade Cycle:

- The cost of using (borrowing) money is the interest rate for the period in which the money is borrowed. According to this theory, each period has a "natural" rate of interest that would be the market rate in the absence of outside intervention.
- Economic decisions regarding new business projects (including entire new businesses) use the market interest rate as one of the critical factors in determining if the project will be *economic* – that is, viable and profitable.
- When a central bank manipulates the market rate of interest downward through increasing the money supply, the market rate of interest becomes lower than the "natural" rate of interest. This causes uneconomic projects to *appear* economic and, therefore, implemented.
- The economy *expands* as capital is deployed to implement both the actually economic and apparently economic projects. This increases employment and demand for goods and services due to the increased earnings of the participants.
- Since the apparently economic projects are not actually economic, eventually they must fail, but not all at once. Capital and jobs are lost.
- If the central bank has not returned the market rate of interest to the natural rate, there will be a continuation of the adoption of both economic and apparently economic projects.
- Eventually, enough uneconomic projects fail and enough capital is destroyed that a "tipping point" is reached and the economy moves from expansion to contraction (recession). This assumes the central bank doesn't "double down" by lowering the interest rate even further, making the problem worse by making even more uneconomic projects appear economic. If the central bank doubles down, the expansion may or may not carry forward a little longer.
- The economy finally feels the full effects of the recession, which is somewhat dependent on the amount of capital destroyed. When most of the capital that can be recovered is recovered and a sufficient amount of time passes, entrepreneurs and other businesspeople will begin taking risks and deploying capital on new business projects.
- If the right conditions exist, the economy may begin an "organic" recovery (my term) not fueled by the distortion of interest rates by the Fed.

Observations:

- The contraction phase is where an economy actually gets healthy. Like having a cold, you get sicker until you begin manifesting symptoms. Those symptoms are your body's immune and defense mechanisms curing you. The recession is the phase under which the "disease" is "cured."
- Pundits, politicians and (some) economists (especially Keynesians and post-Keynesians) consider the trade cycle a "natural part of capitalism." Austrians believe it doesn't happen without an activist central banking system. Make up your own minds.

What Changing the Value of Money Does

Hayek's theory discusses the distortion of the economy because of an artificially low cost of money. What about the capital lost from losses incurred by participants (especially producers) from mispricing products and services due to a decline in the value of the currency involved in the transactions?

Among the calculations done for continuing business and new projects are profitability calculations involving the sale of goods and services – both new and on a continuing basis. Making a profit is difficult enough in a fair and relatively unchanging economy. *Introducing more hard-to-quantify variables into the price and cost structure of a business increases the risk of loss – sometimes dramatically*.

Imagine complicating that with a currency changing value that might go unnoticed and with a market rate of interest that is dramatically below anything that may resemble a natural rate of interest. Do you think it might be daunting to try to calculate a competitive price that allows your business to make enough profits to survive, let alone thrive or expand, creating jobs?

Markets hate uncertainty. By now, the reason should be obvious. What about introducing unknown costs from legal and regulatory changes that are as yet unquantified and may be unquantifiable for the foreseeable future? Healthcare? Taxes? New regulatory costs? How the heck do you make sure your company survives?

Is it surprising in such an unfriendly environment that people and companies will hoard cash, spend less and not hire or start new projects? Isn't it *responsible* to "stand pat" until you can see a path to survival, let alone profitability? The government's baby steps to encourage business expansion are outweighed by the additional difficulties and uncertainties they're made businesses deal with currently. When governments screw up, they collect more taxes to make up the loss; *businesses go under*. Remember that as you listen to politicians criticize our businesses, not realizing their policies are part of the problem, not the solution.

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