The CJ Investment Newsletter

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Steroids & Soft Walls

Purpose

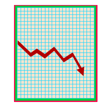
The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement 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
?	

- What happens if you've used steroids to improve your performance and now you have to stop taking them to live?
- What are the unintended consequences of trying to provide a little extra protection?

I was recently discussing with a non-client friend (whose opinion I respect) portfolio protection strategies in difficult markets, which, of course, I consider this one.

I was speaking about how I don't trust this market because the rise in the market has been (in my humble opinion) almost entirely due to machinations by the federal government and the Fed (Federal Reserve Bank). I've dealth with this in the last year or two in the *CJ Newsletters*, so I won't get too repetitive here. However, I would refer you to the last two *CJ's*, for more explanation of what the government has done and what the effects of those actions actually appear to be to me.

I might add, if you're not taking care of yourself, it doesn't mean the Doctor is wrong when he warns you that acting as you are could kill you. So it is with dangerous economic behaviors. Just

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"Never underestimate the difficulty of changing false beliefs by facts."
- Henry Rosovsky, *The University: An Owner's Manual* (New York: W. W. Norton, 1990), p. 259.

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because it hasn't happened yet doesn't mean it won't happen. Cause eventually leads to effect, even if takes a frustratingly long time. Reminds me of an old Wall Street joke: "What do you call being early on Wall Street?" Answer: "Wrong."

Steroids

In the short-term, anabolic steroids can nearly work miracles, sometimes saving patient lives that might not otherwise be saved. Using anabolic steroids can increase the strength, size, coordination and other desirable characteristics of users. High dosage and/or long-term usage (abuse), however, can bring on severe, perhaps even life-threatening, problems. As if that wasn't enough, *most of the positive effects of the steroids only last as long as the user continues to take the steroids.*

As I've described for many months in the *CJ Newsletters*, the government, through deficit spending enabled by the Fed, and the Fed directly through money supply increases have been trying to "fix" the broken economy by using the same techniques that broke the economy in the first place. Of course, they *believe* (through Keynesian and Monetarist thinking) that they are doing the things that actually will fix the economy. I've discussed the differences between Austrian economics and Keynesian (including Monetarist) economics dozens of times. We won't revisit that here in any depth.

Suffice it to say that I believe their actions are akin to putting the economy on steroids. For a while it seems great (growth, etc.), but eventually the side effects can become serious enough to endanger the life of the abuser. Hard to believe people as smart as Greenspan, Bernanke *et. al.* can continue to believe in these theories in the face of the overwhelming evidence to the contrary. And, if they stop, stimulating the economy before it is actually self-sustaining, most or all of the benefits of the stimulus disappear. *Therefore, going off the "steroids" becomes very problematic for the politicians and the Fed.*

To carry this analogy to its conclusion, the enormous edifice of debt created by the (unholy) collaboration of the government and the Fed are not benign at this level and for this long (3x the monetary base over the last 3+ years). *In fact, like steroid abuse, the side effects from continuing usage are actually endangering the life of the economy.* Despite politicians' self-serving statements, the economy's health has not improved in any meaningful fashion since the fall of 2008, when the Fed began this dangerous course.

But, look at the bright side: we have managed to add 50% more to the national debt since the Fed began loosening monetary policy beyond all historical norms while not really helping the economy become self-sustaining. Of course, the stimulus plan of 2009 and massive deficit spending by our government since then has helped make the debt much larger, again without really healing the economy.

Some in the House and Senate are aware of this and propose plans that would actually begin to heal the economy. Perhaps the most famous would be the Pauls (father Rep. Ron Paul and son Sen. Rand Paul, named after Ayn Rand) and Rep Paul Ryan of Wisconsin.

They, along with their allies, face a difficult fight, however. FDR began using the US education system to indoctrinate citizens with Keynesian economic theory in the 1930's. They stopped teaching all of the (then legacy) economic theory founded by Adam Smith and continued by David Ricardo (early 1800's), Fredric Bastiat (mid 1800's), Carl Menger (late 1800's), and Ludwig von Mises (early to mid 1900's), to name just a few. I've explained why in past *CJ Newsletters*. But, it boils down to this: *governmental power and control*. Keynesianism allows for governmental control; previous economic theory was adamant that governmental interference would only damage the economy.

To paraphrase Reagan, "It's not that our friends on the other side don't know anything; it's just that so much of what they know isn't true."

So, the folks who may actually be able to fix the problem face:

- having to overcome the economic "knowledge" we were taught in high school and college to convince us of what we should do
- convincing the public to endure the economic *pain* necessary to actually go off the steroids and heal.

What a herculean task!

An average politician would most likely think this way: "Just follow the crowd, do more deficit spending to buy some votes, stay in power, have the Fed increase the money supply and kick the can down the road. Let someone *else* deal with the hard stuff. *I* want to be popular and reelected. *Nobody* understands any of this stuff anyway."

That's why I don't trust the rally since 2009.

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Soft Walls

As I alluded to earlier, a friend of mine brought up a very interesting story that has direct application to investing behavior.

At the Kansas Speedway, the turns were originally constructed with concrete or some similarly hard and durable substance. At some point, someone determined that the walls' construction was perhaps exacerbating the damage and injuries caused when the drivers collided with the walls. The problem was researched. It was decided that perhaps if the walls were "softened" with padding or other substances, that perhaps some of the injuries would be less severe, maybe even saving lives. So, those in control proceeded to make the previously hard walls into "soft walls" to help protect the drivers.

What was the net result of this change? Surprisingly (to me at least), the racers reacted by driving around the walls *faster than they did previously*. Of course, it would be hard to quantify, but the behavioral change by the drivers certainly negated (to some extent) the good intentions of the managers of the track to mitigate the damage from *collisions by making collisions more likely due to driving at higher average speeds through the relevant sections of the track*. The drivers were counting on the "soft walls" protecting them, so they deliberately increased their speeds, and, therefore, the likelihood of the collisions happening!

This is *not* a singular incidence of this type of behavior. Apparently, people in all kinds of activities react in a similar fashion when protective safeguards are built into virtually *any* dangerous behavior. *Including, it seems, taking investment risks*. In fact, you could assert that this is the very definition of *moral hazard*. From Wikipedia: "In economic theory, **moral hazard** is a tendency to take undue risks because the costs are not borne by the party taking the risk."

Contrary to what we (and the government) might wish would happen as a result of the government providing "soft walls" to prevent major capital and economic disasters, mitigating devices such as "bailouts," TARP programs, or other such things end up having *the net effect of creating additional risk taking in investing behaviors*.

Let's restate this in no uncertain terms: *If the government tries to mitigate economic or investment risk through having taxpayers take on (pay for) some or all of the risk through protective government actions, **the risk is not mitigated because the participants** count on the government protections and **take on even more risk, effectively negating the protective government actions***.

Therefore, the good intentions of the government effectively *socialize* the risk. Should those risks be realized, taxpayers who would not have taken those risks pay at least some of the costs for the participants who did. Yet, any profits arising from such behavior remain private (albeit taxed). Wow.

Let's not be victims and pretend the government doesn't already know all this; we're not breaking new ground here. The question remains: why does the government do what they do anyway, knowing all this? Why did the administration bail out (the unions of) GM and Chrysler? The cynic in me says, "Votes. Millions of union votes." The logician in me says, "There's no good reason." The realist in me says, "Votes. Paid for by the people that have more money than they do votes." Doesn't exactly evoke images of George Washington, Thomas Jefferson and John Adams, does it? Wait. Maybe that *last* part was the cynic…

Last Minute Market Thoughts

Because of the re-write done on this month's *CJ Newsletter*, the date of this writing is actually 4/4/2012. That gives us a few extra days of insight.

The market has been down the last two days as measured by the DJI and SPX. A complex "top" is forming in both indices. Similar action was seen in other broad indices. Will my expected decline occur now? Conditions are favorable, but they have been for some time and the rally since 2009 hasn't failed yet.

Gold the metal broke through its $1640 support level, finishing down $50/oz to around $1620. If gold doesn't rally above $1640 tomorrow or Friday, I'd consider the support at $1640 broken. There is no further downside support I see until the $1460 level - $180 further down. The $1460 support is gold's second strongest support level. Silver was down 2.22 to $31.04/oz and is clearly weaker than gold here. I see no support for silver before $24.40. That's silver's strongest support level.

The decline in gold and silver are reasonable as selloffs in stocks create additional demand for US$ from market makers settling with an excess of sellers. As demand for US$ increases, commodities become cheaper in $US. The same action happened in 2008-9.