The CJ Investment Newsletter

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Thoughts about 2012

Purpose

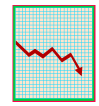
The *CJ Investment Newsletter* deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement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

- 2012 – The Economy, the Election & a New Nash Equilibrium (?)
- 2012 – The Markets (Hint: Bear)

2012 – The Economy, the Election & a New Nash Equilibrium (?)

Before I start, I'd like to say I'm sorry; this will be somewhat negative. The economy in 2012, according to my assessment of the conditions, should worsen from 2011. There's many reasons why I believe this, but I'll try to focus on the big picture. If you want more details, stats or theory, please call me and we'll discuss.

An overarching problem with the economy is the good possibility of a new Nash Equilibrium (NE) in place in our economy. You may recall my discussion of the NE. The original (longer) article appeared in the 6/2006 *CJ Newsletter*. The *Kansas City Star* liked the article and asked me to write a 600-word version of it, which appeared in their 6/27/2006 edition.

John Nash, a famous mathematician, was the subject of the movie "A Beautiful Mind." He first conceived of and described the NE as a part of game theory.

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Here's a basic biology principle governments should keep in mind: *Successful parasites don't kill their hosts*. As much as they refuse to admit it, they need us more than we need them. We pay for all they do and for their very existence. What if we choose to stop?

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Essentially, an NE occurs in a multiplayer game environment where the players find themselves in positions such that any move an individual player would make would only work to his detriment. All the other players are in the same position, so none of the game parameters is changed by the players. The players are "stuck" in their current positions, as they are unwilling to lose ground and unable to gain any.

Full disclosure: I didn't make the association of the NE with an economy back in 2006. I read about it in an article written by the brilliant Stephen Roach, a deservedly famous market analyst and strategist.

The 10/2011 CJ was entitled "Reasons Why the US Economy is Stuck." It dealt with the federal government's interference with both the *cost* of money (interest) and the *value* of the money itself. Both of these distortions make economic decision-making even harder than it is already is, causing improper cost and revenue calculations and creating excess economic losses, just at the time where the economy needs to create, rather than destroy, capital in order to recover.

It recently occurred to me that perhaps another reason the economy is unable to begin a serious expansion is that the Keynesian structure created by the unholy duo of the Washington pols and the Fed, combined with human nature, may have created a new NE. The structure primarily consists of:

- Excessive governmental (called "national") debt from massive federal deficit spending enabled by
- A complicit Fed since Alan Greenspan took over in the 1980's, followed in lockstep by Ben Bernanke. Their cooperation has
- Lowered interest rates WAY below the "natural" rate of interest, to about 0.25% for the overnight rate, tripling the Fed's already bloated balance sheet and monetizing vast amounts of federal debt – the lion's share since 2008!

Over the years, I've discussed many aspects of how these actions have distorted the economy and the markets – to our detriment. We won't revisit them this month. Suffice it to say that it hurts our economy and our citizens' prosperity much more than it helps.

But, we find ourselves in a spot where many realize these Keynesian "solutions" are not working and it certainly seems doubtful they will if they haven't started to "take." Conditions are actually worsening.

In an election year such as 2012, with a faltering economy, following in the footsteps of the failing economies of Europe, one would expect politicians to be working together feverishly to repair the economy, or at least show the potential for major improvement, by the time the elections occur in November. Yet they aren't. Why?

Here's where the NE comes in: Because, if either group (or both together) actually succeeds in getting the changes needed put in place, the short term reaction of the economy would be negative before turning positive in ensuing months and years. This would alienate voters, costing the "brave" politicians (a non-sequitur, I admit) their seats in the November elections. The pols and the Fed are terrified to remove the massive stimuli already in the economy, fearing the further manifestation of its sickness prior to beginning to heal, if they even believe it would heal at all – especially in an election year. It's more like using chemotherapy than antibiotic therapy.

Additionally, if they even discuss such courses of action, the "true believers" in Keynesianism and the voters who simply benefitted from the policies would likely vote the pols out who "betrayed" them. Not to mention that, for some reason, most of the pols in this country refuse to admit to mistakes, fearing excoriation by the press and fearing not being reelected. So all the players are punished for making any kind of move that could actually help. An NE.

Sadly, it's worse than an NE, because it's *not* equilibrium. The steps the government and the Fed have taken since FDR (with a short break in the early Reagan years) will continue to make the economy *worse* until the federal government actually does the right thing, we MAKE them do the right thing or the economy collapses into a state much worse than this.

It's truly hilarious to listen to people (especially pols and pundits) assert their disapproval of what's happening in Europe and act like it couldn't happen in America. It could. It is. The difference: we're not at the point of no return – ***yet***. We can stop it. But, most folks may not have the knowledge of how economies really work, nor citizens the collective will to demand what we actually deserve from our governments: Equal Opportunity, not Equal Results. Freedom. For the governments to stop playing with things they don't understand – like the economy. Finally, to stop taxing some citizens to buy benefits (and votes) from other citizens using the "cloak of altruism."

If you don't believe this is what's happening, please tell me how our situation is dramatically different

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from Greece, who overspent on government benefits, running up such a large debt they can NEVER repay it – period. The people holding Greek debt will suffer huge losses. If you think the US has acted differently, I have five words for you: California, Illinois, Massachusetts, New York. The US federal debt is also up $9.5 trillion since 2000; $5.5 trillion during Bush's 8 years, $4 trillion in Obama's 3 years, for a total of $15 trillion – three times what it was in 2000.

If something doesn't change soon, our economy, and perhaps the US$ itself (depending on how it plays out), will collapse.

2012 – The Markets

Surprisingly, while I think the US markets will decline eventually, 2012 may experience a market and economic bump early in 2012 because the problems in the EU are so bad, the US market and the US$ look good by comparison. Certainly the US$ has shown more strength that it probably would have were the Euro not so weak. However, this will not fix our economic problems in the US, nor should we expect this situation to buoy us for any significant period.

A smart government, knowing they've been given a reprieve of sorts, might use the extra time to take more steps to shore up the economy. Decide for yourself if you think that's going to happen.

2011 was an unusual year. Some examples:
- The DJI was up 5.53%
- The SPX was flat – almost perfectly
- The COMP was down 0.58%
- The Russell 2000 was down 5.84%
- Gold was up 9.3% for the year, closing at $1566.80, but was *down* 17.4% from its 8/22 closing high of 1897.40, retracing 81.3% of the move begun in early July.

The indices were demonstrating almost perfect "generals and soldiers" behavior. In a bear market, the soldiers are the first to fall, then succeeding ranks fall, finally ending with the fall of the "generals." Certainly, the indices of smaller stocks seem to be falling. Accounting for close to 20% of our entire GNP, the 30 DJI stocks certainly qualify as "generals" and the DJI was up for the year. This behavior is more consistent with bear markets that are crumbling underneath than markets leveling out for a bull run.

Most indices are up since their Q3/Q4 bottoms, but given the overwhelming weakness in the EU, that shouldn't be considered surprising as foreign capital finds markets in the US that are working better – at least for the time being. Let's not ignore the precipitous market declines that happened in late July and early August last year either. Those declines have not yet been recovered.

My proprietary *CJC Indicator* is not suggesting great strength at this time, nor much "lift" going forward for the major US stock indices. I think it's "safe" to say that recent market strength represents an influx of foreign capital looking for a better chance of profits than in their home markets.

I'd love to discuss China here, but information coming from China is both difficult to obtain and manipulated by the Chinese government. It's not reliable enough for me to opine on it. However, it's easy to find other opinions on both sides regarding China's near-term future prospects. One comment: if, in fact, they are experiencing significant problems (as many believe) and they need capital to deal with them, what happens to the US$ if they start selling their $1 trillion plus reserves into the world markets to obtain that capital?

A word about gold. I was worried about having missed a buying opportunity in gold of some sort for clients and I by the late summer, early fall of 2011. After all, it was up over 30% YTD at that time! It made an almost vertical climb from about $1500/oz to almost $1900/oz from July 1 through late August. Still, gold is ***not*** a tech stock in the late 1990's. This behavior seemed more consistent with a "blow-off" (speculative) top, so I stayed out. Considering gold's subsequent decline, that seems like a good decision.

It's useful to keep in mind the definition of a bull market, as documented in Bull's Eye Investing by John Mauldin: Bull markets are defined by the *expansion* of the P/E ratio. Therefore, bear markets are defined by the *contraction* of the P/E ratio. Other factors change, but these remain constant and necessary. This also dovetails into why Marshallian K theory works sometimes in bad economies, provided a Fed monetary injection is done. (Call me on that one.)

I am not at all convinced the majority of investors are willing to "pay up" (expand the P/E ratio) on a continuing basis for stocks trying to make and/or expand profits in such a low interest, low growth, high unemployment economy such as this. Such behavior would normally be considered speculative. Until conditions allow for a sustainable improvement in the economy, it's hard for me to imagine investment capital entering the markets in sufficient amounts to set a market bottom and begin a new bull market.