The CJ Investment Newsletter

Callom B. Jones, V — Investment Adviser Representative

September, 2012 — *One Hundred Seventy Seventh Issue*

The Nominal Versus the Actual

Purpose

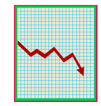
The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement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

- I believe this is a very important letter! While the subject may be dry, some of what is discussed directly affects your quality of life.
- *In order to deal with the current investing and economic environment, you need to understand the difference between the nominal (presented) and actual (real) value of money.*
- The mini-lesson returns after a multi-year hiatus! In it, we discuss the amount of money (money supply) versus its actual value, including inflation and deflation, forces which change money's value. Different aspects of this have been discussed before in previous *CJ Newsletters*, but I hope to pull these ideas into a coherent whole herein.
- I believe the government's actions, enabled by and along with bad Fed policy, is why markets are so chaotic since the last correction in 2008-09. The creation of so much money by the Fed has distorted financial markets to the point that *price determination* (a primary market function) is virtually crippled.

When asked, Alan Greenspan, former Fed Chairman, answered with a straight face that he didn't understand how people could worry about the US being unable to pay its

(Continued on page 3)

> "There is only one difference between a bad economist and a good one: the bad economist confines himself to the *visible* effect; the good economist takes into account both the effect that can be seen and those effects that must be *foreseen*."
>
> \- Frederic Bastiat, 1850

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

Mini Lesson: Capital, Money Supply, Inflation and the Financial Markets

Let's distinguish the difference between capital and money. *Capital* is wealth created through saving or from creating something new and useful. *Fiat money* (money by government edict) is nothing but a medium of exchange. Remember that fiat money only *measures* wealth; it is not equal to it. Wealth is houses, buildings, clothes, food, cars, computers, *etc*.

While not technically required, the economic definition implies the presence of a central banking system. In the US, we call this central bank the Federal Reserve Bank, or, more simply, the Fed. To my knowledge, no economist has ever *proven*, logically or factually, that a central banking system is either necessary or even the best way of dealing with an economy's money.

The framers were, almost to a man, against the notion of paper money as we have it today. When Hamilton argued that the government should create a central bank, Jefferson was alarmed and aware that such a system would break down the guards on federal power in the Constitution. The founders opted instead for money with intrinsic value, such as gold or silver, also known as *specie*. *The key point is that money, at that time, was not just a medium of exchange; it also had its own intrinsic value recognized by virtually everyone*.

Why would the government decide to use paper money and create an institution such as the Fed? Two major reasons why any government would want this *power* are:

- It makes it much easier structurally for government to finance its activities through *deficit spending*, instead of having to collect honest taxes (and deal with the voter backlash) to pay for its spending.
- It allows a government to manipulate (*control*), however crudely, the economy.

Key government words: *power* and *control*.

Deficit spending, enabled by the Fed creating US$ to purchase federal debt, is what robs wealth from the populace by creating *inflation*. To understand inflation and deflation, imagine balance scales, such as the scales of justice. In one basket is the "value" of the economy – goods and services. In the other basket is the money supply. *By axiom, the scales must balance over the long term*. Now, imagine the Fed adds money to the money supply, which doesn't change the wealth on the other side. What happens? No wealth was created, only additional measuring units (US$). Still, axiomatically, the sides *must* balance. So, the *nominal* cost of the wealth in the other side of the scale goes up – that's *inflation*. Conversely, if the money supply is reduced, when the sides rebalance, the *nominal* cost of the wealth goes down – that's *deflation*.

Note that the *actual* wealth (capital) never changed – only the measuring units did. That's why *inflation and deflation are purely monetary phenomena*. Incidentally, someone attempting to deceive could falsely call an inflationary increase *economic growth.*

Keep in mind that *we can only measure the economy indirectly through its own monetary units.* Therefore, we're trying to measure the changes in an economy with the same units with which we wish to vary with its size. This circularity creates many difficulties, not the least of which is accuracy. Knowing this, we can posit the following: ***Changes in inflation or deflation can be present in an economy without being detected via measurement statistics.***

Marshallian K theory states that as long as there is more money than the economy needs, the excess will migrate into financial assets. K theory also works in reverse. Therefore, detection of changes due to inflation could be further delayed for long periods, as the excess money supply would be expressed as higher prices in the financial markets. How can you tell if you are looking at asset inflation or a proper rise in stock prices due to increased wealth? A topic for another article.

At a common sense level, the government creating dollars with no real wealth to back them up is not functionally different from counterfeiting. Remember, the Constitution does not allow for a central bank or the creation of dollars as we now allow it.

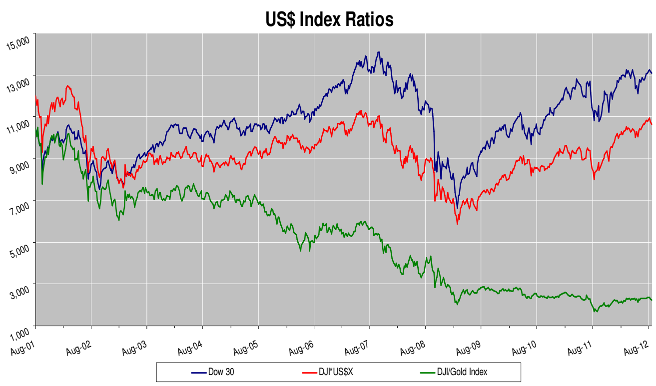
Additionally, the business or trade cycle *is caused by* the lowered interest rate that happens along with the increase in the money supply without backing the new money with real wealth. The cheap interest rate (cost of money) fools businesspeople into undertaking uneconomical projects (malinvestments). This happens during the boom portion of the cycle, in fact is responsible for part of the boom itself. However, when the sponsors realize the projects are uneconomic, they shut down the nonviable projects and valuable capital is lost. When enough of this happens, the economy contracts, creating the bust portion of the cycle.

Price distortions through Fed created inflation and deflation alter market activities, including hampering or preventing proper *price determination*, a primary market function. It is unconstitutional. It is immoral. It is there because politicians are more short-term afraid of losing voters than they are of the long-term consequences of not levying honest taxes for America and its citizens. *Only we, as informed voters, can stop these devastating behaviors from continuing*.

(Continued from page 1)
debts because, after all, we could always just *print the money to pay off the debts*.

As Harry Shearer says, "Pardon me for thinking clearly, but…" isn't that a little like borrowing 100 gold coins, cutting out ¼ of each coin, returning them to the creditor and considering the debt paid? If you're repaying debts with inflated (less valuable) dollars, are you really repaying the debt? Or, are you stealing from the lender?

Please review this chart:



It's hard to read, but here's what you need to know:

- The blue line is the DJI as reported by Dow Jones
- The red line is the DJI restated for movements in the US$ Index
- The green line is the DJI restated for the change in the price of gold since 8/13/2001
- DJI on 8/31/2012 (the nominal DJI): 13090.84
- DJI/US$I on 8/31/12: 10631.07
- DJI/CJ Gold Index on 8/31/12: **2240.24**

Consider that the *value* of an ounce of gold has not changed in real terms since 8/13/2001 because neither the demand nor the supply curves have demonstrated significant market changes since then. There has been no major new use for gold, which would increase demand. There has also been no significant change in worldwide supply such as a major new supply opening up or the exhaustion of major sources of the ore. Logically, then, the likelihood of gold's *intrinsic (actual) value* having changed is very low. Therefore, the *increase in price of gold is reflective of the change in value of the US$,* not a change in equilibrium price generated by supply and/or demand factors.

It's critically important to understand and believe that there has been almost no reason for the actual value of gold to change since 2001 intrinsic to gold itself or to supply and demand forces.

While the *nominal* (unadjusted) value of the DJI moved from 10416.25 on 8/13/2001 to 13090.84 on 8/31/2012, the *actual* value (adjusted for the change in value of the US$) of the DJI diminished to 2240.24 on 8/31/2012, *based upon the value of 2001 US$'s. Perhaps put more simply, if you consider the 2001 US$ to be worth $1*, ***the value of a 2012 US$ is 17.2 cents, or roughly 17% of a 2001 US$ - an 83% decrease in 11 years! Of the remaining 31.1% (2001) value on 2/1/2009, 45% has been lost in 3 years and seven months, or about 14% of the total 83% loss since 2001.*** (31.1% x 45% = 13.995%, or about 14%)

I'm aware you may not accept my analysis because it seems unbelievable. After all, we've been told for years *by the same government causing this to happen* that inflation is "low" or "controlled." Using only the amounts reported in or derived from *nominal* US$, my analysis would not appear to be true. Remember this from the Mini-Lesson above? ***Changes in inflation or deflation can be present in an economy without being detected via measurement statistics.***

Further, there will be some inaccuracy in using the price changes in any *one* economic item as price changes occur due to supply and demand changes, as well as inflation and deflation based changes. Still, I believe gold is the purest and most representative of US$ value changes, due to the reasons described above and because gold (and to some degree, silver) is still considered the only "real" money by *billions* of people, including many millions in America.

But, even if my estimated change in value is off dramatically – say 50% - would you be any less alarmed to think the US$ has lost "only" 41.5% in 11 years versus 83%? Does "only" a 41.5% destruction of the saved capital in a US$ since 8/2001 mean there's no problem? If you think there's no problem, be sure to vote for more of the same this November.

Finally, rapid inflation and/or deflation of the money supply hampers market efficiencies, compared to lower, more predictable inflation or no inflation at all. Such market inefficiencies can cause capital losses by themselves. When efficiency losses are added to capital losses from malinvestments, an economy can be tipped into recession or an existing recession exacerbated and/or protracted. Such conditions also make fundamental and technical analysis more difficult and less accurate, increasing risk and inhibiting needed investment activity. Sound familiar? The Fed should reconsider its strategy, tactics and responsibilities. Better yet, let's return to the gold standard or at least responsible no-deficit governance.