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The CJ Investment Newsletter

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The Liquidity Monster

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**
?	?

- "Just because something is inevitable does not mean it is imminent." I wish I knew who to credit with this great quote. It is quite germane to our topics this month.
- Wisdom from Jim Grant.
- Action plan update.

Jim Grant's Pizza Wisdom

Sometimes, CNBC has some of the great living investment minds on for interviews, even asking them to opine about various current subjects of interest. When I notice such an interview about to occur, I turn the sound on and listen to what the interviewee has to say.

On 3/21/2013, I happened to be lucky enough to see the stunningly brilliant Jim Grant, publisher of *Grant's Interest Rate Observer*, interviewed by Maria Bartiromo. Early in the interview, Ms. Bartiromo was discussing how many believe Bernanke's Fed and its policies had been keeping the economy afloat, no inflation, etc. Grant, of course, disagrees and foresees disaster in the end from Bernanke's Fed policies, much as I have written (*ad nauseum*, I'm sure to a lot of you) in the *CJ Newsletter*. As does virtually any person who believes in at least stable, if not hard, money believes.

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Here are some of Grant's notable quotes from the initial part of the interview:

"This so-called recovery has been painfully and, in a very un-American way, drawn out, undynamic and, to people who are looking for a job, downright cruel. And the Fed insists that for reasons of economics as well as humanity, it will insist on continuing to do what has not worked.

"This is the greatest and most perilous experiment in the history of paper money. Every central bank in the world is doing approximately what the Fed is doing. Every central banker in the world of any consequence thinks what Chairman Bernanke thinks. They all have the same model, the same outlook, the same conceit about what they can know. The people who run the Fed did not see the most obvious and disastrous excesses of credit in residential real estate when they were struck between the eyes with these excesses.

"This will end in immense inflation, in immense destruction of wealth. When? I certainly don't know, but that is certainly, I think, I think, the outcome."

As a way of explaining why, Grant came up with a much better common-sense example than I ever have of what printing money as the Fed has for at least 30+ years does:

Grant: "If you have a pizza and you divide it, not into 12 pieces, but into 36, is anyone going to be happier? Will there be more food on the table? What we are led to believe about money is that more money is more better. The more they print, the more wealthy we become, but if it were that simple, Maria… (interrupted)"

Bartiromo: "But there's only one pie."

Grant: "No, there's not. The pie is, at least in the context of American dynamism, in the context of enterprise, the pie wonderfully grows. That is the fruit of enterprise. What we are seeing is the suppression of enterprise through the manipulation of markets.

"The market is going to have the last word. The Fed is in the business of suppressing prices and manipulating prices. It's in the business of price control. The Fed won't say that. But, that truly is what it's about. And, I say, that markets will have the last word. That prices will finally escape from this prison into which the Fed has thrust them."

Some closing Grant quotes from this great interview:

Regarding what to invest in now:
"In any market, there is likely to be something mispriced, right? Even in this market, which has doubled and more than doubled, there are occasional opportunities. I think the thing to do as investor is to search for compelling absolute value. It's not so easy to find. Certainly, in the bond market, I think it's altogether absent. I think that gold mining shares, which are almost universally despised, represent a call on the surviving monetary asset. That is one area of compelling absolute value."

Regarding the Fed and the results of its policies:
"(It all comes back to the Fed) until people rebel against the Fed. They rebelled against the Fed in the late 70's, don't forget. G. William Miller, then Chairman of the Federal Reserve, had this idea that if he only printed more dollars, things would become better.

"They didn't. Then markets rebelled, interest rates went up and up and up and then came Paul Volcker with a most draconian policy to put things right with terrific attendant human suffering. It seems to me something like that will happen now.

"I mean, markets are enthralled to these central bankers. It's astonishing that, after so many years of demonstrated human error on the part of these Mandarins, that people still seemingly trust them. But they do, for now; they won't always."

Grant is one of those rare people who is the smartest guy in any room he walks into. But, he and a host of other brilliant investors and financial gurus have had the same problem: the final reckoning still hasn't occurred even after the crash of 2007-2009. While I certainly wouldn't put myself in their august company, any of you who have talked to me or read my letters would know that I agree with them, which has kept me *very* cautious about this market since 2007.

Just Because It's Inevitable…

My opinion is based on sound money, sound economics and centuries of experience with fiat money failures going back at least as far as John Law. Law established the first central bank and first fiat money in "modern times" in France in 1716. Depending upon who is writing the history, Law's policies either failed miserably (hard money advocate, Austrian) or failed in spite of being *right* (fiat money advocate, Keynesian, Neoclassicist). How positively *economic* that is! Either way, France suffered mightily.

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Most of the founders of the US did NOT agree with John Law's theories. One very notable exception: Alexander Hamilton, who proposed the creation of an American central bank well over 100 years before the establishment of the Fed in 1913.

Jefferson and Madison, who authored the Declaration of Independence and the US Constitution respectively, were particularly against the use of fiat money in the US and many other financial policies held by Hamilton. This rift caused Madison to turn against his old ally, Hamilton, with whom he teamed along with John Jay to get the Constitution ratified. Letters written by the three to that end were published as The Federalist Papers.

We spent a great deal of time in the last couple of months' *CJ Newsletters* dealing with why the stock market has risen despite a lackluster economy since 2009. The first was February, which, when shortened, appeared as my 17th article published in the *Kansas City Star* and is included with this month's *CJ*. The *Star* thought my explanation of the market movements had some merit, especially the idea of "Super K," the supercharging of Marshallian K theory because of Fed actions. The second (March) was how the Fed's manipulations broke my primary TA timing tool used to limit risk and enhance return, which was recently been rebuilt to compensate for the Fed changes which limited its effectiveness.

Over the years since, in both good and bad markets, I have outlined my thinking and objections to how well or poorly our government and the Fed have handled the economy. I also expressed my thinking regarding risk and return, especially since 3/2009. I have laid out the arguments of some of the finest economic and market minds as a basis behind my conclusions and of my actions taken as a result of those conclusions.

All of the people in whom I have confidence in both their underlying theoretical approach and their market and economic thinking, essentially have agreed with me. In fact, their writings and interviews form much of the basis of my own conclusions and actions, both factually and theoretically. (About the only market analysis I do almost entirely with my own resources is TA.) I don't recall one of them foreseeing the stock market rally since 2009, nor did I. Even after the rally was in full swing and the losses since late 2007 had been half recovered, the stock market rally was a mystery. *There was/is simply no underlying basis for the stock market rally since 3/2009, other than the absolute flood of liquidity coming from the Fed since 9/2008.*

I intend to be neither an optimist nor a pessimist. Being a realist is the goal for which I strive. Accuracy in assessing the economy, the markets, and the accompanying risks and rewards seem to me to be the key to successful long-term investing. Someone else will have to decide how successful I've been; it's neither proper nor appropriate for me to express such an opinion. What I can say, though, is that most of my clients would be called long-term clients. Many have been with me more than a decade.

…Doesn't Mean It's Imminent

I believe that those who jumped on the stock market bandwagon since 3/2009 fit into one or both of two categories:

- *Eternal optimists* These folks believe that being "in the market" will always reward you, despite history's long periods of evidence to the contrary.
- *"Don't fight the Fed"* (A market mantra) If there ***is*** a sound argument to be made for getting into the stock market after 3/2009, this is it. More below.

The "Don't Fight the Fed" argument is a good one. Once again, if you ignore the *eventual* consequences of the Fed simply flooding the economy and markets with liquidity every time the economy or the markets stagger, you can make *nominal* gains by being in the market. Whether *real, inflation-adjusted gains* are made is an entirely different matter and would have to be calculated to discover the answer. There are two serious caveats to not fighting the Fed, however:

- *No one really knows for sure how to tell when liquidity rallies will end.* After all, the crash from 2007-2009 was a crash of Fed liquidity driven markets – the real estate markets, the bond markets, and the stock markets.
- *"If you don't keep it, you never made it."* (Another market mantra) If an investor stays in the market and loses unrealized gains in a market downturn, the investor doesn't improve his/her wealth position at all. That means the investor (or advisor) needs to know when to get out to realize gains and avoid losses. For guidance on this, see the first bullet.

In all probability, virtually all stock market crashes are liquidity crashes at their root cause. I don't know of any major crash in the US markets since the Fed was created in 1913 that wouldn't be classified as a liquidity crash. Crashes usually happen when market P/E's are elevated, meaning recent investors are overpaying for the earnings of the assets they are purchasing. Eventually, under the *Greater Fool Theory*, the greatest fool appears and the

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price of the security in question has to decline. Depending upon how many fools have bid up the price of the asset and how far over some objective measure of value it is, the asset price might crash instead of moving into its objective value range in an orderly fashion. When such events are market wide rather than isolated, the result is a market crash.

While I suspect we are at or close to a stock market top, I can't be sure. Given the liquidity driven crash that birthed it, I never thought it would have carried this far. Obviously. It never reached a bottom that indicated it had a buildable economic foundation, at least not to my thinking. But, clearly, as Lord Keynes said, "The market can stay irrational longer than you can stay solvent."

Action Plan Update

We can only act in the present. Given the content of last month's newsletter regarding the *CJC2* and my willingness to test the market waters, what has happened? Has TCM made any moves, entered any positions?

The short answer is no, not yet. From last month's *CJ Newsletter*: "Specifically, the market will pick a direction (in all 3 time frames) after this interim frothy period. I will use selected securities to exploit the *intermediate-term* direction." Since that time, while the market has gone up, it has become, if anything, even *frothier* than it was when last month's *CJ Newsletter* was written. In other words, in my opinion, the market has NOT picked a direction. Just today (4/5/2013), the market is down on poor jobs data. With its down close today, the SPX has alternated between losses and gains for 13 consecutive trading days, an all-time record. Does ***that*** sound like "picking a direction?"

The action plan is intact. There are some reasonable candidates for going long if the market picks that direction. As I find more, the list becomes deeper. If the market corrects or goes into a bear market, we are already defensive and prepared. It would not be unreasonable to expect a correction with additional moves to the upside following it. See the discussion above, especially the Keynes quote. In such a case, we should be able to pick up shares with upside potential at better prices than today. Returning to the main subject…

The Liquidity Monster

Why would investors overpay for their investments? Clearly, there are many reasons, given the nature of human decision-making. Some can make sense in a given temporal context; others are simply due to "irrational exuberance" as so famously stated in 1996 by the "Maestro," Fed Chairman Alan Greenspan. Of course, this was years before Greenspan set the stage for liquidity driven bull markets in stocks and real estate after the 2000 market crash. These bull markets later crashed themselves under Bernanke's Fed watch in 2007-2009.

Anyone else see a pattern here? Do you understand Grant's frustrations, along with many others, including me? Why do we still believe in these Mandarins?

Sadly, for us, this is a growing problem. Especially in the last 15 years, each time the Fed has expanded the money supply to enable both the deficit spending of the federal government and to "stabilize" the economy and financial markets, it has taken larger and larger injections of money.

As stated in the *CJ Newsletter* so many times, this process only works because our population continues to act as though a US$ is worth a US$, when its value is clearly being eaten away, like cutting pizza into 36 instead of 12 pieces. When Wile E Coyote runs off a cliff into thin air, he doesn't fall until he realizes where he is. It works that way *for a while* with us, as we ignore our problem. If we reacted appropriately to what is happening instead, both the government and the Fed would have much less power and control over us. Funny. That was the *intention* of the founders, who risked life, property and sacred honor to found a country based on freedom, not government.

Instead, we have allowed the federal government and the Fed to *create* or *become* (I'll let you decide which) a **Liquidity Monster**. We can get some measure of how big the monster is by looking at the annual deficit and the national debt. Like market tops, no one knows when it will become so big that it devours our economy and forces an enormously painful period of "readjustment" known more commonly as a recession. Or worse, a depression. Are we still in "The Great Recession?" If so, where do we have to go from here – *eventually*? *The liquidity monster has to be shrunk willfully through sound money, balanced budgets, and commitment to repayment of our debts*. Otherwise, it will become too big, break loose and wreak havoc on us, as it did in the 1930's and 1970's.

But, just because it's inevitable… doesn't mean it's imminent.