The CJ Investment Newsletter
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It's a Technical Market

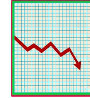
Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF's, ETF's, open-end mutual funds, and derivatives). Essentially, it reflects what I'm actually doing with my clients.

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.

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 analyze the markets and economy, as well as 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 contact me for more information.

Quick Look

Market	Next Expected Move
	

- This market appears to be trading on technicals, as opposed to fundamentals.
- We discuss what technicals and fundamentals are.
- Can the market continue to rise under these conditions?

"Today, we're in an amazing situation far worse than that of 1929. People have gorged on investments. They own debt in the forms of junk bonds, muni bonds, corporates, Treasuries and mortgages. They have invested in real estate and are still praying for a turnaround. They own stocks at record prices. They own precious metals. And they've got bank accounts, which are IOU's backed by IOU's. There is a widespread, unstated conviction that you have to own *something*, that whatever you do, *don't hold cash*, because cash is trash." Robert Prechter, 7/19/2013 *Elliott Wave Theorist* (Newsletter)

Technicals *vs*. Fundamentals

The two most common ways of viewing market action with an eye towards figuring out what it might do in the future are called fundamental analysis and technical analysis. The differences between the two are pretty stark, but, of course, there are some analysis techniques that bridge the two. There are also some outliers that don't fit comfortably

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into either type.

Before going into more detail, all security analyses have the basic goal of attempting to determine the direction in which the price of the security in question will move. This obviously brings up the question of *time*. Like most, I would posit that there are essentially *three investment time frames: short term, intermediate term and long term*. Unlike most, I will actually *define* what those terms mean:

- *Short term*: Less than 6 months, which I equate to *trading*.
- *Intermediate term*: 6 months to 2 years. Also called *speculation*.
- *Long term*: greater than 2 years. This could also be called *long-term investing*, or, more simply, *investing*.

Beware the analyst or other investment "professional" (everyone is a "professional" these days) who uses these *or any other* terms without defining them. He/she is hedging his/her bets and looking for wiggle room in case he/she is wrong.

No one time frame is inherently better than any other is. It's more important how successful and comfortable the analyst is with each time frame than the time frame itself. For income production, I favor investing. For capital growth, I favor speculation.

I will attempt to exploit trading opportunities, but I don't look for them. They usually appear while researching the other opportunities. Trading is inherently riskier and shorter time frames seem to favor losses over gains statistically. If such an opportunity presents, I apply additional vetting to it, since the shorter time frame generally keeps an investment from being initially a loss, then later an overall gain. The longer speculative and long-term time frames allow such reversals to happen more often.

Fundamental Analysis (FA) centers on metrics calculated for both the company underlying the stock and for the stock itself. These metrics (there are many, the most commonly used and quoted probably being the P/E ratio) are then compared to *the same metrics for* other specific stocks, the company's other industry stocks, as well as for general and industry indices. All of these metrics are also compared to historical amounts and norms.

The objective of these calculations and, therefore, fundamental analysis is to determine some understanding of the "*absolute" and relative value* of the stock being analyzed. From this analysis, the analyst can sometimes form an opinion about whether a stock (or other investment such as industry or index CEF's and ETF's) are *undervalued, fairly valued (fully valued) or overvalued*. Obviously, and with all other things being equal an *undervalued* stock has "room" to appreciate, *fairly valued* stocks are not good buy candidates, but may be held, and *overvalued* stocks are probably better sell candidates. In the *overvalued* case, you may decide to hold it anyway if you bought the stock for the VERY long term and/or for some type of dividend return that may persuade you to want to hold it despite its short to medium-term capital loss prospects.

Technical Analysis (TA) uses the charting of primary factors – price and volume – and mathematical derivatives of these two factors to attempt to foresee the future direction of the security price. While some folks still consider TA "voodoo," it's at least as "scientific" as fundamental analysis. While FA focusses on absolute & relative value, TA focusses upon repeatable or predictable patterns of behavior by the quasi-fixed sets of investors for securities.

The behavior of groups of people is considerably simpler and more predictable than that of individuals, although predicting group behavior is fraught with uncertainty and error, also. There are several observed mathematical principles that provide some measure of predictability to securities price movements. Applying these principles to both the raw and derived data presented on TA charts can provide insight into the future direction of a security or an index.

As an example, the principle of *regression towards the mean* comes to mind. A mean is simply an arithmetic average covering a certain number of numbers. If one were to calculate a moving average of closing price, the principle presents itself as follows: the farther above or below the moving average today's closing price is, the more likely it is that it will move in the direction back towards the average, as opposed to moving further away. This can be expressed in currency units, although it is more often expressed in terms of *standard deviations* (sigma) away from the moving average. Generally, about 2/3 (66.67%) of all price action happens within one sigma of the moving average, about 95% occurs within 2 sigma, with even more within higher sigma levels. Therefore, if the current
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price is more than 2 sigma above the moving average, it is *extremely* likely that the price will begin to decline until it reaches, then overshoots, the moving average.

There are many other examples of how TA analysis can help to uncover higher probability price movements. In general, however, TA analysis uses techniques that focus on:

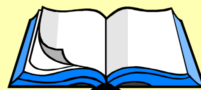
- Trend Following indicators and techniques indicate the direction and strength of a continuing trend
- Change of Direction (Oscillators), which identify potential turning points.
- Sentiment indicators indicate levels of bullish and/or bearish sentiment, with an eye upon continuation versus sentiment change.

Many, if not most, sound analysts use both TA and FA in order to get the most complete picture possible of both underlying market conditions and factors applying to individual securities. Sometimes, however, the markets themselves tend to favor one form of analysis over another, when conditions diminish one form of analysis or tend to favor one type over another. That is the crux of the next two sections.

It's a Technical Market

This market is not a fundamental market, in my opinion. The primary reasons for my assertion are:

- While earnings are expanding, corporate revenues are not, or they are expanding at a much lower rate. Such a situation puts an effective "cap" on future earnings.
- As discussed many times in the *CJ Newsletter* (*CJ*), the massive injections of money into the monetary base have distorted the value of US$ and the reading of the markets.
- The value of the US$ has changed significantly, even in the last 15 years, but especially the last 5. This has exaggerated the difference between the nominal value of the US$ versus its actual value and, therefore, made the assessment of "earnings" and "growth" questionable, at best. If earnings are up 10%, revenues up 4%, and the value of the US$ down from 5-10%, is there earnings and/or revenue growth at all? Or is there hidden capital loss through currency unit value destruction?
- Especially with government encouragement, some investors have ignored these problems with FA definitions of absolute and relative value and put capital at risk without having any true fundamental idea of what is happening in the economy.
- Some investors simply believe in "Don't fight the Fed" more than any other mantra. They are willing to ignore most or all other factors when the Fed is increasing the money supply.



Recommended Reading

John Mauldin, in his regular *Outside the Box* column shares a frighteningly apocalyptic article entitled "The Blip," which explains the position taken by economist Dr. Robert Gordon, who has had a named chair at Northwestern U for decades. Idea support is not presented technically, but historically. You should decide for yourself if Gordon's ideas are convincing. http://www.mauldineconomics.com/outsidethebox/the-blip

Another important article comes from Doug Casey's Casey Research group regarding the Fed and the implementation and continuation of its QE policy. Link: http://www.internationalman.com/78-global-perspectives/973-will-the-federal-reserve-taper-off-on-qe?acm=23849_146
You may be less sanguine about what the government and the Fed are doing after reading this article. Written in nontechnical language, I highly suggest you read and digest this article.

Before you dismiss any of the above bullet points as untrue (especially the third) recall this quote from the 6/2013 *CJ*: "In fact, the Fed tripled the size of M0 (the monetary base) in a period of 7 quarters (21 months).

	M0 (billions)
9/10/2008	874,826
6/1/2011	2,625,301

From 9/10/2008 until 6/1/2011, the annualized rate of growth for M0 was 71.5%! The "Bernank" and the boys were just getting warmed up. At $80 billion/month (the current QE infinity scheme), the growth of US$ will be 36.5% for 2013!"

If you remember where inflation comes from (the scales of justice explanation), you know that the value of the US$ (or any other currency being subjected to massive expansion) can't possibly be prevented from its value declining in all three time frames. When your primary measure of value (the US$) is no longer stable, trying to determine *value* becomes questionable at best. At this point, you could rightly ask:

- Why has the US$ held up against other international currencies?
- If things are so bad, why are foreign investors investing in the US? Why are we having net capital inflows?

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The answer lies in an old saying: The US$ is the "best house on a bad block." Virtually ALL the major economies of the world are experiencing similar problems to those in the US, and *they are doing the same bad behaviors to an even greater extent than we are.* They are using massive amounts of deficit government spending to attempt to prop up ever weaker private economies. Their central banks (Fed's) are doing their own QE's at even faster rates than we are. In short, they are destroying the value of their own currencies faster than we are.

Europe and the Euro are in worse shape than the US. More debt, more government spending, more monetary expansion. Japan is expanding their money supply in order to create "inflation" in their economy, as if that's a good thing. China has lied for so long about their economic data that no one really knows what is happening there, probably including them. A similar situation exists regarding Russia. Resource rich countries like Canada, South Africa, Australia and Brazil are experiencing economic slowdowns due to lack of worldwide demand for their natural resources.

Wealth Creation

Before going any further, a relevant and critically important thought came to me as I was talking to a fellow professional recently: *Wealth cannot be expanded when it's based upon expanding debts.* Not for ANY type of entity – not a person, company, country or world. This is perhaps a clearer way of saying, "You can't borrow your way to prosperity."

Creation of wealth depends upon two things:

- *Savings*. Consume less than 100% of production.
- The creation (production) of things people need and/or want and that people are willing to pay more for the production than the cost of the production, creating *profit*.

Without these things, no person or group can increase wealth.

Therefore, "jobs creation," "infrastructure," or any other government program financed by deficit spending simply puts a balancing debt entry into the relevant balance sheet. The debt *itself* equals what is created (a wash transaction), preventing wealth creation. Further, because government projects are notoriously too costly for the benefit derived, they create *losses*. No personal profit motive and/or no personal risk of loss = ineffective cost control. This doesn't even consider how factors involved in repaying the debt add to the initial losses in the future.

Government drains upon societal capital can be mitigated by limiting the size of government. (Where have we heard that before?) If the size and profitability of the private economy is sufficiently large and government spending is sufficiently small, the profits earned in the private sector can exceed the capital drain created by the government, allowing for a net increase in societal wealth.

I have not looked for any calculations that would uncover the minimum ratio of private economy to government economy that would be still allow for wealth creation, although I will in the future. Certainly, if such a ratio could be calculated at all, it would need to consider the relative capital increase created by the private sector through profits less the capital destruction rate of the relevant government. Both the creation and destruction rates would vary over time, of course.

Only system feedback from government purchases providing profits to the private economy prevent the limit of government spending from being 100% of annual profits. So, if you're a big government fan, don't disparage those (free market, honest) private profits gleaned from public expenditures! Otherwise, we could only afford a very small government, indeed!

Of course, reality, beginning in the 20th Century, indicates that governments grow and become more socialistic continually. Recent history shows they become ever larger portions of their nation's economies, regardless of the potential risks. Apparently, governments are more concerned about power and control than they are about being afforded.

All of the above in this section ignores the economic distortions created by currency unit value destruction from both deficit spending and money creation as economic "stimuli."

Since the widespread adoption of central banking, we have experienced the Great Depression, beginning about 1930, The 1970's massive inflation and two major crashes and recessions in the 2000's. What lies ahead in the 20-teens?

In summary, governments have made this market purely technical. The inability to assess value due to currency unit value destruction seems to render any type of FA impotent, in my opinion. The numbers can still be calculated, but any norm for value doesn't exist. Until corrected, that would appear to make behavioral assessment through TA perhaps our only meaningful way of assessing future investment trends.

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