The CJ Investment Newsletter

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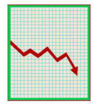
Has the Inevitable Arrived?

Quick Look

Market	**Next Expected Move**
?	

- Stock indices declined significantly last month, especially the large cap indices. Is this the beginning of a bear market?
- The corrective factors applied to the original *CJC* to correct for Fed distortions provide evidence supporting the *prima facie* presence of the distortions.

August Moon Swoon

The major stock market indices swooned in August, buffeted by several factors. On the other hand, gold and precious metals rallied significantly. The changes:

DJI	<4.45%>
SPX	<3.10%>
COMP	<1.00%>
Spot Gold	6.40%

Importantly, the DJI has closed below 15,000 every day but one since 8/21/2013. From its closing peak of 15,658.36 on 8/2/2013, the DJI has lost 848.05 points, or 5.42%. While the tech heavy COMP has not suffered nearly as much damage, it never participated in the upward moves to the extent the large cap DJI and SPX have.

It's always ominous when the stocks of the biggest, strongest companies in the world decline as a group. I'm not sure of the exact percentage now, but at one time, the DJI 30 companies represented 20% of the US GNP.

Not surprisingly, there is a lot of chatter in the financial media, as well as from government sources, related to the decline. Also not surprisingly, the government and those supporting the government's agenda are asking investors to remain calm, suggesting that this is likely a temporary event and that it is being fueled by short-term events. Insert ironic quote marks where you deem appropriate.

The reality is, no one really knows how this will play out. If, in fact, we are seeing investors run from the valuations artificially created by Fed policies since the end of WWII, it could indeed bring back the bear market in effect prior to the Fed's quantum leap in money creation beginning in 9/2008.

The government and, particularly, the Fed under Bernanke are playing monetary games that historically end in the destruction of the underlying currency. Such events take major tolls in capital destruction and human misery. But – HEY! – Ben Bernanke is the smartest man in the history of the planet, right? Obama second? I bet people praised John Law the same way in France in the early 1700's.

Were it not for these policies undermining the viability of value measurement and the resultant economic distortions creating huge levels of malinvestment throughout the economy, I might agree with those suggesting that the current conditions would only create temporary and shallow declines. However, when interpreted as triggers for larger declines due to severe underlying problems, these temporary events could set

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off a cascade of corrective events that, if fully expressed, could wreak destruction in the world economies, much like the events that created the Great Depression. Ironic that Bernanke, the acknowledged *authority* on the Great Depression, would institute the very policies that might set off another one!

It's hard to tell. Over the course of the last few months and years, I have tried very hard to explain why creating money from nothing, backed by nothing, and worth nothing would distort the very fabric of the world's economies. (Some evidence discussed below.) These actions create a huge number of problems that would remain unnoticed until they finally become so big, so pervasive that they could not be absorbed easily, if at all, by the world's economies.

I also recognize the irony of being wrong for so long, as people ignore what *has* to happen eventually, focusing on the (distorted) nominal amounts appearing as economic activity. They continue to invest as if all those increasing US$ spread over the same amount of wealth represent real economic activity. The *CJ Newsletter* has also written that this situation seems much like the story of the bumblebee, whom engineers say can't fly. However, the bumblebee doesn't know this and continues to fly anyway! *So far*, so have the markets.

The source of my error was my belief in the self-correction of the market despite the Fed's machinations. I had no idea that investors would continue to act as if the Fed manipulation *wasn't even occurring*, much less matter, for so long! Believe me; I am now *fully* aware of the meaning of the adage: *Don't fight the Fed*. I have learned the markets have certainly moved up much farther than I once though possible. But, even the Fed's money manipulations have limits. And consequences.

It does appear there are rumblings about Fed policies being ineffective at reigniting the economy. The Fed governors themselves seem to be shifting towards a more restrictive monetary policy, seemingly becoming mindful of the dangerous game they are playing. At this point, any type of reduction in the rate of monetary growth would likely be looked upon badly by the markets, especially as interest rates back up, causing significant capital losses in bond investments. At the very least, this could cause a disruptive shift between major investment categories. Of course, these Fed policies can't go on forever, either.

Ben Bernanke, President Obama and others are committed to the actions undertaken during and after the financial crisis/crash beginning in late 2007. Their opinions won't change, if for no other reason than to try to save face. The market bottoms occurred in 3/2009, but despite the market rally, the economy has never really gotten going again.

Sadly, it appears that Bernanke and Obama, in particular, are simply interested in finishing their terms before the final reckoning occurs. Whether they understand or believe what will happen is debatable. Nonetheless, my opinion (and that of others) is that if the crisis occurs while on their watches, Bernanke and Obama and their supporters will spend most of their time finding a way to avoid taking the blame, not trying to fix the additional problems they themselves created or exacerbated. To be fair, that behavior doesn't appear any different from that of virtually all modern US politicians. One would simply hope that the President and Fed Chairman would actually rise above to a higher standard. It appears not. They probably won't like how history will judge them.

Cynical? Yes. Untrue? You decide.

As explored in some detail in the 4/2013 *CJ*, *just because something is inevitable does not mean it is imminent*.

Having been surprised by (and wrong about) this market for so long, I will not predict that we have reached the final top and that a significant, if not major, bear market is at hand. However, my clients are still protected to some degree and can become more protected if needed.

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Recommended Reading

Brent Arends, Marketwatch, 8/15/2013:
http://www.marketwatch.com/story/fed-tapering-the-math-investors-need-to-know-2013-08-15
This article is particularly rich at explaining how a rising Fed interest rate, regardless of how it's portrayed, will affect the mathematics of valuation in the bond and stock markets. It contains several useful links that provide other information that makes the article even more meaningful, especially to a non-professional. One caveat; when he calculates how interest rate changes will affect bond and stock prices, he is referring to the idea of *discount to maturity*, a time value concept used in the calculation of Net Present Value (NPV) and other time value calculations. If you don't use these calculations, his mathematics appear wrong. They are not. For clarity, he should have referenced discount to maturity.

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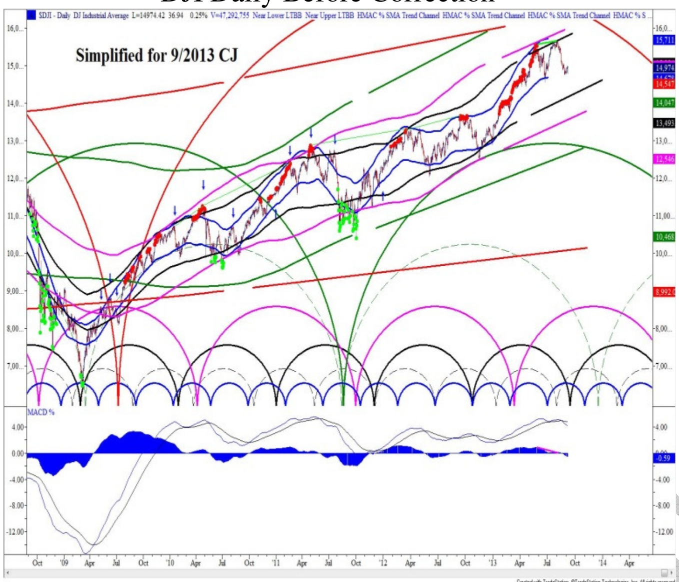
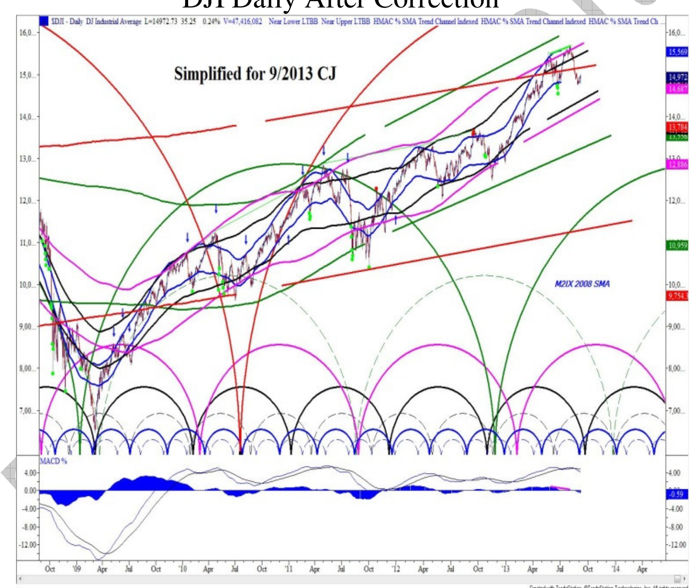
My *CJC2 Indicator* shows numbers of tops, especially in major indices and large cap stocks. Perhaps the August Moon Swoon is merely the start of a normal correction. Perhaps not. Underlying economic distortions created over a period of years seem to have put this market and the economy in general in a critical state, as defined by Mark Buchannan in Ubiquity: Why Catastrophes Happen and last defined and discussed here in the 6/2013 *CJ*.

Factoring Out Fed Distortion

DJI Daily Before Correction



DJI Daily After Correction



I have discussed distortions introduced into the economy from the Fed's massive money creation since 9/2008. We have also discussed in previous *CJ's* that the *CJC Indicator* had been relatively crippled, as had *many* other technical indicators. The charts above and the following discussion are evidence of distortions introduced into technical analysis (TA) *from the price distortions created by the Fed policies*, particularly since 9/2008.

Before going further, you need to keep in mind that *all* TA is based upon two basic data streams: price and volume information. The differences described below are due to price changes, the majority of which are directly traceable back to the beginning of the massive money creation started by Bernanke's Fed in 9/2008. *Since my corrective factors are calculated using Fed monetary data since that date, the distortions factored out by my math are directly supportive evidence of market price distortions created by these Fed policies.*

Keep in mind that I'm not going to give the store away here. I worked thousands of hours creating this system, then refining and improving it over the years. It's a big part of my competitive advantage over my competitors. Additionally, it's axiomatic that if my techniques became commonly *known*, they would become commonly *used*, and would therefore be *factored out* of the market. This would render the *CJC2* indicator useless, of course. I'm not going to let that happen without

- Retiring
- Being compensated for my intellectual property.

Forgive me if this discussion is sparse on specifics. The fewer specifics I give, the better for both my clients and myself.

These are *highly simplified CJC* and *CJC2* indicator charts. Parts of the charts are left out entirely and the remainder is simplified considerably in order to provide greater readability and visibility for the reader so you can focus on the discussion of the differences, which show the distortions Fed policies introduced into securities prices since 9/2008.

The first chart is not done as I would have done it as a stand-alone chart. In order to provide maximum contrast and comparability, I used the cycle lengths from the second (corrected) chart to build the first chart. Otherwise, the comparison described below, especially at these sizes would be VERY hard to understand. However, if done as a stand-alone chart, the cycle lengths and the bandwidths are significantly different, actually adding evidence that the mathematical corrections incorporated are proper.

Look at the widest (red) band in both charts, notice how much wider the red band is in the first chart than

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in the second chart. This is also true for all the other bands. *Since the bands use a percentage deviation from the moving average, this is indicative of market price increases occurring since 9/2008*. As stated in previous *CJ's*, not all of the money created by the Fed has been absorbed into the economy. Therefore, after evaluating the most commonly used money supply measures, I chose a higher order money supply measure to use as one of the compensation factors, since it would reflect the "real" economy more than M0, the money supply directly controlled by the Fed.

Why this matters is that the cycles shown at the bottom of the panels are the same length as the moving averages of their color-matched bands. The entire point of the upper pane in the charts is to contain the majority of the price action for each moving average length, permitting visual feedback as to when prices are reaching their self-defined limits. When these self-defined limits are approached, reached or exceeded, it is most likely that a *regression towards the mean* will occur, indicating the presence of a top or a bottom. Of course, tops and bottoms, when accurately spotted, are the holy grail of investing as they represent the best sell and buy points, respectively.

So far, what you see are techniques individually used by many TA analysts. But, the devil is in the details.

The cycles (arches) shown on the bottom of the upper panel are then matched, as closely as possible, to the appearance of the tops and bottoms occurring within the band defined by its specific cycle length. This gives additional indications as to whether the cycle for that band is ascending or descending. If the cycle doesn't correspond fairly well to the actual price action within the band, there is a good chance that the cycle and band are mismatched. This means that, either the cycle length or the displacement percentage needs to be revised for a better fit. Unlike "set it and forget it" TA techniques, all *CJC* and *CJC2* charts are custom fit to the individual security or index being charted. So, there is an "art" to setting down the *CJC2* indicator so it can be used effectively.

Since it is critical that the cycles correspond to the price action as closely as possible within the band it defines, the widening of the bands due to the inflation of the securities markets caused by the Fed are what limited the usefulness of the original *CJC* indicator. The bands are designed to contain somewhere close to 95% (2 sigma) of the price action for the relevant moving average. When the bands were widened dramatically after 9/2008, and, especially 3/2009, it became quite hard to find the tops and bottoms that become markers for proper cycle placement. It's hard to find touch points, let alone directional change indications, when the bands now contain 125% or more of the price action!

Reviewing the charts again in light of the discussion above, it's clear that the usefulness of the original *CJC* was limited by the difficulties in determining directional change points from prices nearing band tops or bottoms and in making sure the charts were accurately drawn through proper band and cycle coordination. Additionally, charts that had been accurate for years became much less valuable due to the extreme expansion of the bandwidths, as shown on the "before correction" chart. When I figured out how to correct for the distortions, I was extremely happy to have my favorite TA indicator back and fully functional!

Sometimes, finding the fix to a problem can help prove the problem was real in the first place.

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. I'd also love to hear any questions or comments you may have about 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.