The CJ Investment Newsletter

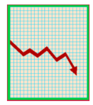
Investment Adviser Representative

Callom B. Jones, V

August, 2014 Two Hundredth Issue

The Laws of Nature

Quick Look

Market	**Next Expected Move**
?	

	Month	**YTD**
DJI	**<1.56%>**	**<0.08%>**
COMP	**<0.87%>**	4.63%
SPX	**<1.51%>**	4.45%
Gold	**<2.97%>**	6.72%

- We take a note of having reached a landmark 200th issue with a little reminiscing.
- Please note that gold is still outperforming the major indices YTD as it has all year.
- The laws of nature versus the laws of man.

200 Issues!

The *CJ Investment Newsletter* (*CJ*) was actually the idea of an old friend of mine back in 1997. Also, at the time, I had a partner named Mark Hines who had convinced me to become his partner in the investment broker business. I actually started as a broker in January, 1997. Of course, that was the "go-go '90's." So, the first *CJ* was actually the *HJ Growth Strategy*. Six months later, Mark and I were no longer partners and the *CJ Growth Strategy* was born.

It was a fun time to start out as a broker, although not without its challenges. Online trading was coming into its own and discount brokers were ubiquitous because of the roaring bull market. Who needed a full service broker when you could make money pasting a copy of the *Wall Street Journal* on the wall, blindfold yourself, throw darts at it and buy the stocks your darts hit?

This happy condition lasted until mid-1998, when the markets took a major dive in what would probably be called a "flash crash" now. I'll ***never*** forget the sick, sinking feeling in my stomach as I watched that market dissolve my clients' profits and some of their capital, too. It was the first time I had really understood, on a visceral level, what *risk* really is. Believe me; the psychologists are right about how pain avoidance is more powerful than seeking pleasure. It is a downright primal feeling.

The market reversed quickly and began its seemingly inexorable climb again. The idea of a "new era," whereby the known behavior of the markets (for at least 100 years) had changed due to the "Tech Revolution," was commonplace. Of course, the old pros knew better. However, I wasn't an "old pro" yet. I'll never forget one TV commercial (for a national investment firm) that asked, "Do you believe that the rules of investment have changed? That we are in a new era of investing? (Pause) Us, too!"

That all changed in January, 2000 as documented in the 2/2000 *CJ*. A true bear market had arrived. It lasted almost 3 years, not bottoming out until 10/2002. Of course, 9/11/2001 didn't help much, but who knows if it protracted the bear market or shortened it?

On a lighter note, I got tired of the appearance of the *CJ* and changed it in 11/2001 to the format used today. No major format changes have happened since then. I still feel the format looks fresh and professional. If you disagree and think it needs to be changed again, please contact me and let's discuss it.

As an aside, the title of that issue was "New and Improved!" which was kind of an inside joke between myself and a co-worker who

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always contended that phrase was ridiculous and self-contradictory. Actually, if you think about it, he was right – something can be new OR it can be improved. If it's new, it's new. If you improved it, there is now an "old" version of it. It can't be both. Chalk up another demerit to American marketing firms for teaching us that something that makes no sense is good grammar!

The 100th issue of the *CJ* happened in 4/2006. It was entitled "Commodity Road." There was a brief discussion of how and why I wrote the *CJ*, then a discussion of commodity prices at that time. One paragraph from the discussion about the *CJ* caught my eye and bears repeating here:

"Another, equally important, reason to understand current and developing market and economic trends is in order to *protect* existing capital and profits. If you can't keep your money, you may as well not have made it. Learning what to avoid and what to get out of that you already own is every bit as important as learning what to buy that has solid profit potential."

That is an important point for someone to keep in mind always when he/she are responsible for investing for themselves and/or for others.

The "Commodity Road" portion of that *CJ* visits some ideas you may find familiar:

"Notice I used the term *prices* instead of *inflation* in the discussion above. Milton Friedman, the Nobel Prize Winning economist, said: *Inflation is always and everywhere a monetary phenomenon*. Essentially, inflation, to an economist, is an increase in the money supply. Period. Inflation can raise prices by increasing the money supply faster than the economy is expanding. Prices could actually *contract* in an inflationary economy if the rate of increase in the money supply is less than the actual growth rate of the economy.

"If the money supply is not increased at all (no inflation), *the natural state of economies is that of decreasing prices brought on by competitive market forces*. To some, especially Austrian, economists, this is the natural and "utopian" state of an economy. The US government and the Fed do not share this opinion, since it prevents the government from using inflation as a hidden tax to pay for its programs and prevents the Fed from "priming the pump" to encourage business growth. Why do you think only Keynesian economics and its derivatives are taught in public schools and universities? Because it's *true*???

"The Fed raised the short-term Fed Funds rate 0.25% to 4.75% on 3/28/06, ostensively to control inflation and to "cool off" an overheated US economy. Two things to keep in mind:

- The government controls inflation through monetary policy. They could stop it anytime they wish.
- The government calculates and reports the inflation rate.

"The calculation of the inflation rate, whether it is measured as the change in the CPI, the GNP deflator or others is highly complex and contains many assumptions that are arguable as to their validity or proportionality in the calculation. I will not say that the government manipulates these indicators for various purposes because I don't know. However, others with respectable credentials have made such assertions. Given the Fed's recent cessation of the publishing of M3 (I still believe they are calculating it), there certainly seems to be a cloud of reasonable suspicion regarding the amount of "control" the Fed and the government seems to be willing to exert to keep inflation in check.

"Is inflation "under control?" I have my doubts. Certainly, the massive growth in the money supply as evidenced by, until it stopped being reported recently, the growth of M3 indicates that money supply growth is not being controlled."

2014 update: We do know the government does manipulate all kinds of their statistics, especially economic ones, and some of the techniques they use. See the 10/2013 *CJ* or read chapter 13 of Chris Martenson's book, The Crash Course.

Does any of that sound familiar? It should. Outside of the update above, I still believe everything I wrote in the 100th issue of the *CJ*, published 4/2006.

The Laws of Nature

Unlike the laws of man, the *proven* laws of nature can't be broken. Try breaking the law of gravity sometime. To a true scientist, laws are not granted by opinion, either. It doesn't matter if 97% of scientists agree about anything. The criterion is whether the theory predicts outcomes from specific variables under specific conditions with 100% accuracy or not. I imagine for eons, almost the entire human population believed the Earth was flat, including virtually all the scientists. They were 100% wrong, as was shown by the works of Galileo, Copernicus, Kepler & Newton.

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Physics and chemistry have the highest percentage of these natural laws. Although there are some biological laws, you would be able to trace them back to the chemical and physical laws from which they're built. Since some animal behavior is instinctive, there may be some real laws regarding behavior. As you look at animals with more advanced brains, what few behavioral laws exist would be less applicable to not applicable. Especially at the human level.

Economics is a disciple that, like many disciplines, began to seek similar prestige as those of the so-called physical or natural sciences – physics, chemistry and biology. Beginning in the last half of the 19th century, their efforts to be taken as a serious science led them to become more mathematical, like the natural sciences.

One of the first steps in this process involved Alfred Marshall's famous postulation of equilibrium. I will often sardonically say that you only have to postulate something if you can't prove it. Without this postulation, all of the so-called "demand side" or Keynesian economics mathematically and logically fall apart. Would it not make sense then, to go through the effort to *prove* that economies do indeed exist in equilibrium? I have yet to see that proof. If it was, in fact, provable, why hasn't this been done? There are several demand-side schools whose laws find their logical and mathematical bedrock in the equilibrium postulation.

One of the other aspects of demand side/Keynesian economics that bothers me the most is the tendency to treat human beings, especially in populations, as simple stimulus/response automatons, which must follow the demand side "laws." I believe this is a natural outgrowth of the above discussion. After all, if you need equations to balance and to preserve equilibrium, the behavior of the economic participants would almost necessarily be predictable, wouldn't it? Does that seem how human beings are to you? Crowd behavior is indeed simpler than individual behavior, but I don't believe it's as simple as demand side economics presupposes, even in crowds.

Say's Law – A Real Economic "Law"

Says law is one of the most misunderstood and maligned laws of economics, at least by demand side economists. Jean Baptiste Say was a Frenchman that lived from 1767 to 1832. Say's Law (it's actually a theory), simply put, states, "Supply creates its own demand." Of course, this flies in the face of those who believe that demand is what drives an economy.

Recommended Reading

"The Approaching Inevitable Market Reversal," Casey Research's *Midweek Matters,* 7/23/2014, Charles Hugh Smith with an introduction by Dan Steinhart. www.caseyresearch.com/cdd/the-approaching-inevitable-market-reversal

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The article presents a great deal of evidence that, in the past has indicated that a market downturn of some substance was about to occur. Sentiment indicators in particular are presented, in addition to logical argumentation. One table on page 9 shows the actual inflation of many everyday prices in the US since the year 2000. I think you will find it hard to listen to anyone represent that we are in a state of "low to no inflation" after reviewing this table.

In some ways, debating whether supply or demand is the prime economic driver is somewhat foolish, as both are needed for an economy to work. They are akin to the Asian yin/yang. However, given the history of the policies undertaken by all world governments and central banks working under demand-side economics and the generally bad results derived from those policies, perhaps it's not so foolish after all. Let's revisit some of the history and arguments about this debate.

One of the biggest problems with understanding economic demand is that demand is not a stand-alone concept. Economic demand is inseparable from both supply and price. Think of the supply/demand curve graphs we were all taught in middle or high school. Here is the most complete, understandable definition of economic demand I could find through Googling: "Demand is *a buyer's* ***willingness and ability to pay a price*** *for a specific quantity of a good or service*. Demand refers to how much (quantity) of a product or service is desired by buyers at various prices. The quantity demanded is the amount of a product people are willing to buy at a certain price; the relationship between price and quantity demanded is known as the demand." From http://en.wikipedia.org/wiki/Demand Italics and bolding are mine.

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Demand, then, is ***not*** an emotional want or need in the economic sense. There can be no economic demand for a product that doesn't exist. Supply. Demand. Price. The three are inseparable. But, one thing is quite certain. Demand requires two things:

- Supply of a specific product or service
- A price at least some economic participants are willing to pay

From the 1/2009 *CJ* (available on TCM's website, references can be found in the original article, along with more details):

"The first view (demand side economics) began in the 17th century and it was heavily influenced by the Mercantilism of the time. The second view (supply side) was argued most famously by David Ricardo in the 19th century. From *MacKenzie* (above right): 'David Ricardo and Thomas Malthus argued over this matter, with Ricardo arguing correctly that Demand Side economics was wrong. J.B. Say also proved the irrelevance of Demand Side economics by showing that demand derives from the supply of goods to markets. Ricardo and Say won this debate, and this issue was settled for more than a century.'

"During the Great Depression, Lord John Maynard Keynes reintroduced Demand Side economics in his famous The General Theory. Governments worldwide, including ours, quickly grabbed at the opportunity to justify interfering with their economies. Prior to Keynes, accepted economic theory provided no justification for government interference in their economies. Whether Demand Side economics was true was no obstacle to governmental adoption of it.

"… from *Corrigan*: 'For the best part of the century… it was accepted that if you worked to produce a saleable good (or to offer a saleable service), you were then entitled to exchange it for the fruits of someone else's efforts at a price to be freely negotiated between the two of you.' As *Corrigan* puts it: 'That this should be controversial shows how far we have fallen from the good common sense of our forefathers.'

"It's simple. You have to work to create something to offer in exchange for something you want from someone else. You work to produce. Your production creates supply. *Your supply creates the ability to demand.* It takes two parties with supply in order to have a free exchange. You don't have the right to demand anything if you haven't produced something of value to exchange. We do have a name for such a one-sided exchange, however. It's called stealing.

"Working from Demand-Side economics puts the cart before the horse. The governments' working from this paradigm prevent them from seeing the problem clearly and, therefore, solving it. However, as if that isn't bad enough, it does not merely stop there. The "solutions" they enact to correct their badly defined problem actually exacerbate the problem itself and creates other distortions in the economy, and, therefore, other problems. The most obvious of these are distorting interest rates, creating malinvestments, interfering with capital formation, and creating higher highs ('bubbles") and deeper recessions in the business/trade cycle."

My article was from 1/2009. The Fed began its massive QE experiments beginning in 9/2008. Using the above principles, doesn't it seem that my predictions about the results of governmental interference since that time have been realized? Isn't that evidence of the truths of these principles?

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 consider 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.