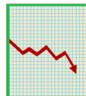
The CJ Investment Newsletter
Callom B. Jones, V Investment Adviser Representative

December, 2014 204th Issue

Apply Liberally. Rinse. Repeat.

Quick Look

Market	Next Expected Move
	

	Month	YTD
DJI	2.52%	7.55%
COMP	3.47%	14.73%
SPX	2.45%	11.86%
Gold	0.27%	**<2.20%>**

- The Fed says they intend to begin reversing QE, probably sometime in 2015. We look at some of the issues involved.
- We discuss what we expect to see in the fairly near future and what strategic and tactical moves we anticipate taking and why.

Exiting QE

Most of the concerns we've had since the inception of the Fed's QE (Quantitative Easing) program in the fall of 2008 have been related to the distortions created from such rapid creation of money without having anywhere close to matching wealth creation. Now, after more than quadrupling its balance sheet, the Fed acts as if it's manageable to return to normal interest rates and to a normal size Fed balance sheet.

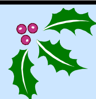
Of course, even though Keynes himself required that monetary injections used to stimulate the economy would be withdrawn after a crisis passed, this hasn't been the actual practice. Any significant injections have only been partially withdrawn, with even that being the exception. According to whatever government was involved, there was always a "new" crisis that required the stimulus not be withdrawn. In fact, the stimulus would need to be *expanded*. Or, perhaps, the government simply couldn't balance the budget that year (*i.e. every* year) and needed funds to cover the deficit they were creating.

*Therefore, what the Fed is aspiring to start has **never** been done and they have no real idea how to do it or know the consequences.* There are many scenarios that could play out, most of them bad, some catastrophic. We can't say such a return to normalcy is impossible; it's just unlikely, especially without causing a lot of disruption and pain along the way.

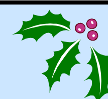
No one really knows how it will play out. In fact, that is one of the dangers. With little or no experience in dealing with the unknown effects, those attempting to manage the task (the central banks, the governments) will have a difficult time understanding the events that occur, how to determine if they are serious or not, and what to do if they decide the events are serious. They are in unknown territory.

Since there are so many unknowns, let's discuss the nature of the problem as a means of being able to predict logically some of the major problems we will be facing as the Fed and our federal government attempt to return to normalcy. (Spoiler alert: Unless our assessment is dead wrong and the Fed is able to manage this swimmingly, our bet is they will cease the attempt at the first sign of trouble for a variety of public image and political reasons. The Fed Chair serves at the pleasure of the President. Our President is no Reagan, so Chairwoman Yellen will likely

(Continued on page 2)



** Merry Christmas and Happy Holidays **



Trend Capital Management, LLC
9717 W 121 Terrace ▪ Overland Park, KS 66213 ▪ O (913) 897-7576 ▪ C (913) 568-9916
e ▪ www.trendcapitalmgmt.com

(Continued from page 1)
NOT get the support Reagan gave Volcker if the economy tanks or the policy becomes unpopular.)

It's important to understand that deficit spending by the federal government is debt financed. The closest comparable to the lives of the rest of us is like getting a new credit card with a high credit limit and living it up until the card's balance reaches its maximum. Afterwards, you find you can only make the minimum payments and even that is a major struggle sometimes. Now, your lifestyle takes a sudden and long-term turn for the worse, as the debt must be paid.

Moving back to the macro picture, what that means is that future production has been time-shifted into the present and paid for by debt. By necessity, that means that future consumption will be reduced by the amount of consumption time-shifted into both the past and the present. It's cumulative. Eventually, ALL the previous and present time-shifted consumption plus interest must be paid or bankruptcy is declared.

Specifically, in the case of the federal government, future spending will have to be curtailed by the amount of taxes collected that will need to be applied to paying the debt. Therefore, either taxes will rise or spending will be reduced, or both. Our guess is that, because of the size of the national debt, it will have to be both. Unless the federal government chooses to default on some or all of the debt, a likely possibility. Good luck floating future debt issues using the "full faith and credit of the United States" as a sales tool after defaulting on any of its debt.

It's unconscionable; future generations will be impoverished in order to work off the debt from our time-shifted consumption. The only other option besides belt-tightening for *decades* is to continue to inflate the money supply to make servicing the debt even possible. In other words, defer the problem through further deficit spending and money creation as the Fed and federal government have done since the inception of the Fed over 100 years ago. It's like adding another credit card each year. This has and will erode the value of the dollar over time through inflation, as we've described in many past *CJ Newsletters*.

The national debt is just under $18 TRILLION. The last annualized GDP released by the St. Louis Fed measures our total annual production at $17.55 trillion. Our national debt now exceeds our annual *production*. *Government debt has to be paid from taxes. Taxes have to be paid from profits or earnings*, not raw production or we end up decapitalizing the economy. How much longer can they kick the can down the road?

Now that we understand the basics of the problem, hopefully also understanding its severity, let's lay out some of the problems the Fed will face in attempting to return to normalcy.

Deficit Spending

Despite all the decades of talk about balancing the budget, we don't believe it's been balanced since WWII. Will the Fed hold DC's feet to the fire and simply not finance the deficit? They never have. The Fed was created in 1913 with the intention of being a "lender of last resort" in order to make sure that private citizens would not have to be counted on to provide credit in a crisis. This was the case in the Panic of 1907, where JP Morgan put together a consortium of banks to provide credit.

Further, the Chair of the Fed "serves at the pleasure of the President." How long do you think a Fed Chair would continue in that office if the Fed chose NOT to fund deficit spending for a year on moral or theoretical grounds?

Budget Cutting

Much of the consumption in the US economy is funded by entitlement programs; the current figure is that over 50% of American citizens receive some sort of government assistance. What would reductions to those programs do to aggregate demand? What would happen politically?

Clearly, aggregate demand would decline from reductions in entitlement programs. Recipients would prioritize more on basic needs, so non-necessities would be the hardest hit initially. Those industries would see reduced demand, which would then be reflected in reduced prices and reduced production, including reduced profitability and stock prices. Their vendors would then see reduced demand, would reduce their production, and so on.

This process would continue to work through the economy until supply and demand were again balanced throughout the economy. The economy would eventually stabilize at a generally lower level of production. However, this would not be a smooth process. There would be major disruptions, perhaps even panics, along the way. However, we are not talking about another Great Depression. Although it could happen, that is not the likely scenario.

(Continued on page 3)

Trend Capital Management

(Continued from page 2)
Politically, the US government has (for lack of a better word) *spoiled* the citizenry with unsustainable benefits and hopes for decades – at least, since FDR was President. By time-shifting future consumption into the past and the present, governments have allowed people to live lifestyles beyond what they have earned, keeping those governments in power for the most part. But, it's a Ponzi scheme and it can't last. Perhaps an oft-used quote from the brilliant Ludwig von Mises bears repeating at this point:
"*There is no means of avoiding a final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion or later as a final and total catastrophe of the currency system involved.*"
QE is/was the ultimate credit expansion.

If the Fed does what they intend (the right thing), the outcry from the populace, especially those receiving the most benefits from the government will be more than politicians, as a group, will bear. The Democrat party, in particular, will be vulnerable to loss of support from its voting base. Eventually, both parties will cave to their constituencies. What shape that takes, we can't predict. But, it will be disruptive politically. The first victim will likely be the Fed Chairwoman; perhaps even the Fed itself will be replaced with another central bank.

That is not a partisan statement. Let's be clear: Ever since they discovered deficit financing, BOTH parties have bought votes from their constituencies. It's much easier to buy votes with benefits and/or tax breaks than to have to earn them with sound ideas and true leadership. It's much easier to gather votes with "you deserve" instead of "you must earn" or "you must compete for." So, we end up where we are because we, as a group, voted for politicians promising to give us things we didn't earn, regardless of the forms they take. We've allowed the Referees to *become* the game, instead of just insuring fair play.

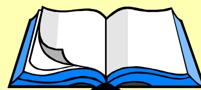
Debt Reduction and Interest Rate Normalization
Because of the size of the QE, the capability of the debtors (primarily the US government) of retiring the existing debt purchased by the Fed to execute QE becomes a process issue. The Fed creates money by purchasing debt from Fed corresponding banks. They reverse the process to reduce money supply

The current debt load (>100% of GDP) clearly presents a problem to the Fed in reducing the size of the balance sheet and returning money supply and interest rates to normal levels. It's clear from the discussion above that the federal government will not be able to retire significant amounts of its debt in the near future. The assets on the Fed's balance sheet consist of that same debt, purchased from the Fed corresponding banks. If the government is still deficit spending (it is), how will they retire significant amounts of debt on the Fed's books? In that case, won't the interest be paid and the debt simply rolled over? So, QE has to be reversed by the government acquiring money *already in the system.* How will the government raise those funds?

Additionally, we doubt the Fed would "push" the debt out into their corresponding banks directly because of the reserve, capital and other regulatory requirements the banks must adhere too – especially the stiffer requirements imposed after the 2007-2009 banking crisis by the Dodd-Frank and other acts since that time. They may be able to push some of the QE debt back into the banking system, but not nearly enough. Besides, at current rates of interest, why would banks *want* such debt on their own balance sheets?

Let's restate a critical point from earlier:
Government debt has to be paid from taxes.
Taxes have to be paid from profits or earnings.

In nature, successful parasites have learned a critical lesson: They don't kill their hosts. Applied to the current situation: Governments can't levy taxes larger than the fraction of the combined total of earnings and profits that allows a private economy to sustain itself or grow. Stresses placed on the economy and its participants from the tax load prevent the economy from performing and growing optimally. As tax loads increase, the economy will sequentially stagnate, contract and collapse, depending upon tax load levels.
(Continued on Page 4)



Recommended Reading

Atlas Shrugged, Ayn Rand, 1957

Ayn Rand (1905-1982) was born in Russia, watched it become the USSR in 1922, and finally escaped to the United States in 1926, at the age of 21. She became a US citizen in 1931. She had witnessed the treatment and impoverishment of her countrymen after the Bolshevik Revolution. She wrote both fiction and nonfiction. Through her writings, she became a champion for capitalism (over statism of any kind) and proposed a philosophy called objectivism. Atlas Shrugged is considered her greatest novel, although The Fountainhead (1943) is only slightly less esteemed.

Trend Capital Management

(Continued from Page 3)

The government is too big to be sustained through taxation without harming the private economy, from where its life's blood is produced. It does too many things for too many people and the government is involved in things it shouldn't be. In the process, it discourages self-reliance and induces dependency upon the citizenry, limiting freedom and economic health and growth while currying votes. No government is ever perfect, but our federal government's sheer size and appetite for resources have reached the point of endangering the existence of perhaps the greatest country in the history of mankind.

Upcoming Strategy and Tactics

If the Fed does begin reversing QE and, specifically, raising interest rates, our existing investments which are bond-based will decline in value as their principal is discounted to maturity using higher rates. We will monitor this situation carefully, attempting to sell parts or all of these positions in order to preserve capital. Once interest rates begin to change in a meaningful way, you can expect your bond based ETF's and mutual funds to be reduced accordingly.

That money may or may not be reapplied in another area immediately. It will depend upon how overall market conditions are, especially in the stock market. If it appears that other investors selling their stakes in bond-based investments are piling into the stock market, we will find some solid candidates that have profitable businesses, financial strength, and positive looking *CJC2 Indicators* to purchase in order to acquire some capital gains. Special consideration may be given to large cap, financially healthy, dividend paying stocks that have positive *CJC2 Indicators*. Especially in times of stock market stress, dividend paying stocks often show greater strength than non-dividend paying stocks, as well as providing an actual cash return, a return on assets actually passed through to shareholders.

Please note that some of the longest holdings in your account are petroleum based MLP's. However, the nature of these companies is that they provide *transport* of petroleum for the actual owners of that petroleum. Only one of them has inventory exposure to petroleum products. That means their revenue and dividend streams are minimally impacted by changes in petroleum prices. These are examples of stocks that provide both capital gains and cash returns over time. MLP's are also tax advantaged in taxable accounts. One of our cadre of these investments converted to a standard C corporation recently, but we believe it is still a viable investment.

If the stock and/or bond markets throw tantrums as the Fed tries to normalize money supplies and interest rates, we will probably be out of virtually all investments besides the bear market hedges and perhaps, gold ETF's. At least until the bear market we've been expecting for a long time declines to an investible bottom on an intermediate or long-term basis. Incidentally, two of the most famous investment newsletters called the October top THE market top. While they may be temporarily wrong, their records indicate they should not be ignored.

Our *CJC2* chart for gold is somewhat positive currently, but inconclusive. Some famous market analysts we read believe we are at an intermediate bottom (at least) for gold. Gold and precious metals, historically at least, become flights to safety during periods of great market stress, as well as sound investments during inflation. Should their technicals indicate strength during the expected decline, we may add or increase positions in these investments.

Trend Capital Management

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.