The CJ Investment Newsletter

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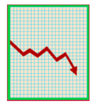
If You Don't Keep It, You Never Made It

Quick Look

Market	**Next Expected Move**
?	

	Month	**YTD**
DJI	-5.30%	-5.30%
COMP	-1.74%	-1.74%
SPX	-3.56%	-3.56%
Gold	3.49%	3.49%

- A significant market decline occurred in January. Is there more to come, or is this just another small decline in a massive Fed-induced liquidity rally?
- Is money as a storehouse of wealth just an antiquated idea? Is money truly nothing more than a medium of exchange? Does liquidity matter more than solvency?
- Is group human behavior so predictable that the Fed and other world central banks can create money of no value, mix it with money that has some value and effectively control our behavior?
- Are we really no more than a bunch of automatons, unable to think for ourselves and willing to believe whatever we are told by the government, media and academia, without bothering to discern ourselves whether what we are told is true?

Bull or Bear?

For the first time in quite a while, the US stock markets had a bad month. The DJI is made up of 30 of the biggest, most powerful and successful companies in the world. Virtually all are global. Yet, in January, they declined.

They declined in spite of:

- Massive monetary infusions by the Fed.
- Massive deficit (read: over-) spending by the US government.
- Massive bullish sentiment (> 80%) by virtually all financial advisors, and, especially those that would find themselves presented in the media.

Even so strong a signal as a 5+% decline in the DJI in a single month is no guarantee that we have begun the bear market I have been expecting for what seems like forever, now. We just have to see if there is follow-through, moving the market past 10% down ("correction" status) to past 20% down ("bear market" status).

For what it's worth, I think there is a sufficiently good chance we have begun a bear market that I took action earlier this month, adding certain protective securities to client accounts to buffer a sudden and/or significant bear market move. Other moves will follow if I'm right about this.

Buried in the mini-rant of my bullet points are some VERY important questions:

- Is it that simple to control crowd (investing) behavior? Add some money to the monetary base and we never have to worry about a bear market again?
- If it's that easy to control investing behavior, what other aspects of human behavior will be equally easy to control?
- Does *freedom* become a meaningless term under such "truths?"

I took those protective measures because I DON'T believe people can be so easily controlled. Either I am right or I am wrong.

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Market adage: *If you don't keep it, you never made it*. So much for buy-and-hold investing.

Market Risks Now

The massive, continuous use of monetary injections into M0 by the Fed since Bernanke started QE in 9/2008, have put the following risks in the market. We have covered why in virtually all the *CJ* issues published in 2013, so we will not go into the explanations here. In those issues, I tried to warn readers that the party couldn't last because it was built on nothing. I believe the party is over and we're in for a painful hangover. Contact me to discuss further.

The Risks:

Bonds The lowering of the interest rates to negative real rates by the Fed created a huge rise in the value of all but the worst junk bonds as bond prices increased to mirror lower market rates using an analysis method called discounted yield to maturity. This has yielded many capital gains in the bond market, not something most investors reach into the bond markets for.

Regardless, interest rates backing up will lower market principle amounts as the amounts paid by all bonds will again be discounted to newer, higher market yields. Since the interest payments will not change (except on relatively rare securities with interest rate changes built into them), the principal amounts attached to the bonds will be reduced in order to achieve the newer, higher market rates.

Therefore, investors holding bonds subject to repricing will suffer principal declines from recent levels in those bonds. Depending upon when an investor's bonds were purchased, this may mean a decrease in the total capital gains or it could mean actual capital losses on a bond-by-bond basis. This will also happen in bond mutual funds, CEF's and ETF's.

Summarizing, *there is greater risk of loss in the bond markets than probably ever in my lifetime*. Perhaps at any time. Some bonds will simply default, but I don't believe that is where the damage will be done. Usually, bond interest rates are set based upon both market interest rates combined with the risks involved with the bond issuer. While those processes still exist, they have been co-opted and diminished greatly by policies of central banks worldwide, including our Fed. The real risk is that bonds will simply lose principal value from the changes created by interest rates backing up to "normal" and discount to maturity forcing significant principal declines.

Stocks As described in many previous *CJ's*, stock prices have nominally risen to extremely high levels since 2009 due to the application of Marshallian "Super K" theory as explained first in the 2/2013 *CJ*. Due to extremely low bond yields, money often bypassed the bond markets, going instead into the stock markets in order to achieve an "acceptable" rate of return. I doubt whether investors thought seriously about the increased risks in doing this. The cost of not clearly considering those risks may become exceedingly painful to those investors.

It would be reasonable to assume that the same forces pushing excess investment funds into the stock market from "Super K" would act similarly in reverse. Therefore, it would be reasonable to conclude that the stock market decline will be much greater as a percentage than that of the bond market when the bear market finally appears.

Please understand that this decline will not be fueled primarily by the failure of companies any more than bond declines will be fueled by default. The real risk is that company stocks which have been bid up to unsustainable levels from the market distortions caused by our own government and the Fed will fall to and below fair value, based upon the metrics used by fundamental value measures. For example, GE will not probably fail as a company. But, that will not prevent its overpriced stock from being cut in half or worse in a mean bear market. Investors holding GE through the decline will suffer a major loss of value in those positions, if not an outright capital loss in them.

The risk of "overshoot" is very high in this decline. Stocks do not normally fall to fair value, then stabilize. *The psychology involved causes prices to drop well below "fair value" measures and long-term average trend lines*. Sometime after the destruction is done, stocks will begin a slow, tentative, almost tortuous climb up towards these measures. Regression to the mean still works, but history suggests extreme overvaluation will lead to extreme undervaluation in a bear market decline.

There should be no surprise in these statements. After all, there have been two major market declines already since 2000. The first was probably akin to a "normal" mania. But, government and Fed policies related to increasing home ownership clearly caused the run-up and subsequent bursting of the real estate bubble, the financial crisis and the market meltdowns of 2008-9. Similarly, government and Fed policy has created this new bubble and its subsequent bursting.

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Physics Envy

Economics, as it is thought of today, took a major tack in the wrong direction beginning with Adam Smith's *Wealth of Nations* over 200 years ago. George Gilder, in his new book *Knowledge and Power* explains this beautifully. Below is a condensed version I hope will remain as clear as it was originally.

"The passion for finding the system in experience, replacing surprise with order, is a persistent part of human nature… Powered by the (new) calculus, the new physics of Isaac Newton… wrought mathematical order from what was previously a muddle… The new physics depicted a universe governed by tersely stated rules that could yield exquisitely accurate predictions.

"Science came to mean the elimination of surprise. It outlawed miracles, because miracles are above all unexpected… Smith sought to find similarly mechanical predictability in economics… Codified over the subsequent 150 years and capped with Alfred Marshall's *Principles of Economics*, the classical model… (was) an arrestingly clear and useful description of economic systems and (their) core principles… Ignored in all this… was the one unbridgeable gap between physics and any such science of human behavior: the surprises that arise from free will and human creativity. The miracles forbidden in deterministic physics are not only routine in economics; they constitute the most important economic events.

"Flawed from its foundation, economics as a whole has failed to improve much with time. As it both ossified into an academic establishment and mutated into mathematics, the Newtonian scheme became an illusion of determinism in a tempestuous world of human actions. Economists became preoccupied with mechanical models of markets and uninterested in the willful people who inhabit them."

Gilder exquisitely explains my issues with classical and modern Keynesian style economists believing in this deterministic math, which I believe rejects outright our humanity and free will. That same rejection explains why "traditional" economists like Bernanke and, now, Janet Yellen and their models make notoriously inaccurate predictions. Yet, in spite of demonstrably bad predictions and consequences suffered by us from acting on Fed predictions, our government refuses to let go of the *illusion* of power. *Those who do not learn from the past will repeat it.*

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Recommended Reading

http://www.mauldineconomics.com/outsidethebox/the-language-of-inflation *The Language of Inflation* by Dylan Grice (presented as a part of John Mauldin's *Outside the Box* series) is impressive thinking and research, not to mention communication of some difficult ideas in a way that gives me "writer's envy." Here are some (great) snippets. Enjoy!

"…metaphor that the economy is basically an engine… (the metaphor) allows economists to pretend that like an engine, the economy is something that a well-trained expert… should be in control of, and "do things to."…

"The problem is that the metaphor is wrong… and any attempt to achieve "macroeconomic stability" using its prescriptions is doomed to failure. Or at least, now that the results have come in over the past few decades, there isn't much supporting evidence."

"By working hard and saving you're more likely to grow wealthy than if you don't… Patience, thrift and hard work are all a part of the same package, and all serve in the natural process of capital formation and wealth accumulation…

"But inflation inverts this calculus... Thrift makes no sense. Only idiots save. Patience is punished too…"

"…it must be understood that language isn't only a reflection of thought and action. It is a driver too. Language is our cognitive machinery; it shapes our ability to interpret, recall and process concepts…

"There are so many different types of risks to consider in the practice of capital stewardship… Some are to be avoided without exception; others are to be embraced. But all require judgment because none are measurable…

(re: money *vs* capital) "Yet this is a fundamental error of thought. Capital is *not* money. One is scarce, the other is infinite… the problem is solvency, not liquidity. Capital comes from savings, and the policy of cheap credit with its inflation of time preference has encouraged spending, not saving. Scarce capital is growing ever scarcer."

"Success in the long run requires that thought and action be fully independent from the false ideas of the herd. Yet today's language of inflation embeds so many of these false ideas that the full rottenness of what passes for financial thinking today is obscured."

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Mini-lesson: The Minimum Wage Controversy

From John Lennon: "I've had enough of reading things by neurotic, psychotic, pig-headed politicians. All I want is the truth. Just give me some truth. No shorthaired, yellow-bellied, son of tricky dicky is gonna mother hubbard soft soap me with just a pocketful of hope. Money for dope. Money for rope."

Recently, in his State of the Union Address, President Obama "proposed" that ALL companies receiving payments from the government be required to pay a minimum wage of around $10/hour. Of course, he wants to do this for two reasons:

- To "force" Congress's hand such that they would actually legislate this level of minimum wage. An obvious power play.
- To garner votes. It's ALWAYS about votes. This consideration NEVER goes away to most politicians, even if they are lame ducks. Such pols still want to garner votes for their party, to minimize opposition power and to enhance their own.

Leaving aside all the "standard" pro and con arguments of income inequality and job destruction, respectively, why don't any of the reporters or the opposition ask why we would need to raise the minimum wage in the first place? *There's* the rub…

If you've read my newsletter for a while, you will understand what I say next with little explanation. If you haven't been a reader, feel free to contact me to discuss this for understanding.

The REAL reason we shouldn't raise the minimum wage is because it is through deficit spending and taxpayer wealth stolen through inflation that the wage would *prima facie* need to be raised.

- *Inflation* caused by Fed policies, enabling the government to live beyond its means (through deficit spending), causes the
- *destruction* of the value of the US$ and, therefore, the resultant rise in prices which then puts the poorest of us even further behind as the US$ loses even more of its
- *buying power.*

In other words, the destruction of the value of the US$, making the poor even poorer is *caused* by the Fed's willingness to feed the federal government's *addiction* to deficit spending. The *government* is impoverishing those they supposedly care about, buying votes using wealth taken from the poor themselves (and others). This is the apex of both hubris and dishonesty. The government solution? *Raise the minimum wage in order to continue feeding their addiction.*

How many counselors helping clients with addictions of various kinds would recommend a partner (the taxpayers) perform behaviors that enable and reinforce the addict's addiction? I've never heard that being suggested as a solution to an addiction.

That's why the minimum wage should *not* be raised.

Until the core addiction (deficit spending to buy votes) is addressed, all that will happen is the continued destruction of the US$, making us ALL poorer. A new cycle in which inflation makes the poor become even poorer will begin, signaling a "need" to raise the minimum wage again in the future. *The only "need" being addressed is feeding the addiction caused by the government's refusal to live within **our** means.*

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.