The CJ Investment Newsletter
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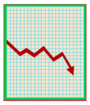
October, 2014 *202nd Issue*

Interest & Exchange Rates

Quick Look

Market	**Next Expected Move**
?	

	Month	**YTD**
DJI	**<0.32%>**	2.81%
COMP	**<1.90%>**	7.59%
SPX	**<1.55%>**	6.70%
Gold	**<5.93%>**	0.80%

- We review the important relationships between wealth, money, interest rates, and currency exchange rates.

Definitions

Since this is a technical discussion, knowing the technical definitions should help us understand the discussion better. All of these definitions should be consistent with Austrian economic thought.

Wealth consists of the ownership of things of value, whether tangible or not. Wealth is created either through savings or through profits.

Capital is a subset of wealth. It consists of items used in the production of consumer goods, including long-lived assets, inventory precursors, etc., but not labor. The important thing to remember is that capital is wealth that is part of a plan to produce consumer goods, even if the capital is intangible.

Money is something that serves as a medium of exchange for items. Thus, money is also a means of measuring the items' relative values. It comes in two forms, depending mostly upon government edicts:

- *Specie* is money made from items of intrinsic value, generally metals, but not always.
- *Fiat money* is money that has no intrinsic value of its own. Its use is forced upon a given populace by government fiat (law).

Money that is backed by and redeemable for specie used to exist. In fact, the US$ used to be this type of money. You could actually exchange it at certain facilities for a specific amount of specie. No modern economies of any size have this type of money anymore.

Interest is the cost of borrowing money from a lender. Essentially, an interest rate is the *price* of having purchasing power currently, to be repaid later. This has many implications to our discussion.

Currency **Exchange Rates** are used in financial trading markets by which the relative purchasing powers of different currencies are equalized. As you exchange one currency for another currency using these rates, your buying power remains equal for a short period – minus any exchange fees paid.

The New Problem

In the modern world, central banks appear to have the power to set interest rates. They do in the nominal sense, up to a point, and especially for shorter-term interest rates.

However, if we think for a second, it makes no sense in anything but a socialist economy that central banks could have such power. While, by law, the issuing government does own the money itself, it does not own its purchasing

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power, except through confiscation. The purchasing power belongs to the persons who have acquired the purchasing power, generally through earnings.

Further, honest interest rates are set by markets, not central banks or governments. Austrians have a phrase for what rates of interest would be if not for government interference: the *natural rate of interest*. If you wish to pursue a more exact meaning for this term, one good reference would be The Austrian Theory of the Trade Cycle and Other Essays (listed in the recommended reading section of TCM's website). The natural rate of interest is at the very core of Friedrich Hayek's theory of the business (trade) cycle, for which he won the only Nobel prize ever awarded an Austrian economist. To my knowledge, even for Keynesians, it is still the only truly predictive working theory being used.

The reason for writing this article is to allow my readers to interpret the widely varied opinions related to current economic and monetary conditions and get some idea of why some of those opinions, which on the surface make sense, really don't make sense. Long time readers will understand many of the concepts involved and how they fit together.

The core issue being newly discussed is the strengthening of the US Dollar (US$) versus most of the other major currencies worldwide. The US$ has recently strengthened versus the Euro, the Yen, the Australian dollar, and the Chinese Yuan, among others. As I listen to many of the commentators on CNBC and other outlets, sometimes I'm dumbfounded at some of the things they think will happen as a result.

It's as if they are channeling the virtuous cycle of the Roaring '90's, where the value of the US$, as measured by the US Dollar Index (DXY), rose to a peak over 120, as I recall. A score of 100 would have put the US$ in purchasing power parity with the components in the basket used for the index calculation. Anything above 100 would indicate overall greater purchasing power; anything below 100 would indicate lesser overall purchasing power.

Critical Thoughts to Keep in Mind

Before proceeding, please keep the following idea in the front of your mind for consideration: *When a central bank increases the counting units of a fiat currency, no wealth is created.* All that really happens is that the overall wealth over which the currency is spread remains constant while the number of counting units increase, *diluting the value of the currency on a per unit basis* (after full absorption into the economy). The currency/money *itself* loses value. The nominal effect is to make items appear more expensive, because it takes more of the less valuable counting units to make up the actual value of what is being priced. The consequences, aftereffects and repercussions of this policy have been discussed from time to time in the *CJ* for years.

Welcome to inflation fueled by government deficit spending enabled by central bank policies.

Still, if we are having economic problems, how can deliberately creating inflation, which systematically destroys the value of currency units, possibly help the situation? *It can't*. To paraphrase Winston Churchill's famous quote about taxation: *To believe we can inflate ourselves into prosperity is like a man placing his feet in a bucket and trying to pick himself up by the handle.*

Yet, these are the strategies and tactics the US Fed has used to create our newfound "prosperity" ever since the 2000 crash. These tactics were used before, of course, but never to the extent that has happened since 2000, and, especially since 2008. There are many aspects of economic theory in play, but, essentially, the price increases in both investments and all other things economic are generally reflective of a cheaper currency, not wealth creation. Mostly, the wealth creation reflected, especially since 2008, is an illusion.

Please keep this in mind: The Fed's inflation, QE, ZIRP (Zero Interest Rate Policy) policies and the tactics used to implement them cannot, will not work. To believe otherwise is to believe that something can come from nothing – and nothing is exactly what the added US$ not backed by real wealth are worth.

The "Increase" in the Value of the US$

According to the DXY, the US$ has increased from about 79 to over 86 since the spring of 2014. What is the *one thing* we can state for certain about this change? This: *Relative to the other currencies in the basket used to measure the DXY, the US$ is more in demand than it was at the period beginning*. Nothing else. We can reason out the causes for this change, but the change itself does *not* mean that the US$ is appreciating in purchasing value. The index reflects many moving parts simultaneously. But, we can be SURE that as long as the US Fed is deliberately inflating the money supply and diminishing the value of the US$ *as a policy*, the value of the US$ is *not*

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increasing. What is most likely being reflected is that the US$ is *decreasing in value less quickly* than the other currencies in the index. Most or all of the currencies in the index are also being intentionally devalued.

Why would there *ever* be an increase in the demand for US$? Because there has been an increase in demand to buy goods and services that are *denominated* in US$. (Details below.) Therefore, in a competitive bidding situation for these goods, the *relative* value of the US$ will increase.

What was just said is a LOT different from what the administration and the ones that agree with them in the media are saying. Keep in mind there may or may not be deception involved. The disparities between Keynesian and Austrian thought (and their derivatives) can bring about very different interpretations of the facts. As always, you will have to decide for yourself who is right and who isn't.

For example, it appears that the primary driver for the increase in demand for US$ would be for foreign demand for some of the energy resources now produced in the US. The rise of fracking and the reemergence of the US as one of the primary carbon based fuel producers in the world has certainly changed the demand/supply factors for the currencies in which that energy is traded. (This particular trend has been developing and happening for years now, not just the period of the recent DXY increase.)

This doesn't even count the effect on the DXY from US companies not needing foreign currencies to purchase foreign carbon based energy, as has previously characterized the US for many decades now. Clearly, the rise of demand in the US$ from foreign purchasers of energy, coupled with our declining need to acquire foreign currencies to purchase that energy from outside the US would, in the absence of other changes, tip the balance in the currency trade for US$, increasing the relative value of the US$ regarding those currencies.

That Which is Not Seen – or Discussed

With a tip of the hat to last month's *CJ* and the brilliant Frederic Bastiat, we now revisit the concepts of interest rates and their interplay with currency exchange and central banking policies. If I'm Janet Yellen, given her severe dovish stance and Keynesian bent, I'm not very happy with recent developments involving the "increase" in the value of the US$.

Previously, we have established the following conditions and definitions:

- Demand for US$ has increased, increasing its value relative to some other currencies.
- Interest is the cost of money.

What is the next logical event? Interest rates on borrowing US$ should *increase*. If the relative value of the currency increases, borrowing demand increases also, increasing interest rates.

In other words, Chairwoman Yellen is finding the policies she wants instituted becoming harder to maintain. Market forces are now dictating part of interest rates; the Fed no longer has total control of even the short end of the curve, much less durations out past 5 years.

You might ask: What is wrong with the value of the US$ increasing, either absolutely or relative to a basket of depreciating currencies? All other things being equal, nothing. But, all other things are *not* equal.

Problem 1: Decades of deficit spending enabled through Fed inflationary policies have created a massive federal government debt overhang – close to $17 Trillion. While some politicians and their sycophants (including the Fed) try to gloss this over as not a problem, it IS a problem. Somehow, that debt has to be repaid, unless the government decides to destroy the "full faith and credit" of the United States by defaulting on that debt. Meanwhile, the debt has to be serviced, that is, make interest payments in order not to default. Both increases in currency value (even relative) and increased interest rates make debt service more expensive.

Most of the more recent debt is shorter-duration and, sometimes, have adjustable rates. If market interest rates increase, the debt service cost could skyrocket. For example, current 2-year US treasuries yield about 0.5%/yr., *way* below the historical average of 2-year treasuries. Should the yield curve shift upwards as little as 0.25%/yr., the interest cost of rolling over the existing notes as they mature would increase debt service costs by 50%/year. That same shift in the yield curve would increase shorter-duration debt service costs by a greater percentage, longer-term service costs by a lesser, but still substantial, percentage. That is one of the eventual prices that should be expected from implementing a ZIRP. I seem to remember seeing calculations of how the overall debt service costs (NOT repayment) would rise. It would force a massive, economy-destroying increase in taxes and/or

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the reduction or elimination of funding of virtually all meaningful government programs, including defense, welfare, education, etc. Ms. Yellen's fears related to increasing interest rates creating massive debt-service problems for the federal government are quite justified.

Who thought buying all those votes funded with deficits would become so expensive? Those rascally Austrian economists did.

Problem 2: Increases in interest rates will cause significant shifts in both business activity and the financial markets.

Business Activity Shifts Remember, *interest rates are the cost of money*. It is an integral cost of any planned new business, business project, or business expansion. As such, it is a factor in the calculation of break-even or profitability analyses of such activities. In the worldwide global business environment today, profit margins are often razor-thin. It doesn't take a lot of thought to realize that the 50% increase in two-year rates (above, including the other increases in different note durations) could easily tip the results of these analysis calculations from profitable to unprofitable.

The results of unprofitable calculations? The new projects, which would expand business, jobs, *etc*., would NOT be undertaken, at least for the most part. Any general business expansion would certainly be slowed down or curtailed. If the failure rate of existing businesses exceeded the expansion rate, we would find ourselves looking at another recession, although its severity would depend upon the specific circumstances. Clearly, Ms. Yellen's concerns here are also justified.

Financial Markets Shifts Interest rates are also a prime deciding factor in investing. When investing in secondary markets (like the stock and bond markets), interest rates can often determine where the best relative value or potential for income and profits relative to risks are located.

As mentioned in previous *CJ's*, the Marshallian Super-K phenomenon occurred as a result of interest rates becoming so low (due to Fed actions designed to lower those rates) that investors could not purchase reasonable rates of returns in the bond markets. Therefore, investors took on additional risk via bypassing the bond markets to enhance their returns. This was accomplished by selling existing bonds to purchase stocks and by applying an inordinately large percentage of new money into the stock markets, as opposed to the historical bond/stock market averages.

It doesn't take a genius to understand that once those unusually low rates began to unwind, so would the effects of those policies. Therefore, we should expect some of the "extra" funds invested in stocks to be withdrawn in order to reinvest in stocks. The effect? The bond market will tend to rise, and stocks will tend to decline. How much? Since the bond market is *10 times bigger* than the stock market, the bond market will probably not experience large increases, but the percentage reduction in stock values will be much, much larger. Ms. Yellen's concern is again justified.

Ms. Yellen is supposed to be one of the best economists in the world. Surely, she knew that there would come a day when the Fed's unprecedented recent meddling in the US economy and excessive accommodation of federal deficit spending would come to an end and what those effects were before she agreed to be the Fed Chairwoman? Right?

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.