The CJ Investment Newsletter

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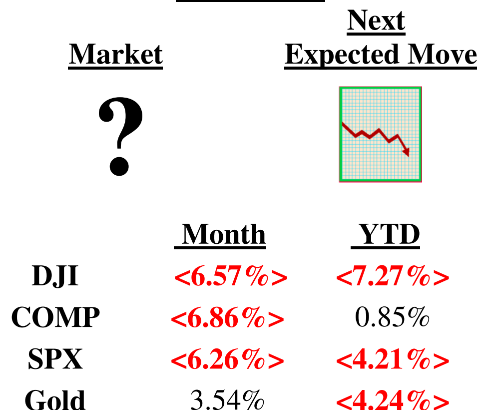
September, 2015 *213th Month*

Self-Made Pain



Quick Look

Market	**Next Expected Move**
?	

	Month	**YTD**
DJI	**<6.57%>**	**<7.27%>**
COMP	**<6.86%>**	0.85%
SPX	**<6.26%>**	**<4.21%>**
Gold	3.54%	**<4.24%>**

- A nasty July was followed up by an even worse August. Only the COMP is still in positive territory YTD, and then only due to a massive 2-day rally on the Wednesday and Thursday before month end.
- We review the history of the 2007-2009 financial crisis as a means of perhaps being able to assess future prospects for the markets and the economy.

History and Perspective

All Clients should know that current normal portfolios are constructed to maintain as much capital as possible coming out the bear market we believe to be inevitable, if not imminent. Once the bear market appears finished, we plan to reenter into the markets cautiously, but aggressively, consistent with individual client risk tolerances and applicable market circumstances. This is consistent with our strategies even prior to the existence of TCM as an RIA, in our owner's prior life as a stockbroker.

Beginning in September of 2008, the Fed, under then Chairman Ben Bernanke, began a program of lowering overnight and short-term interest rates to zero (ZIRP), which included, so far, several programs of Quantitative Easing (QE). QE, in this sense, is where the Fed uses Federal Open Market Committee (FOMC) operations to influence interest rates beyond the short-term through purchases of longer-term debt instruments than it normally has. If you wish to understand more, please call me.

It's important to understand that the Fed had not undertaken such extensive actions before. Ever. *In effect, they were experimenting on a collapsing financial system and economy with no experience regarding the consequences.* They still are, too. Short-, intermediate- and long-term effects of this policy were and are still largely unknown.

Why did they do this? Because the country (and the world) was in the throes of a massive financial crisis. It can clearly be argued this was primarily the result of misguided and unwise federal fiscal and regulatory policies and the Fed's enabling of those policies. The system that was "too big to crash" was crashing, and the debt-based "wealth" created by it was vanishing as fast as the underlying debt was found to be uncollectable.

Subprime Loans

Yes, there were other factors at play, but our evaluation indicates the root cause of the problem was that the policies undertaken by the Fed and the Treasury specifically to increase home ownership in the US from the high 60%'s to the mid 70%'s. This policy was originated by Bill Clinton and was adopted and continued by George W Bush.

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"*"There is no means of avoiding the 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.*" – Ludwig von Mises

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The goal itself wasn't wrong-headed, other than it contained the typical hubris of attempting governmental control of free markets and expecting superior results. We'll briefly try to show why, once again, government micromanagement of pretty much anything is a bad idea, but especially anything economic.

It's also important to recall that the US and the world was dealing with the "dot bomb" crash that happened from 2000 – 2003 at about the same time this home ownership policy was being implemented.

What was wrong-headed was the means by which the federal government attempted to accomplish this goal. Fed corresponding banks, those few, powerful banks that borrow directly from the Fed, have a significant interest rate advantage over other banks in the Federal Reserve System (FRS), not to mention prestige. Other banks in the FRS have to borrow from the small cadre of corresponding banks or from a bank that borrows from one of them already. It's a tiered system, and each tier gets to earn a little additional interest from lending to lower tiered banks with *theoretically* almost no risk.

Using the almost forgotten Community Reinvestment Act of 1977 as legal cover, the Fed, under the administrations' orders, essentially commanded their corresponding banks to begin making home loans to lower income individuals who would not normally qualify for such loans, because they didn't have sufficient income or other issues that made loaning to them inherently riskier. Presto! You now have ***Subprime*** loans, because the loan recipients did not meet the requirements to be considered prime risks. Generally, if there was any increase in interest rate for these loans, it was not sufficient to cover the additional loan default risks posed by the circumstances of the loan recipients as a group.

I'm not sure what additional pressure was placed on banks by the Fed and the regulatory authorities, but essentially the entire banking system was making subprime loans by at least 2003 – 2005.

So, let's lay out what some logical effects would be to the implementation of these policies and the creation of subprime lending:

- More people, primarily lower income, would qualify for home loans and purchase homes relying upon the existing and new lending standards.
- Demand for family home real estate would surge as the pool of eligible buyers expands.
- Because of the bullet above, applicable real estate prices would increase because of the shift in the demand curve without a similar initial increase in the available supply.
- A boom would occur in the family home homebuilders as they rush in to take advantage of the price increases and the increased profitability associated with them. More jobs, more profits.
- Building suppliers experience a boom in business and their supply and demand curves shift similarly. More jobs, more profits.
- Banks and other real estate lenders experience an increase in lending activity as the supply of real estate increases, allowing even more subprime mortgage lending to occur. More jobs, more profits.
- Overall, the economy would experience some increase in activity due to the engine of the combined financial and real estate industries driving it.
- The entire process creates a kind of "virtuous cycle" similar to increased business activity from Fed activity involving lowering generalized interest rates. The cycle becomes somewhat self-feeding, further increasing the activities involved.

Wow! Is this great or what? Why doesn't the government do this ALL the time? (Hint: it DOES. Can you believe that prior to the late 1930's, most economists thought government interference could only be counterproductive? Now, "conventional" economists can't wait to interfere fast enough.)

However, before we strike up the band for this brilliant strategy implemented by Messrs. Clinton, Bush and their administrations, let's look at some of the other, less obvious, but predictable, logical effects:

- The risk portfolio of the banks and (as we'll discuss below) the financial markets was increased dramatically with all the subprime lenders now having mortgages. This increases the risk to two primary groups in the economy:
    - *The lenders*. When defaults begin to pile up on the subprime loans, investor and lender capital will be destroyed, decreasing lendable future capital and the willingness to further lend it for even worthwhile purposes later.
    - *The borrowers*. Those mortgagees with subprime loans have generally placed a big chunk, if not all, of their financial future by trusting the government's processes that qualified them for their loans. Upon default, they would likely

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- find their entire financial structures substantially destroyed, including being unable to borrow for *any* reason for several years, if not longer.

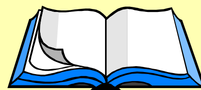
- Capital that might have properly been invested into projects with more permanent positive effects was invested instead into the real estate boom and its downstream effects. *At best*, the real estate boom created would be temporary, with the effects becoming minimal after the new equilibrium was reached when all normal and sub-prime lenders had been serviced and sufficient real estate built to meet the temporary surge in demand.

Net effect? You get a temporary surge in some businesses, not fund other worthy projects with sound long-term benefits and the risk profiles of the entire financial industry AND the subprime borrowers is dramatically increased. If anything goes wrong, the society, and certainly those specific participants, will suffer losses *in excess of the short-term benefits*.

ALL of the above is easy for a competent economist to predict. (Bastiat: *That Which is Seen and That Which is Not Seen* – referred to many times in past *CJ Newsletters.*) It really makes you wonder who thought this would actually be a good idea, what their qualifications were, and how smart the politicians who decided to implement this actually were. If you don't believe this was predictable, try looking at some of the *CJ Newsletters* from 2006 – 2007 prior to the crash beginning in 12/2007.

(To be fair, if the people nowadays were taught anything besides Keynesian and post-Keynesian economics in school or college, there would have been enough other opinions about this course of action that it may never have been implemented at all. Prior and other schools of thought would have seen the risk/reward relationship was tilted clearly towards risk and, perhaps, stopped the implementation of the program. Then again, those same schools of thought put forth ideas like government interference in the economy should be done with a VERY light touch, if at all. Can't have that, can we? Especially using federal education funds.)

Regarding the risks outlined above, the financial industry found a way to help mitigate the additional risk they undertook from underwriting sub-prime loans. Unbelievably, they began to securitize the loans, selling them to investors as collateralized mortgage obligations (CMO's), collateralized loan obligations (CLO's), both subsets of collateralized debt obligations (CDO's). The financial industry would continue to service the securitized loans (and collect some fees for doing so), but the default risk was effectively passed to the investors purchasing the CMO's. Slick, huh? I imagine some commissions were also obtained from the sale of these obligations to investors. Do you agree?



Recommended Reading

"Weapons of Economic Misdirection," John Mauldin, *Thoughts from the Frontline*, Mauldin Economics

http://www.mauldineconomics.com/frontlinethoughts/weapons-of-economic-misdirection

You may never look at GDP the same way again.

To us, anyway, securitizing subprime loans WAS an unpredictable consequence. At least, *we* didn't predict it as we did other effects. However, that didn't mean we didn't recognize the risks associated with such securities when they did appear. We never sold these collateralized obligations to any of our clients.

While the press and politicians of a particular bent were howling about Wall Street greed being the reason for the financial crisis, the reality is that the underlying conditions for the crash were created by federal government and the Fed themselves. Simply put, politicians of that stripe, in particular then Congressman Barney Frank, have to own up to one or both of the following:

- They did not understand the consequences of what the conditions they created were or
- They are liars.

Both of these circumstances are equally bad. Would you rather go down because of the ignorance and lack of perceptiveness of our governing officials or because they were liars? In the final analysis, does it matter?

That said, greed did entice some of the Wall Street crowd to sell these questionable securities to the public. Of course, there was a TON of pressure put on financial advisors to sell these profitable vehicles (CMO's, CDO's, and CLO's). Amazing how the threat of losing their job or their bonus will cause some people to justify the unjustifiable.

(Again, to be fair, even as great a mind as John Mauldin, who we admire and envy greatly on many levels, was convinced (by others) that CDO's did not

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represent a systemic risk simply because the "system was too big" to be collapsed, even if the risk in these particular securities was fully expressed to the downside. If we ever find the article in which he put that idea forward, we will give you the citation to that article in which he put forward this concept. We didn't buy it, but if it came down to believing John Mauldin or ourselves on such matters, it would be a hard decision to make.)

If you trust your governments and their regulators to protect you from new and unknown risks, even if predictable, perhaps you should reconsider the level of your trust. In addition to any conflicts of interests involved when the government ITSELF creates the risks, the likelihood of regulators recognizing, sounding the alarm and minimizing leading edge risks is minimal. It's an unreasonable expectation to expect such things of such organizations. There simply aren't the resources or the political will to be able to recognize and protect the populace from such risks.

The Not-so-New Risks

A famous, now discredited, comedian once said, "I told you that story to tell you this one." (Imagine crowd laughing.) Once the markets' crashes began in 12/2007, the real search by the press and politicians was to keep themselves clean while smearing their opponents in the wake of the damage created. How useful and forward thinking!

Once the bear market and economic recession was in full swing, then Fed Chairman Ben Bernanke began the current program of ZIRP and a series of QE's beginning in 9/2008 and continuing to the current time. (See page 1) Please review the quote from Ludwig von Mises (also on page 1) at this time.

Given the history presented above (and granting that Mises may have actually known more than Keynes about this particular subject), how successful do you think the Fed's easing of monetary policy and reducing interest rates generally since 2008 will be in the long run? Isn't the definition of insanity to continue doing the same things while expecting different results?

There have been many effects of the Fed's policies since that time, many of which have been discussed in prior *CJ Newsletters*. Certainly the market distortions in both the bond and stock markets, low bond yields driving investors away from bonds and towards riskier stocks (Marshallian "Super K" Theory – February, 2013 *CJ*, March, 2013 *Kansas City Star*) were explained and discussed.

The Fed's recent policies under Bernanke and Yellen will not work, nor have they ever worked. They simply create better conditions for a while, followed by much worse conditions as the excesses of low interest rate policies and easy money are flushed (via recession) from the economic system in question. To quote Mises from his famous The Theory of Money and Credit, published over 100 years ago (1912): "If one wants to avoid the recurrence of economic crises, one must avoid the expansion of credit that creates the boom and inevitably leads into the slump." (p 482)

TCM will do our best to protect our clients and to warn others of the predictable dangers from political policies and events. As long as our governments believe they can control business and the economy in violation of human nature, we will continue to have to live with the consequences. How long will it take us finally to realize wealth cannot be created without work and that when we try, we set up future disasters?

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.

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