The CJ Investment Newsletter

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August, 2016 224th Month, Our 19th Year

You May Not Want What You "Deserve"

Quick Look

Market	**Next Expected Move**
?	

May 2016 Results:

	Month	**YTD**
DJI	2.80%	5.78%
COMP	6.60%	3.09%
SPX	3.56%	6.34%
Gold	2.21%	27.99%

- The major averages have managed to rally to new all-time highs in late July. The rally seems to be losing some steam at month end, though.
- Gold is still rallying significantly in 2016, with Silver doing even better.
- Oil has dipped again, levelling out around the $40/barrel level for now. Geopolitical forces seem to be capable of pushing the levels even lower, but some production capacity would drop out at lower levels, tending to support oil prices. That could mean that oil is looking for a bottom here.

We were surprised to see the stock markets' rally to new all-time highs in July. It's somewhat confusing, given that economic indicators and company earnings didn't support such appreciation. The nearest we can figure, the difficulties in Europe and the rest of the world, both economic and political, still make America the "best house on a bad block." Therefore, foreign capital was likely flowing into American markets for safety and return reasons, with the net effect being price appreciation without underlying causality.

This is (partly) a reissue of previously disseminated information. *We originally published this article in 8/2004. Changes have been made to add clarity (we hope), to deal with a couple of new important concepts and to keep it topical.*

Before you begin reading this month's letter, it's important that you understand why we wrote it. Economics, politics and investing are forever intertwined. Understanding politics and the implications of political policies is as important to solid investing as understanding how to read financial statements or technical analysis. Election results can dramatically affect which investments make money in the future, as well as the direction of the economy.

There is no *personal* judgment in this letter regarding your political viewpoint. Still, political policies are subject to the law of cause and effect. *All* policies will have certain positive and negative effects. We will discuss some of the effects of policies upon our economy, investing and the society as a whole. Your vision of the "perfect" America may be different from ours. Hopefully, the ideas presented here (that we believe to be true) will be meaningful to you without being individually judgmental. We know they help us do *our* jobs better.

Finally, the use of *she or her* as indeterminate pronouns for a person in this writing is NOT a direct reference to Ms. Clinton. As mentioned above, this article originally was written in 2004. Rather, it was recognition that we were tired of writing "he/she" and simply deferred to the feminine in order to avoid offending our politically correct readers.

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"It's not an endlessly expanding list of rights — the 'right' to education, the 'right' to health care, the 'right' to food and housing. That's not freedom, that's dependency. Those aren't rights, those are the rations of slavery — hay and a barn for human cattle."

— Alexis de Tocqueville 1805 - 1859

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You May Not Want What You "Deserve"

When a politician uses the word "deserve," what does she mean? To *deserve* means to *earn* or *merit* whatever it is you are receiving or expect to receive. So, for example, how is it that people *deserve* health care they haven't paid for? (*Original* 2004 topic – CBJ) The hard truth is, they don't *deserve* it unless they have *earned* the money to pay for it or have provided some service to society which *merits* them such coverage – like our military personnel. Any other use of the word *deserve* is improper and deceitful. We, as a society may *choose* to provide healthcare, welfare, education and other social programs to all citizens regardless of whether some have earned what's required to pay for it. That is a societal choice we may make in order to meet currently fashionable social goals. But, those who do not earn or merit benefits do not *deserve* them.

When a politician uses the words "you deserve," what she really means is that, if you *vote* for her, she will *tax (confiscate)* from people who have more resources than votes and give that money or benefits to voting groups who have more votes than resources. This tactic only works because there are many more poor and middle class voters than "rich" voters. *The politician is buying the poor and middle class vote by taxing the "rich." Not altruism – Votes.* If the politician was *honest*, she'd say, "Vote for me and I'll take some of the rich folks' money and give it to you." Politicians use the term "deserve" in order to make income redistribution and other socialist policies more politically palatable to those who oppose socialism – in other words, to deceive. It's actually charity, except the *donors* (taxpayers) don't get to choose which causes they support. Some politicians call this "fairness."

The misuse of the word "deserve" by some politicians is but a single example of creeping Orwellian doublespeak used by some to change the hearts and minds of voters. Currently, "fairness," "science" and "investment" also come to mind. Words have meanings. Words influence thinking. The intentional misuse of words by applying them in a fashion contrary to their true meanings appears both insidious and dangerous to us. Listeners might do well to look past the emotional appeals and to examine how their favorite politicians misuse language in order to achieve their ends. Such misuse has significant implications. Are you willing to risk that the politician you like defines "fairness" as you do? Is the "science" she refers to really science or is it actually *statistics*? The two are vastly different. We will discuss "investment" below.

Why does this matter to the economy and to investing? Because, in a capitalist economy, the "rich" provide virtually all of the investing resources which the economy needs to survive, grow and thrive. For example, say somebody makes $1,000,000 in a given year. After federal, state, local taxes and FICA have been taken out, she is lucky to be left with $550,000. Regardless of how you feel personally about the "fairness" of the tax load, can we agree that instead of having $1,000,000 to spend or invest after her efforts, she has a little more than half *of her own income* remaining to use as she sees fit?

The "rich" tend to *save and invest* to make more money. After all, how many people have "too much" money? When asked how much money was enough, the richest man in the world at the time, J.P. Morgan, responded, "I'll let you know when I get there." If our hypothetical taxpayer chooses to forego consumption with her remaining after-tax income, those *savings* would (generally) flow into the capital markets (directly or indirectly), providing needed funds for new small businesses or existing business expansion. That means more job creation and more investment in small businesses that may become big businesses, creating new "rich" people to continue to feed and expand the economy.

In fact, this process – savings, entrepreneurial invesment and profits – is the lifeblood of a healthy economy. There will be failures of both established and new businesses, so this process keeps the economy from collapsing altogether. If sufficiently laden down with governmental taxes and regulation, this process may be unable to perform its stabilizing and growth functions.

Returning to our example, let's assume our "rich" person did not have her $450,000 taxed away and she chose to consume rather than invest that amount. The consumption (of her existing income) creates *demand*, which *can* trigger the creation of new businesses or expansion of existing businesses *provided, among other things, there is sufficient savings (investment capital) provided by other people.*

A point that should not be missed, however, is that government "*demand*" is actually done with *our wealth. No government can create wealth*, although they can certainly print money – and do. *Wealth is something of intrinsic value created from human*

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effort. Fiat money is, *at best*, a medium that makes exchange easier. Misused, fiat money debauchs the currency, taxes secretly (through deficit spending) and distorts market pricing mechanisms, making markets disfunctional even without additional manipulation. Even Lord Keynes said: "There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million can diagnose." More below on this.

Government "demand" is acquired through the confiscation (taxing) of the wealth *earned* by the people. Therefore, taxes *redirect* wealth created by the populace into *demand* the wealth creators may not have chosen. Government wealth consists of either confiscated *wages*, *profits, and, sometimes, savings or property*. Either way, our $1,000,000 earner can only stimulate the economy to the tune of $550,000, instead of the full $1,000,000 she earned. So, our millionaire's *choices* impacting the economy are severely limited by the taxes she pays. The higher their tax load, the less impact the "rich" will have on the economy. Put simply: Higher taxes lead to less savings, therefore less capital creation from entrepreneurial investment and lower consumer demand in the economy – and, consequently, less societal wealth. All of these lead to less business activity and jobs than would happen without the high tax load.

One new political buzzword is "investment." My 1973 Webster's Collegiate Dictionary definition: "the outlay of money, usu. for income or profit : capital outlay; *also* : the sum invested or the property purchased." Seems pretty clear a lot of politicians, especially in the last 20 years, have decided to "alter" the definition of investment for their own purposes.

One example: *Investment in infrastructure*. This is Orwellian doublespeak because:

- The government can't own "investments" because *they use our assets to "invest."*
- *They are taking no risk*. The government can't lose money. *It's our money they use*. If they lose our money, they simply tax *more* of our money later to replace the "loss."
- With the exception of toll roads and user fees (which generally don't cover actual costs), there is no expected "income or profit."

No ownership. No risk. No return. Whatever it is they are doing, they are *not* "investing." Don't even get me started on governmental "investment in human capital."

That said, many worthwhile governnment programs are needed and must be paid for – like defense, roads, the judiciary system, police, and fire protection. But, once government goes beyond what are called "basic services," the costs incurred versus the benefits derived for virtually all other programs are certainly debatable. If you have not already read it, I highly suggest you read Frederic Bastiat's classic <u>The Law</u> (1850), where he discusses the true core purposes of government.

Regarding debauching the currency, we have a very recent and continuing example of the destructive power of debauching the currency. The Fed put the US on ZIRP (Zero Interest Rate Policy) in the fall of 2008. In other times, this policy would have led to massive inflation. In fact, it has now in the economic sense of the word. But, the *manifestation of this inflation* has been through excess money supply flowing into the financial markets, in particular the stock markets and in excessive risk taking and overbuilding by businesses, which was not the Fed's primary intent. What happens to stock prices elevated by liquidity when the liquidity is no longer present?

The Fed intended to minimize the damage from the collapse of the financial industry and to stimulate both consumer demand and business investment through lowering interest rates to zero. In short bursts, lowered rates can be a powerful tool to help stabilize and stimulate an economy, but, has a whole list of bad effects if done for long periods.

It's observed in psychology, sociology and economics that if something is "free" or virtually so, people will waste it. After all, it's "free," right? *Interest* is the cost of money. In order to use someone else's money, you have to pay interest, as well as the principle, to the lender. So, take a second to think about what an 8-year ZIRP would do to people's behaviors with money, including, our government's behaviors. If money is wasted, that damages the underlying wealth to which money has a claim.

Further, "free" money distorts behaviors in predictable ways. When oil was at $120/ barrel and money is free, is it really any surprise that oil industry capital investment ran wild and overbuilt the productive capacity of the industry, increasing supply and inventories and driving down prices? Such wild price swings are disruptive and require economy-wide rebalancing, including business failures from revenue shortfalls based upon prices no longer sustainable due to excess supply. This is but *one* example.

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Business Taxes and Regulatory Costs

Some politicians virtually drool when they talk about taxing "big business." Everybody wins, right? The government gets money, keeping your taxes lower and no "people" (aka voters) are taxed.

First, businesses *can't* be taxed. Only *people* can pay taxes. Since businesses are legal entities only, *they have no money to be taxed*. All of the money or assets businesses have were provided by people buying their products or services, loaning them money or investing directly into the business. Eventually, profitable businesses pay taxes from *profits*, that is, money charged to their customers, net of costs the *government decides* are legitimate. Profitable businesses are the only ones that stay in business, so *businesses have to treat taxes as product costs and build them into the price of their products*. In other words, business taxes are nothing more than additional product costs to consumers, effectively raising consumer prices. These same principles apply to the costs incurred by businesses to comply with government regulations.

Is this bad? It depends upon your goals and values. However, business taxes and regulatory costs are *regressive*. The additional product costs are not only passed on to their "rich" customers, but also to *all* customers equally based upon their consumption. That $25,000 car, that is 10-15% taxes (our guess), costs the poor buyer proportionately much more than the rich buyer. All the basics of life – food, clothes, etc. are proportionately more expensive to poor consumers than to rich consumers. *If you're a politician running on the platform of "looking out for the little guy," these are incredibly hypocritical and deceitful tax and regulatory policies*. It sells well, but really hurts the "little guy" in the process.

The Wrap Up

We've discussed major ways politics affect our lives. This is why we pay such close attention to the political landscape. Taxes, legal matters, reporting and regulatory requirements, monetary policy, among others are ways in which economic and investing environments are significantly affected by elections. There are multitudes of other issues our politicians make decisions about as our representatives. Many are politically charged; others are mundane.

Every tax levied by the government negatively affects investible capital and demand. Taxes, double and multiple taxation of dividends, and regulatory costs not only deprive people of what some would consider rightfully theirs, but also prevent people from adding needed capital and demand into an economy where people are complaining not enough jobs are being created. Ultimately, we all need to realize that government can indeed "kill the golden goose" (capitalism) that is the American "secret" to success and greatness. I believe current Washington policy is clearly taking us down that road. Will enough voters see the danger in time to elect people who will stop the car and turn it around before it's too late? So far, no. We continue to become more socialist every year.

When you look at the big picture, you may prefer the *job* you would get in a thriving American capitalist economy rather than the benefits *the government decides* you "deserve" from levying higher taxes on the "rich" and manipulating the economy, both intentionally and unintentionally.

Your vote matters. You can make your life better or worse with it. Use it wisely. An uninformed vote can be worse than no vote at all.

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.