The CJ Investment Newsletter

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Large Perspectives

Quick Look

Market	**Next Expected Move**

May 2016 Results:

	Month	**YTD**
DJI	0.08%	2.08%
COMP	3.62%	**<1.19%>**
SPX	1.53%	2.59%
Gold	**<5.84%>**	14.77%

- The major averages have managed to eke out an almost flat performance for 2016, after declining severely through the middle of February.
- Gold is still rallying in 2016, although it is no longer up almost 22% for 2016, as it was at the end of April.
- Oil has joined gold in rallying in the last couple of months and has seemed to stabilize, at least temporarily, at about the $50/barrel level.

Pre-ramble

One thing we've really noticed recently in the articles we've read and the stories we see on CNBC and other investing news outlets is the disparity between the outlooks of people involved in the investing world as to where the markets are and, perhaps more importantly, which direction they are headed.

This disparity goes far beyond the "normal" amount of disagreement – or, at least, it appears to. It appears that market "experts" have lost a sense of where they are and, without that, are even less sure of what will happen in the future. Of course, there are still permabulls and permabears, even lacking confidence in which phase the primary trend is. Fundamental analysts are generally negative. Technical analysts are sometimes positive and sometimes not, depending upon the measures they trust the most.

About the only "investors" seemingly making out like bandits nowadays are short-term traders. Finding data for the performance of ALL traders is a daunting task. The successful ones we see on TV and read about may not tell the whole story. We at TCM do not pretend that we have the skills or resources to make short-term trading worth the risk.

The Fed is Everything

The Fed has always been watched closely, at least since the 1980's, because a great deal of business decisions depends upon decisions the Fed makes. But, after the crash of 2000-2003, the federal government has supposedly tried to limit taxation, albeit with limited success and they've *postured* that they were limiting spending, while piling up larger deficits each year.

Because DC has not provided any real fiscal stimulus and no real pro-growth policies, this has left the Fed as the last organization in the US with the power actually to stimulate the economy through injected liquidity and artificially low interest rates. We've discussed many times in previous *CJ Newsletters* why this strategy is a bad idea.

Congress has hamstrung the Fed with their famous "dual mandate of price stability and

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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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maximum employment." Essentially, the Congresses and Administrations involved have laid *their* jobs at the feet of the Fed.

Because Congress isn't fulfilling its obligations – responsible budgeting, appropriate taxation and reasonable, not smothering, business regulation – the Fed has become the most watched entity in the US financial world today. Perhaps in the entire world, since the US still has the largest economy. In other words, the Fed is everything when it comes to manipulating the US economy.

Having gone to a Zero Interest Rate Policy (ZIRP) and quantitative easing since 9/2008 (with limited success), the Fed has managed to inflate the stock market, inflate the US$ and caused all kinds of market distortions without actually creating an economic recovery. The statistics coming out of DC by the Congress and, particularly, the Administration are false and not truly comparable to past periods. This has been discussed in past *CJ's*, but in particular the October and November, 2013 issues.

Cause and Effect

We've visited this topic before, but it's particularly relevant to our discussion today. First, let us assert that most people do not take the time to consider which effects follow which cause(s) and they particularly don't recognize *when* the effects begin to manifest. The worst part is, when someone does properly consider effects and time needed, he/she is often bombarded with misapplied statistics and false conclusions by parties with other agendas… like getting through the next election and staying in power.

It takes miles to turn an oil tanker or a cruise ship. The effects of turning the rudder take place over a relatively long time and distance. So it is with huge economies involving large parts of the world. In economics, especially when you are talking about millions of people, the effects that follow causes don't generally manifest in minutes, days or weeks. It will often take months or years and, sometimes, decades to see the full effects of causes.

The time lapse between economic cause and effect often confuses those without solid theoretical economic understanding – and even some that do. Therefore, many false conclusions appear true and mislead future decision makers. Moreover, as stated earlier, it doesn't help when people with their own agendas purposely give false information to others, whether intentionally or through ignorance.

Just to take an obvious example from relatively recent history, many people consider Bill Clinton to have been a good economic President. Why? Because the US and world economies were as strong from a real standpoint as they had been in the 1950's and 1960's. Bill Clinton gets credit for that *simply because he was President at that time*. However, he never *caused* it. There wasn't *time* for his policies to create effects prior to his leaving office.

The phenomenal economy of the 1990's was caused by the Reagan revolution of the 1980's, especially due to the tax reductions and easing of regulatory burdens that Reagan managed to get through a Democrat Congress early in his first administration. These changes had massive effects by the end of his administrations. These changes also created effects that carried through long after he left office.

Both George H.W. Bush and Clinton increased tax and regulatory burdens during their administrations. We are still amazed that Bush I took such steps after sees with his own eyes how Reagan's policies transformed America from a second-world power to the USSR to a first world power in a world without a USSR. In 1980, Bush I called Reagans economic policies "voodoo economics." After witnessing them work, you would have thought Bush I would have started believing in "voodoo." Instead, he pursued policies that began taking back Reagan's gifts from all of us.

Clinton did the same thing, initially. But, once the Republicans took over the House in 1994, he was smart enough to compromise with the Gingrich House and focus on what he really wanted, letting the Republicans get some of what they wanted, too. Fortunately for us, Clinton wanted to pursue social policies more than damaging "progressive" economic policies. While Reagan's legacy was in full flower, the effects of the policies from Bush I and early Clinton had not yet taken enough hold to cripple the economy. That was to come later, in the Bush II and Obama administrations, where compromise was rare and executive orders were common.

Only because Clinton did not actively pursue as many economy-destroying policies as Bush I, Bush II and Obama have, we have to conclude that Clinton was, in fact, the best economic President since Reagan. However, he was the beneficiary, not the cause, of the great economy that is ascribed to him by the Democrat party and its followers – the media, academia, etc.

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The Fed's Causes and Effects Since 2008

To be fair, the Fed was placed in an untenable circumstance by our government. We have recounted why the financial crisis of 2007-2009 occurred in detail over many issues of the *CJ*. The *government* caused the crisis by:

- forcing Fed corresponding banks to lend to unqualified borrowers (the creation of subprime lending)
- the Fed's lending of money for housing purchases at below market rates distorting the real estate markets throughout the US.

The greedy Wall Street bankers were merely the fleas on the back of the government bull in the proverbial china shop.

So, despite creating the financial crisis through both lower real estate interest rates and forcing banks to lend to those not qualified, *the Fed decided the right medicine was to lower ALL it's interest rates*. In fact, they lowered them to Zero quickly, beginning in September of 2008. The ZIRP has been in force ever since. Both the ZIRP and its time in force are unprecedented actions by the Fed.

Let's look at the causes and effects of what the Fed and the federal governments have actually done, at least according to sound Austrian theory and through the filter of almost 8 years of experience with ZIRP.

Insufficient Yield on Bonds: First, the lowering of the market rates of interest by the Fed (directly for overnight funds and through QE for longer maturities) had a couple of effects:

- New bonds were issued with much lower interest rates than the market rates prior to the Fed's implementation of ZIRP.
- Initially, investments in existing bonds became dramatically more valuable due to the existing bonds' higher than market rates of interest in each period. When bonds are discounted to maturity with above market rates, their principal values generally rise above their face values.

Regardless of whether bonds were new or existing issues, the net effect was to create an interest rate environment that had insufficient yields to meet the income needs of many, if not most, investors. This *alone* drove investors from the bond markets into the higher, but riskier returns of the stock markets.

However, that was not the only effect causing investments in stocks to increase proportionately to bonds… There is an old investing "truth" involving the relative return versus risk of investing in bonds versus stocks. P/E ratios are used widely in the evaluation of stocks relative to each other. You can also compare the relative return of a stock versus a bond by calculating a "P/E" for the bond based upon its yield. For example, a bond yielding 5% has a P/E of 20 (100%/5%). A bond yielding 4% has a P/E of 25. So, all other things being equal, if a stock and bond both have yields of 5%, the bond would appear to be the better investment, in general, because the bond returns its yield more safely than the stock does. (Note that we are using the *earnings* of the company, *not its dividend yield* for these purposes.)

Using this relative valuation "rule," what happens to the comparable stock P/E when a 10-year bond is yielding, say, 2%? Does that make a company that was just recently worth a 20 P/E now worth a 50 P/E?

Marshallian Super-K: First described in the February, 2013 issue of the *CJ*, it is a modification of Alfred Marshall's famous "K" theory. Marshall's theory says that any monies in the money supply not needed by the economy in general to do its business transactions will flow into the financial markets, inflating them. **Super-K theory** modifies the original K theory to change the relative proportion of monies allocated to stocks and bonds flowing into the financial markets due to continuing artificially low market interest rates.

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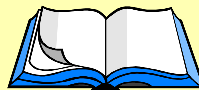

Recommended Reading

"The New Mind Control," Robert Epstein, with an introduction by John Mauldin, *Outside the Box*, February 26, 2016, mauldineconomics.com

http://www.mauldineconomics.com/outsidethebox/the-new-mind-control

If you read nothing else this year besides this article, PLEASE read this. In his introductory letter, Mauldin explains Epstein's qualifications, but once you start reading the article, you will believe its validity. His description of the studies involved and the conclusions are convincing to us, anyway. I was shocked, and the more I read, the more shocked I became. Sobering, but critically important to know and understand in the modern, internet-connected world.

Especially if you believe in exercising your own free will, you will need to read this in order to understand how you can recapture a bit of that free will in the future.

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Applying Super-K theory, the stock markets would and did receive a much greater proportion of total investment funds than usual. The "normal" distribution of monies is about 91% bonds/ 9% stocks. Since ZIRP reduced bond yields to insufficient levels, TCM estimates this amount to be closer to 73%/27% or perhaps even 64%/36%.

Clearly, this creates an overvaluation bubble in stocks, which will correct should the Fed ever actually normalize rates instead of just talking about it. Still, does the Fed have the power to keep the markets from normalizing through its own actions? That would mean that the Fed is more powerful than market forces. That's quite an assertion. Maybe the Fed and other central banks have figured out a way to unwind ZIRP that is not commonly known or taught. If not, the normalization of market interest rates will have painful, perhaps disastrous, effects.

Government Debt Service Costs: Implementing ZIRP has lowered the debt service costs of the national debt (and state and local debt), since interest is the cost of borrowing. Therefore, raising interest rates would increase the cost to servicing the governments' debts. This could lead to tax increases to cover the additional expense if interest rates are raised. ZIRP also makes for lower carrying costs from the massive deficit spending since 2009. Spending incurred in spite of the "recovery" we kept being told was happening. This begs the question: *Would the Fed keep ZIRP in force just to keep government borrowing costs low and not because the "recovery"* ***needs*** *the lower rates?*

Risk of a Major Recession: The implementation and continuance of ZIRP by the Fed (and most of the world's central banks) has created conditions Austrian economists describe as *malinvestment*.

Sufficient amounts of malinvestment would make it difficult to avoid another major bear market and recession, as predicted by Hayek's Nobel Prize winning explanation of the business cycle. This process was reviewed in the March, 2016 *CJ*, so we won't belabor the points here.

It's no accident the government and the Fed are talking up the "recovery," including the outright manipulation of economic statistics as well as presenting them in comparison to numbers with which they are no longer comparable. The Fed is taking baby steps regarding normalization because they are fully aware of the danger. They are praying that by doing the process s l o w l y, they can keep people from panicking and maintain confidence that the government and the Fed are in control and know what they are doing. Even though the odds are as low as ZIRP interest rates.

But, stalling and maintaining this status quo only adds to the malinvestment and the difficulty of the ultimate correction. The stock market bull is looking VERY long in the tooth, and appears to be rolling over one more time without reaching any new highs. To be fair, the stock market has already recovered from a "correction" once earlier this year, but it has not bested the highs posted in May (DJI, SPX) and July (COMPX), ***2015*** yet. That is a VERY long time since new highs still to be a bull market. Especially one built on artificially low interest rates.

There is significant risk built into current market conditions. Will the Fed be able to hold off the forces they have created? Do NOT expect the Fed to raise interest rates unless a MAJOR positive change occurs in the US and/or world economies. If the market and economic dams break, then cash, metals and energy will look good next to other portfolio investments.

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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