The CJ Investment Newsletter

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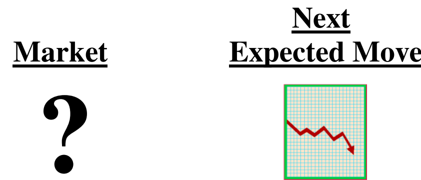
Spotting/Measuring the Bear

Quick Look

Market	**Next Expected Move**



2015 Results:

	Month	**YTD**
DJI	0.32%	**<0.58%>**
COMP	1.09%	7.87%
SPX	0.05%	1.04%
Gold	**<6.75%>**	**<10.11%>**

January 2016 Results:

	Month	**YTD**
DJI	**<5.50%>**	**<5.50%>**
COMP	**<7.86%>**	**<7.86%>**
SPX	**<5.07%>**	**<5.07%>**
Gold	5.26%	5.26%

February 2016 Results:

	Month	**YTD**
DJI	0.30%	**<5.21%>**
COMP	**<1.21%>**	**<8.98%>**
SPX	**<0.41%>**	**<5.47%>**
Gold	10.91%	16.75%

- Even after a solid rally in late February, the major averages are now near or below their starting values for ***2015***.
- Gold is rallying in 2016, fighting the general decline in commodities, presumably due to flight-to-safety behavior and its perceived status as permanent wealth.

Hunting Bear

Given market activity this year, investors need to be wondering if we are back in a bear market for the first time since 3/9/2009.

A 10% decline from the peak is commonly considered a "correction." While the DJI did find its way into correction territory in mid-February, the late-month rally moved it well away from that benchmark. The SPX was also in correction territory mid-month. The COMP has done considerably worse, still being near correction levels even after the late-month rally.

For the record, the closing peaks of the major US indices are:

	Amount	**Date**
DJI	18,312.39	5/19/2015
COMP	5,218.86	7/20/2015
SPX	2,130.82	5/21/2015

The actual definition of a bear market follows below, but many (in the media, anyway) consider 20% down from a peak to be a benchmark demonstrating a bear market is in force. Using a 20% loss as a benchmark, the RUT (Russell 2000) and the TRANS (Dow Transports) are both in bear markets, having been down 24% and 25% from their 2015 peaks, respectively. These are both important indices in their own rights, but they are not considered broad market measures because they focus on market segments instead of the broader market or an exchange total.

So (to quote how Fed Chair Janet Yellen

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America: home of the brave and land of the regulated.
- Callom B. Jones, V

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begins about half of her answers to questions), why don't we look at a time honored definition of what a bear market is by one of the greatest Dow Theorists (and investors) of all time, Robert Rhea?

In The Dow Theory by Robert Rhea" (1932), a bear market is defined as follows [emphasis ours]:
*"**A primary bear market is the long downward movement interrupted by important rallies**. It is caused by various economic ills and **does not terminate until stock prices have thoroughly discounted the worst that is apt to occur**. There are three principle phases of a bear market: the first represents the abandonment of the hopes upon which stocks were purchased at inflated prices, the second reflects selling due to decreased business and earnings, and the third is caused by distress selling of sound securities, regardless of their value, by those who must find a cash market for at least a portion of their assets."*

Notice that there is no mention of an arbitrary 20% threshold to define a bear market. As mentioned earlier, the 10% correction and 20% bear market thresholds came later. We suspect this was more of a "media" definition than one created by serious students of securities markets, although we've never researched the subject deeply to prove that. *The point being made, however, is that there can be a lag between the actual beginning of a bear market and the recognition of a bear market being in force*. It might be prudent, however not to *rely on* arbitrary thresholds created by non-expert market opinions.

With regard to the phases Rhea mentioned above, both our charts and other market observations strongly lean towards our stock markets being in the first phase (selling of overpriced stocks) of a new bear market, although there are certainly elements of the second phase (selling due to declining business conditions and earnings) beginning to be in play. Clearly, we are nowhere near the third phase, which would commonly be characterized as capitulation.

The great Dow Theorist Richard Russell used to point out regularly in his newsletter: *Rallies in bear markets often look better than "the real thing."* Expanding on Russell's comment, what he is talking about it the tendencies of primary moves versus their contrary moves. In a primary bull market, "normal behavior" means making steady, but generally smaller, moves to the upside on a consistent basis. Contrary (downward) moves within a bull market are sharp and fast, then the smaller, more consistent upward moves resume. In a bear market, a contrary (upward) move would be sharper and more violent than the steady smaller upward moves in a bull market ("the real thing").

The message? We need to be cautious when determining if there has been a real change in the primary direction of the market.

The Rant

As a reminder, TCM believes this entire bull market was more a result of a dangerously accommodative Fed than because of actual improvements in the US economy. Did the wealth effect from having an inflated stock market drag the economy to a better place kicking and screaming? Some in the current administration and Fed would argue so, although we seem to remember that so-called "trickle down" economics was portrayed as phony, unfair and wrong during the bulk of the Reagan administration. Why would it have been wrong then and appropriate now? Either it works or it doesn't. We imagine it worked a lot *better* in the 1980's when the policies were much less hampered by excessive taxation and regulation. It seems counterproductive to implement a policy, then to hamper intentionally its effectiveness with other policies, but that's our current politics for you.

We discussed government manipulation of statistics a while ago (*CJ Newsletters*, 10/2013 and 11/2013) and it doesn't appear that has lessened any, if at all, during this administration. The open manipulation of statistics by the government, coupled with an essentially complicit media (the *Demomedia*) is particularly egregious this time. Perhaps we have longer memories than some others do, but we remember when George W Bush was criticized heavily for a jobs (created) number under 250,000 because that was the "minimum necessary to keep the economy expanding and reduce the unemployment rate." Really? Now, the Demomedia tells us what "great" jobs reports are coming in if the number even approaches 250,000... or even 200,000.

Have we had a major decline in our country's population in the last decade? Of course not. We suppose it all depends on the team you play for, not the numbers themselves. Such political tactics preclude the discovery and implementation of *real* answers.

Are we in a bear market? We suspect so, but we have also been doing this long enough to know we don't have all the answers, as our politicians seem to think about themselves. The rub is that the pols' answers
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may be implemented, but they don't work. Even with more statistical manipulation, the economy has grown slower than ever before coming out of a massive bear market. Fewer jobs have been created. Less prosperity for all but a select few. All of this with policies supposedly targeted (by the current administration) to help the poor and middle class the most.

Why the Rant?

Almost all politicians are just like regular people, only more full of themselves. When faced with problems they have no clue how to solve – or they are unwilling to do what it takes to solve – they try to resort to the easiest answer they can sell to their public. It doesn't have to work; it just has to sound like it COULD work.

In this case, the government deferred to/required the Fed to create the most accommodative monetary policy in in the history of this country over *two* administrations. The Fed, beginning with Ben Bernanke and followed by Janet Yellen, both incredibly dovish central bankers, lowered short-term interest rates to virtually 0.00% (ZIRP – Zero Interest Rate Policy) for *7 years* – and counting, for all practical purposes. Similar tactics been attempted before – with invariably terrible consequences – in the past in other places. France under John Law in the early 18th century and the Weimar Republic in Germany following WWI are two such instances. However, to my knowledge, never in the US and never by the largest economy in the world, accompanied by most of the other large economies of the world.

John Law is a particularly interesting case. From Wikipedia (emphasis is ours):
"John Law (… 1671 – … 1729) was a Scottish economist ***who believed that money was only a means of exchange that did not constitute wealth in itself and that national wealth depended on trade...***

"In 1716 Law established the Banque Générale in France, a private bank, but three-quarters of the capital consisted of government bills and government-accepted notes, effectively making it the first central bank of the nation. ***He was responsible for the Mississippi Company bubble and a chaotic economic collapse in France...***

"Law's views held that money creation will stimulate the economy, that paper money is preferable to metallic money, *and that shares are a superior form of money since they pay dividends."*

If you know anything at all about modern Keynes-influenced economic theory, the statements about what John Law believed about money should sound eerily familiar.

Two more interesting things of note about Law:

- His theories and their results, predate Adam Smith's Wealth of Nations (1776) by about 60 years, minimum.
- The collapse of the French economy (above) was well known by the founders of the US, and probably had a great deal to do with why very few of the founders wanted anything to do with a central banking system and paper money not backed by *specie* in general.

Nonetheless, the relentless need for politicians to control every aspect of their countries and their citizens' lives finally overthrew the founders' wishes when the Fed was created in 1913. The US created its first nationwide income tax in this same year. It's notable that the progressive movement was strong in the US at that time, having had Theodore Roosevelt as US President earlier and Woodrow Wilson as President from 1913 – 1921. Since that time, the US dollar has lost over 98% of its objectively calculated value. Yet, our "learned" economists in the Fed wish to "target" inflation at 2%/year. Go figure.

Paying the Piper

The answer to the question of whether we are in a bear market is straightforward: probably. After all the

- experimentation done in the monetary system by the Fed
- additional regulations clogging the arteries of our economy like LDL
- fiscal and tax policies driving home grown companies out of the US for years

this money supply/interest rate driven market is due for a major bear market and the economy is definitely due for a resumption of the recession it never truly worked through due to the Fed's ZIRP policies.

We've made this analogy before, but it bears repeating. If you consider an economy analogous to a human body, then bull markets and economic expansions created by Fed or fiscal policy are like catching a cold or the flu. Things look great, but underneath, the economy is actually getting sicker as time goes on. When the body's immune system finally fights back, symptoms begin and the body usually fells terrible. Still, ***the healing occurs in that process.***

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And, so it is with an economy. When the markets tank and the economy goes into recession, all the false valuations get "trued" and capital that must be lost in the process is, in fact, lost. It still feels terrible. However, it's ***still the process*** in which the healing occurs.

Based upon Friedrich Hayek's Nobel Prize winning fleshing-out of the business/trade cycle, *a recession begins when the failure rate of uneconomic projects begins to exceed the creation rate of new businesses*. Uneconomic projects occur because central-bank-created artificially low interest rates generate false profit signals and misleading those considering those projects into thinking they will be profitable. The recession will continue until virtually all of the uneconomic projects undertaken fail. Capital is destroyed in this process, although some is recovered. In this way, virtually all of the misallocations of capital (malinvestment) are cleaned out of the economy and the economy can move forward from a lower, but stronger base. Again, ***when the painful symptoms happen, the economy is in the process of healing***.

What is different about the current situation from those of the past? For the first time in American history, our Fed has entered into a ZIRP Policy and, in addition, kept it in force for *7 years*. If one understands Hayek's theory of the trade cycle, this could be expressed as *doubling down on the low interest rate policy that got you in trouble in the first place*.

The low interest rate policy regarding real estate from the early 2000's is the triggering force that caused the 2008-2009 bear market and subsequent recession in the first place. No matter how many times the *Demomedia* tries to blame the financial crisis on Wall Street and banking industry greed, it still comes down to the policies set in place by the government and *forced upon that industry* (by a *Republican* administration, we might add) that caused the eventual crisis – greed or not.

An integral part of those policies were the targeted lowered interest rates for unqualified homebuyers, *i.e.* subprime borrowers. When the whole economy came crashing down because of those policies, what did our Fed (under Bernanke at the time) do? They doubled down by lowering interest rates for ALL kinds of short-term borrowing to Zero.

This caused some of the processes that make the economy sick to overwhelm the healing forces of the recession and the US began a slow, non-recovery. It has been in place for 7+ years as Ms. Yellen has faithfully continued Mr. Bernanke's dovish policies. Is that clear? ***The interest rate policies followed by the Bernanke and Yellen Fed's since 2008, have not only delayed the processes which would heal the economy, but have in fact, made the economy much sicker and more vulnerable than it was prior to the financial crisis***.

The economy was never healed from the financial crisis/bear market/recession that began in late 2007. Due to Marshallian K Theory (and Super K Theory as we described in the February, 2013 *CJ Newsletter*), the stock and bond markets have rallied, but the economy has not. The economy was never allowed to heal. Eventually, the Piper has to be paid. We believe "eventually" is just around the corner. Client accounts have been defensive for a long time, preparing to deal with the coming bear market and resumption of the recession that was never finished. Beware when politicians seeking reelection try to avoid economic laws. TCM genuinely hopes the coming healing period is less painful than we fear it will be.

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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.