



On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

Volume 13, Issue 2

April 2011

Black Swans And Higher Prices

Expanding on last quarter's newsletter titled "Black Swans and Blowflies", the number of those unwelcome birds continues to expand exponentially. Since I wrote that in late December, we've experienced both artificial black swans in the form of revolution in Egypt, Libya, Yemen, and Bahrain and a real black swan in the form of the Japanese earthquake/tsunami/nuclear disaster.

And with all of these black swans, the equity markets keep going higher because the Federal Reserve needs a higher stock market in order to maintain the "Confidence Game" (another former newsletter title) that convinces people to keep spending as if we're experiencing an economic recovery. So despite war in Libya, Iraq, Afghanistan, Bahrain, Yemen, sovereign bankruptcy throughout southern Europe, dramatically higher food prices around the world, and devastation in Japan, the stock market will continue to move higher until the Federal Reserve's interventionist efforts no longer work.

food and gasoline will go and the more social unrest we'll experience throughout the world. Thus, the title of this missive is an attempt to show you how the efforts of the Federal Reserve, European Central Bank, Bank of Japan, and Bank of China to try to hold back a severe economic downturn are creating unintended consequences, or black swans, throughout the world.

Inflation

The government is in charge of executing economic policy *and* measuring the results of those policies. Does anyone else see a conflict of interest here? We've also given the statisticians at the Bureau of Labor Statistics (BLS), who measure the consumer price index (CPI) great latitude in determining how much products have improved and how we substitute products that are cheap in lieu of products that are expensive. Not only do they measure prices, they make complex estimates about how cars improve, how computers are faster, and how we switch from beef to chicken when prices rise. In short, the CPI is generally viewed as inflation, yet it bears no resemblance to the way we spend our hard-earned money.

The funny thing is that the Federal Reserve admits that inflation is currently a problem but they claim rising prices are "transitory" and that they won't last much longer. Yet, the picture below is the official measure of inflation and it's currently below trend meaning that it doesn't reflect the inflation that the Fed admits is out there. Does anyone else see the incongruities in what officials are saying?

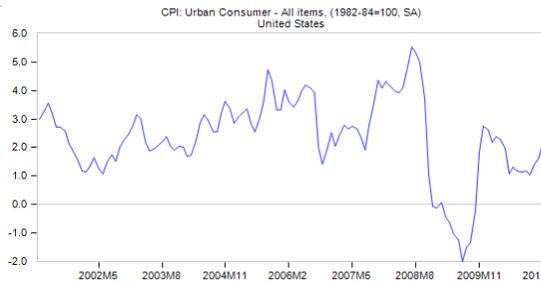


Unfortunately, the more the Fed continues to print money, the higher the price of

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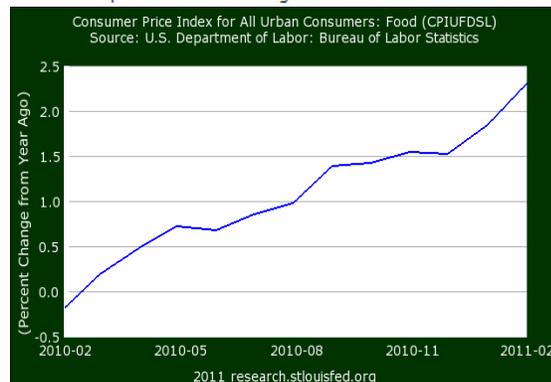
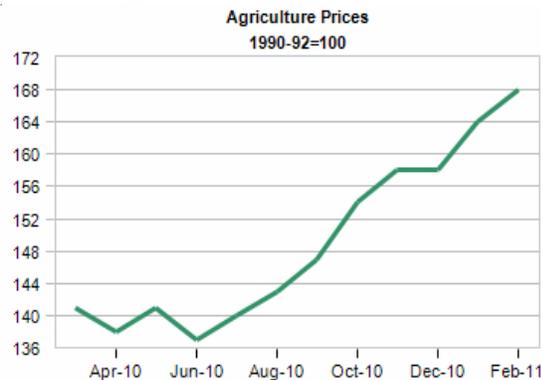
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The funniest part is that the BLS is telling us that food inflation is only 2.3% higher than a year ago while the Department of Agriculture is telling us that agricultural prices are 24% higher than a year ago – 10X higher than food. Did I miss something? Do our farms no longer produce food?

I would really like to know where the BLS shops for food because obviously I'm shopping at the wrong place since my experience matches the Department of Agriculture's estimates. And if my personal situation is anywhere near the average in this country, it means that the government is understating inflation and overstating economic growth.



Even the Chairman of WalMart admitted recently that prices are going to spike this summer, so plant a garden and stock up your pantries ahead of these increases.

Food

We take it for granted because we live in a country that produces an abundance of high quality food and since food is a relatively small percentage of our household budgets, we grumble but accept. And for the 15% (and rapidly growing) of us who are hurting badly economically, the government is picking up the tab with Food Stamps. But that's not the case everywhere. One of the primary variables driving social unrest throughout the world is the price of food. Recall the previous chart of agricultural prices that reflects the sharp rise in food prices, which are 24% higher than a year ago, and extrapolate the effect on other parts of the world.

A typical Chinese family spends around 40% of their income on food and food prices are rising by 20% or more in China. So after one year, they'll be spending close to 50% of their budget on food and after two years, it would be close to 60%. Because they need to eat, the Chinese will have to cut 20% out of their non-food budget which is a disaster for those companies selling the items in that 20%.

If the Chinese try to raise prices on the things we buy in WalMart to pay their workers more, we'll cut back on what we buy from them – which is a lot. Taken to its logical conclusion, how much longer can the Fed print money without it destroying demand for non-essential products?

Is it a coincidence that food prices began to soar when the Fed started printing money this past summer? Is it a coincidence that rising food prices are an important driver of the unrest in the Middle East and North Africa? What happens if the Fed remains unconstrained so they can continue these policies indefinitely?

The Stock Market

I no longer consider the stock market to be an economic indicator that reflects the expectations of informed investors regarding the future of this country. Instead, I view it as just another policy tool that can be manipulated to create confidence amongst the masses. A couple of years ago, I didn't think it was possible but now I'm a firm believer. Besides, since March of 2009, the stock market is perfectly correlated to Quantitative Easing, or more clearly, printing money.



Quantitative Easing Version 2.0, or QE2.0 is set to end in June. This means that without further printing through an extension of QE2.0 or a new QE3.0, the market will fall. But don't despair because a correction in the stock market would undoubtedly bring on QE3.0. We've reached the point of "No Return" in regards to the financial markets.

There are natural limitations to this behavior and we're quickly approaching those "speed limits". Food inflation is the primary limitation but margin compression, or decreased profitability is almost equally as important.

Companies make money by buying inputs like steel, oil, plastic, etc., and transforming those inputs into a product that people want to buy. The price of those inputs are skyrocketing faster than the stock market which means that companies will have to pass those higher costs along to consumers or they'll see profits decline. Given that consumers can

no longer borrow against their homes and have stopped ringing up their credit cards, there are no sources, other than the government, for paying those higher prices. The result will be reduced demand on a unit basis, which is the very definition of economic contraction.

If solving our economic problems were really as easy as ramping up the stock market, we'd have done it for the past 200 years. Our goal is to participate in this rally but also hold onto those gains, which we did in 2008.

Japan

The earthquake and tsunami weren't just a black swan, it was a black swan the size of a house. The Japanese did an extraordinary job in protecting the population from the initial ravages – I thought the death toll would be far higher but the nuclear situation is something else.

Initially, I tried to understand the details of what the experts were spewing forth regarding the situation but I quickly realized things were getting worse despite official statements to the contrary. When our two super carriers, the USS Ronald Reagan and the USS George Washington, left port near Tokyo due to excess radiation, I became increasingly concerned for Tokyo. Over the past three weeks, it appears to be getting progressively worse.

In the short run, we came extraordinarily close to another "Flash Crash" which I discussed in the January newsletter. It took a major intervention by the world's central banks to reverse the spike in the Japanese Yen, which would have forced markets lower very rapidly. The Japanese printed enough money to roughly match 2/3rds of the Fed's latest efforts and stock markets everywhere jumped back up.

The problems with Japan are far from over. Ignoring the vacuous argument that





rebuilding Japan will lead to prosperity, the Japanese economy is in a very bad place and it will have repercussions throughout the world for years.

Most profound over our investment horizon is that the Japanese are severely electricity deficient at the moment which means that a host of products that we depend on are not being made right now. Secondly, the Japanese people won't be in a position to consume which means that US companies who rely on Japanese sales are in for a disappointment. The worst of the effects should be revealed by this summer.

Economics

You may have noticed that my interpretation of economic data is often quite different than the interpretations of mainstream economists. The reason is that most economists take government data at face value whereas as a fundamental stock picker, I have been trained to take nothing at face value. It's the reason why I look to verify data by triangulating it with similar, non-governmental data, and why I ask the simple question of whether the data makes sense given what we know of the world.

The other area where I differ with mainstream economists is that I'm more concerned with the sustainability of a change in the economy than the change itself. The so-called current economic expansion can be traced to the expansion of government debt, which I view as wholly unsustainable.

Under normal circumstances, this approach yields opportunities to take valuable contrarian stances to the market such as our excellent performance in 2007 and 2008. Other times, it requires patience to wait for the right time to take a contrarian stance, such as the present environment.

I don't believe our economy has expanded over the past couple of years although I acknowledge that the downturn from 2009 has been temporarily halted. Instead, I continue to see an extraordinary public relations campaign to make us believe that we are expanding, similar to the campaign that resulted in the housing and internet bubbles, only this time it's the US government that is on the hook for the bad loans being made.

The GeoVest Approach

If printing money were a viable economic policy, the world's central banks would compete to have the fastest machine to ensure prosperity for their respective countries. Instead, history tells us that printing money is the last act of desperation that creates hyperinflation. We are rapidly approaching that point.

Using the term "Black Swan" in its colloquial form, we are starting to see an acceleration of the incidence of these "birds" thanks to the Fed's choice to hyper-inflate our currency instead of allowing the bad decisions of our banking system to be recognized. Along the way, the dollar has gone from a relatively fixed way of measuring success or failure to a variable measurement – it changes constantly.

From an investment standpoint, this requires us to understand what I call "real value" or things we really need when forced to make tough choices. When this disappointing episode in our nation's great economic history is finally ended, I believe that historians will look back and see where a value-based approach proved to be the best course of action. Thank you and it is our pleasure to serve you.

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