GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

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Waiting For The Next Train

Instead of printing money in the US, it was the Europeans that printed the money that allowed the stock market to elevate. We largely missed the move as I didn't like the names that were rising, particularly banks. But not to worry, there will be another train behind this one.

Unlike the manic depressives that yo-yo between optimism and pessimism, we have calmly executed a plan based on our assessment of the global economy that we established in 2003 that led us to our first purchases of gold and the sale of all of our bank stocks. The only thing that has surprised us since has been the willingness of central banks to manipulate the markets to create the appearance of recovery.

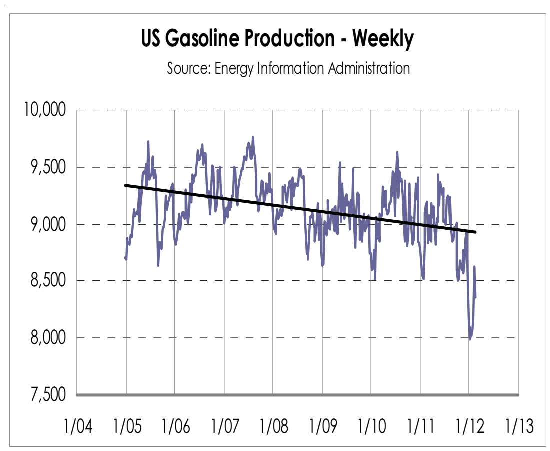
Limits to Intervention

Pundits like to talk about the Fed like it's an all-powerful institution that has the ability to fix economies and drive markets with their fabulous money machine that sits behind a curtain in a room next to Ben Bernanke's office. Instead, he's a bureaucrat with a printing press, a first-rate public relations team, and a vassal state made up of the major Wall Street banks.

The truth is that the Fed is limited by the perception of inflation. Everyone loves a higher stock market but when commodities rise along with stocks, we ultimately start paying higher prices for gas, food, and other essentials. That's when we realize that the Fed isn't in the business of making our lives better.

Since the middle of December, the S&P500 has risen 16% versus a 36% increase in the price of gasoline. At what point will gas prices start to make you angry?

The next chart will really drive you crazy – the jump in gasoline prices has occurred despite the fact that we are using much less gasoline than in previous years. Not only does falling gasoline demand run contrary to rising gasoline prices but it also disputes the Fed's contention that our economy is actually expanding!



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Strictly based on my observations, it appears to me that the Fed favors bursts of monetary largesse with breaks in between to allow for people to acclimate to higher prices believing that people will accept gradual increases in prices as opposed to sharp increases. During these breaks, the market has tended to fall.

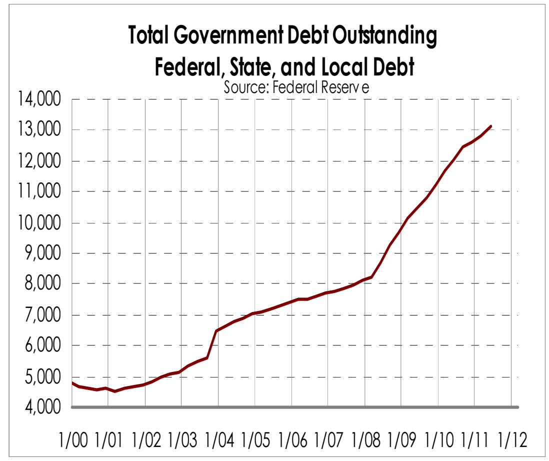
I think we're close to another break as the price of gasoline is making the Fed very uncomfortable.

Unintended Consequences

The Law of Unintended Consequences tells us that intervention in a complex system creates unanticipated and often undesirable outcomes. The Fed has been intervening aggressively in the bond markets since 2000 and the equity markets since 2009. Since that time, our economy has stagnated at best.

Intervention creates false signals and false signals lead to malinvestment. Housing is the obvious example but less obvious is the size of government.

Outsized government spending is an unsustainable trend as the Greeks, Italians, Portuguese, and Spaniards will painfully tell you. Corporations have taken advantage of this outsized spending and many are highly reliant on its continuation. As a stock picker, an unsustainable trend screams unsustainable earnings to me and that is why we are avoiding companies that rely on continued outsized government spending.



For the past twelve years, federal, state, and local governments have gone on a debt binge, the likes of which we have never seen before. Government debt has more than tripled during this time. Salaries rose, benefits improved, and public sector workers became the envy of private sector workers. We've done exactly what the Greeks did before they got into trouble, yet if we tried to practice austerity at this point, we would guarantee a depression.

Government officials behave like gamblers – they know they can't continue yet they convince themselves that there is some way they will get lucky and the economy will grow out of this problem. It's been twelve years and the problem keeps getting worse.

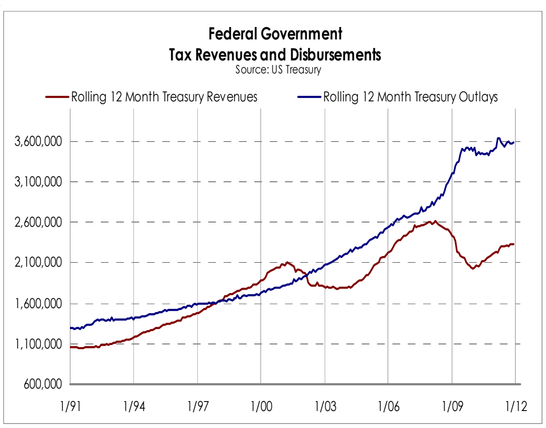
Without market intervention by the Fed, interest rates would be high enough to force discipline amongst public officials. By intervening, public officials get to continue their spending spree without negative ramifications and as we all know, when you put a penny in a politician's hand, he'll spend a nickel!

Economic Recovery

It's Springtime which means it's time for propaganda about how our economy is improving. The numbers back this up but the drivers behind the numbers do not. Let me explain. Every movement in the economy has an explanation. Examples include an increase in federal government deficit spending, easier credit for borrowers, inventory building, capital investment, etc. There is a cause and effect to every change in the economic data.

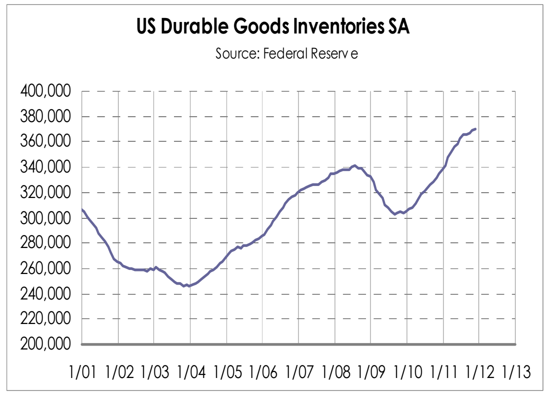
As I write this, we have three inter-related economic drivers in our economy: massive government deficits, corporate inventory building, and an expansion of sub-prime loans for auto purchases, none of which signals sustainable economic performance. On the contrary, all three point to difficulties ahead.

I've already shown you a chart of the massive expansion in federal debt. Here's another chart that shows both the expansion of federal spending and the lack of growth in tax revenues.



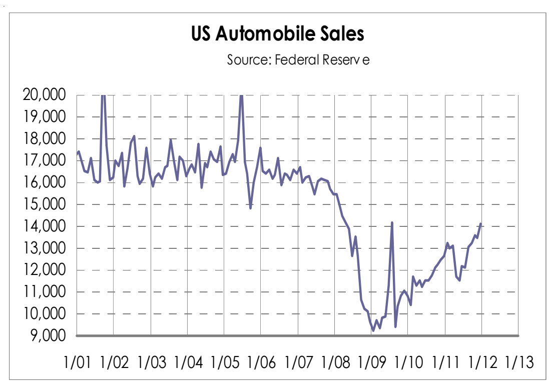
In effect, the federal government is borrowing and spending 10% of gross domestic product each year to grow our economy 2%. It's not sustainable and it makes us look much like Greece.

Corporate inventory building is the other major driver of our economy. When companies grow inventories it makes them reliant on growth in demand, otherwise they are later forced to cut prices and book losses.



Inventories are currently higher than they were in 2008 despite our soft economy. If any of the "black swans" touch down to shake confidence in the US economy, companies are going to rapidly cut production to reduce these bloated inventories.

The economists in the federal government seem to have figured this out which is why auto dealers have started to push sub-prime loans to clear some of the bloated automobile inventory that is building up. You'll remember from past newsletters that the US Treasury owns Ally Bank, which is the country's biggest auto lender. In February, auto sales shot back up to 15 million per annum rate but half of the cars leaving the lots had sub-prime financing.



We can sell cars in the United States but it takes the same lousy lending decisions that produced the crisis in 2008 to make those sales. Instead of the banks being on the hook, it's now taxpayers.

A little off topic but relevant in the long run, one thing that I find extremely positive is the quality of the cars US automakers are starting to produce. Freed from the shackles of bad past labor decisions, Ford and GM are starting to make some really impressive cars and trucks and that bodes well for the future as it shows that Americans are still very capable manufacturers.

Following Fabius

Quintus Fabius Maximus was a former general of Rome who is famous for establishing the "Fabian Strategy" whereby a smaller army attempts to exhaust a superior invading army by staying close, refusing battle, but constantly harassing the larger army's supply lines to the point where it exhausts the larger army.

Fabius employed such tactics when the great Carthaginian general Hannibal invaded Italy during the Second Punic War. Hannibal, being one of the greatest generals in history, repeatedly destroyed every army the Romans threw at him until Fabius took charge.

Historians generally agree that Fabius would have succeeded had public opinion not turned against him for appearing to do nothing. Instead of exhibiting patience and trust in a superior general, the politicians of Rome appointed two "aggressive" generals to replace Fabius in order to draw Hannibal into a pitched battle with a massive army the Romans subsequently organized. The result was that the massive Roman army was destroyed at Cannae, after which the Romans once again turned to Fabius to restore order.

Ultimately, the conditions were right for the ascendancy of Scipio Africanus who took the fight to Carthage with tactics the opposite of Fabius and destroyed the Carthaginian Empire.

The GeoVest Approach

The hedge fund community is littered with aggressive investors that experienced their own versions of Cannae. They manage one or two great years, then lose the great performance with one bad year.

We're following a Fabian-like strategy because the circumstances dictate that we follow one. I have little doubt that Fabius disliked the strategy as much as we do but if our goal is to maximize client capital over the long term and a long term value-based strategy is made impossible by intervention by central banks, then it's the only logical choice.

To trust in those central banks invites disasters akin to 2008 but to fight them means forgoing potential returns. The middle ground of owning companies which continue to increase in value while maintaining hedges against central bank mistakes is the right strategy. To do otherwise is to gamble with long odds.

Inflation will be the ultimate reward for putting our faith in central banks and that inflation is getting closer each day. Only when the central banks lose control will the time be advantageous for changing the strategy.

Thank you for choosing GeoVest Advisors. It is our pleasure to serve you.

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