On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Tremors

Unless you're from Cyprus, the most recent bailout of a profligate European nation probably hasn't been high on your list of interesting topics. Sure, the stock market had a couple of down days but in the grand scheme of things, it was minor.

Personally, I don't view the actions in Cyprus as a big deal when considered in isolation but I do believe it's a symptom of some bigger issues that will force us to take aggressive action later in the year. For now, it's appropriate to continue exercising "Blind Faith" in the Federal Reserve's ability to keep the stock market artificially elevated but we also need to be vigilant because Cyprus represents a tremor in the financial markets – a tremor that will be followed by others as the year progresses.

Stock Market

There is no way to say this nicely, so I'll just strive for saying it clearly. The stock market is in a dangerous bubble and this bubble is far worse than the one that deflated in 2008. It's more dangerous because the markets are dominated by computers to a far greater degree than they were in 2008. They're more dangerous because there is less liquidity in this market than in 2008 as trading volumes have collapsed over the past five years. This means that a truly bad event could crush things quickly.

Notice the sharp drop in volume since 2007. If we're right, it means that there are fewer investors buying stock than in recent years, despite the sharp rally.

But a dangerous market doesn't mean that it's going to go down just yet. I continue to believe that the Fed is exerting a tremendous amount of control over the stock market because it represents their policy of "creating wealth" so we all get happy and run to the store. It's the same strategy that failed in 2000 and 2008.

When I wrote the last newsletter, I had reservations about the Fed's ability to jam volatility (or VIX) any lower given weakening global profits and social unrest in many areas of the world but they succeeded. Recall how the volatility index measures by how much investors are buying insurance against a market downturn. A high value of the VIX indicates that investors are nervous while a low level indicates that they are confident. Notice how the Volatility index fell from 14 to 11 – a sign that nobody is willing to buy insurance against a market correction. Also notice how a similar occurrence happened before the last stock market crash in 2008!

Table of Contents

GeoVest Advisors, Inc.
245 Willowbrook Office Park,
Fairport, NY 14450
Tel: 800 - 638 - 5050
Fax: 585 248 8784
www.geovestadvisors.com

Based on history, it's possible to drive the market a little higher before negative global economic conditions destroy this latest attempt to create an artificial wealth effect. We believe there is at most 10% upside left in the markets but not much more.

For now, we're taking some gains on assets that we've held a long time and which have done extremely well for our clients in favor of some un-loved names in the oil and gas industry. We delayed some purchases around the end of the quarter just in case the Cyprus situation turns into a major event but we expect to be fully positioned again in the next few weeks.

Cyprus

The reason it's a really big deal is that the European Union set some very dangerous precedents in shutting down the Cypriot banks. In effect, they unilaterally decided who would lose and who would win as bank deposits over 100,000 euros will be virtually wiped out. They also shut the banks for a couple of weeks and limited the amount that depositors can withdraw.

These were banks that recently passed the European Central Bank's stress tests a couple of months ago and were pronounced well-capitalized and safe. In addition, much of the assets on the banks books are reputed to be sovereign debt from European countries but unfortunately, bankrupt countries like Greece.

Some have pointed out that the Cypriot banks were full of illicit Russian deposits stolen from Russian companies. This may be the case but the European's were happy to use those funds to bring down interest rates across Europe when it was convenient.

Perhaps the worst part of this drama is that with the stroke of a pen, the European Union has effectively wiped out half the Cypriot economy – 48% of their GDP comes from banking. Cyprus will cease to be an international banking center and its 1 million inhabitants have had their life savings and livelihoods destroyed in a few short weeks. It's no wonder that the Europeans are preparing for bank runs all over southern Europe. Who is going to trust the European banking system after what they did to Cyprus?

Gold

In my opinion, gold should be going through the roof. In addition to the unfortunate situation in Cyprus, our Federal Reserve is printing $85 billion a month and now, the Bank of Japan is printing a similar amount. We anticipated these actions ten years ago when we first started buying gold and it's the precise reason why we own the yellow metal.

The only thing I can surmise is that it's being driven lower by central bank intervention in the market. I believe that much of their success can be attributed to ill-considered speculation. I'll explain further in the next section but it appears to me that central banks are taking advantage of those investors who are using leverage when betting on gold and that leverage leaves them vulnerable.

There have been rumors of central banks manipulating the price of gold for years. Former Fed Chairman Paul Volker has expressed his regrets about not forcing the price of gold lower in the late 1970's. Keep in mind that central banks are printing money around the world. If they don't work feverishly to keep a lid on the price of gold, they risk losing the legitimacy of their currencies.

Cyprus is the just the start of another banking crisis in the world. At some point in the not-too-distant future, central banks will lose control of the markets and when that happens, our patience will be rewarded.

Market Manipulation

The price of gold is a good segue into explaining how the markets are being manipulated. Anyone who has read about the Japanese martial art known as Judo knows that the basic tenet of the art is to use the attackers leverage against him. Instead of picking up one's opponent and throwing them down, Judo experts redirect the force created in their opponent's attacks to knock them down. It's the same in the markets.

We're not the only investment firm that understands the problems in our economy and markets. Since 2008, a lot of work has been done to understand the problems in the world and this work has led to bets on the market – oftentimes with leverage such as selling short a stock, buying a put option, or borrowing money and buying gold.

Whenever investors use leverage, they leave themselves vulnerable because leverage turns small losses into big losses – it's the reason why Lehman Brothers is no longer around. Knowing this, the Fed and its agents wait for these traders to place leveraged bets, and then the Fed's agents forcefully take the other side of the trade. This is why we include charts of the VIX – they represent leveraged option trades.

A year ago, US corporate earnings growth was slowing meaningfully, Japan was recovering from a nuclear disaster worse than Chernobyl – one that continues to get worse – and at the same time, southern Europe was at the point where nobody would buy their debt and traders were making extreme bets against European markets and the European currency. All it took was a promise by Europe's central bank to "do whatever it takes" to prevent bankruptcy and the markets reversed in a huge way. Anyone betting against the European central bank incurred heavy losses. Later in the year, the Fed, then the Bank of Japan did the same thing with similar rallies.

The market has figured out this strategy which is why nobody is willing to bet against the world's central banks in a meaningful way any longer. It's the reason why markets are going up despite the tremors we face such as Cyprus, Italy, Spain, Portugal, North Korea, China, Japan, Argentina, and economic stagnation in the US.

Without speculators to crush, the Fed's ability to keep the markets moving higher is seriously compromised.

Currency Wars

We've had enough of war but this one isn't too bad as it's between the countries that trade with us. Japan started a currency war with China and South Korea in the hopes of recapturing their old export magic like the champagne days of the 1980's when Japanese manufacturing companies were the scourge of the global supply chain.

In recent years, Japan's manufacturing companies resemble fading starlet's more than lean fighters and the country's economic fortunes have slid for 20 years. Knowing that Japan is bankrupt if he fails to act, the Japanese Prime Minister Shinzo Abe has embarked on a path to make the Japanese yen trade lower in currency markets by flooding the markets with newly printed yen that's roughly three times more aggressive than our Federal Reserve. The result has been a sharp drop in the value of the yen.

The Japanese hope that a cheap yen will allow them to recapture manufacturing market share from the Chinese and South Koreans by making their own manufactured goods cheaper in trade. The problem is that they're trying to take a bigger piece of a pie that keeps getting smaller as global trade is showing signs of diminishing. They're trying to sell more stuff to US and European consumers who are retrenching due to continued economic stagnation/recession/depression depending on the part of the world you visit.

It's a desperate strategy by a desperate country. It has no chance of succeeding based on the potential opportunity in trade, but the Japanese have attempted it anyway and this has upset the Chinese and South Koreans to no end.

They're all fighting over trading with the US like bankers over a bonus and that's good for us as consumers – for now. While the US consumers win, South Korean and Chinese manufacturers will lose because they have to compete more aggressively on price. The biggest loser is the Japanese retiree who will see his/her savings cut in half by devaluation before Abe is finished.

The GeoVest Approach

We've known about the problems at the Cypriot banks for more than a year. We've known that Italy, France, Spain, Portugal, Ireland, and the Netherlands are close to insolvency for a few years. We've known that Japan is the closest to insolvency and that they would attempt to print money when everything else failed. We've known about the Chinese housing disaster for years. We know how the Fed has maintained the illusion of prosperity for the past few years and now others have figured it out as well.

The reason our long term track record is one of the best in the business is that we do the extra work to understand economic reality as opposed to accepting the mainstream story. This is why we are confident that we can continue to grow our client's money through our present economic difficulties. Forewarned is forearmed as they say. Thank you for investing with GeoVest Advisors. It is our pleasure to serve you.

Philip M. Byrne, CFA
Chief Investment Officer

GeoVest Advisors, Inc.
245 Willowbrook
Office Park,
Fairport, NY 14450
Tel: 585 248 5050
Fax: 585 248 8784
www.geovestadvisors.com