GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

HFT or Bust!

HFT, or high frequency trading, has been in the news of late thanks to a new book by Michael Lewis called "Flash Boys" and a subsequent interview on 60 Minutes where Lewis claims the stock market is rigged. In my opinion, Lewis is correct that the markets are rigged. Furthermore, I believe it's been sanctioned by the government thus far to create a "wealth effect" as a means towards pulling us out of the economic downturn that started in 2008. I've been alluding to this for the past year in my newsletter.

The mechanics of HFT are complex but in its simplest form, it allows computers that belong to private parties, and not an exchange, to see all of the trading orders before they're executed. In effect, these extraordinarily fast and powerful computers can impact just about every trade that is executed on an exchange like the New York Stock Exchange. Allowing these parties unprecedented access can only mean one thing; they serve a higher purpose.

Since I haven't been able to find a connection between the Fed's printing money and the stock market other than correlation of timing, I'm forced to conclude that there is another reason why the stock market has continued higher these past few years despite worsening economic and corporate fundamentals.

High frequency trading may have been the primary reason why the markets advanced over the past few years as opposed to the Fed's money printing. If you understand the fundamentals of HFT, you can readily see how the market could have been manipulated higher when combined with corporations buying back their own stock to such a great extent. I don't know for certain, but when I see companies that can go a year or two without having a losing day trading in the markets, as well as corporate chieftains making vast fortunes on the stock options of their companies while the economy remains depressed, I find it difficult to believe that the game is fair.

LBO of America

I'm sure you all remember Michael Milken and the great LBO, or leveraged buyout, fad of the 1980's. You couldn't pick up a copy of Business Week without reading about how some financial titan was borrowing a massive amount of money in the debt markets to buy some poorly run major company with the prospect of making that company lean and mean.

I believe we've experienced a slow and steady form of the LBO in America since 2000 as companies have used the cash flow generated through operations to buy back their own shares. Over the past three years, companies have used the gift of low interest rates to borrow massive amounts of money in the debt markets to buy back their own shares and to pay dividends. In effect, the LBO craze is back and it's being done by company management. The chart below shows the level of the S&P 500 relative to the level of EBITDA which is earnings before interests, taxes, depreciation and amortization – or cash flow – the actual cash generated by companies which is a cleaner measure than reported earnings. Notice how the market has powered higher despite cash flow generation still being below that of the last peak.

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Chart: Bloomberg

This chart proves what I've been writing about for the past couple of years; corporate America is being managed for cash, not for growth. Corporations in America have been attempting to maximize the generation of cash flow in order to pay dividends and buy back shares in their companies, a move that makes the near term prospects of their stocks attractive but the long term prospects very unattractive. Simply written, companies that invest for the future generate returns in the future; companies that give away their investment capital today suffer earnings declines in the future.

From the standpoint of a long term investor, this is the equivalent of a meal that starts with a sumptuous dessert followed by an unpalatable entrée. We've experienced the virtuous part of the cycle and unfortunately, the vicious part awaits.

Impact on Employment

I believe this dynamic where corporate America is being run to generate cash is hurting our economy. Undoubtedly, there has been an expansion of consumption by the wealthy but this has been overwhelmed by the decline in consumption by the middle and lower classes. Why else do we still talk of recovery six years after the last downturn? By failing to invest in the growth of America, corporations are impeding our ability to pull out of the 2008 recession. Not only are corporations failing to hire people back, they're continuing to reduce the headcount of higher priced talent. In addition, by failing to invest in America, they're hurting small businesses where 67% of new employment originates. Think back to the technology boom of the late 90's and how many small businesses flourished thanks to major capital investment projects by companies like Verizon. Think of the housing boom and the beneficial impact it had on contractors, real estate agents, and title companies – not to mention the companies that supply these people. The only thing to rival this today is the shale oil and gas boom but this is tiny by comparison.

The chart below does a great job of explaining our present employment picture. We're still roughly 500,000 jobs off our peak from 2007 but the quality of jobs has fallen dramatically and the results explain why retailers such as WalMart and Family Dollar Stores are struggling so badly.

We've replaced good, middle class jobs with subsistence employment. The aggregate numbers look like they're improving but they fail to tell the full story which is a large group of people taking any work they can find. Without a capital investment boom, there is little that can reverse this negative trend.

China

Things are starting to get a bit dicey in the Middle Kingdom. As I wrote in the last newsletter, China was the real savior of the global economy, not the Federal Reserve because the Chinese went on a building spree of epic proportions starting in 2009. Since then, they've built the equivalent of 50 Manhattans, including a replica of Manhattan (no kidding!) and 90 million meters of residential real estate – think of our misguided housing boom on steroids.

It wasn't just lousy investment; it was so bad as to defy any rational equivalent of the term "investment" but it kept the global economy humming for a few years while the Chinese bought the inputs for their great blunder. It's bad enough when you build ghost cities but when you borrow a ton of money to build ghost cities – think trillions of dollars – and you don't generate rent to pay back the loans, you've got a problem. In China, some of those loans are starting to come due and Chinese authorities don't have enough money to bail them out.

In addition, the new Chinese government has decided to get out of the ghost city business and instead is focusing on more disciplined and rational investments. That sounds nice but along the way, they have to face the hangover that comes from $15 trillion of largely wasted investment. When you consider that we're still facing the hangover from the 2000's, the Chinese are facing one that is much worse and at a time when they have been the major driver of the global economy.

Stock Market

Returning to the stock market, we've started the year off poorly. The first quarter was largely flat and as I write this a couple of weeks later, the indexes are in negative territory for the year. This isn't surprising after two stellar years but when you understand just how fragile HFT makes markets, it's worth more than a little caution. The bright side is that we're having a good year.

The problem with manipulated markets is that you don't know when the manipulation ends and reality sets in – that's the real reason why I haven't been willing to aggressively chase this thing. It's terrific when the market rises like 1999, 2007, and 2013 but it's awful when real economics and fundamentals assert themselves like in 2000, 2008, and ?. Right now, there are lots of things that worry me at night – China, Russia, weak consumers, high valuations and high frequency trading. The thing that probably worries me the most though is that the conditions that gave us this great rally since 2009 are rapidly fading.

Natural Gas

Turning away from the negative, let's concentrate on something that fills us with optimism – natural gas. A cold winter has depleted the excess inventories that impeded development of further production which has helped our investment in Devon Energy shown below.

It's been nice watching this stock move higher but as a long term investor, the thing I really love about natural gas is that we can produce a ton of it in the US and at costs that are lower than those enjoyed in much of the world's industrial economies.

In short, we have a tremendous competitive advantage and competitive advantage is what produces profits.

The GeoVest Approach

When markets are left alone, they provide important clues about the state of the economy. If we were to judge our economy based on the recent returns in the stock market, we'd conclude that things are going well but we know that the market is providing a false signal because our economic leaders are still searching for the elusive "recovery".

I'm guessing that the market is rigged. To quote the "duck test" given to us by James Whitcomb Riley: "If it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck."

If it is rigged like it appears, then at some point fundamentals will begin to matter once again and since we make investments based on fundamentals, I expect our clients to thrive even if things get a bit messy. Thank you and it's our pleasure to serve you.

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