GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

New New Deal

This is what I call the efforts by the financial establishment to restore our economy to prosperity. Unlike the 1930's, we don't have a Tennessee Valley Authority to create hydroelectric power to light the homes of the South or a Hoover dam to provide electricity to the West. Instead, we have high frequency trading computers that ensure that the market never goes down. We have non-stop entertainment on our Iphones, Ipads, Samsung Galaxies, and whatever else keeps people plugged into cyberspace, allowing them to miss the reality that is around them.

As a public relations campaign, it has worked rather well. As a means of restoring our former economic vibrancy, it has been a disaster.

Stock Market

It all starts with the stock market. Before they started manipulating the market, it was a valuable economic indicator. Putting aside some notable insanity such as the "Nifty Fifty" from the early 70's or the "Tech Boom" of the late 90's, the stock market did a nice job of telling us what was hot and cold in our economy. Today, it's useless apart from telling us that our government views the stock market as critical for our economy and that creating a wealth effect is in our national interests.

To create this wealth effect, they had to manipulate stock prices, a move that will one day prove costly when real investors demand a high risk premium to compensate for this lack of trust. In addition, to accelerate earnings growth in a torpid economic environment, we've incentivized companies to downsize and buyback stock with their freed up capital. This has the effect of pulling forward future earnings to the present but portends earnings declines in the future. This has already started with the S&P500 companies expected to experience a 2.8% earnings decline in the first quarter of 2015.

Stock market moves that look like this are not normal. It takes massive intervention to produce this chart and probably something of a disregard for the law. But who cares? Nobody gets hurt - in fact, it actually helps quite a few people. Right?

Actually, real people are getting hurt and more will get hurt in the future. In order to make the market rise like this, companies have had to manage themselves for cash and that means they're not investing in the long term health of their business - in aggregate,

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

the long term economic health of our country. Making this worse, those companies are letting long time employees go so they can generate the profits that allow them to justify these stock prices.

But that's water under the bridge - it's already happened and we have no choice but to prepare for the consequences. The government won't be able to hold the market up indefinitely.

Confusion

Lots of people have awoken to the dangers of the stock market but they don't know what to do about it. Most will admit that company earnings, in aggregate, will be down 3% in the first quarter of this year. Others will note that the market advance is already too old for it to continue and therefore, recommend prudence. Still others will point to the chart below of the broadest measure of stocks - the New York Stock Exchange Composite - and how it hasn't advanced in a year as evidence that something is wrong.

Sure something is wrong - it's been wrong for the past fifteen years! Faced with economic uncertainty and risk, the smart thing for companies would have been to pay down their debt and make sure their businesses are strong. Instead, they added multiple layers of additional risk to their business models by borrowing money to buy back their own stock.

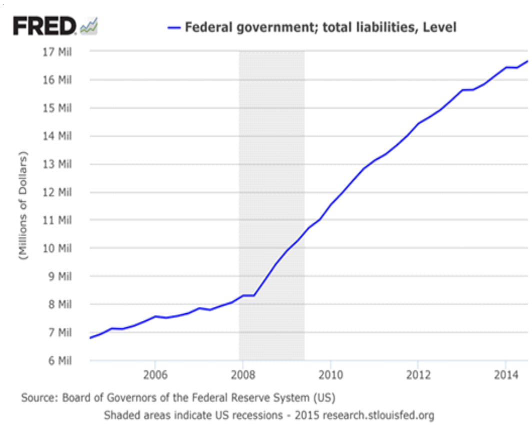
The reason why the broad market has topped while the major exchanges such as the Nasdaq, S&P500, and Dow Jones Industrial Average continue to go up is that large companies still have borrowing capacity while smaller companies have effectively been shut out of the market. Large companies can still borrow money to buy back their stock while smaller companies aren't deemed safe enough by bond investors. This is why I believe the large companies will continue to advance while the typical stock remains flat to down!

Last week, General Electric announced that they would sell off most of their GE Capital business - the one that got them into trouble in 2008 - and use the proceeds plus a ton of new debt to buy back their stock. So what does this tell us?

It tells me that GE believes that their industrial businesses will provide the growth in the future - that's the good news. It also tells me that they expect the Federal Reserve to devalue the dollar, making the debt on their balance sheet worth much less. This is why we still own gold.

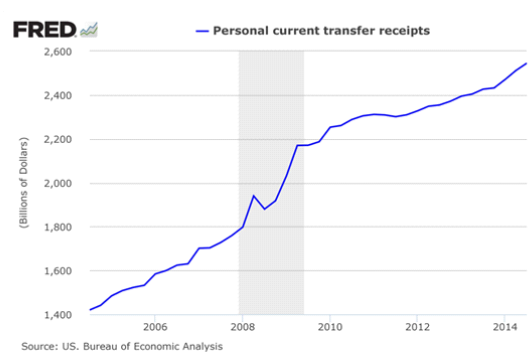
The Economy

Our forecasts for the economy over the years have proven extremely accurate apart from one variable - one very big variable! We didn't believe that our government would be able to borrow such extraordinary sums while the bond market allowed interest rates to fall. What they've accomplished over the past six years is both unprecedented and astonishing. They've defied every economic convention that has ever existed - they've achieved the impossible. Alas, it's only temporary.



They've doubled the national debt in seven years! Countries that double their national debt don't get to do so with lower interest rates, but we did. They also don't get to do this while the value of their currency rises.

In economic and financial terms, this is the equivalent of a three headed goat. It took extraordinary manipulation of the financial markets to make this happen but they've succeeded for now.



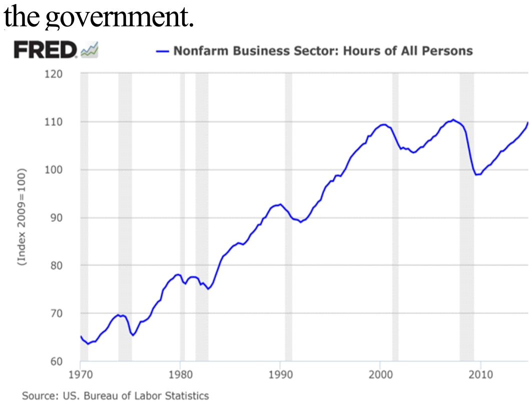
This is how the government has been able to stabilize our economy. Since 2006, we've added $1 trillion per year in additional transfer payments - Social Security, Disability, Welfare, Foodstamps, etc. These payments are spent in the economy but they don't produce anything tangible or intangible - they're just consumed with virtually no multiplier effect.

This one variable, by itself is responsible for nearly 35% of the growth since 2008! And it's not growth in a conventional sense because nothing was produced to offset these payments. It was simply funded by debt - debt that has to be serviced.

In addition, the Federal Reserve has printed $3.7 trillion since 2008 by expanding our base money supply by 180% and this represents 125% of the economic "growth" since that time. Needless to say, we haven't experienced growth in the conventional sense.

The term "Breadwinner Jobs" refers to jobs that pay more than $50,000 per year. Over the past fifteen years, we've lost 2 million of these jobs, replacing them with part-time jobs that pay a fraction. Over this time, median income has fallen from $57,000 per year to $53,000 per year.

And if you're wondering how this happened, look no further than stock buybacks. In order for the market to stay elevated, heads have to roll and every time a breadwinner job is lost, our economy gets more dependent on the government.



This chart is effectively telling us that the private sector hasn't grown in 15 years. Whatever passes for growth these days is basically tied to the government borrowing money in the bond market and spending it. It's working today but it's not sustainable.

But as long as the stock market keeps going up, it's easy to believe that our economy has improved. This is why the stock market is so important and why I'm temporarily bullish on the market when others are getting scared. I know that the moment the stock market corrects, the rose colored glasses come off and people will start to question the decisions of our elected officials and financial leaders.

The Next Crisis

Our economy hasn't improved and now we're starting to see signs that another round of weakness is on the horizon. And it's not just weakness in the US; we're seeing it throughout Asia, Africa, South America, Europe, and Canada. In fact, the US appears to be the strongest economy in the world, at present, thanks to the aforementioned ability to finance current consumption in the bond market.

The Federal Reserve has been talking about raising interest rates in the US because they claim our economy has strengthened. Like the stock market, I believe the discussion about raising interest rates is more a desire to portray the economy as getting stronger than an actual reflection of an economy that is getting stronger. I consider the distinction to be crucial to getting the call on the next economic crisis correct.

The Fed may follow through with a token quarter of a point in June but I don't believe they can do more than that without crashing both the stock and bond markets.

The GeoVest Approach

I don't know if I've ever seen so much confusion about the markets as I see today from financial commentators. This is because our financial leadership has changed all of the rules on investing over the past seven years.

When he retired from being the Chairman of the Federal Reserve Board, Ben Bernanke commented that nothing from economic theory suggested that his policies would work but that somehow his policies worked and saved the world in the process. I imagine it will be difficult when he learns that his policies only bought us a little time.

We are preparing for when the crisis resumes. Until that time, we hope to stay on the edges of the party and get as much as we can without losing perspective.

Thank you and it is our continued 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