GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

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Strange Days Indeed

It was John Lennon, who wrote the unforgettable lyrics “nobody told me there would be days like these, strange days indeed, most peculiar Mama.” Last quarter, we recommended that investors “turn and face the strange”. Now, we recommend that they embrace it.

Manipulated markets don’t make sense outside of the understanding that they’re manipulated for a reason. The purpose is to shape people’s perceptions about the health of our economy. A strong stock market indicates a strong economy.

It is why it is important to understand how the market is manipulated. When financial authorities intervene in the markets, they don’t buy safe electric utilities, they buy securities where negative speculators are making big bets that a company will fail and negative speculators make these bets for very good reasons.

Perhaps the best example is Peabody Coal, a company that is presently in technical default on its debt and likely headed to bankruptcy. The stock rose 300% in March as negative speculators were forced to reverse their trades, only to fall back down again to the original price.

Peabody Coal didn’t suddenly become a good investment on March 6th. Instead, a flurry of short-term buy orders hit the market that forced negative speculators in the stock to reverse their positions and buy the stock - a short squeeze. The initial buyers who forced the “short squeeze” book a nice gain while the negative speculators book a very big loss - despite being right about the company’s fundamentals. Welcome to the new reality.

Why Manipulate?

You can thank Keynes and Bernays. John Maynard Keynes was a great economist and a great investor. Keynes correctly observed that people make decisions based on how optimistic they feel “at the moment” and not based on some mathematical expectation function like utility. Based on this observation, he suggested that if you can maintain consumer confidence, you can direct people’s “animal spirits” towards optimistic decisions - decisions that maintain consumption levels in an economy.

Edward Bernays was the nephew of the great psychoanalyst, Sigmund Freud. He is the man credited with creating modern public relations in the United States. Bernays knew that public opinion could be directed through press releases and advertising. We can see his influence everywhere in society today.

Based on the work of these two men, it’s clear to me why the stock market is so

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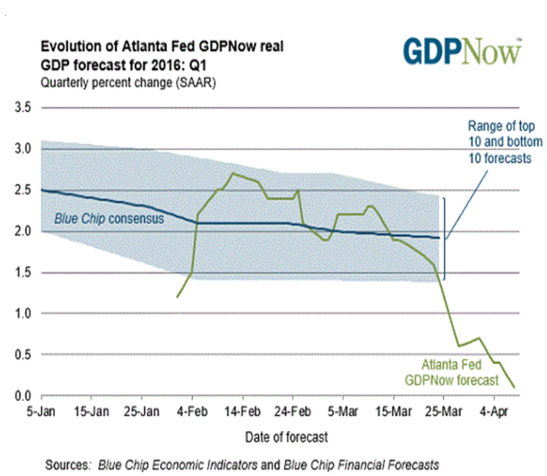
important to economic leaders. As long as the stock market remains elevated, the natural optimism of Americans stays kindled regarding our economy - even in the face of contradictory evidence.

Economy

Negative evidence regarding the US economy is everywhere. The Federal Reserve Bank of Atlanta has been publishing a new statistic called “GDP Now” that seeks to anticipate the Bureau of Labor Statistics Gross Domestic Product Report much earlier based on already announced components. You can readily see from the chart below that our economy is weakening.



GeoVest anticipated this economic weakness as far back as 2012 but as we got steadily closer over the past four years, we noticed that the stock market and the economy no longer seemed to be correlated, forcing us to adjust our investment disciplines. Those adjustments are the reason we’ve done so well over the past three years and the reason why we remain guardedly optimistic at the moment.

We live in a consumer-based economy. 70% of our gross domestic product comes from personal consumption and that is why it is so critical for economic leaders to keep the stock market elevated. Abraham Lincoln once said: “You can fool all of the people some of the time, and some of the people all the time, but you cannot fool all of the people all of the time.

They can manipulate the markets today but it’s still just a temporary strategy. At some point, they’ll lose control.

Our Strategy

The manipulation strategy is working but it creates a strange set of causes and effects. Some days good news takes the markets higher; other days good news takes the markets lower. The same can be said for bad news. It’s almost as if the market has a bi-polar personality, which makes short-term movements virtually impossible to predict.

In good times, it’s smart to invest in what people want; in bad times, it’s what they need. People need our government more than ever so we’ve been buying the stock of companies that supply the US government. People need to eat, so we own food companies. People need electricity and natural gas so we own electric and gas utilities.

It’s a simple but effective strategy. Sure, the manipulators won’t act on the stocks that we own but we don’t want to own companies with questionable fundamentals in this strange time because we know that at some point, manipulation will fail.

But it’s not always about what you own. Often it’s about what you don’t own.

Valeant Pharmaceuticals has been very popular with the hedge fund community. We wanted no part of it - thankfully.

They may have enjoyed success in the month of March but we're trying to limit stocks that rely on the business cycle, such as Alcoa. In order to buy these stocks, we would have to expect a turn upwards in the economic cycle. No such recovery is expected.

Fixed Income

Junk bonds had a major snap back rally in March. They're still losing money for investors over the past year but that didn't stop people from throwing money at these extremely risky bonds last month.

Personally, I believe the investors who bought junk bonds over the past month are making a major mistake. Instead, we continue to favor high quality issuers and there is no higher quality issuer than the US government.

This is an interest rate chart and since the beginning of the year, the rate of interest on 10 year US Treasury obligations has fallen from 2.35% to 1.70%. When interest rates fall, bondholders make money. Our clients are doing better than the junk bond investors - and without the risk!

Emerging Markets

Notice how the chart of the emerging market ETF looks *exactly* like the chart for junk bonds and Alcoa. It's not a coincidence. All three have lousy fundamentals and are likely to lose a lot of money for investors in the future.

The reason why it was so important to take these risky groups higher is that doing so creates the image of a global economy that is expanding. It reassures people. It gives them confidence to keep spending money and it's exactly what Keynes and Bernays prescribed all of those years ago.

Social Change

Large generational cohorts such as the "Baby Boom" generation (born between 1946 and 1964) put their stamp on our country in often unique and unpredictable ways. An analyst in the 1950's would never have been able to predict the social and political changes we experienced in the 1960's.

Today, another large cohort, the "Millennial" generation (born between 1982 and 2004) is set to put its stamp on our country in an unpredictable way. We're already seeing evidence of their influence in the upcoming national election as Bernie Sanders and Donald Trump are polling stronger than would have been predicted a year ago.

When we talk of demographics, we have no choice but to speak in generalities. In general, this group has been left behind in today's economy. They're suffering a high unemployment rate and an even higher *unde*r employment rate. As a result, we're seeing evidence of increased frugality and growing entrepreneurism.

The manipulation strategy is an attempt to maintain the status quo but I'm confident that the coming social changes will overwhelm this strategy. It's only a question of when.

Some look on this uncertainty with trepidation but we're looking at it as an opportunity. I view the "Millennial" generation as the new locomotive that takes the US economic train further down the track.

The GeoVest Approach

We may be embracing the strange today but we're doing so with our eyes open. We know it won't last forever but we also know that economic leadership will do whatever it takes to delay a major downturn in the global economy. We're enjoying today while planning for tomorrow.

The "Millennial" generation is our future and they're starting to assert themselves economically and politically. Just as the "Baby Boomers" did in the 1960's, this new cohort is going to create tremendous opportunity. But as the Boomers turned outward looking to make a difference in the world, I suspect the Millennial's are going to turn inward to revitalize our domestic economy.

Thank you and it's our continued pleasure to serve you.

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