



On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Shades of 2008

The stock market was roughly flat for the year while our clients did better than the averages. 2011 was a year of violent swings in the equity markets due to the wide scale perception that Europe is bankrupt and because there are definite signs of economic contraction around the world. Yet, the US equity markets were flat on the year?



August was a particularly violent month, reminiscent of August 2008. Major banks such as Dexia and MF Global went bankrupt in 2011, Southern Europe is widely considered insolvent and the euro is in jeopardy of being broken up and the markets rallied back? How is this possible?

In my opinion, the capital markets have become a policy tool as opposed to an exchange for buyers and sellers. While once unthinkable amongst my peers, this opinion is becoming widely embraced, particularly since our Fed Chairman has obliquely admitted to it.

Most of the benefits of this policy are in shaping the perception of our economic future. Had the stock market collapsed this fall, consumers would have behaved differently during the holiday shopping season, which would have made this challenging economic environment far more difficult. If companies had a true assessment of our economic climate, more employees would be laid off, more growth projects would be scrapped, and a general sense of malaise would encompass our country.

As I've written before, I could embrace this policy if real changes were being made to put our economy on a solid footing but I've been painfully disappointed by our economic leaders as they merely attempt to delay the inevitable, hoping that we'll miraculously grow out of our problems. Growth comes from real investment, not stock market games. Unfortunately that's where the money has gone.

Intervention

If the government is willing to intervene in markets, then why not adjust economic data? Why not "massage" the data to send a message that is consistent with your economic goals?

I have no idea whether it's being done or not but I don't have much confidence in the data that emanates from governments around the world because the political pressure to produce good numbers is enormous. It's the reason why we triangulate, or find multiple sources to validate every piece of data that we can.

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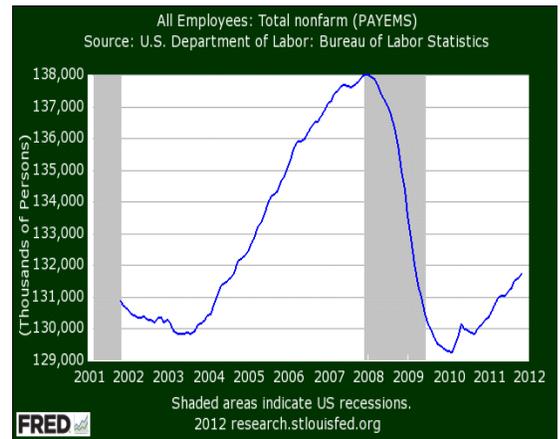


I do know that faulty data creates false signals and false signals are deadly to long term investors because they induce people like me to allocate client capital to the wrong places. One recent example was from the National Association of Realtors, which is the primary source for data on the sales of existing homes. On December 21st, they admitted that they overstated home sales by 4,190,000 or 14% of the total of homes sold between 2007 and 2011. Anyone relying on that data reached the wrong conclusions on the state of our economy. Investing in banks would have been a logical outcome but as you can see from the attached chart, it would have been a mistake.



By “triangulating” the data with mortgage application data and anecdotal evidence that mortgage brokers and real estate agents were losing their jobs, it was clear that something was wrong.

Employment data was overstated by close to a million jobs a year between 2008 and 2010. Had the data been accurate, and the trend-line of growth maintained, there would be 135 million people employed in this country instead of just under 132 million. Those relying on the data reached a logical conclusion when they forecasted a typical economic recovery.



Instead, as you can see from the chart, we’ve got this slight improvement that’s more stagnation than recovery. The point is that it has never been more difficult to pick your way through this mess because we keep getting false signals in the market and from the data.

Europe

Europe is what happens when technocracy combines with socialism to outlaw capitalism and common sense. The mistakes made in Europe were so unbelievably stupid and so grotesquely obvious that a study of those mistakes should be required for all business school students over the next 1,000 years.

Greece is the most obvious starting point. Some smart fellow with a spreadsheet figured out that if you could lower Greece’s borrowing costs, investment would follow and the economy would grow. By forming a currency union with Germany, the market initially treated Greece debt like it was similar to German debt. The numbers indicated that all was fine – lower borrowing costs allowed the government to expand employment, services, and ultimately salaries. One problem was that being part of a (formerly) strong currency like the euro left them at a competitive disadvantage in shipbuilding but nobody seemed to mind because the government was hiring.

Fast forward ten years and there are no industries left to pay the taxes that service

the debt that gave the Greeks a very pleasant ten years. Going strictly by the numbers, GDP was expanding – and isn't that a good thing? It is when there is real growth, not borrowing and spending. Anyone who followed the money trail in Southern Europe could predict this end because the same thing happened in Portugal, Spain, Italy, and to some degree, France.

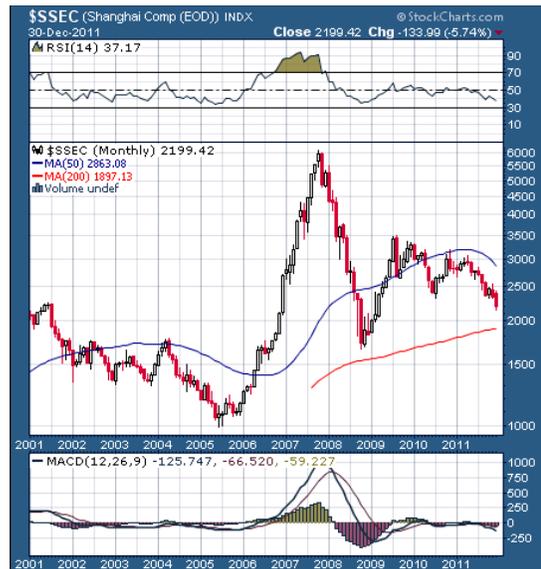
Those economies are currently contracting aggressively and will continue to do so because banks are reducing loans, not creating new ones. Unlike previous downturns, they no longer have basic industries like steelmaking, shipbuilding, textiles, and small manufacturing to spark a recovery.



Talk about intervention! The common currency is facing a break-up, the European economies are facing varying levels of austerity, people are rioting in the streets and the market is a mere 14% off its highs?

China

China is experiencing similar problems as Europe but for entirely different reasons. Where Europe and the United States allowed key industries to migrate elsewhere, China attracted them, whether it made financial sense, or not.



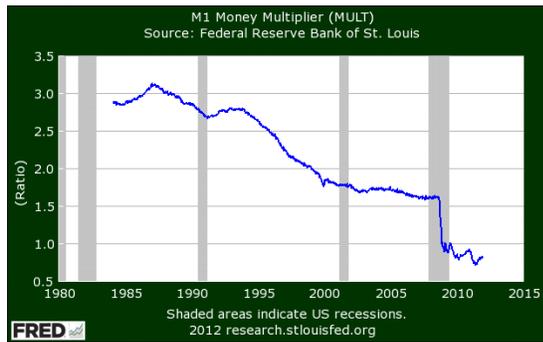
As everyone knows, China saved the global economy in 2009 by stocking up on commodities and using them to build tens of millions of homes that are presently unoccupied. Think of their actions as trying to mimic what the US did in 100 years in just 20 years. They developed too rapidly and without a profit motive and the result will be a failed banking system, just like Europe.

The only saving grace is that China now possesses key industries and technology. If they can find a way to utilize them in the future, it's possible that they can recover from this serious downturn.

Gold

This brings us to the reason why we continue to own gold. If you understand money, then you understand that all money is backed by debt, not real assets like gold. When the global banking system is sitting on massive unrealized losses that are growing daily, the reality is that we've experienced an unrealized reduction in money. It's the reason why efforts by central banks to add money to the banking system hasn't yet resulted in runaway inflation. The chart below shows the money multiplier of base money, or the amount a dollar changes hands throughout the economy in a given year.





Think of the banking system as a mug with a hole in it and the Fed as the bartender. Instead of fixing the hole in the mug, the bartender keeps pouring more beer into the mug to maintain its level and not worrying about the mess being created. We own gold for clients because we are worried about the mess ultimately turning into hyperinflation.



2011 was a good year for gold but up until December 24th, we were having a great year. I don't know if it was intervention, but I know that we gave back half of our gains for the year over a week of very light trading volumes. I also know that we've made a lot of it back in just a couple of days in the new year.

2012

We believe 2012 has the potential to be a very good year in the capital markets. The Fed has its back against the wall. Just about everything it has tried has failed but they've got a printing press and Ben Bernanke has proven that he's not afraid to

use it! Besides, the inflation hawks that voted on the Federal Open Markets Committee during 2011 have rotated back to non-voting status, to be replaced by Federal Reserve Bank Regional Presidents noted for their soft stances towards inflation. I expect that a market swoon that accompanies some weak economic data early in the year – perhaps more pressure in Europe and China – and the Fed will flood the markets with more money.

The GeoVest Approach

The media tells us that our problems are complex and they add a ton of noise to what is absurdly simple at its core. We have a debt problem – a very big debt problem. We have a global economy built on the hyperbolic growth of debt over the past 40 years and now we have a growing list of insolvent nations. The global central banks are trying to maintain the status quo and while impossible, they continue to try.

We've written about this problem dutifully every quarter for the past eight years while striving to both grow our client's assets and protect them from market collapses at the same time. The apparent market interventions have added a layer of complexity to our asset allocation decisions in ways that were never necessary in the past.

We continue to believe that the only long term approach to today's uncertainty is to own stocks of companies that sell essential goods and services such that the mistakes made by our economic leadership don't impinge on the value these companies create. Thank you and it is our pleasure to serve you.

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