



On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Black Swans and Blowflies

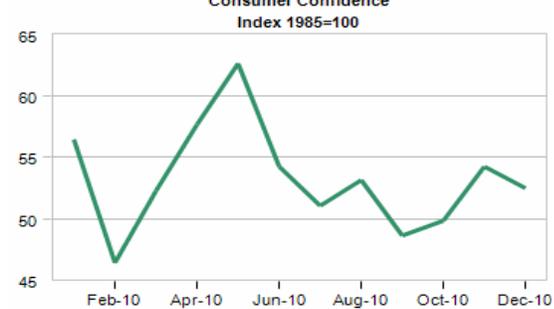
2010 will go down in the record books as a very strange but ultimately profitable year for the stock market. It's a year that was deeply negative a few times when market participants realized that we're not experiencing an economic recovery but which ultimately took off when the chairman of the Federal Reserve all but acknowledged that he's expanding money supply to take the stock market higher.

We had a good year as well. As you know from past newsletters, I'm trying to match market returns while maintaining downside protection while also trying to own stocks that will perform well in both inflationary and deflationary environments. This intrusion by the Fed will have short term implications that will require some temporary adjustments on my part but our long term strategy of taking advantage of changes in the global economy remains intact.

Quantitative Easing v 2.0

As I mentioned in the last newsletter, the Fed has chosen to expand its balance sheet to buy Treasury bonds in the hope of freeing up capital for investment. That's what they say but what they fail to say is that the banking system is already overwhelmed with spare liquidity that can be used for lending – and they know it. Instead, their strategy is to provide liquidity to take the stock market higher in the hopes that a higher stock market will raise consumer confidence to the point where consumers will spend, thus expanding gross domestic product. It showed signs of success in early 2010, evidenced by the chart of consumer confidence but notice the time period

from August to December – hardly any improvement.



On its surface, this sounds like a great plan – I mean who doesn't want a higher stock market? The problem is that this approach creates short term gain and long term pain – and we're long term investors. Instead of rewarding prudent investment, the Fed is rewarding trading operations. Quoting Machiavelli, one could argue that the "end justifies the means". Unfortunately, the Fed has to go to greater and greater lengths to keep the game going and as I wrote in October, we are perilously close to the edge of a cliff.

Black Swans

As Nicholas Taleb wrote in his book of the same name, Black Swans are supposed to be unanticipated events that lead to dramatic loss in asset values. Taleb really meant catastrophes like the Gulf oil spill or meteor strikes but Wall Street and Washington have used it to suggest the

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collapse in 2008 was a Black Swan. How could it possibly have been a Black Swan when I steadfastly wrote about it to you every quarter from 2004 through 2008? I wrote about it so often that I was sick of reading my own work!

Today, the market has a flock of potential Black Swans circling the world, any one of which can take this market much lower and those Black Swans are procreating like Blowflies. In 2008, we had a broken banking system, an overvalued housing market, and highly indebted governments – state, local and federal. Today, thanks to government actions around the world, we still have a broken banking system, dramatically more government debt, veritable bankruptcies in Dubai, Greece, and Ireland, soon to be followed by Portugal and Spain which will finally force the break-up of the euro. We also have rising inflation in China and South America as rising food prices make gold look like a laggard. Meanwhile, the housing market in the US is set to fall much further. And perhaps the biggest Black Swan of all is our dramatically overvalued stock and bond markets.

I think Ben Bernanke spends so much time acting like a scarecrow to keep these Swans from touching down that he's done nothing to fix the long term viability of our financial system.

The Stock Market

The market has gone up like a rocket since late August, yet it's increasingly unstable as it makes this move because investors continue to remove money from mutual funds and insiders continue to sell aggressively. Since last spring, domestic equity mutual funds have experienced an outflow of close to \$100 billion. Folks, this is the money that historically has made the market go up. In fact, mutual fund cash positions have been the lowest on record since the summer – yet the market keeps going up.

I believe the Fed's efforts in the equity markets are aimed at creating a "wealth effect" to expand consumption and new investment. Ben Bernanke has all but admitted his goal of taking the stock market higher in his November 5th editorial in the Washington Post and on his recent interview on 60 Minutes.

Under normal circumstances, I would simply play along and take the largesse provided by the Fed but I believe I know how they're doing it and it's extraordinarily risky. If you recall May 6th of this year, the Dow Jones Industrial Average fell 1,000 points in a half hour because buyers in the market mysteriously disappeared while the trading computers reacted instantly by pushing through sell orders. Notice the long skinny line in May that reflected the "Flash Crash".



Today's stock market is dominated by computers. I've read where the average holding period for a stock is something like 20 seconds – that includes firms like GeoVest that hold stocks for years. Some of these computers can execute millions of trades per second which means there is a potential for the market to collapse in just seconds. We saw a prelude to this possibility in May. It's the reason why our stock selections are in companies I would like to hold regardless of the market or the economic environment.

Putting all of this together, I'm going to have to change our strategy a little to compensate for the Fed's unprecedented involvement. As long as they persist with

quantitative easing, we'll have to maintain our inflation bias and possibly broaden our industry focus to include more winners from the 2006-2007 timeframe.

The Bond Market

The Fed announced their intention to start printing more money in August, then approved it in early November. It's clear to me, that their true aim was the stock market, not the bond market.

Unfortunately, a lot of people who were buying bonds at 2.4% got crushed when rates rose.



One particularly awful chart is the representation of the municipal bond market. I use the Nuveen Muni Value Fund as a proxy. Since municipal bonds are supposed to be safe, the following chart is extremely bothersome. It appears that a lot of people watched the 60 Minutes piece on state finances where the Illinois Comptroller admitted that the state can't pay its bills – this is something GeoVest has expected for a few years.



This represents a 10% decline in municipal bonds in two months! As much as I don't like municipal debt, the speed of this drop is a deep concern of mine. Now

there is talk out of Washington about allowing states to declare bankruptcy.

We have stuck with low yielding Treasury Notes the past couple of years because they allow us the luxury of moving into higher yielding securities when rates ultimately go higher and without worrying about credit risk. It's a choice between two ugly options: accept low yields today but maintain value for much higher rates later or accept slightly higher yields today but lose a lot of value when rates go higher. As a long term investor I don't like these options but the choice is easy.

The Economy

The US economy is like sausage – it looks edible as long as you don't know what's in it. Having studied it for the past fifteen years, I can tell you that it's presently sausage that's not fit for consumption. Perhaps the best way to describe it is to recall the Biblical story of the Prodigal Son who wasted his inheritance on easy living, only to return to the old man for forgiveness. What passes for economic expansion is merely grotesque increases in government debt to fund unemployment and other transfer payments, along with other forms of spending guaranteed to make today's data look good but nothing to show for the future.

In essence, we're borrowing close to \$2 trillion a year (or 12% of GDP) to fund operations, instead of funding investment in national priorities that will produce future tax revenues. In fact, if you look at federal tax revenues, they are still 16% below 2008 highs. A "real" recovery would involve rising tax revenues and would not involve borrowing unprecedented sums to fund operations.

As of September 30th, the USDA estimates that 43 million Americans are receiving food stamps, up from 32 million Americans in January 2009. Recent





private estimates suggest the number has grown to 46 million Americans at a time when we're supposed to be in economic recovery. With a population of 310 million, it means that 15% of us are receiving food stamps.

As they say, the proof is in the pudding and I can back up my analysis with a simple statement. The Federal Reserve would not have taken the unprecedented step of "printing money" if our economy was truly expanding at a 2.5% annual rate. What's more, they're printing 2X the expected growth in GDP. As it stands today, the government is borrowing \$4.70 to produce \$1 of GDP growth.

If corporate earnings are as good as Wall Street tells us, then corporations would be hiring workers and the Fed wouldn't need to push stocks higher. It really is that simple.

According to a Wall Street Journal article from December 10th, companies, in general, are hoarding cash instead of investing in growth. This makes their current earnings higher but without investment, there is no growth. Without corporate investment, there won't be any new jobs. Without new jobs, tax revenues won't expand.

Inflation

The Federal Reserve's actions can potentially spark hyperinflation in the United States. The government tells us that inflation is under control but agricultural prices are rising 20% per annum, oil is up 30% since the summer, and my favorite, gold, is up 30% in the past year. But even with higher prices in the US, it appears that the emerging markets are bearing the brunt of our money printing. China, where the next piece of *honest* data released by its government will be its first, has outlawed price increases in cooking oil, a sure sign that inflation is higher than reported.



This is a chart of the CRB index which measures commodity prices in the US. As you can see, speculators have boosted this index by 26% since August, roughly in-line with the stock market. This tells us that the Fed's efforts to drive the stock market higher will be accompanied by inflation. Their willingness to accept higher inflation is a sign of desperation.

The GeoVest Approach

The Fed is trying one last gamble to reverse the negative economic trends by attempting to drive the market higher. Wall Street traders currently believe that the Fed won't "let the market go down", and they've gone on a risk-buying frenzy. It can't possibly succeed in the long run but it's a game changer for the near term. I chose not to chase it for the simple reason that it's fragile and prone to collapse which is also the reason why we maintained our hedges but their unprecedented strategies have forced me to embrace their efforts in the short run. By doing this, they've effectively blessed our long term strategy but highlighted the need for a few short term adjustments.

While this may be the most confusing and challenging time for most investors, we continue to believe we have the right game plan for the short term and long term and that our clients will continue to be rewarded for their faith in our strategies. Thank you and it is our pleasure to serve you.

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