GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

Blind Faith

It's not just a great Rock and Roll band from the late 60's; it's a prerequisite to investing in the stock market these days. In our last newsletter, I expanded on my belief that the Federal Reserve is manipulating the stock market. I also suggested that little upside existed in the market because very few people were betting against the Fed at that time and it appears that we were correct in that assessment. Since then, the market has been flat to down despite the Fed announcing another round of money printing referred to as QE 4.0, or quantitative easing version 4.0.

The idea that the Fed is manipulating the stock market is widespread although most believe that Ben Bernanke is mysteriously buying stocks with Federal Reserve funds. I don't share that view. Instead, I believe the Fed is manipulating stocks higher by making well-timed announcements designed to incite the computers that dominate stock market trading. As I explained in the last newsletter, this only works when there are speculators betting against the market because most of the "buying" is done by those unfortunate speculators effectively being forced to close out money losing "short-selling" trades by an influx of computer-driven buy orders.

Just like the end of the 3rd quarter, speculators are not betting against the stock market. Instead, they have embraced Blind Faith and are betting that the stock market will go higher. The likely outcome is that the market falls from here until the Fed gets even more desperate and finally commits to buying stocks with printed money.

Stock Market Computers

There has been a lot written about how ultra-sophisticated computers dominate the market. Most of what you read discusses how the greatest minds of our country are developing systems that can anticipate human behavior and can learn from mistakes and successes in a virtual feedback loop that guarantees that they'll make money in the market.

Personally, I believe all of the complexity shields us from what's really happening; illegal activity that gives the owners of the computers an unassailable advantage when trading in the market. I refer to it as illegal because when I was a trader, the same activity was considered illegal when it was performed by humans. Back then, we called it front-running, or learning about someone's market orders and buying/selling in front of the order to drive the price up or down.

Table of Contents

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These same computers seem to prey on speculators, especially those nasty short-sellers who place bets that call for the market to decline. I believe that the majority of the upward move in the stock market since March of 2009, and all of the gains in 2012, are the result of these efforts to crush pessimistic speculators. The reason why this is important is that those pessimistic speculators have gone the way of the Dodo bird into extinction and have taken the impetus for a market rally with them.

You might reasonably ask why regulators allow this behavior. The reason, in my opinion, is that the government is making extraordinary efforts to try to get us out of the economic downturn that started in 2008 and a rising stock market indicates confidence in our future. The confidence is artificial. It is occurrinig despite the fact that an estimated $400 billion to $700 billion has been removed from the stock market by individual investors since 2007 which means that we're experiencing the first bull market where investors removed money instead of added money. Strange? And at a time when corporate earnings are falling – stranger still!

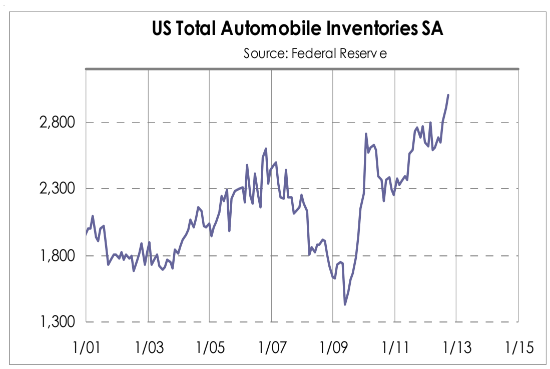
Economy

Have you noticed that I never mentioned the economy as a factor in the stock market's performance? It's because that for the moment, the economy is irrelevant. The short run performance of the stock market is being driven by the aforementioned factors, not by reality.

As for the economy, we continue to bounce around what can be best described as "stagnation". Holiday sales appear to have been flat to down as compared to last year. Some analysts try to place the blame on the so called "fiscal cliff" but I doubt it. Instead, I think people are getting squeezed by hidden inflation, falling income, and a stagnant economy that only appears good to the folks who design the economic policies that don't seem to work.

Along those lines, there was a fascinating piece in the Wall Street Journal on December 12th about how the prescriptions to fix our ailing economy are really an experiment by a group of global central bankers with ties to the Massachusetts Institute of Technology (MIT). Clearly, it was a planted story because mortals don't get to read about the inner connections of central bankers unless it serves a purpose. My interpretation is that they're telling us that they have the power to fix this mess by influencing economic activity through the markets.

I can believe this because there are a lot of strange things occurring in the economy that wouldn't happen in a market economy. One glaringly obvious factor is that auto inventories are at obscene levels and have been for a year. The market for cars is still soft yet our carmakers continue to build more. Historically, this was a recipe for disaster, seen most recently among home builders.



Another thing is that I've read some strange stories that indicate that metals like aluminum are being produced and stored in vast warehouses, presumably to keep product off the market so prices can rise. We're seeing similar activity in oil where the Cushing, Oklahoma oil hub has recently doubled capacity to 100 million barrels of oil with plans to add another

50% on top of that. With demand for oil continuing to drop in the US while our domestic production continues to expand, hoarding oil is absurdly irrational because the more oil stored, the more prices will fall in the future.

When we put all of the pieces together, we see that the MIT plan is nothing more than widespread manipulation of various markets stretching from commodities to stocks as a means towards generating economic activity. Manipulation works in the short run but it creates imbalances that lead to sharp corrections later on – just like with housing.

Fiscal Cliff

Lately, we have been inundated with non-stop coverage of the "fiscal cliff" by the media outlets. On New Year's Day, we got word of an agreement to raise taxes without spending cuts. A lot of people talked a lot about it but in the end, it was just noise – a tempest in a teapot.

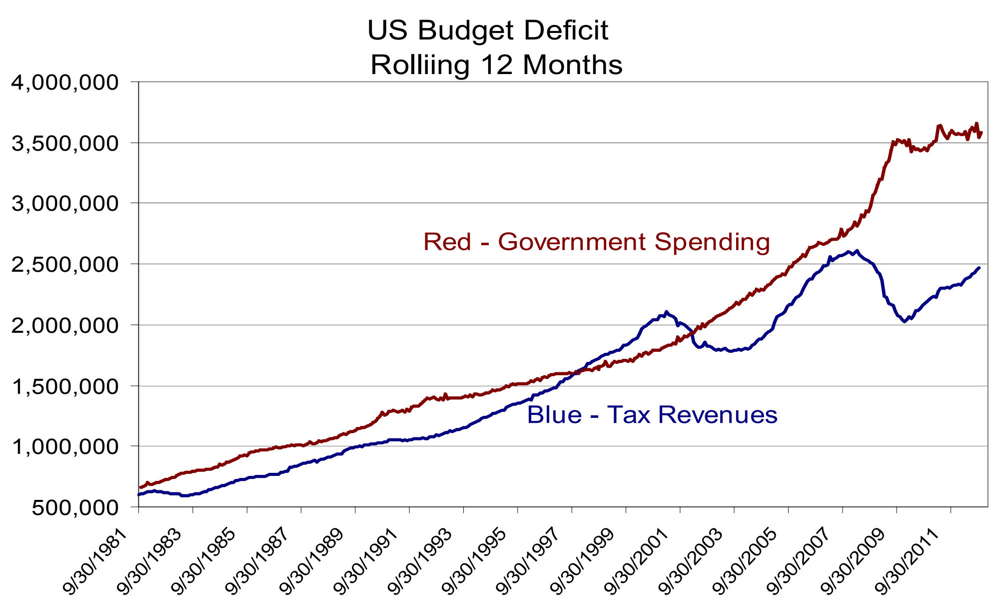
Our taxes will go up but it won't make the slightest dent in our deficit as we are spending over a trillion dollars a year more than what we generate in taxes. Some call it temporary but it's been four years. At some point, you've got to see it for what it is.

The fact is that our economy is dependent on government spending. Without the big deficits, we would quickly experience the effects that were put off in 2009. Notice how we're still at the same level of government revenue as 2006.

Going Forward

This involvement complicates matters. Under normal circumstances, you can be sure that when auto inventories get to a certain level, they're going to stop building cars. Under normal circumstances, you don't expect cheap, sub-prime loans for cars when real incomes are declining. Under normal circumstances, the bond market wouldn't allow the US to run a deficit that's 10% of GDP for four years.

We've continued to use hedges because corporate earnings have been falling in the US, Europe continues to be a mess, and China is showing signs of a sharp slowdown in its economy. But we can no longer bet against the market manipulators because they've proven they can take the markets higher despite continued redemptions of stock mutual funds by investors.



We expect volatility to return in 2013. At various points, the market is going to be up big, down big and will probably close the year strong like 2012. The reason is that the stock market appears to be the most important element of the MIT strategy to save the world. The problem is that they've run out of speculators to crush in their effort to take the markets higher which means that a new strategy is likely.

Gold

When we started buying gold miners in 2004, we did so because we anticipated that the world's central banks would have to start printing money to get us out of the problems that they helped create. At the time, it was hard to imagine because the world was starting to recover from the Internet bubble. The rationale proved highly accurate.

The Federal Reserve is printing $85 billion per month. Collectively, the global central banks have printed $12 trillion since 2006. Leading liberal economists are floating a trial balloon that would have the US Treasury mint a $1 trillion platinum coin to be deposited at the Federal Reserve that can be spent by the government. Does anyone really believe that the price of gold is going to fall given this situation?

We do the extra work as analysts because it allows us to stay with investments that prove temporarily unpopular. The gold miners are paying us nice dividends while we wait for the investing world to come to its senses.

For me, the final step in picking a stock is whether I would like to operate the company in the event that the market no longer functioned. Would I like to operate a company that pulls gold out of the ground at a time when central banks are destroying the value of cash? You betcha!

The GeoVest Approach

We've never faced as much uncertainty in the world as we face today. To combat this uncertainty, the government has continuously tried new things over the past four years that have never been tried before. They've succeeded in producing stability at the price of some grotesque imbalances in the markets and in the economy.

Fortunately, these imbalances favor our portfolios over the long term which is why we have stuck with them. Every step taken to ensure stability raises the likelihood of currency devaluation in our future. Who needs Blind Faith when you have hard work and careful planning! Thank you and it is our pleasure to serve you.

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