On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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The Paradox

2013 was a year when our stock market hit a new "all-time" high while the global economy continued to show signs of a cyclical downturn. It was a year where the capital structures of our domestic corporations got riskier yet the value of their equity went higher in virtually uninterrupted fashion. It was a year that the stock market signaled unparalleled prosperity while 1 in 5 Americans had to receive food stamps. To say it was a weird year in the markets wouldn't do it justice.

It was a year where the Federal Reserve announced that they were "thinking" about reducing their bond buying, a few months after they expanded their purchases. This caused a mass exodus out of bond funds into stock funds which appears to have given us the strong year we experienced. It wouldn't be a stretch to suggest that investors were herded out of bond funds into stock funds for the purpose of creating a "wealth effect" in stocks.

It was a year where corporate earnings failed to grow, apart from the benefits of stock buybacks on earnings per share. It was also a year where interest rates went dramatically higher which normally makes stocks worth less. Finally, it was a year where the market rewarded companies for borrowing money to buyback their own shares despite the heightened risk of doing so.

Financial Engineering

The Paradox I'm referring to in the title pertains to the fact that companies that borrowed money to buyback their own stock were some of the best performing stocks in the market. Think of it like a slow moving form of the leveraged buyout craze that gripped the 1980's. It brings back memories of Michael Milken and RJR Nabisco.

Companies that take this route borrow money in the bond market and use the proceeds plus cash flow from operations to buy back their stock in the market. It works really well if speculators are aggressively betting against their company because it forces the speculators to re-purchase their "short positions" which takes the stock price higher.

It's a paradox because smart investment in new assets is what makes companies more valuable yet this trend is doing the opposite. How can a company be worth more when it doesn't invest in operations and adds risky debt to its capital structure? How can a company reduce assets and employees yet still be worth more over the long term? That's the paradox and it's logically inconsistent.

A similar question could have and should have been asked during the run-up to the housing crash. How can people with terrible economic prospects afford such expensive homes? Instead of individuals taking on more debt than they can service, it's corporations that are doing it today. History tells us that individuals couldn't service that debt just as history will one day tell us that corporations won't either.

This rally was a perfect combination of greed meets market manipulation. Greed

Table of Contents

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was evident among hedge funds who aggressively bet against the market in 2013 opposed by greedy corporate management who used excess cash flow to buy back company stock forcing hedge funds to reverse those trades. Corporations won convincingly.

Instead of using the higher values of both stocks and bonds to fund new investment projects, clever corporate managers simply borrowed money to fund a wild stock market party. To keep it going, companies have slashed capital investment and employment to make near-term earnings look better. Since the bulk of compensation for corporate chieftains comes from the rising value of their stock options, 2013 was the perfect year for those folks to make a fortune. That they imperiled the long term viability of their companies seems irrelevant when compared to the benefits of a strong stock market today.

This brings us to the second paradox – a growing economy isn't consistent with widespread corporate buybacks. If the economy was indeed growing, corporations would be using excess funds to invest in that growth. Instead, corporations bought back $500 billion worth of stock in 2013.

Stock buybacks are great when you have a company that is past its prime in its life cycle and can no longer find productive uses of excess capital. Intel is a great example of such a company. But when our supposed growth companies are following this strategy, it tells us that they believe that our country is past its prime on the life cycle which is profoundly more problematic. The chart below shows the employment levels in the companies that make up the Russell 2000 which is the small cap stock index and supposedly made up of our future great companies.

Even small companies are shrinking their employment bases and buying back shares. In the case of the Russell 2000, there are 50% fewer employees than in the year 2000. So what is the Fed accomplishing by actively supporting the stock market if CEO's are just using the moves to downsize their companies?

The Stock Market

In my opinion, the Fed is trying to spark consumption in our economy as a means towards signaling to CEO's that it's time to invest aggressively in the US. The stock market is a wealth indicator and the Fed is trying to artificially make us feel wealthy so we'll go out and spend.

The rising stock market suggests that all is well in our economy but in general, corporate earnings are no longer growing apart from cost cutting and stock buybacks. This has been the case since the 3rd quarter of 2011.

The rally started when the cyclical recovery in earnings that the Fed engineered in 2009 had run its course. Since that time, we've had some modest increases in earnings but they've predominantly come from cost cutting and from financial engineering. Throughout history, investors have ignored earnings of such low quality because they don't provide a source of future earnings.

Also, notice how narrow the advance was – it was almost straight up. So the market went straight up when the earnings stopped growing! In my opinion, that's the picture of a market that is being used as a policy tool. I believe that the Federal Reserve has used its position to effectively herd investors into stocks as an attempt to drum up consumer demand and confidence in the US. Unfortunately, this hasn't worked as evidenced by a very disappointing holiday season.

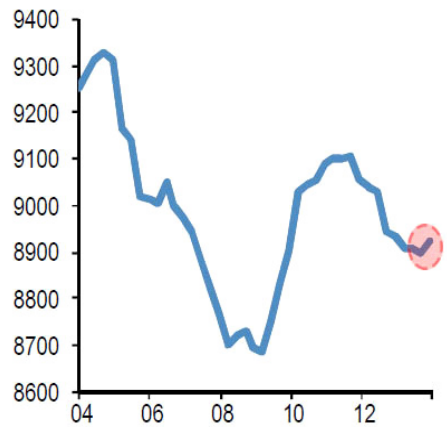
We witnessed similar exercises during the stock bubbles that popped in 2000 and 2008. The difference between this one and the two previous bubbles is that the current bubble is far more obvious. We have more economic uncertainty than most of us have experienced in our lifetimes but the stock market advance has been the least volatile – ever!

The bubble is going to pop but it's a question of when and how high the market gets before it pops. I suspect it will be fairly soon because it's clear that this supposed wealth effect isn't working because corporations are doing exactly the opposite of what will help our economy succeed in the future.

My guess is that 2014 is the year things turn ugly again because corporations appear to have used up all of their buying power in 2013 evidenced by the chart below which shows that the number of shares in the S&P 500 index is starting to turn up. This suggests that one of the primary drivers of the rally is exhausted. The rally was never about strong fundamentals; it was a bold attempt to create a wealth effect. When the effects of the Fed's intervention are exhausted, I suspect much of the gain will be given back.

Figure 1: S&P500 Index Divisor

bn of shares, quarterly data, last obs is Q4 2013



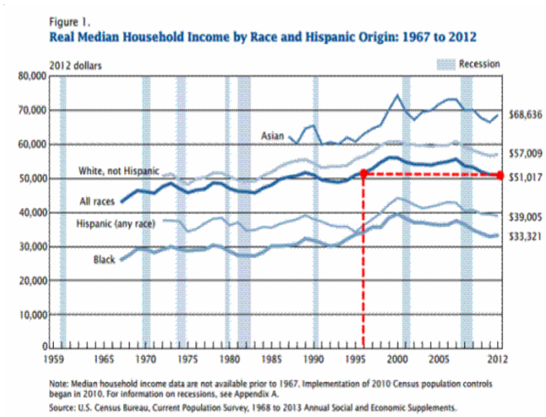
Source: S&P indices

Employment

In November of this past year, we supposedly had 136,765,000 people working in the US – almost exactly the number that was working in November of 2006. If the economy truly expanded since 2006, why aren't more people working? Why are 1.5 million fewer men over the age of 16 working as compared to 2006? Why have most of the job's created been part-time or low quality?

The funny thing is that if you adjust for inflation, corporate earnings are exactly where they were in November 2006. The formula for corporate earnings is sales minus expenses. A margin is simply the profit divided by sales. It's the amount of money that companies make on each dollar of sales. Since we know that corporate margins have never been higher, logically, we must accept that we haven't grown since 2006, apart from inflation.

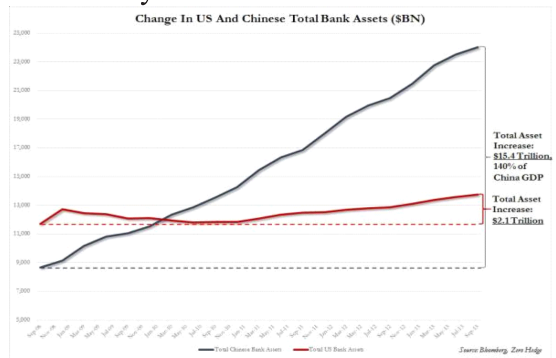
70% of our economic activity comes from consumers in this country. Since 2006, we haven't grown employment; median household income has actually fallen. The poverty rate has gone from 12.5% of the population to 15% of the population. I realize it's a bifurcated economy but companies we invest in depend on US consumers to produce profits.



If median household income has been falling since 2006 and since we have the same number of people employed as 2006, the next logical question should be how has our economy expanded since then? Based on my work, I don't believe it has but assuming that government data is correct, the difference has been made up by government transfer payments – social security, food stamps, welfare, etc. These payments are only possible if the government can continue to borrow an additional $1 trillion each year at close to 0% interest rates.

China

There has been real economic activity in the world since the crisis of 2008 – misguided but real. As much as the Fed takes credit for "saving the world" with its actions, it was China, and not the US, that was responsible for the majority of real economic activity. The chart below shows loans in the US banking system versus the Chinese banking system since 2008. The US added a couple of trillion dollars in new loans, largely for new cars and education while China added $15 trillion to build empty cities and greater levels of excess capacity in things like steel, cement, and aluminum. Those loans funded the economic activity that allowed the emerging markets to show some signs of recovery.



The Chinese made an aggressive bet – 300% of their GDP – that the world would pull out of the last recession. It didn't which is why the Chinese leadership is quietly trying to put a band-aid on the damage that spending spree caused.

The GeoVest Approach

We do the in-depth work that allows us to stay sober when the market is drunk with unrealizable expectations as well as to remain confident when the markets are in crisis. Based on our work, the seeds of the next crisis have been sown but are not yet mature.

The secret to benefiting from crisis is to be ready. We're presently putting an aggressive buy list together to take advantage when the next opportunity comes around. Despite some crazy economic policies, it's pretty clear that the next economic expansion will involve cheap energy and industrial expansion; that's where we're focused.

Saying Good-Bye

Unfortunately, we'll have to do this without a couple of long time friends. Both Donna Curtis and Chuck Puls retired at the end of the year and will be greatly missed. While new people will take over their responsibilities, people of such high caliber are never replaced. Thank you and it's our pleasure to serve you.

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