On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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For What It's Worth

I'll end the year with a classic from the Buffalo Springfield that gave us the memorable lines: "*There's something happening here. What it is ain't exactly clear*" and "*there's battle lines being drawn. Nobody's right if everybody's wrong*."

The song, written in late 1966 just as our nation started its move toward the upheaval that marked the end of the decade, spoke of confusion and misguided confrontation. Fifty years later, many of the same emotions are surging through our country which portends both volatility and opportunity in the capital markets.

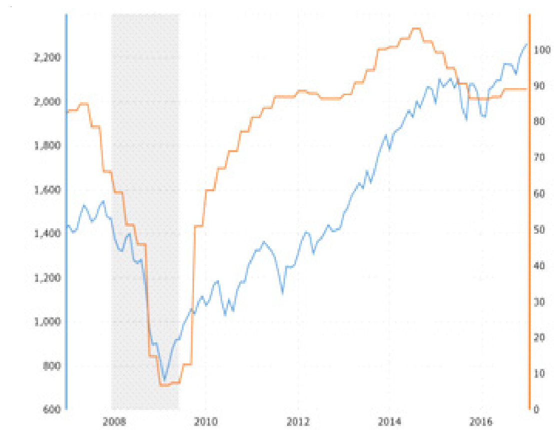
2016 was ultimately a good year in the stock market and a rough year for bonds, at least at the end. At the halfway point of the year, the opposite was true. It was a very strange year. Fortunately, we embraced the strange and were prepared.

Federal Reserve

The Federal Reserve raised interest rates in December and hinted at another two or three rate increases in 2017. They said the same thing in December of 2015. *"There's something happening here. What it is ain't exactly clear."*

Janet Yellen, the Chair of the Fed, explained that the Fed is worried about igniting inflation by remaining accommodative for too long and believing that our economy is on a firm foundation such that a rate increase will not disrupt it adversely. That's what she said but she was either being disingenuous or extremely poorly informed. I'm betting on the former.

Below is a chart of the trailing 12 months earnings per share of the companies that make up the S&P500 index. The orange line represents the earnings.



Source: Metacharts

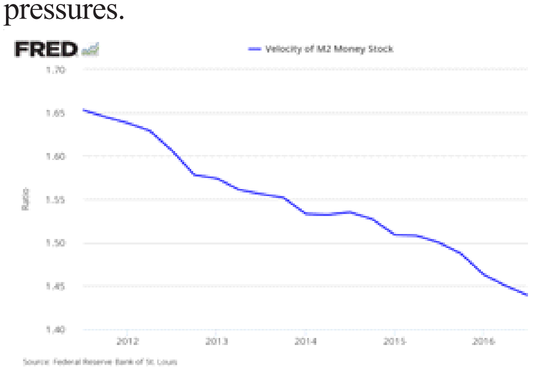
Notice anything strange - like why are corporate earnings at roughly the same level as 2008? Keep in mind that corporate America has been buying back shares with reckless abandon since 2010 making them both riskier and of lower quality. So why is the Fed raising rates when there is clearly something wrong with our domestic economy?

Conjecture is all we have but we can start by ruling out inflation. The chart below is the US dollar versus other global currencies.

A simple reading of this chart tells us that imported goods are likely cheaper than a year ago. In fact, the only parts of our economy where costs are rising are healthcare, education, and home rental. Oil prices are up since the beginning of 2016 but are roughly half the level they were just two years ago.

Rising interest rates are unlikely to have an impact on healthcare because those prices are rising as a result of the Affordable Care Act (ACA). Additionally, higher rates will likely have a negative impact on home rental costs because it will cost more to build affordable housing. In this way, it appears that the Fed's actions are actually detrimental to reducing the few inflationary pressures that actually exist.

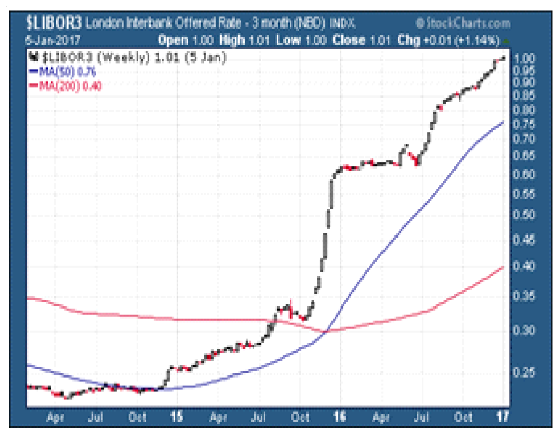
Furthermore, the rate at which money changes hands in the economy is called the "***velocity of money***". A rising rate indicates growing inflationary pressures while a falling rate indicates the opposite. The rate continues to fall. This indicates disinflationary pressures.



I have a different explanation. I believe there is trouble in the interbank market, something like what was experienced in 2008 and it's manifesting itself through higher interest rates because banks no longer trust each other. They demand higher rates to compensate for higher risks.

Furthermore, I believe the Fed is raising rates and creating the narrative that it's due to strength and inflation when the truth is that in general, banks are having a difficult time generating earnings because the spread between where they borrow and where they lend is too tight. By pushing long-term interest rates higher, the hope is that bank earnings will expand such that they can withstand any increase in bad loans from a weakening global economy without suffering losses.

The chart below is of LIBOR, or London Interbank Offered Rate. LIBOR is not only the index that most variable rate loans price off; it's the price at which banks with excess cash trade with banks with insufficient cash.

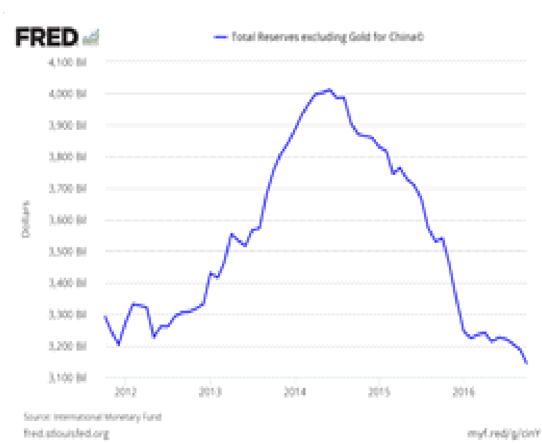


Every tick up in the above chart makes the cost of financing more expensive in the US, which has a *negative* effect on economic growth. In addition, every rate increase by the Fed *increases* the value of the US dollar in foreign trade, which *reduces* inflation risks as opposed to raising them! This is why we continue to favor long-term US Treasury bonds.

This is in addition, of course, to my *Great Game Thesis* that posits that the US is actively hurting China in the currency markets as a means towards destroying their claim on becoming a global reserve currency in the future. As I've written before, having the global reserve currency allows the US to seemingly borrow without limit. Every rise in the value of the dollar puts downward pressure on the Chinese yuan, at a time when their citizens are trying to get their money out of the country. In effect, we're creating a frenzy to get money out of China.

China

The growing weakness of the Chinese economy is the biggest story for 2017. You'll never get an honest assessment out of Beijing but fortunately, there are some indicators that are largely outside of their control.
The first is currency reserves and while I believe they're overstated, the chart below reflects just how tough a time Chinese officials are facing.



In the case of China, the chart is indicative of a country that is both losing export orders as well as a country where citizens and corporations are trying like mad to get their capital converted to dollars and out of the country. The chart below will make this clearer.

This is a chart of the US dollar/Chinese yuan exchange rate. Since 2014, the Chinese yuan has lost around 13% of its value versus the US dollar. It now takes roughly 7 yuan to buy one US dollar versus roughly 6 yuan in 2014. In my opinion, the yuan is likely to fall much further in 2017.

Each time the Chinese buy oil or food, they have to pay for it in dollars, excepting the trade they conduct with Russia and Iran. To make international payments in dollars requires the Chinese central bank to sell US Treasury bonds. To store dollars acquired in trade requires the Chinese central bank to buy US Treasury bonds. The problem is that they're being forced to sell much more than they're buying.

It's the same for corporations and citizens wanting to move assets out of China; they first convert yuan to dollars, then move those dollars to international banks outside of China. The combination of the two tells of a vast exodus out of China. Not only are China's exports being hurt by the global economic slowdown, risk-adverse investors want to get out of China.

It's not a pretty picture for the Middle Kingdom.

The Bond Market

We presently favor longer term US Treasury bonds as well as longer term bonds of very high quality borrowers. This asset allocation hurt our fixed income performance in the second half of 2016 but we remain very confident that our purchases will be rewarded in 2017.

As of 6/30/2016, our longer dated bond position was a huge winner but it reversed into the second half of the year and was hurt (temporarily) following the Presidential election. Fortunately, nothing has changed since we determined this allocation was the proper choice for clients.

The US dollar is strong, the global economy is weak, and the US government is the least risky government in the world. At some point, money is likely to flow back into US Treasury bonds and when it does, we expect very strong performance in our fixed income portfolios.

Additionally, the longer interest rates remain elevated, the weaker our economy will be in 2017. Sure, we can expect the new Administration to pass some form of stimulus but it won't impact our economy until the second half of 2017 at the earliest. Until then, we expect continued malaise in our economy, which is ultimately good for long-term Treasury bonds.

The GeoVest Approach

"There's battle lines being drawn. Nobody's right, if everybody's wrong". Personally, I can't recall such divisiveness in our country in my 50 years. I was a newborn when Stephen Stills wrote these classic lines and yet, they may be more applicable today than in 1966.

Historically, social unrest precedes change and change portends opportunity. At GeoVest, it's not our business to advocate for change; it's our business to profit from change. One change that I've noticed is a latent trend towards self-sufficiency. I view this as the start of the real recovery in our economy.

So while everyone vies for pyrrhic victories in political discussions, we plan to keep making the best of the present situation. Thank you for investing with GeoVest Advisors. It is our continued pleasure to serve you.

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