



On Course

# GeoVest Advisors

*Growing Your Portfolio While Managing Market Risk*

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## Black Swans And Funny Markets

What a difference a week makes! In the usually quiet week before the July 4<sup>th</sup> holiday, the stock market went from being flat on the year to up 6.5% and it was all because the Europeans unveiled another phony bailout plan for Greece. If anyone doubted the Federal Reserve's resolve to keep the stock market strong, last week should have dispelled any such misconceptions.



And yet, the Black Swans keep multiplying like newlywed rabbits in a hutch. We now have definite proof that the Fed's QE2.0 (money printing program) hasn't worked (Bernanke admitted it!), the first threat of a default on the federal government's liabilities since the days of Andrew Jackson, more trouble in Europe, and signs that the China growth story is over. But even with these problems, the stock market stays elevated.

In the old days, the stock market took care of itself – grow the economy and the stock market goes up but today that's been reversed to “artificially stimulate the stock

market” and hope that a “wealth effect” induces consumers to consume. Thousands of economic textbooks going back to Adam Smith and this is the best they can come up with?

Pundits like to tell us that the stock market is cheap at 16X earnings and when combined with generational lows in interest rates, those corporate earnings are worth a lot more. And under different circumstances, they would be correct. Unfortunately, our present circumstances are quite unique as the extraordinary number of risk factors (Black Swans), argue for a dramatically lower stock market. In addition, the quality of earnings reporting has never been more suspect as banks are allowed gross distortions in representing bad debts and thus, earnings.

Unmentioned by pundits is an elemental aspect of earnings quality, namely that a corporation must first invest sufficient capital to maintain current earnings power. For the past ten years, US corporations, in the collective, have failed to reinvest earnings back into domestic operations, preferring to outsource these activities to foreign firms. The result has been lower corporate expenses, some sales growth to developing markets but a loss of productive capacity that once gave a firm its competitive advantages. It's the reason why job growth in the US has stagnated and the reason why I believe earnings are over-stated.

And let's not forget the federal government impact – for the past couple

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of years, the government has been expanding debt by \$2 trillion a year as a means towards keeping the economy elevated. Recent power games by the GOP to maintain the debt ceiling suggest that this form of economic stimulus won't be driving the economy over the next six months which makes me wonder how they'll maintain the illusion of prosperity when the government's Visa card has been suspended. Add to that the Fed's decision to temporarily stop printing new money and we're looking at a serious cause for concern in the markets.

Since my work entails looking at the statistics of all the major economies of the world, I can say with great confidence that the major economies of Asia and Europe are under stress such that export growth to those regions is highly unlikely. South America remains buoyant but the first signs of stress are appearing there as well. In short, the factors that created an "artificial virtuous cycle" in 2009 have been used up.

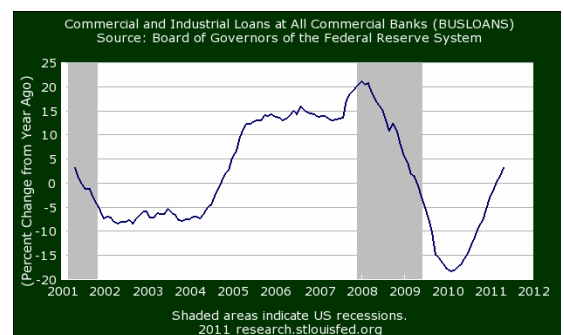
## The Economy

Study of the economy is an integral part of long term stock investment because long term investments rely on social change, which can be either ephemeral or secular in nature, or really anything in between. The point is that it pays to understand the source of change as well as its sustainability and likely duration.

At GeoVest, our economic analyses are designed to understand sustainability and duration of change and based on this criteria, I can honestly say that there has been nothing done by our federal government to support long term economic growth. The best that can be said is that they used a few "tricks" to make the data look better temporarily, hoping that positive psychology would take over. It's the reason why a true

economic recovery can't take root despite unprecedented "tricks" and "gimmicks".

Corporations have proven themselves smarter, at least in the short term. They've taken the gifts such as tax breaks and stimulus spending and simply put the money in the bank. There has been virtually no increase in jobs, apart from some part-time spots, and virtually no capital spending. In addition, corporate chieftains have used the two year stock market rally to aggressively sell their own positions. The chart below shows how bank lending hasn't yet recovered.



So the important question is what can stimulate the economy? Historically, a recession was a cleansing process where the mistakes of the last cycle were written off to price levels that allowed new investors to generate a positive rate of return. We prepared and thrived during the "washout phase" but the Federal Reserve effectively negated this process by ramping up asset prices before the losers from the last cycle were flushed out. They saved the banks temporarily but the result is very few true investment opportunities.

A productivity revolution that raises S&P earnings would seem to be helpful at first glance but when you consider that productivity enhancements usually result in pink slips for labor, you must conclude that it would be painful in the short run. This would be especially true given that consumer activity is the bulk of our economy.

Logically, we must conclude that the government is going to continue to try “tricks and gimmicks” for the foreseeable future and beyond that, they’ll be forced to devalue federal government debt through Federal Reserve money printing.

## Investment Strategy

Tricks and gimmicks give you trading opportunities but few long term investments. These ideas are tempting but I must admit that I’m not confident that the Fed/Wall Street can keep this market elevated with a sky full of Black Swans. You read a lot about some hedge funds that have booked fabulous returns in a given year by making a big commodity bet or by using leverage on South American properties but if you continue to watch those same funds, you often find they get crushed on a bad trade and have lost most of their gains. That’s why we’ve maintained our discipline by holding stock in companies that we believe will thrive while the economy transitions to its next phase.

Food companies and electric utilities are boring but they’ve got pricing power and the ability to raise prices is critical when central banks are printing money. Other than our gold investments, our portfolio is full of names that are common denominators in any economic environment. From Depression to Expansion, you’ve got to eat, drive, use electricity, heat your home, fix your car, and defend the country. The companies are in good financial shape and sell products that we need regardless of our economic condition.

Eventually, the Federal Reserve’s efforts to avoid the worst elements of a recession will prove unwise and that will be the point where societal changes provide us with opportunity to change our strategy.

## China

This is where things start to get really interesting. As all of you know who have been reading this missive for the past ten years, I’m not a fan of China. Over the past 20 years, I’ve watched the Chinese steal middle class jobs through currency manipulation, steal technology from our leading companies, and completely distort the laws of supply and demand throughout the globe. In short, China made the malinvestment that pervades the Western world possible.

In 2009, China was instrumental in stopping the slide in the global economy by creating their own massive housing bubble. They built millions of apartments which kept people employed, banks lending, and commodity prices high. Leading companies in China like Lenovo were generating a lot of their income speculating in the Chinese housing market as opposed to making computers. Notice the meteoric rise in the Chinese market from late 2008 to 2009 but also notice how it’s been falling for two years!



It doesn’t appear that China learned from us. Instead of being prudent in their lending practices, they’ve been unconscionably aggressive and now they’re swimming in bad debt – trillions of dollar worth in an economy barely 1/3<sup>rd</sup> the size of ours. All of that lending





created new money and now they've got a terrible problem with inflation.

You may recall how 40% of a Chinese family's income goes to food – probably 50% by now. They can't continue expanding money supply by 30% per year and hope to hold food inflation down. In addition, they're experiencing generational droughts throughout an already dry country, putting further pressure on food production. The Chinese people are growing hungrier, angrier, and increasingly poorer and that's why the Chinese government had to put a stop to reckless lending.

With a global economy that is already weakening, this has the potential to derail the "Chinese Miracle". Reckless lending to build unoccupied properties has been the "driver" of the Chinese economy the past two years and now they're forced to stop. Without another driver, this has the potential to be a very important determinant of global asset returns later this year.

## Europe

"Neither a borrower nor a lender be; For a loan oft loses both itself and friend; And borrowing dulls the edge of husbandry."

William Shakespeare wrote these prophetic words and while widely read, they've never been taken to heart. The term husbandry in this case refers to the judicious use of resources.

Europe is bankrupt. The Northern Europeans had excess savings and when they befriended Southern Europe through a currency alliance, the euro, they lent the Southern Europeans those savings that allowed a housing boom to blossom along with generous welfare terms to be paid to those who lost their jobs to the emerging Asian nations. Now Northern Europe and Southern Europe are at odds and the result should be the dissolution of the euro with

a few countries kicked out at minimum. I expected this to happen sooner but until recently, I didn't fully realize just how much bankers control global government.

At risk is the whole European banking system. Southern Europe can't service its debts, so it's obviously bankrupt but Northern Europe will have to write down a significant amount of the money they lent to Southern Europe and may very well become insolvent as a result. The point is that nobody wants to admit it, so they "roll over the debt" which is another way of saying they extend the due date plus increasing the loan, knowing they'll never be paid back but unwilling to accept the consequences.

## The GeoVest Approach

Whenever a banking system is wiped out, the answer is to "print" money. People act as if this has never happened before, but in the 1930's when we were on a gold standard, the government simply made the dollar worth less versus gold. In the 1970's, we went off the gold standard and expanded fiat (unbacked) currency like mad. It's going to happen in the US, Europe, and Asia – it's the way civilizations deal with bad investments.

Our goal is to make sure you aren't hurt by this eventuality. When we get to the other side of this mess, with our client's capital intact, there will be real investment opportunities. I fully realize that many of you are tired of this negativity but you can't possibly be as tired of it as I am. I persist because it's the right thing to do.

Until then, we'll continue to watch this thing closely, understand what the government is saying and doing, and wait for our opportunities. Thank you and it is our pleasure to serve you.

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