GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

Volume 14, Issue 3 July 2012

On Course

Competitive Advantage

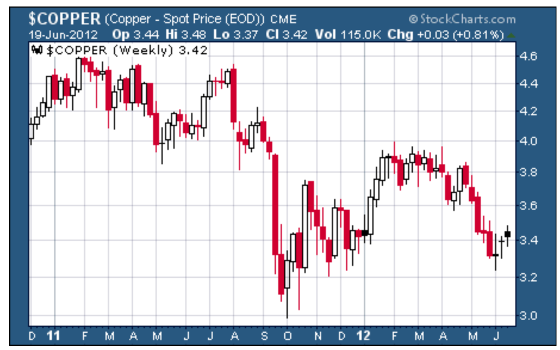
Before the Federal Reserve started dominating markets, the capital markets acted as a score keeper for the winners and losers in the world of commerce. Up until ten years ago, we, as professional investors, spent our time determining which companies had competitive advantages and how much extra returns they could generate for stakeholders if we invested in them.

China put this form of analysis on hold because the Chinese were willing to embrace any industry whether they could generate positive returns or not. In effect, they destroyed the equilibrium of the global economy by their willingness to operate at a loss – and a gigantic loss it will ultimately prove to be.

The Chinese, in their overwhelming zeal for shedding their third world status, made a pact with the devil. In exchange for their efforts, they accepted cash from the West, while helping to destroy the Western industries that generate that cash, replaced by government spending paid for with money borrowed from the Chinese.

This symbiotic relationship always had an expiration date but it spawned a new temporary equilibrium that allowed some industries like housing, big-box retail, wireless internet, industrial commodities, and most of all – banking, to flourish for a while. Government workers became the biggest beneficiaries as their ranks exploded while their salaries went from a discount to a premium compared to private sector workers.

If you watch carefully, you can see this relationship starting to unwind. In the US, housing has already crashed, government workers are being furloughed, industrial commodities are falling in price, and telephone companies are starting to curb unlimited usage plans.



Checking with our old friend "Doctor Copper", the PhD in economics, its 26% drop over the past year is telling us that something has changed. Our other trustworthy indicator, the Baltic Dry Index, which measures the cost of shipping goods by water, recently, fell to levels last touched during the depths of the last global panic. The difference between then and now is that the Fed is actively supporting the stock market.

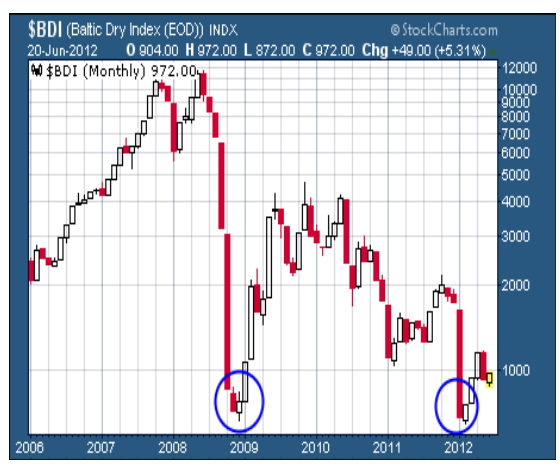


Table of Contents

Optimism	2
Europe	2
Stock Market	3
Economy	3
Gold	4
Geo Vest Approach	4

GeoVest Advisors, Inc.
245 Willowbrook Office Park,
Fairport, NY 14450
Tel: 800 - 638 - 5050
Fax: 585 248 8784
www.geovestadvisors.com

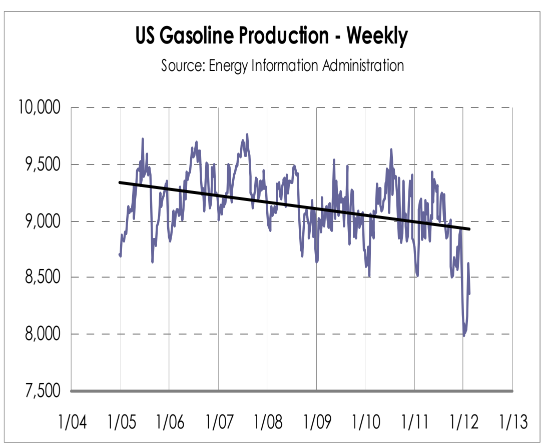
Internationally, Southern Europe is in a deep depression as their governments can no longer borrow from the market. China seems to have stopped growing and many global stock markets are negative for the year.

Reason for Optimism

For the first time in years, I'm growing optimistic. It's got nothing to do with the Kabuki Theater that masks government intervention in the stock market on a daily basis. Instead, I'm optimistic because the US is rapidly creating competitive advantages in the energy and chemicals markets.

Natural gas and natural gas liquids like ethane are in extreme abundance in the US which makes our petrochemical and chemical industries the low cost producer in the world! We're also pulling more oil out of the ground which is going to reduce our dependence on foreign oil.

Further adding to our burgeoning competitiveness, we're using less gasoline each day. While it is proof that our broader economy remains weak, it also means that Americans are tightening their belts and conserving. Notice the chart below.



We're producing more oil and we're using less. The reasons aren't necessarily positive but the outcome is.

More importantly, we've got cheap energy and Asia does not. Our chemical, petrochemical, and oil companies are the best in the world and their advantages are growing compared to the rest of the world. It's the starting point that is going to put our country back on top of the global economy.

Europe

On the other side of the spectrum is Europe. I fully expect Southern Europe, including Italy, Spain, Portugal, Greece and France, to approach third world status over the next twenty years. The reason is simple – they no longer know how to compete. They've traded their old industrial advantages for government bureaucracy, rules, and welfare. More importantly, energy is expensive.

When the bond market stopped lending to them, the game was over. The southern part of the continent is one giant bank run, held at bay by emergency deposit transfers from the central bank to local banks. People are so desperate to get their money out of the south that border guards are checking for cash movement out of affected states. It's not covered by our media but it is that bad.

The world is pressuring Germany to backstop the south but the Germans want control of state budgets in return for help. With the Germans in charge, severe austerity would result which is impossible for countries where the government ***is*** the economy. There is no way out of this mess. It's so bad that the Europeans have taken the unprecedented step of outlawing the use of ratings agencies like Moody's and S&P – presumably to save them the indignity of being rated as junk bonds, but possibly because it would point out just how thinly capitalized (and bankrupt) their banks truly are.

The fallout from this will undoubtedly harm the US but there will be winners and losers and our job is to identify the beneficiaries.

The Stock Market

As I mentioned at the beginning, the stock market is a policy tool for the Fed. They're tools have proven ineffective for fixing the economy, so the only thing they can do is use the stock market to make us believe that things are fine.

The problem with continuously telling people that everything is fine is that at some point, you've got to prove it. The only proof they can show is the stock market, thus the rationale behind intervention. As I've written many times, people look to the stock market as a simple indicator of the economy and based on the above chart, you'd naturally conclude that things are stable but far from good.

With Europe entering a depression and China weakening, the Fed is going to have to do something extravagant to maintain this illusion and that's when the stock market starts to fly higher. Yes, you read that correctly, I believe the market is going higher.

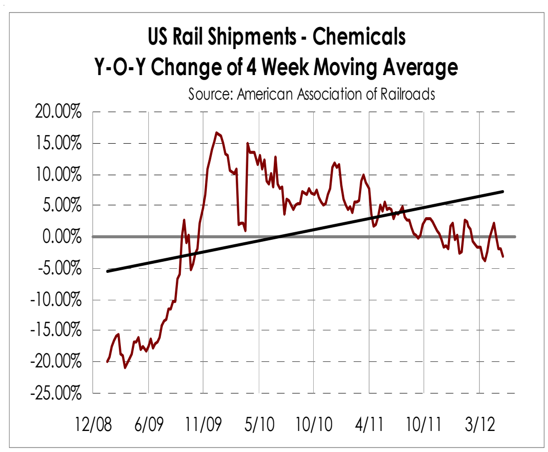
I expect the Federal Reserve to react aggressively once they've determined that the global economy is rapidly weakening and I believe they'll act before the election. It's the reason why I told you in the last newsletter that we're simply waiting for the next train to pull into the station so we can make some minor adjustments to our portfolios.

The Economy

I think it's probably safe to say that the US economy is currently flirting with another recession – at least the conventional variety that denotes a weakening of final sales. Personally, I no longer like to think in terms of recession/expansion anymore because governments that are in crisis mode are constantly acting against the perception of recession such that traditional remedies no longer make sense.

If we use the stock market as an example, recessions normally lead to a drop in the value of stocks. It makes sense because reduced economic activity leads to reduced earnings. But with the currency crisis in Europe, as well as our own well-publicized problems, a big drop in the stock market would shake confidence at a time when it's most needed.

This means that I have to put on hold my desire to buy chemical companies that are taking advantage of those competitive advantages outlined earlier. The prices of the stocks simply don't justify the inherent risk they face today. Notice the chart below.



We know that input prices for chemical companies are falling but so is demand for their products. With Europe and China experiencing economic difficulty, there is little reason to expect the stocks of these companies to rise in value – apart from efforts by the Fed. This gives me no reason to add them to our portfolios unless I can justify a cyclical recovery (I can't) or they fall in price. I plan to wait and continue to prepare.

Gold

Where chemicals are the idea for the future, gold continues to be my favorite idea for the present. I've shown the chart below many times and hope to share it many more times in the future.

A number of times over the last nine years, we've encountered resistance in this long term trend, only to watch gold break out to new highs. I believe we'll get another sharp move upward sometime over the next six months simply because I believe the Federal Reserve will have to print again given the aforementioned economic slowing.

Longer term, when you consider the mountain of debt that world governments are dealing with, devaluation of the currency is the most likely course of action. Today, it's Spain, Portugal, and Italy but tomorrow it will likely be France and ultimately, it will be Germany and the US. The numbers are inescapable which is why gold can double from here.

The GeoVest Approach

I've been watching and waiting for an actionable trend to invest in for the future. The past ten years have given us vacuous nonsense in the form of China, government spending, housing, excess consumer spending and green energy. None of these trends were sustainable in the first place and now they're all crumbling in some form.

Wall Street and the White House trumpet every piece of economic data as proof that our unsustainable economy is back on track and that we'll be back to our debt-fueled buying patterns before long. It hasn't happened and it won't happen. Future winners learn from mistakes, not from re-living them.

The US didn't attain great economic heights by accident. We got here because we took our national advantages and levered them with hard work, ingenuity, and self-reliance. Cheap energy in the form of natural gas, oil, and coal, along with an advanced infrastructure will put us back on top.

The US can achieve narrow, but strong growth simply by recapturing exported dollars in domestic industries. This won't bring prosperity to the miles of strip malls in the Northeast or the largely bankrupt states like Illinois and California, but it will be the start of a virtuous cycle that ultimately muscles out the mistakes from the past 30 years.

If we can avoid the last generation's mistakes while taking advantage of this new frontier of investment opportunity, our clients should benefit and that's all that matters. Thank you for choosing GeoVest Advisors. It is our pleasure to serve you.

Philip M. Byrne, CFA
Chief Investment Officer

GeoVest Advisors, Inc.
245 Willowbrook
Office Park,
Fairport, NY 14450
Tel: 585 248 5050
Fax: 585 248 8784
www.geovestadvisors.com