GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

Volume 15 Issue 3 July 2013

On Course

So Much For Trust?

Some things in life you just have to experience to believe. People can tell you that something is bad but until you've experienced it first hand, it's often tough to accept. Investors have placed their trust in the Fed evidenced by the high level of the stock market and the low levels of interest rates based on previous missives from the Fed that promised low interest rates for a long time.

I've been writing about it for the past four years as the equity markets and the bond markets soared higher. It's been an artificial rally, completely unsupported by fundamentals – the kind that ultimately results in a crash.

The past four years have been what I would characterize as a predatory market. On the equity side, the Fed has used the bets made by those who believe the markets are overvalued against them. Each short sale was squeezed higher. We discussed this extensively in our last newsletter.

On the bond side, the Fed pushed interest rates so low that investors reached for yield which allowed predatory financial institutions to sell their bad debt to unsuspecting investors. Portfolios are full of junk bonds and structured notes that are currently falling in price.

On the housing side, hedge funds have been lured into buying overvalued homes with the intent to rent them at a profit. They created a buying frenzy that allowed banks to unload bad housing loans. The hedge funds had hoped to securitize these homes and sell them to retail investors in search of yield. Notice a pattern here? Gold has fallen prey to the predators as well despite it being the one asset that protects investors from the Fed's policies. Gold has been leaving the system as smart investors have been pulling their gold out of the bullion banks seemingly out of fear that the precious metal would be absconded by the banks themselves.

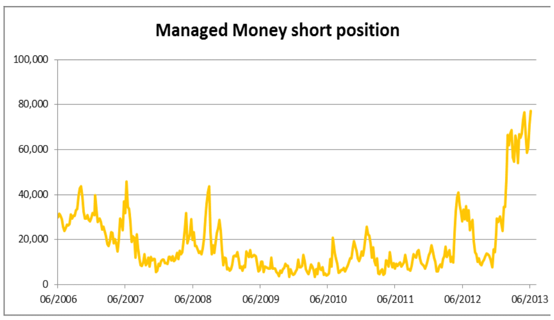
Tapering

Faced with a shortage of gold in the system and with potential heavy trading losses at the bullion banks, which were heavily short gold, I believe the Fed resorted to talking about reducing the amount of debt they are buying on a monthly basis. The idea being that they plan to stop devaluing the currency, thus removing the rationale for protecting your assets with gold. The chart below shows a sharp decline in the amount of physical gold in inventory at the COMEX, or commodities exchange where gold is traded.

Table of Contents

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

Faced with a sharp drop in inventory, prices in a normal market typically move higher to induce holders to sell. That didn't happen this time. I believe the Fed orchestrated a drop in the price of gold in the markets through coordinated short sales of gold by hedge funds. Recall that a short sale is where you sell something you don't own based on the belief it will fall in price. The chart below shows how hedge funds have unprecedented short positions in gold.



Prices in a market are set by the forces of supply and demand. Demand for physical gold – gold in hand – hasn't fallen, evidenced by the mobs of people willing to pay premiums for the yellow metal throughout Asia and the Middle East. In addition, a hedge fund would never short gold given falling inventories and continued money printing around the world unless given assurances by the Fed, particularly since the conditions for a meteoric rise in the price of gold are in place.

In addition, there is no way that the Fed can reduce purchases of bonds in a meaningful way without interest rates skyrocketing. Just look how much rates have risen since they started talking about it! Quantitative easing has always been about monetizing the Federal debt, regardless of what officials say. The US is expanding our debt by $1 trillion to $1.5 trillion a year and "QE" has always been about taking that debt off the market as a means towards suppressing interest rates while funding government operations.

They may be talking about reducing their purchases today but I fervently believe that they'll actually accelerate those purchases within a year.

The Bond Market

Bond prices have been hit badly over the past quarter. Interest rates for ten year US Treasury bonds have jumped from 1.6 % to 2.7% resulting in huge losses for investors. Junk bonds went from being the best performing sector in the market this year to one of the worst – in just over a month! All because the Fed suggested that they might reduce purchases of bonds later this year.

Bond fund liquidations are massive right now as a lot of people got drawn into these vulnerable investments because of their faith in the Fed. Emerging market bond funds appear to be racking up even bigger losses. For years, I've been shaking my head over these investments but with people so desperate for yield, mistakes are easy to make.

That said, I don't believe the Fed wanted rates to rise like they did. It's conjecture on my part, but I believe the Fed wanted to crush gold yet leave the stock and bond markets intact. If I'm right, it would reflect the very essence of hubris at the Fed…

The Stock Market

Unlike bonds and commodities, stocks have held up quite nicely. While off their highs for the year, stocks are still up double digits. As I mentioned in the last newsletter, the worst/riskiest sectors seem to be performing the best which I ascribe to predatory firms squeezing negative speculators out of short positions. For instance, the Russell Microcap Growth Index, perhaps the riskiest index out there, is up 22% this year, despite obvious pressures on small businesses. Like junk bonds, I suspect these stocks are going to fall hard later this year.

Just like in 2008, we're starting to see the sign posts that point to a crash. Commodities have gotten crushed. Interest rates have started to rise. Corporate earnings are softening. Insiders have been selling their own stock. But probably the most damaging sign is that firms that specialize in computer trading are starting to merge and/or go out of business. It seems that these parasites have consumed those foolish enough to believe they can win at a rigged casino and now the cupboard is bare!

We've seen many of these signposts before which is why we are waiting for one more variable before aggressively preparing to protect client portfolios. When short sellers capitulate, as measured by the VIX, or volatility index, we'll move quickly.

We know the Fed actively manages the stock market through quantitative easing, through speeches by Fed executives, and through carefully coordinated "leaks" to the press. We also know that short sellers are the fuel to take markets higher, not money printing. When the last short seller has been crushed, the market is going to fall and we haven't reached that point – yet.

Valuations

One argument I've heard about stocks is that corporations are buying back shares aggressively and that makes them more valuable. The idea is that corporations are making so much money, that they don't know what to do with it. The problem is that it's not what's really going on. Generalizations can be tricky but this one does a nice job of illustrating the basic trends in the US. Corporations are using earnings plus borrowed money to buy back their own stocks and pay dividends. Earnings per share are rising due to lower interest costs on debt, fewer shares to divide into earnings, and due to fewer investments in growth. This strategy makes today look great but tomorrow look lousy because corporations are not investing in future growth. It's the reason why the US isn't producing new jobs, apart from low-end, part-time work and it's the reason why stocks are overvalued.

Zero percent interest rates make future earnings more valuable but if corporations are not investing in future earnings, then they won't materialize. This is the reason why US earnings have basically stopped growing. It's also a reason why most corporate bonds will likely be abysmal over the long term because less investment today means less cash flow to service bonds in the future. This suggests that today's corporate bond holders are basically paying for the current stock market rally.

Emerging Markets

A lot of people jumped on this bandwagon because the story sounded so good – strong growth, low wages, and strong trade with China. What's not to like? Plenty, it seems. The Brazilian stock market is down 35% off recent cyclical highs while China is down 42% off highs in 2010.

It seems elementary but few people thought through what they were buying. Brazil was selling natural resources to China so China could build properties that nobody would live in. Common sense tells us that this is unsustainable.

The GeoVest Approach

Our strategy has been to wait it out and make as much money as possible without leaving our clients exposed to big losses. It's a difficult strategy because it requires patience and discipline. It means sticking with assets like gold that we believe are dramatically undervalued and avoiding investments like structured notes, corporate bonds, financial stocks, and small cap stocks that we believe are horribly overvalued.

Investors who placed their trust in the Fed have been rewarded over the past few years but recent events suggest that continued trust may prove damaging. By aggressively attacking the gold market, they've broken the relative stability they spent three years building. By squeezing negative speculators for four years, they have ensured that nobody is dumb enough to do so again.

The Fed concentrated its efforts almost exclusively on manipulating markets. They succeeded in taking the stock market higher but they created an economic environment where it was more profitable for corporate chieftains to invest in their own stocks than to take risks in their industries. In this, the Fed succeeded in ensuring that our economy is unable to break out of recession.

During this whole period, we've invested based on the operating environment, not on the market environment, believing that market manipulation is always temporary. We're confident that we're correct in this assumption and that our strategies will prove highly beneficial for our clients.

Thank you and 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