On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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No Worries!

After a rough first quarter, the market is back in positive territory and showing signs that 2014 is going to be a pretty good year. We're also having a good year now that we've embraced the reality that it's possible for the market to move higher despite deteriorating fundamentals.

Take a moment to consider what I've been writing about for the past couple of years – it's no longer a market, or at least the kind of market we had prior to the 2008 crash. Today I fervently believe the markets are now administered policy tools – think government policy!

The market is behaving like a once wild animal that has been tamed into being a lapdog. Years ago, changing economic conditions were reflected in the risk premiums that investors demanded for dealing with the uncertainty of the future. Today, changing economic and geopolitical conditions are met with a yawn as negative market forces are reversed to propel markets higher.

In this environment, you either adapt to the changing market structure or you find a new line of business. But note that adapting doesn't mean believing. I don't believe the stock market at 1900 on the S&P500 bears any resemblance to economic reality. I also believe that a future drop is in front of us – but not today.

Policy Tool?

Why bother manipulating the market? How does it benefit the economy? Years ago, we transitioned from an economy where people make things to an economy that consumes things. Apart from the nostalgic Super Bowl ads about making things in the US again, this is the unvarnished truth.

Faced with a crumbling world economy in 2009, the Federal Reserve attempted to create a wealth effect in the stock market and in the housing market despite horrible fundamentals as a means towards getting us to buy indiscriminately once again. The so-called recovery in the housing market is a topic for another day but it's enough to say that the housing recovery is pure fiction, dependent on a wave of ill-considered purchases by funds and another wave of foreign purchases that some argue is akin to money laundering.

Historically, the stock market has been a gauge of business activity. When it was a market, it measured expectations for company earnings, growth in earnings, stability of corporate balance sheets, and the general attractiveness of the US for investors. Today, it reflects none of these things although clever Wall Street marketing tells us otherwise.

Table of Contents

Policy Tool 1
Stock Market 2
Risk 2
The Economy 3
GeoVest Approach 4

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Now it's a policy tool because we've been conditioned to see it as a gauge of business activity. This means that as long as the market goes higher, all is well in our economy. Social Security may be running out of money but a rising value of the Dow Jones Industrial Average creates the illusion that investors believe that whatever problems Social Security recipients experience will be minor and transitory. Talk to anyone on Social Security and they'll tell you how worried they are.

Stock Market

The stock market recovery is for real, albeit incredibly fragile. It's built on three legs – market manipulation, stock buybacks, and herding people's savings into risk assets – call them the three legs of the stool.

Market manipulation is pretty straight forward. High frequency trading, or HFT, is where our authorities allow high powered computers owned by private companies to connect directly to the stock exchanges where their speed and early access to information gives them the ability to effectively push the market where authorities want it to go.

Stock buybacks are another topic I've covered extensively in this missive but in effect, US companies stopped investing in the US and used the proceeds from their internally generated cash flow to fund stock buybacks and dividends. I recently saw an interesting analysis on the subject. Since the first quarter of 2008, US companies in the Standard and Poor's 500 index have generated $4 trillion in reported income – and paid out $3.8 trillion in the form of dividends and stock buybacks. In effect, our domestic corporations are being managed to generate cash today but not growth tomorrow which effectively means that they're in liquidation mode.

The third leg of the stool has been the zero interest rate policy that has pushed people out of low-risk assets like US Treasury bonds into incredibly risky assets like bond funds and ultimately, the stock market. This may be the most insidious of the Fed's policies because in search of yield, investors with low-risk profiles are piling into the most toxic fixed income paper imaginable – stuff that would never have been considered ten years ago. It helps the stock market because it has allowed corporations to sell their debt at much lower yields which has allowed corporations to increase their earnings.

I believe the biggest losses in the capital markets will ultimately come from the wealth management products that are currently being pushed on people that believe they own safe bonds. Instead, they own the cash flows of a mishmash of securities that may include junk bonds, leveraged loans, and derivatives. We don't own these types of securities.

Risk

The narrative the Fed prefers is that they saved the world by Quantitative Easing (printing money) since 2009 but all they really did was to buy a temporary relief from the crisis by making it much bigger in the future. Basically, the Fed has taken much of the "safe" assets out of the market which has pushed people into much riskier assets than they would otherwise choose. The very act of herding people into these assets creates the illusion that they're increasing in value instead of the reality which is that the Fed is systematically leaving investors with fewer options for their savings.

They accomplished this by creating the illusion that less risk exists in the world. Below is a chart of the Volatility Index, or Vix. This is an accepted measure of risk expectations in the stock market.

In a non-manipulated market, measures like the Vix would be much higher, reflecting the expectations and fears of well-informed money managers. But notice how we're hovering above generational lows! Does anyone truly believe we're experiencing low levels of risk in the world today?

Just to name a few that I follow closely, we've got the rapidly slowing Chinese economy. This is the big one but the one most difficult to understand as the Chinese economy continues to be an enigma to most analysts. They see the skyscrapers going up but miss the fact that the buildings that are going up are staying empty. They've also got a major financial scandal on their hands as gigantic metals inventories in copper and aluminum apparently have many more owners than there is metal. This could become an epic example of fraud.

The next is the Japanese economy. Much like the US, the Japanese are more open about the way they manipulate their markets. The Bank of Japan doubled money supply and most of the money flowed into their stock market but it has done nothing for their economy which continues on a form of death watch.

The European economy is a shambles as well and they're starting to experience runs on banks in Austria, Portugal, and Italy. Most of these banks got glowing reports from regulators in recent audits – just goes to show you that those audits have little real world value.

Throw in the rising military tensions in Ukraine, Syria, Iraq, Kuwait, Iran, Afghanistan, Egypt, Libya, Israel, Vietnam, the Philippines, Thailand, and a few others that I've undoubtedly missed. I could also add financial troubles in Argentina and Venezuela, a schism between the US and Germany over spying, Scotland making a strong bid to leave the UK, and countless examples of tension everywhere. In short, this is the most real world volatility that I've ever experienced in my 47 years, yet the markets are reflecting the least amount of risk ever.

By intervening in the markets, I believe that the Fed has increased systemic risk, not reduced it. The only difference between 2008 and the present is that much of the risk has been pushed into supposedly safe assets like bonds.

Ultimately, you can't manipulate risk out of the markets. It continues to build until it overcomes the best efforts of the manipulators.

The Economy

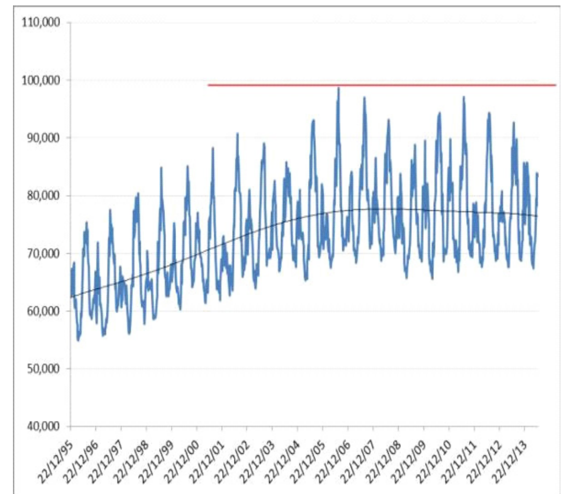
The government is telling us that the US economy weakened in the first quarter of 2014 due to bad weather. The weather was certainly bad, so that much is true but feedback from companies like WalMart suggests that the middle and lower classes are in trouble financially and can no longer afford to shop as often. In general, retailers who sell to the middle class are experiencing difficulty in maintaining sales levels apart from essentials such as food and household staples. It's not a coincidence that retailers like WalMart and Target are devoting increasing floor space to essential items.

I think a bigger culprit than the weather is hidden inflation, particularly in food and healthcare. Here's a chart of food inflation based on food commodities that are traded in the commodities markets.

My wife does the shopping in our house and she complains constantly about the rising cost of food and other essentials she buys for our family. In particular, you must have noticed that container sizes are getting smaller. We all know that a half gallon of ice cream is now 1.5 quarts but if you look closely at what you buy, you'll notice that just about everything has been down-sized. Cereal, laundry detergent, coffee, and just about everything experienced sneaky price increases as a result of smaller packages. We're getting less for the dollars we spend.

The folks that do the Gallup polls have noticed the same phenomenon and decided to take a closer look. They've found that consumer spending has been largely flat for years but that more and more of our household budgets are going to essentials like groceries, gasoline, utilities, healthcare, household goods, and rent with declines in retirement savings, leisure activities, clothing, consumer electronics, and dining out. Our portfolios have reflected this phenomenon for years.

Based on my work, the economy hasn't grown since 2006 but based on the stock market, the economy has grown. Notice the chart below of power consumption in the US that is posted in the weekly issue of Barron's. It shows an economy that hasn't grown its electricity usage since 2006.



Source: Barron's

I've analyzed this phenomenon from many different directions with the same result – no growth since 2006.

The GeoVest Approach

I believe the Fed is manipulating the asset markets including the stock market and bond markets in order to "buy time" for the economy to heal itself from the crisis of 2008. In an academic setting, it was a reasonable strategy but in the real world, investors get their signals from the marketplace and the Fed has effectively created a series of bad signals. The result has been stagnation since 2006 and few signs of healing.

The problem with investing alongside the Fed, particularly when you fervently believe their policies are in error, is that ultimately, all efforts to manipulate markets are overwhelmed by market forces – even for the mighty Federal Reserve. It's the reason we've chosen smaller gains that we believe we can maintain over bigger gains that are likely to prove temporary and worse, likely to produce massive losses of wealth in the future.

Thank you and it's our continued pleasure to serve you.

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