On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Opa!

The markets are rallying back from their summer swoon thanks to an agreement that effectively cedes control of Greece to its creditors. Outside of Greece, people are celebrating as if it's a good thing.

Maybe it's a good thing but I don't consider it to be terribly important because Greece is too small a part of the global economy to matter to us. I believe the real story is China. To make a long story short, the Chinese growth engine has stalled, and perhaps worse, because their slowdown is affecting the world.

I've chronicled the insanity that was the Chinese growth story for over a decade. Its economy was destined to become a smoking ruin; the only uncertainty was the date. You cannot make massive investments with debt that provide no return of cash flow without bankrupting your system. It was as blatantly obvious ten years ago as it is today.

They probably could have hidden these mistakes for a few more years but they did something truly amazing; they challenged the US dollar as global reserve currency while still being pegged to the dollar. As I wrote in our last quarterly newsletter, this is tantamount to declaring war on the US as having the reserve currency is the source of Wall Street's fortunes, our military's budget, and Washington's largesse.

So what happened? The Federal Reserve started a narrative about raising interest rates in reaction to our really strong economy (Good One!) with the result being that the value of the US dollar has soared in world markets. Take a look at the chart below of the US dollar, and then look at the chart below it of the Chinese stock market. Notice anything?

If you noted that the two sharp moves seemed to start simultaneously, you're right. My interpretation is that our Federal Reserve started fighting to defend the dollar as global reserve currency a year ago with the target being China's all-important export trade. In effect, our Federal Reserve has made Chinese goods 25% more expensive for the rest of the world. For a country dependent on exports and drowning in excess capacity in everything from steel to cement, this is a death sentence.

The Chinese clearly tried to retaliate by goosing their stock market to create a “wealth effect” to drive Chinese retail sales but it hasn’t worked. Now, their stock market is crashing along with their economy and has the potential to go much lower unless the Chinese government can successfully intervene.

Reserve Currency

The global reserve currency is the main currency for trade. If you want to buy a barrel of oil, it’s quoted in US dollars - the same if you want to buy just about anything in world wholesale markets.

Because they need to settle global trade in dollars for key imports, global central banks hold an enormous amount of US government debt in reserve so they can use it to buy what they need. The effect is that the US can generally borrow much cheaper and in greater quantity than anyone else. In effect, it’s a blank check, albeit with reasonable limits.

Before the US dollar became the global reserve currency, the currency for trade was the British pound. The Brits had the first truly extraordinary economy of the 19th century starting with their defeat of Napoleon at Waterloo and lasting all of the way through the First World War. Their combination of military acumen and advanced technology forged an economy that generated tremendous surplus with which Britannia was able to dominate the world.

The US dollar followed when Britain was weakened by two World Wars. The combination of natural resources, technology and industrial might made the US the sole superpower after the Second World War. We know this story well because we have lived it.

But in this time, there have been three attempts to dethrone the US. The first was the Soviet Union, which had the fastest growing economy of the 1960’s - centrally planned industrialization that had all of the western Marxists chafing with envy. This was followed by the collapse of the 1980’s when we orchestrated a drop in the price of oil - Russia’s main source of value.

The second was Japan in the 1980’s. Remember when everyone was fretting that the Japanese would one day take over everything? The Federal Reserve orchestrated a jump in the value of the yen in world markets and Voila! Japan’s economy and stock market came back down to earth. It seems that Japan was only successful while they were holding the yen artificially low versus the dollar in currency markets so they could dominate electronics and automotive markets with low prices. When this was reversed, Japan’s weaknesses were exposed.

And now we’ve got China, who along with Russia, is trying to dethrone the US once again. China’s economy has been the marvel of the world for the past fifteen years but like the Japanese, they’ve taken advantage of keeping the yuan pegged artificially low to the dollar. It’s the reason why they ***have*** to own trillions of dollars of US Treasury bonds.

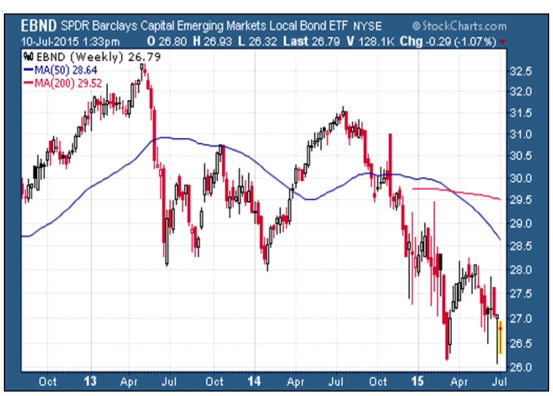
Unlike Britain and the US, both of whom enjoyed tremendous competitive advantages that led to their domination, China offers cheap labor, a disregard for the environment, and a willingness to invest in loss-making ventures that others have avoided. Where Britain and the US created real surplus, China, like Japan and the former USSR, has created unrecognized losses.

Emerging Markets

The first place we have to look when determining the timing of when China's economy will implode is in the emerging markets - the countries that supply China with the raw materials they've used to grow.

In very simple terms, China built itself using imported raw materials from South America, Africa, the Middle East, and other parts of Asia. In effect, China created a wave of demand for raw materials that has now crested, leaving these regions to deal with falling demand for their main exports as the Chinese aren't buying as much as before.

The above is a chart of Brazilian infrastructure companies. After an initial boost of export orders from China in 2010/2011, the group has been selling off ever since, reflecting the retrenchment of their biggest customer. Below is the chart of emerging market debt priced in local currencies as opposed to US dollars. You can readily see the sharp rise in the value of the dollar over the past year has hurt returns in these countries.



A lot of financial planners purchased emerging market funds for clients believing that they were getting diversification in their portfolios when they were really making a levered bet on China. The drop in the value of these securities is telling us that the Chinese economy is weakening for real.

The Markets

The weakening global economy may or may not be reflected in the markets over the coming months because intervention has become the de facto policy for most nations. China's intervention is the clearest possible; they'll put you in jail if you sell stocks in their market.

The US is a little more opaque in their efforts although shutting the NYSE down for four hours amidst a negative trading day has to count as highly suspicious.

The one thing that is most apparent is that the markets have divorced themselves entirely from the economy. This is a temporary condition as markets ultimately follow economic fundamentals but it's a condition for a reason. I consider elevated markets to be a political expediency at the moment but that will change once the costs of keeping markets elevated outweigh the benefits

The market is still up for the year but it seems to have lost some momentum. This loss of momentum along with some negative divergences in some key industries has led to a number of analysts to call for a crash. While it's certainly possible, I don't believe the timing is right.

Instead, I believe a rally from these levels would be politically expedient because it would paint the US as being strong while the rest of the world has weakened. Wouldn't you rather have an economically strong country providing the global reserve currency?

Once China crashes for good along with South America, I believe the costs of keeping the market elevated will outweigh the benefits. But while we're looking for more upside in the market, we're fully aware of the heightened global risks – easily the highest level of risk of my lifetime. That's why we've been slowly adding to a very liquid S&P500 index because we believe it will give us the opportunity to trade out of the markets quickly without losing this potential upside. It's a temporary strategy but extraordinary times call for extraordinary strategies.

The Fed

The Federal Reserve has been talking about raising interest rates since the beginning of the year. It's one of the main reasons why the dollar is so strong currently. They may be able to get away with a quarter of a point but I don't believe they can do much more because our economy is exceedingly fragile at the moment, contrary to what they tell us.

We can see by the chart below of energy consumption in the US that the US is using less energy than in 2007. While there have been some modest efforts to reduce energy consumption, I believe the more likely scenario is a combination of over estimating GDP and using government transfer payments to stabilize people who no longer work/ consume fuel for work.

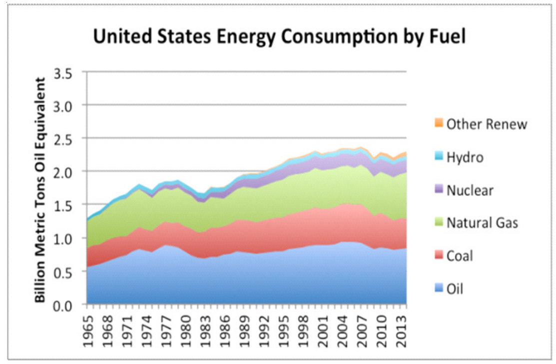


Figure 6. United States energy consumption by fuel, based on BP Statistical Review of World Energy 2014.

This is where having the global reserve currency has really paid off because we have been able to double the amount of government debt since 2007 - $9 billion to $18 billion - paying people to remain idle. Idle people don't consume as much energy.

But keeping people idle is not a long term economic strategy nor can it be maintained over the long term. At some point, a nation loses the ability to maintain massive funding deficits, often by losing their currency reserve status.

This is why it's so important to keep up appearances and why I believe stocks need to stay elevated.

The GeoVest Approach

Ultimately, we'll experience an unwinding of these altered markets. The markets have written a check that the economy is unable to cash.

We believe we understand the significant drivers of the economy and the markets over the next year (and beyond) and we've adjusted our strategies to adapt to these highly unusual circumstances. Thank you and it is our continued pleasure to serve you.

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