GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

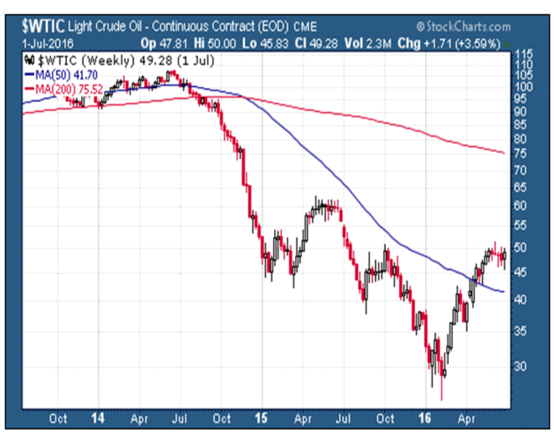
The Great Game

We're having an excellent year, both in stocks and in bonds. In a year dominated by turbulence and repeated calls for a market crash, we've done well because we've focused on "The Great Game" and not the news cycle.

The game is a geopolitical one and it's for high stakes. The winner gets to control the global trade currency while the loser(s) falls into economic obscurity.

Most of the action takes place in the financial markets where the US is dominant. To borrow from William Penn's "the pen is mightier than the sword", I've adapted it to "control of the market is mightier than combat forces". This is because controlling markets allows the US to control (to a certain extent) the economic forces that separate winning from losing in trade.

Consider that Russia gets 70% of their government revenues from royalties on the sale of commodities such as oil. Now look at the price of oil over the past year.



Russia just happens to be on the other side of the great game and their economy is badly hurting. The other major player is China.

Where we appear to be controlling the price of oil to the detriment of Russia, it appears to me that we're using the value of the US dollar to crush the Chinese. The Federal Reserve keeps the dollar elevated by keeping raising interest rates on every board meeting agenda of the Open-Market committee. Given how weak our domestic economy is, the only explanation that makes sense to me is that we're using this tactic to hurt China.

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This works two ways. The first is that the Chinese yuan is tied to the US dollar and is not floated freely in currency markets. This means that the jump in the price of the dollar makes Chinese goods a lot more expensive in Europe and the emerging markets because every tick up in the price of the dollar is a tick up in the price of the yuan and by extension, the price of goods made in China.

The second way we're hurting the Chinese is by giving their wealthy domestic investors a better, safer place to put their wealth. I've seen estimates that suggest that trillions of dollars in wealth has left China over the past few years - that's money that won't be reinvested in China.

Every dollar of wealth that leaves China is inherently making their fragile banking system more levered - or backed by less capital. When things fall apart, the Chinese will have to print more money, destroying the value of savings in the process. You could say that China is like the Titanic where it's hit an iceberg and only a few have access to lifeboats.

Stock Market

At this point, you're probably asking the question of how this impacts you? It's our belief that to attract capital away from China and Russia, we need to keep our markets elevated so capital will flow to the US and away from China/Russia. This suggests that stock market valuations are not being driven by domestic economic forces as much as they're being driven by national security interests.

The chart of the S&P500 shows a market that hasn't advanced in close to two years but it also shows three major drops that have been reversed.

Based on our economic work, it's been clear that the economy has been slowing since 2012. Normally, this kind of slowdown is reflected in the stock market but the current market is anything but normal.

The funny part of all of this is that fundamentals are starting to matter again and that is the reason why we're enjoying this recent success. Nobody can trust the data but those of us who have been around a long time know that companies with the most stable earnings do the best in times of uncertainty, particularly as interest rates are falling. Food companies, electric utilities, government contractors, and healthcare companies enjoy the least amount of uncertainty in their future earnings and that's why they're doing well. Just take a look at the chart of electric utilities.

They're not selling more electricity but they are deemed safer bets than other parts of the market and in a market that isn't allowed to fall, it's not a bad place to hide while collecting hefty dividend payments!

Interest Rates

The real story is that we got the interest rate call correct this year. While others believed the talk by Federal Reserve officials, we were putting the pieces together to understand the "Great Game" and therefore, knew that it was all talk. We extended maturities on our high quality fixed income portfolio and it has paid off.

The chart below is the ten-year US Treasury Bond. The drop in yield from 2.3% to 1.4% means the bonds are worth more than when we purchased them.

Getting this call correct was instrumental in the strong performance of our electric utilities because those hefty dividends are worth more when interest rates fall. It also doesn't hurt that the turmoil over BREXIT, Italian banks, and terrorism has pushed investors to seek safe havens and that's largely what is in our portfolio.

BREXIT

I'll just touch on this topic a little because I'm not terribly bothered by it. In short, the British people voted to leave the European Union. Britain is currently part of the EU but not part of the common currency as Britain still transacts in pound sterling as opposed to euros.

Britain will leave the trade zone, meaning they won't get open access to European markets and investment from European companies who want to operate in Britain and sell back into Europe. The flip side is that Britain won't have to adhere to the EU's oftentimes ridiculous policies that are, by necessity, one-size fits all.

It's a further sign that we're experiencing some tectonic shifts in the global economy as it slows and as the West starts to turn away from the East but as long as we stay focused on the opportunities that change brings, I expect that we'll manage our way through.

Japan

Thanks to the "Great Game", the Federal Reserve can't return to quantitative easing any time soon because to do so would risk a flight from the dollar as both China and Russia would then have a strong case for replacing the dollar in trade with some other currency. Instead, the Federal Reserve needs to act through one of their proxies and in this case, it appears to be Japan.

Japan is an economic and demographic quagmire and has been for the past 25 years despite aggressive economic policies implemented over that period. Most recently, Shinzo Abe, Japan's Prime Minister, attempted to re-ignite Japan's manufacturing economy by aggressively devaluing the

Japanese yen in world markets by printing money. The opposite happened.

Not only did his policies fail to devalue the yen, it actually resulted in a 40% rise in the value of the yen such that they lost export market share to countries like China. The result is that the Japanese economy is still in the quagmire.

But instead of admitting defeat, it appears that Japan is likely to try to do the exact same thing that failed three years ago, hoping that it will succeed this time. Or so they say.

Instead, I view it as another move in the "Great Game". I believe that Japan wants to weaken China's export market by trying once again to take back market share.

Regardless of the outcome, this latest attempt should create a lot of "funny money" to keep the markets inflated for a little longer. And that's why we remain invested and vigilant.

The GeoVest Approach

You're not going to read about the "Great Game" in the media. Like our efforts prior to the 2008 crash, we have done the work necessary to put the pieces together.

Instead, we'll likely continue to read about the imminent market crash, even as the markets continue to move higher. Most won't understand why, not wanting to move past the intervention theory. But there is always a reason why for everything and knowing the reason is crucial for being prepared.

It was Nathan Mayer Rothschild who once wrote: "I care not what puppet is placed upon the throne of England to rule the empire upon which the sun never sets. The man who controls Britain's money supply controls the British Empire and I control the British money supply."

Having the reserve currency that is dominant in most international transactions effectively makes the US in charge of the world's money supply and we don't want to give up that power. The "Great Game" is about wresting control away from the US by our enemies and our moves to thwart them.

Based on this work, we believe the markets have some more upside in front of them and we hope to capture as much of that upside as is safely practicable. Thank you for investing with GeoVest Advisors. It is our continued pleasure to serve you.

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