# GeoVest Advisors

*Growing Your Portfolio While Managing Market Risk*

Volume 10, Issue 1 January 2008

***On Course***

## Opportunity or Threat?

We had a fantastic year in 2007 as our returns were sharply higher than the S&P500 despite having as little as 30% of the risk of the market. And while every dog has his day, chance was not the reason for our success. Instead, it was the gameplan that we laid out for our clients in 2004 when we created the "Hollywood Recovery" theme that resulted in the sale of our financial services stocks and most of our fixed income positions in Fannie Mae/Freddie Mac. This was also the basis for our big positions in gold, oil, and defense companies as well as our use of special funds that hedge market risk.

Perhaps the best part of our gameplan is that while other money managers look on current trends with trepidation, we see opportunity to grow the value of portfolios because, as Louis Pasteur once wrote, "chance favors the prepared mind." But it won't be easy because the problems we face globally are unusually daunting and there is the potential for a major market dislocation.

## Bad Loans

You won't see this written in many places, but the primary reason why we experienced a global economic boom was excessive lending. From home mortgages to the Chinese industrial build out to hedge fund leverage to the recently ended private equity boom, the common denominator was relatively indiscriminant lending practices. We've already enjoyed the early stages of this cycle – rising asset prices that many of us have levered to support lavish lifestyles. And now, we're seeing the start of the flip-side of bad lending – falling asset prices and a pullback in consumer spending.

Financial companies are generally the ones caught in the middle when things turn sour and this time is no different. As you can see from the chart of S&P Bank Index, things are going badly for the money changers.


So far, financial institutions have written off around $100 billion in bad loans but I believe this may be as little as 5% to 10% of the total problem. Things are so bad for the banking system that the Federal Reserve is now lending directly to all depository institutions, instead of just Federal Reserve member banks. Also, the European Central Bank has injected $500 billion into their banking system to keep it afloat. These actions are highly inflationary and are coming at a time when the world is already experiencing a bout of rapidly higher prices.

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## Inflation

Prices have been jumping for the past year, and it's not just in the US. China, Europe, Japan, South Korea, and Canada are all experiencing rising prices. In fact, looking at the chart of China's CPI, you can see where their rate of inflation has tripled over the past year.


Source: Economy.com

Food and energy are the main culprits as the globe's ability to supply the growing needs of China and India are testing capacity to produce, further hampered by drought in the US and Australia.

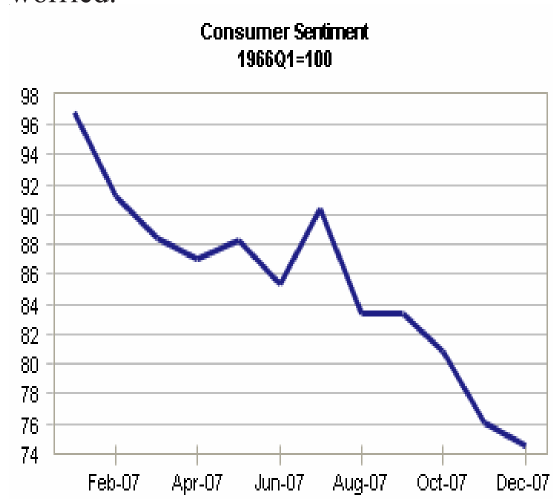
Rising energy prices are no secret to the readers of this newsletter. We've discussed our rationale for our oil and electricity investments to the point where further discussion should be considered cruel and unusual punishment. The ideas have worked and we're now considering reducing some positions going forward. This is because the economic cycle is turning and there is a definite possibility that we've hit the peak on global inflation.

The aforementioned attempts to bolster the banking systems of Europe and the US are ample evidence that global central banks are trying to "inflate" their way out of the current mess. We believe, however, that these attempts will ultimately fail for one specific reason – there is no way to get that money into consumer's hands. Unlike the 1970's inflation, our workforce won't see major pay increases to keep up with inflation because corporate America can simply send those jobs to Asia where lower wages still prevail.

Ultimately, this means that higher prices will result in a lower standard of living for Americans and a sharp decline in retail activity. The good news is that Asia will bear a disproportionate amount of the pain as a result of their "stealing" many of our cyclical industries through previously discussed "mercantilist" policies(they buy our debt in exchange for increased trade).

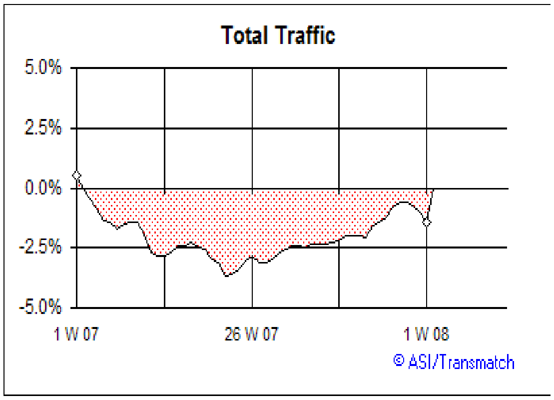
## The Economy

If we're not in a recession today, we're just about as close to a recession as possible. Even the Wall Street brokerage houses are joining us as Merrill Lynch, Goldman Sacs, and Morgan Stanley are calling for a recession. The average consumer already knows the score which is why the economy is the biggest concern for most survey respondents. Below is a chart of the University of Michigan's measure of consumer sentiment which makes it clear that 72% of our economy is worried.




Source: Economy.com

For me, transportation of goods is an excellent indicator of the economy and nothing has been hotter than rail traffic over the past five years. Recent indications, however, show that rail traffic continues to decline on an annual basis which suggests that economic activity has turned negative.




Being a huge fan of finding supporting evidence for all the economic variables I use, the recent announcement by the Danish shipping firm Maersk that they are cutting 3,000 workers in their North American operations confirms much of what we've discussed in the past. For those of you unfamiliar with Maersk, they are the preeminent global shipping company.

Turning to other variables, housing continues to weaken, auto sales are falling aggressively, retailers are reporting disappointing data and companies are retrenching. In short, a recession is a certainty, leaving depth of the recession as the only unknown variable at this time. We're planning for a deep recession.

But a recession isn't the end of the world; it's just the end of our old way of doing things. It's a time to write-down the value of bad investments like housing and turn our attention to learning the fundamentals of future growth areas like alternative energy, and industrial assets to replace those shifted to Asia. For me, I see recession as the time of greatest opportunity to buy great assets at discount prices but to do so requires preservation of capital.

## Gold

The price of gold continues to rise aggressively for the reasons we anticipated when we first started buying it. The more global central banks add money to the banking system, the higher gold will go. Historically, the only way to wipe out excess debt is to make it worth less and that results in currency debasement. During these times, gold is a store of value unparalleled. Notice the rapid jump in gold prices since central banks started reacting to our banking crisis last summer.


We continue to believe that gold will remain a great long term investment and will use pullbacks to purchase more.

## The Stock Market

The market has been in a rough patch since last summer and we believe it's likely to continue. It's very likely that we are in the initial stages of a bear market and it's the reason why we've been using hedges in client portfolios. Notice the chart of the S&P500 below. The period from July 2006 to July 2007 seems to have been the final blow-off phase.

Most market participants are clinging to the notion that corporate earnings will get bailed out by sales to fast growing parts of the world such as Asia, South America, and the Middle East. But, I'm highly confident that this will not be the case as we've already seen the initial pangs of weakness in these areas. Besides, there are strong indications that Europe and Japan are fast approaching recession. I don't believe corporate profits could survive weakness in the three most important economies in the world.

## Emerging Markets

The way I see it, there are two themes driving emerging markets – Asian manufacturing and South American commodities. Going forward, I see the success of South American commodities being the downfall of Asian manufacturing since it appears that the Asian manufacturers are having a tough time passing along the higher cost of food, metals, and transportation.

Assuming the US, Europe, and Japan weaken as expected, demand for Asian manufactured goods and South American commodities start to look dicey. If this is a concern, it doesn't seem to be shared by investors since emerging market securities have performed extraordinarily well.


Another cause for worry is that copper, the commodity which has an excellent track record in predicting the future of the global economy, has been showing signs of topping.


We don't believe Emerging Market economies will be able to survive a global downturn. We have moved from being cautious to being negative on the investment theme.

## The GeoVest Approach

We saw the beginnings of this bank crisis as far back as 2003 when it became obvious that banks were throwing away two thousand years of evidence that lending money to people who will never repay is bad for business. We sold all of our bank stocks in 2004 because first and foremost, we are investors in solid businesses.

We are hoping to find some solid businesses to invest in over the next year with a conservative bias based on unfolding events. There is little doubt in our minds that the next year will prove to be a challenging one but we also believe that we are prepared to profit from these challenges. Thank you and it is our pleasure to serve you.

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***Chief Investment Officer***


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