GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

Housing is the Key for 2007

We had an excellent year in 2006 where achieved the best of both worlds – very strong returns with less risk than the indices. To say I'm pleased with the results is a gross understatement.

Some of you will remember June and July when the markets were negative, your GeoVest accounts were solidly positive. By the end of the summer, we were having a very good year. The rally at the end of the year just made it better.

Oil, agriculture, and electric utilities were our best performers in 2006. We expect continued strength in these areas but believe defense and gold will probably achieve better results in 2007.

Complacency

Success hasn't shifted our attention from what is really going on in the world – far from it. Complacency is pervasive throughout the international investment world, and is even worse than the 1999 to 2000 timeframe. It was obvious during the Spring of 2000 because Internet stocks had gotten ridiculously priced, but today you have to employ some of the arcane knowledge of our industry to see this complacency because it's mostly in the bond market.

Over half of the corporate bonds in the US are rated below BBB, which is the threshold for "junk" status. These bonds have a reasonably high expectation for bankruptcy and are typically offered for sale at high yields to reward investors for the added risk. Notice the word "typically" was used because it's clearly not what's happening today.

The chart provided shows the price of insurance for corporate junk bonds. It reflects the part of each coupon payment that goes to the insurer in return for a commitment to reimburse a bondholder for losses on the bond due to bankruptcy. For example, if a bond pays interest of 7.35%, the buyer of the bond would pay a premium to the insurance company of 0.35% in return for surety, thus reducing the bonds effective yield to 7%. In essence, it reflects the "risk premium" for risky corporate bonds over safe Treasury bonds.

As you can see from the chart, the investors that provide the insurance are demanding much less compensation for the risk they are assuming. It's almost as if investors are daring the investment gods to strike them. But the funniest part is that our returns in our fixed income accounts have been very competitive by simply buying ultra safe Treasury Bills.

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Apart from the corporate bond market, the mortgage bond market has been equally complacent. The amount of money offered to sub-prime borrowers has been staggering but the terms of their home loans even more so. Sub-prime borrowers either have bad credit records, or insufficient assets to qualify for typical mortgage products – in short they are a good bet for foreclosure. Despite these warning signs, mortgage brokers have made loans to these individuals with no verification of earnings, no money down at purchase, and even interest-only payments for five years. It shouldn't come as a shock to you that these individuals are increasingly reneging on their obligations.

The Housing Market

The direction housing takes this year will determine whether the economy/markets have a good year or a bad year. Average home prices dropped around 3% by the end of 2006 which is problematic because we, as a nation, have been using the rising value of our homes to supplement our meager income gains. By the end of 2006, the "run rate" of home equity withdrawals was around $200 billion a year, down from $700 billion a year in 2005. It was the primary reason why retailers had a relatively disappointing holiday season.

Over the past three months, the decline in housing has stabilized, leading some analysts to forecast that the worst is behind us. My forecast is for another leg down in 2007 with price depreciation of around 10%.

I base my conclusion on my years of following bank stocks and a careful study of new financing tactics of those banks. In the past, banks would make a home loan that needed to adhere to strict guidelines from Fannie Mae and Freddie Mac, otherwise, they would need to keep that loan on their balance sheets. Today, banks can make loans with little to no credit analysis, combine them in a pool of similar mortgages, and sell the pool to a hedge fund or pension fund, which are willing to accept the added risk. Unfortunately, we're seeing a lot of those loans have gone bad and the result is that hedge funds and pension funds are no longer willing to buy those risky pools. Because of this, nine large mortgage brokers, companies that specialize in these risky loans, have closed their doors. For me, this is the first sign of trouble and it means that a big group of potential buyers of homes will no longer be "in the market."

The second leg of my forecast is based on an analysis of the adjustable rate mortgage market, which are mortgages where the interest rate goes up and down along with short term interest rates. $1 trillion of these mortgages are set to dramatically increase the interest rate this year, which will force a large number of people to sell their homes once the monthly payment gets too large. That will add a lot of supply to a housing market that is choked with oversupply of homes for sale.

As of the second quarter of 2006, 54% of the value of homes in the US was supported by home owners equity, which is down from the 58% we had in 2000. That means that the enormous increase in the value of our housing stock has been spent in one way or another. The amount of equity taken out of our homes each year matched the increase in the growth of our economy, which suggests that if we can no longer take equity out of our homes, the primary driver of the US economy has been neutralized.

The Stock Market

The stock market, thanks to a wonderful second half rally, has been a definite bright spot. You'll notice from the chart of the S&P 500, the market rallied strongly from the weak summer months to offer a surprisingly strong annual return.

At the risk of looking a gift-horse in the mouth, there are two things that I'm watching closely for signs of distress. The first and most important is corporate earnings. Corporate earnings have been growing at a double digit rate for the past few years, but historically, this is a major aberration. When you consider that corporate earnings grew an average of 6% during the 20th century, a century dominated by American business, it's hard to argue for a continuance of our strong corporate earnings growth in the US.

The second big question mark for me is the lack of participation of stocks that make computer chips. From the chart below, you can see where Semiconductor stocks are back down to levels last seen in September. Given the importance of this industry to our economy, I use the Semiconductor Index as a primary indication of future moves in the market. Its relative weakness has got me a little concerned.

Putting aside our concerns, we continue to favor industries that have very stable revenue streams, the kind of revenue streams that are not dependent on how much money people take out of their homes. We're starting to add positions in the defense industry, because the valuations are attractive and potential problems in the Middle East may give us strong growth. At a minimum, the needs of the armed forces are changing, and we've identified some companies that may benefit from some positive long term trends. We look forward to taking some more positions this year.

The Federal Reserve

Many of the hopes of market participants, especially those in the housing market, rest on the belief that the Federal Reserve will start lowering short term interest rates this year. I share this desire to see lower rates, because I believe the Fed raised them too high last year, but I acknowledge that the Fed is caught between the proverbial "rock and the hard place".

In my view, the Fed would have lowered interest rates already if not for the weakness of the US dollar in foreign currency markets. In 2006, the dollar fell 10% versus the euro, which was half my prediction of 20%, but still enough to keep the Fed from lowering rates. The reason why the dollar is a problem is that our trade deficit requires foreigners to add $2.5 billion to our economy *daily* to prevent the dollar from falling. Higher interest rates entice these foreigners to keep this money in America, and I'm afraid that if the Fed lowers interest rates, these foreigners will sell their dollar holdings.The chart below shows how the dollar fared in 2006. I expect more of the same in 2007 because I believe that a weak housing market will force the Federal Reserve to lower interest rates in 2007.

That would be great for gold and oil, which is why we continue to purchase companies that produce these commodities. Notice how the price of gold was a roller coaster in 2006 but still rose over 25%. Since gold generally follows an inverse pattern to the value of the dollar, I believe that any weakness in the dollar in 2007 will make our holdings of gold more valuable.

The GeoVest Approach

We'll know more about the national housing market when the prime selling season begins in March. Until that time, we're looking for opportunities for new purchases in defense, agriculture, alternative energy, and anything else that can make 2007 a rewarding year for our clients.

We believe our value-based disciplines will allow us to lead to further strong returns in 2007, regardless of the economic climate because we continuously try to anticipate both the opportunities and threats that will impact our ability to offer compound growth in our portfolios. Thank you for investing with GeoVest. It is our pleasure to serve you.

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