GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

The Fed Chooses Inflation

The Federal Reserve shook off its torpor and cut interest rates in dramatic fashion in the middle of September. Before they announced their decision, the Dow Jones Industrial Average was up 7% for the year, the US dollar had declined 4.5%, GDP was positive, yet prices of food and energy were spiking. Clearly, it wasn't the environment for a cut in interest rates, especially not a half point.

But the Fed had very good reason for cutting rates. We were starting to see "runs on banks" in the US and Europe, where people lined up to take their money out of these institutions out of fear that the banks would fail. The Fed was also dealing with a housing crash that continues to get worse. In a nutshell, the financial markets are very unstable right now.

In my estimation, the Fed waited a year too long to make these cuts. Had they started to cut rates sooner, we wouldn't be facing a crisis – just inflation. Because they waited, we now face a crisis and inflation.

To be fair, their short term timing was magnificent. They cut interest rates aggressively during options expiration week which multiplied the upward move in the markets as hedgers and speculators, preparing for market weakness, were forced to buy stocks. It gave the market something to cheer about and perhaps got investors to forget their troubles, temporarily.

Inflation

The Fed has chosen to embrace inflation as the least negative of outcomes. They tell us that they're vigilant on inflation but anyone who shops for food knows differently. By cutting interest rates as prices for necessities are rising, the Fed implicitly admitted that they were afraid of a market crisis.

We prepared for this move by buying gold and we weren't disappointed. Notice the chart below where gold started moving up aggressively in August, a sure sign that the market started to anticipate an inflationary move by the Federal Reserve.

Risk of Recession

70% of our economy comes from consumer spending and consumer spending is weakening very quickly. The chart on the next page shows year over year changes in nominal retail sales, or retail sales that haven't been adjusted for inflation.

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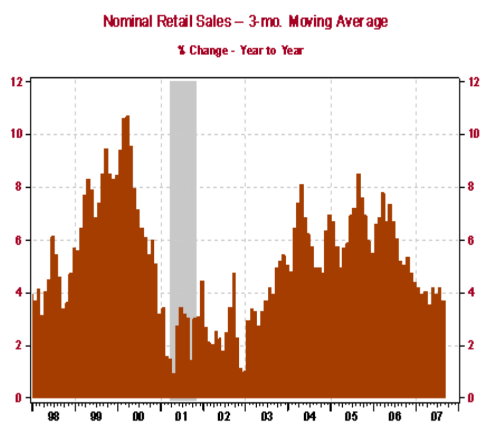
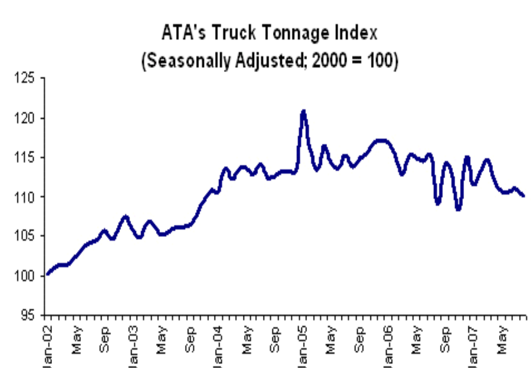


Source: Northern Trust Company

There has been a clear weakening of the consumer and if you consider that inflation has risen over this timeframe, it suggests a bigger weakening than portrayed by the chart. Chain store sales which measure sales at places like WalMart, Target, and Kroger have fallen 2.2% from late July and it may get worse.

Retailers seem to be predicting weaker growth ahead. In August, imports of goods from around the world declined by 1.4%, and have averaged just over 1% year to date. In addition, rail traffic is down 2.7% versus a year ago and trucking volumes are down 2.2% year to date. In fact, looking at a chart of truck tonnage, you can see volumes are at the same level as late 2003.

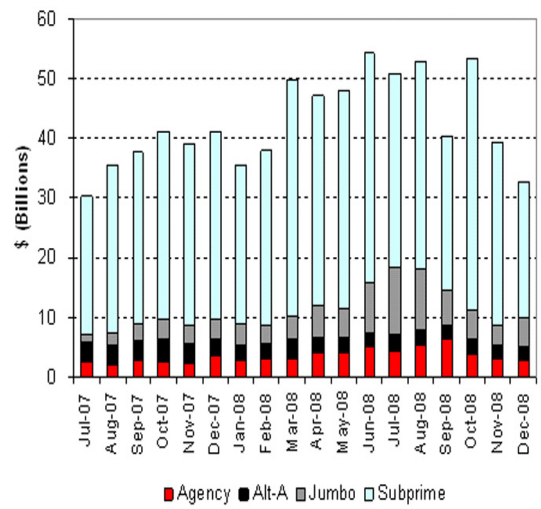


Source: American Truckers Association

It appears to us that consumers are relying heavily on credit cards to deal with rising costs as the recent upheaval in the housing market is making it more difficult for consumers to use home equity to supplement stagnant wage growth. This is only a temporary salve and could lead to another serious problem for banks early next year when consumers start having problems paying off these loans.

The Housing Market

I have written about this topic extensively for years and it is clear that our early predictions have proven correct. That's the good news. The bad news is that we are still very early in this housing correction. Note the chart provided below that shows the amount of Adjustable Rate Mortgages that will be reset at higher prices later this year.



Source: Wall Street Journal

From this chart, it's pretty clear that a lot of people will be in a position where they are forced to either sell their homes or turn their keys into the banks as at least half of these people won't be able to afford their new payments.

To put things in perspective, the Economist magazine estimates that 5% of all mortgages are currently delinquent and that rises to 15% for sub-prime loans. Also, the credit quality of loans made in the first half of this year are already going bad in record numbers where normally it takes a couple of years for loans to sour. This suggests a lack of qualified home buyers currently in the market. In addition, pending home sales are down

21% from last year. This is a crisis and it's likely to get much worse.

The Bond Market

I wrote extensively about the toxic bonds that were at the center of the summer's bond and stock crisis in the past two newsletters, so I hope our growing list of readers came out of it relatively unscathed. At GeoVest, our clients fared very well as we were invested in very high quality government and municipal bonds.

This particular crisis is far from over since most of the problems revolved around mortgage-backed bonds. With housing declining rapidly, home prices will continue to fall. This means that the collateral that backs up the credit on these bonds is declining. Wall Street, in its infinite wisdom, allowed hedge funds and other aggressive types, to use massive leverage when purchasing these bonds. This means that the losses in mortgage-backed bonds, not explicitly backed by the US government, will be massive. This is the real reason why the Fed cut interest rates by 50 basis points.

Making matters worse, European and Asian banks loaded up on these toxic bonds in great quantities. It's the reason why the European money market literally shut down in August and it's the reason why global central banks have been printing money like mad to avert an escalation of the crisis.

We'll continue to favor short term Treasury bonds until the Fed stops inflating the money supply and until we can purchase bonds that will improve in credit quality instead of bankrupting their owners. With the dollar trading at all-time lows, which means that inflation will be spiking, long dated bonds are very risky.

Lastly, in our last newsletter, we mentioned how the buyers of those bonds that fund leverage buy outs (LBO's) were dumb. Well these investors have wised up and have refused to purchase anymore of this worthless paper. Currently, the banks are stuck with about 90% of the bonds with few buyers in sight.

The Stock Market

As mentioned, the stock market staged a sharp rally when the Fed announced their rate cut. Besides gold mining stocks, technology has been the biggest winner which is surprising given mediocre results outside of a few big names. In fact, technology has historically been a terrible sector to own going into a recession. Yet, the chart below shows the Nasdaq is up sharply.

Technology stocks are starting to take on some characteristics of the 2000 time frame, making them very dangerous to own. Many are trading at multiples to earnings that fully discount all possible future growth without any consideration for the growing likelihood of recession. In addition, unlike earlier Technology rallies, there are very few new products that are worthy of excitement. History tells us that the best time to own technology stocks is when they are relatively unloved, not when they are everyone's first choice for a prom date.

The Dollar

The move by the Federal Reserve to cut interest rates has had a dramatic effect on the dollar. If you travel abroad or purchase a lot of imported items, you'll find that your dollars will buy much less than a few years ago and that's inflation. In fact, over the past five years, the dollar has lost around 40% of its purchasing power. Notice the chart below of the dollar.

For an economy that is dependent on importing close to $3 billion from foreigners each day, we're offering them a terrible rate of return. To put it in perspective, the dollar is down 7% so far this year, yet our Treasury Bills are paying around 4%. That means that foreign investors will lose 3% on their money. Without foreign investors, our interest rates would sky rocket. This is the primary reason why we favor short term bonds and gold right now.

The GeoVest Approach

We're having a great year as our gold, oil, and defense positions continue to perform well. Nobody knows whether the markets will experience another violent drop like we had in August but the conditions are ripe for such problems. During the recent sell-off, our portfolios performed well which gives us confidence that any future problems will be relatively minor for our clients.

But that doesn't mean that we're going to hide from potential problems. Instead, we're going to take what the Federal Reserve is giving us – inflation, and use this understanding to add value while trying to limit exposure to stocks that generally underperform in inflationary times.

Since 2004, this newsletter has been written with a thematic approach to inform our clients about what's going on as well as to chronicle the unstable nature of the housing/debt bubble that we identified back then. For those of you who have read all the issues, you'll notice that we haven't wavered in our expectations and now we are seeing many of our predictions proven correct. Taken to their conclusion, our predictions call for some unsettling volatility in the capital markets, the first pangs of which were experienced in August. We believe we are prepared to capitalize on these events. Thank you and it is our pleasure to serve you.

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