



Which Market Is Right?

Warren Buffett, the greatest investor of our time, was once quoted as saying “remember that the stock market is manic depressive”. Manic depression, or bipolar disorder as it’s commonly called today, is an incidence of volatile highs and lows in someone’s personality. Buffett, in my opinion, correctly diagnosed the stock market as suffering from the same chronic illness, as we have seen incidences of both this year.

Recent activity in the capital markets forces us to determine which of the conflicting signals being produced by the stock market and the bond market is correct. The stock market, with the Dow Jones Industrial Average hitting new highs this week, is telling us that the economy is accelerating ahead with no worries. The bond market, with its recent sharp drop in long term yields, is telling us that a recession is on its way.

Oddly enough, I think both signals are wrong. The economy is clearly decelerating thanks to a rapid decline in the housing market but it hasn’t fallen off the proverbial cliff – at least not enough to justify the bond rally. Besides, with inflation growth around 4% per annum, who in their right mind would lend the government money for 10 years at 4.6%?

On the other hand, there are no growth assumptions that can justify the valuation of the Dow, with a yield on earnings of 4.5% when it typically yields 7%. The Dow Jones Industrial Average typically trades around 15 times earnings, and is currently trading around 22 times earnings. In many ways, recent market action reminds me of the year 2000 which was a flat year for Dow stocks but with big spikes up and down.

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Hedge Funds

Rather than signaling the future, I suspect that the recent action in the capital markets reflects hedge funds running amok. As most of you know, Amaranth Advisors lost \$6 billion for clients when natural gas prices collapsed in September. Amaranth collapsed because they aggressively borrowed money so they could bet on the price of natural gas. When prices started to slip, other hedge funds pushed the price of natural gas down to the point where Amaranth was forced to liquidate their holdings.

I suspect that the sharp rise in the Dow and the sharp drop in interest rates have a similar explanation. With inflation rising and housing declining rapidly, there were a lot of hedge funds betting that interest rates would rise and the markets would falter. The recent success of both markets sent hedge funds scurrying to buy back positions they had previously sold short.

Oil

The recent sharp drop in the price of gasoline has presented an excellent buying opportunity for long term investors such as GeoVest. Besides seasonal factors that show up every year, I believe this buying opportunity has been the gift of some hedge funds that owned too much energy in their portfolios and were forced to sell these positions as prices dropped.

Another explanation offered by the Washington Post involves conspiracy theories surrounding the election. With Republicans facing their first big challenge for the House and the Senate in years, it has been suggested that the drop in gasoline prices has been orchestrated to help with the election. Whatever the

cause, I prefer to adhere to the old saying “don’t look a gift-horse in the mouth”.

Unlike the earnings yield on the market of 4%, our new positions in oil companies offer earnings yields approaching 20%. And the best part is that if I’m wrong about the market and it continues to rise based on a strong economy, our portfolios will continue to flourish because our economy runs on oil, which means that we’ll simply use more oil. If I’m wrong and the economy weakens faster than expected, the cheap valuations in the oil industry provide us a huge margin of safety to the downside.



The headlines in the daily paper are telling us that oil and gas inventories are rising, but the Energy Information Administration is telling us that long term supply continues to decline relative to demand. If we’re right, the bull market in oil has a long way to go.

Housing

Housing is the key to the US economy because it has been the key to consumer spending over the past five years. With home prices rising aggressively over the past three years, consumers have taken out \$1.6 trillion through refinancing mortgages to supplement spending. It was a good thing because wages haven't risen, when adjusted for inflation, over this time frame. Unfortunately, consumers can only take money out of their homes when those homes are rising in value and August marked the first month since 1995 that home prices actually fell. We expect further declines in the housing market in the future.

Now, we're not going to beat a dead horse and pile on to this topic – the media is already doing an adequate job of this. Besides, we've been talking about this eventuality for a couple of years, so I assume our clients are very familiar with our stance. Suffice to say, the housing mania was very much like the Internet boom where wealth was created very quickly and will be lost just as quickly.

Instead, we're tracking this situation very closely because it will eventually cause a severe problem with the US economy, unless we can come up with a new growth industry to replace the jobs and wealth that will be lost as home prices continue to fall. So far, there is nothing on the horizon.



The Economy

We started with the “Hollywood Recovery” theme in 2004 and two years later, the title seems like it was an inspired choice. The economy recovered from our last mini recession in 2001, but new jobs and capital investment have been oddly absent. According to Business Week, if healthcare had not added 1.5 million new jobs since 2001, there would have been no increase in private payrolls over that time frame.

Somewhat shockingly, information technology jobs, which were supposed to be the cornerstone of the new economy, have declined over this time frame. Instead, our new economy, if judged by labor growth, is in healthcare, restaurants, and real estate.

It's true that corporate profits have surged over the time frame, reaching 10% of our economy, compared to a normal 5% to 6%, but much of these profits have been driven by reducing employment in the US and increasing it in low wage countries like India. This works for a time, but it leaves our most important national asset – people, underutilized. It also explains my continued strong attraction to gold as an investment choice.





Gold

The price of gold has been extremely volatile this year, as have the companies that mine it. But, if you consider the “nature” of our economy, weak employment and wage growth offset by rising asset prices, it becomes clear that our whole system is dependent on rising asset prices. The only way to ensure rising asset prices is to allow money creation.

As I track money supply growth in China, India, Europe, and South America, I see massive growth in money creation. They use this money to buy our Treasury bonds as a means towards ensuring that the value of their currencies never rise versus the US dollar because if their currencies rise, so to does the price of their goods to US consumers.

Gold, due to its relative scarcity, has historically retained its value which is why I continue to recommend purchases of gold related investments.

Bonds

As I mentioned earlier, the bond market is signaling a recession in the United States as the yield on long term bonds has plunged over the past few months. From previous newsletters, you may remember that when short term interest rates are higher than long term interest rates, it’s a powerful recession signal. Today, we are ten months into this signal, which tells us that a recession is likely.

Yet, despite my well documented problems with the US economy, I expect a recession to take a little longer than the bond market is presently discounting which is why I continue to recommend short term bonds. If our gold thesis is correct, long term bonds could rise in yield later in the year.

The GeoVest Approach

The financial press likes to call our current economy a “Goldilocks” economy because it’s not too hot or too cold. Personally, I refuse to believe in fairy tales, preferring to spend the extra time analyzing the economy that is necessary for me to understand why things are happening in the world. Based on changing developments in the global economy, I like our current portfolios.

We’ve been cautious for a couple of years and we will continue to be cautious because the global economic imbalances that we saw two years ago have gotten worse. Long term investing requires a firm foundation, and you don’t build a portfolio on an economy whose main driver, housing, is decelerating rapidly. In addition, hedge funds, the superstars of the first half of the decade, are starting to blow-up thanks to making big bets using leverage that are being proven wrong.

We are trying to make our website more useful for our clients to follow changes in the global environment that affect their portfolios. I updated the site regularly throughout the past quarter but still want to write a weekly update piece to be posted on Friday nights. I hope you will take the time to visit our site at www.geovestadvisors.com.

If you have any ideas on how we can serve you better, we would like to hear them. Thank you for investing with GeoVest Advisors. It is our pleasure to serve you.

Philip M. Byrne, CFA
Chief Investment Officer