



### Golden Opportunity

Gold is real money. You can mine gold, but only in very limited quantities, and you can't conjure it up from thin air. Medieval alchemists tried to turn lead into gold and failed. This is why gold maintains its usefulness as money. Its scarcity retains its value.

The US dollar doesn't possess the same qualities as gold, especially since it hasn't been backed by gold since 1972. Where gold is scarce and difficult to find, dollars can be created by an economic transaction – the creation of new debt. When large amounts of new debt are created, that dollar in your pocket is worth less because there are now more dollars chasing the same amount of goods. This is the essence of inflation.

Gresham's Law states that bad money will chase out good money. Stated differently, devaluation of the money stock leads to hoarding of assets that have scarcity value such as gold, copper, and oil.

Unlike the dollar, gold can't be devalued by economic events, which is why investors turn to gold during times of economic uncertainty. In our last newsletter, we warned our clients of a potential economic storm on the horizon. The rise in the price of gold is telling us that the storm is getting closer.

Specifically, this run-up in the price of gold is telling us two things. The first is that we are about to enter a period of economic uncertainty. The second is that the government will try to create new money to get us out of the problem.



### Ben Bernanke

Ben Bernanke has been appointed to replace Alan Greenspan as the Chairman of the Federal Reserve Board. Bernanke has impeccable academic credentials and appears to be a decent, well-intentioned man who can work with both of the major parties in our country. But, it is important to understand Bernanke's philosophies because they will have a very heavy impact on the price of gold.

You see, Ben Bernanke's expertise is on the Great Depression of the 1930's. In his opinion, if the Federal Reserve had simply created more money in 1930, the Great Depression could have been averted. Creating money is the same as devaluing it. Bernanke's appointment was announced in November, which coincides with the major upward move in gold.

In addition to Bernanke's philosophies, the Federal Reserve made an announcement that attracted little notice but will have huge consequences for our country. They announced that they will no longer publish money supply data in the form of M3. M3 is a broad measure of the supply of money in our country that reflects the impact of large increases in

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debt. Over the past year, M3 has expanded by 7.5% which is twice the amount of economic growth we are experiencing. In other words, money is being devalued at an increasing rate. The fact that the Federal Reserve is going to take this measure away from us, gives us strong indication of their intent. If we are reading this scenario correctly, it suggests that the price of gold may soon skyrocket.

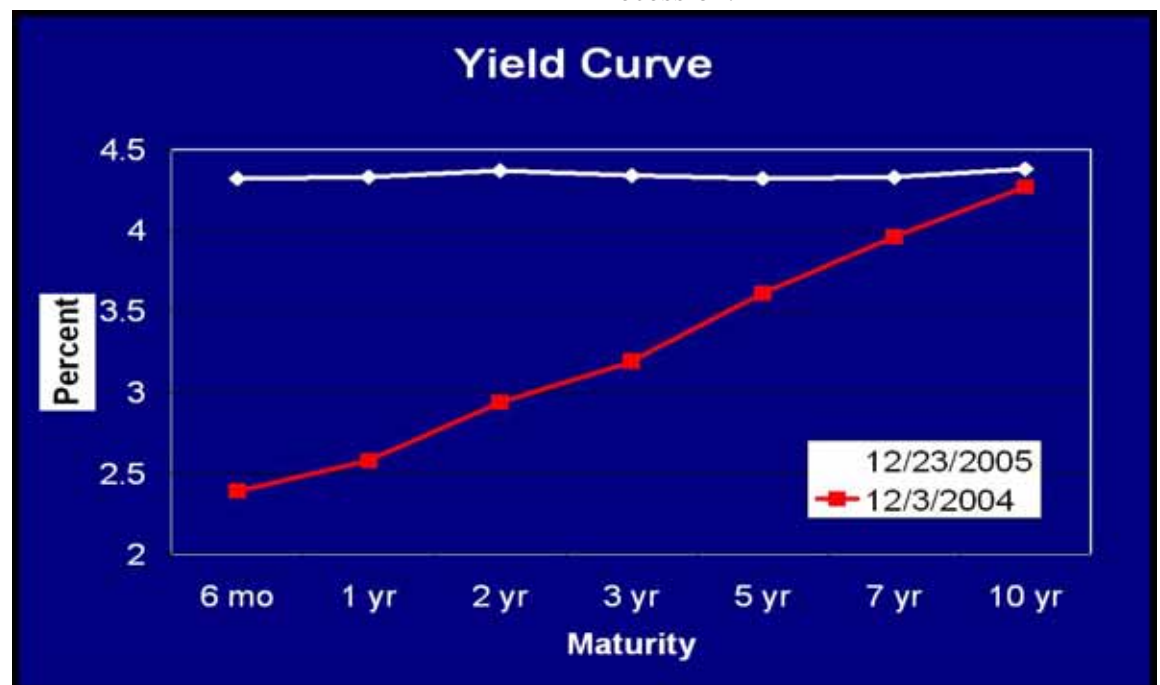
## 2005

Stock market returns are only slightly positive for the year and essentially match our best case scenario at the start of the year. As we've mentioned numerous times, the stock market is expensive and the economic fundamentals that support it are very weak. Our expectation for the broad market in 2006 is roughly the same, but our expectations for GeoVest's clients are very positive. To put things in perspective, and to reinforce our gold theme in this letter, here is a chart of the stock market, *priced in gold*. The chart substitutes ounces of gold for dollars. As you can see, stocks have done very little when priced in gold.



## Interest Rates

Normally when we talk about interest rates, people's eyes start to glaze over, but not today. The yield curve, which indicates the interest rate for each year of maturity, has inverted which, for economists and strategists, is like Paul Revere riding through the villages surrounding Boston crying "The British are coming." The reason this is so important is that 100% of the time since World War II, an inverted yield curve has meant recession. An inverted yield curve, for those less fascinated by economics, is when short term interest rates are lower than long term interest rates. It's basically saying that today's inflation is higher than what is expected in a few years. The only way this can happen is if we experience a recession.





As you can see from the chart on the previous page, we have inversion from the 2 year to the 10 year. This is a very significant variable for banks because banks make money by borrowing money from depositors (short term interest rates) and typically lend over longer terms such as with mortgages. This lack of spread between short term and long term interest rates tells us that banks are experiencing less profit from each loan they make. In order to maintain their current levels of profitability, they will have to make riskier loans, which are priced at higher rates but also have a greater probability of default. It also tells us that speculators will have to borrow money from outside the US to make gains trading.

An example of the involvement of foreign entities could be borrowing money in Japan at close to zero interest rates, and buying a US Treasury bond at an interest rate of 4.40%. The profit from this transaction is around 4% before changes in currency are considered. The risk in this transaction is that the value of the yen rises versus the dollar, wiping out all the profits on the transaction. For some inexplicable reason, investors are ignoring this risk because they are borrowing enormous amounts of yen to buy dollars.



This is where things get really interesting. Japan has an enormous trade surplus with the US, which means that the Japanese yen should continuously rise versus the

dollar. The reason is that we give them dollars for Toyotas which they have to convert to yen to pay their workers. With the yen dropping 12% versus the dollar this year, it tells us that speculative transactions now dominate real world transactions. It also tells us why our yield curve has inverted – foreigners are buying our debt at a dramatic pace - \$1.25 trillion in 2005 alone.

These occurrences, of ignoring the foreign exchange risk, reek of desperation in the capital markets. When risky, speculative transactions dominate real world transactions, it tells us that a storm is coming.

## Energy

Besides gold, our second favorite investment theme is energy. The essence of our interest lies in its scarcity value, coupled with an inflation-driven expansion of the world economy. In the US, our appetite for oil is fueled by big houses and big cars, but we're only half of the story. The Chinese economic miracle is largely fueled by oil as the Chinese have been increasing their usage of oil at a rapid pace.

But the supply story is the real driver of oil prices. There is some indication that we have finally hit peak global production of oil. The Saudi Arabians are renting off-shore oil drilling rigs seemingly because they are unable to meet demand from their massive oil fields on the Arabian Peninsula. They are also believed to be pumping seawater into their land based wells to maintain pumping pressure – a sure sign that these wells are past peak.

Two other events have occurred over the past six months that makes this situation worse – two major hurricanes in the Gulf of Mexico, combined with an indication that one of Kuwait's major oil fields is past peak production.



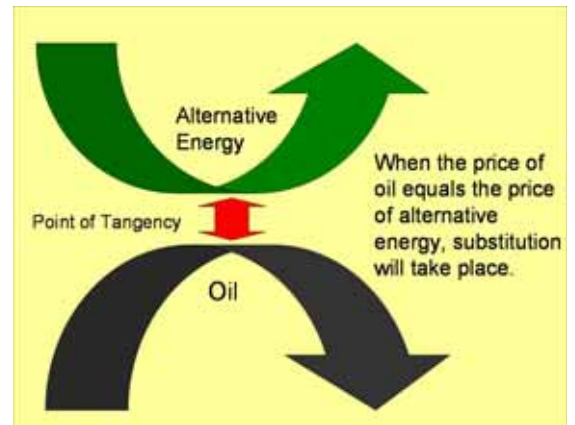
In addition, we believe that Gresham's Law is at work in the oil market. With the devaluation of the dollar through excessive debt creation, we believe that investors are hoarding oil for its scarcity value with the idea that it will act like gold in response to a dramatic increase in dollars.

## Alternative Energy

Most people I talk to about energy make the assumption that when oil is used up, we'll be able to make a painless transition to some form of alternative energy such as fuel cells or some hybrid technology. There are two things wrong with this assumption. The first, and easiest, is that average car loans have gone from around 2 years to around 5-6 years as consumers employ car loans going out as far as 8 years. This tells us that consumers won't be able to switch to energy-efficient transportation in the event that oil prices spike.

The second, and more serious variable, is that alternative energy costs a lot more than oil. Without getting too technical, the internal combustion engine is just about as efficient as you can get and switching to anything else will be much more expensive for each unit of energy created. The chart provided gives you an idea of how we are addressing the investment potential of alternative energy. Until the green curve and the black curve actually touch, alternative energy will largely be useless. Even with rising oil prices, we're still a long way from alternative energy solutions.

We still like oil and natural gas stocks because they are unlikely to be replaced anytime soon, but the caveat of our bullish position is our expectation for global economic weakness. When the global economy goes into a cyclical downturn, it will be time for us to reduce our exposure to energy. Until that time, we believe there is still some money to be made.



## The GeoVest Approach

With the inverted yield curve and the weakening housing market telling us that the economy is likely to weaken in 2006, we'll start the year with our low risk portfolio and a focus on gold. As the year progresses, we should finally get that buying opportunity that will allow us to get more aggressive with the portfolios.

Lousy stock markets are a fact of life. The way you position for the next move determines your value as an advisor. We are prepared to take advantage of the next move when the market finally shakes out of its present funk.

We are a forward-looking organization. We do our own economic and company research, and we often reach conclusions that are outside of those reached by mainstream investors. This is one of the core strengths of our firm. To make things a little more interesting for our clients, we will post our top 10 surprises for 2006 on our website. We hope you will enjoy following these predictions as the year unfolds.

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.

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**Chief Investment Officer**