GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

Volume 8, Issue 1 April 2006

On Course

Gold Continues to Shine

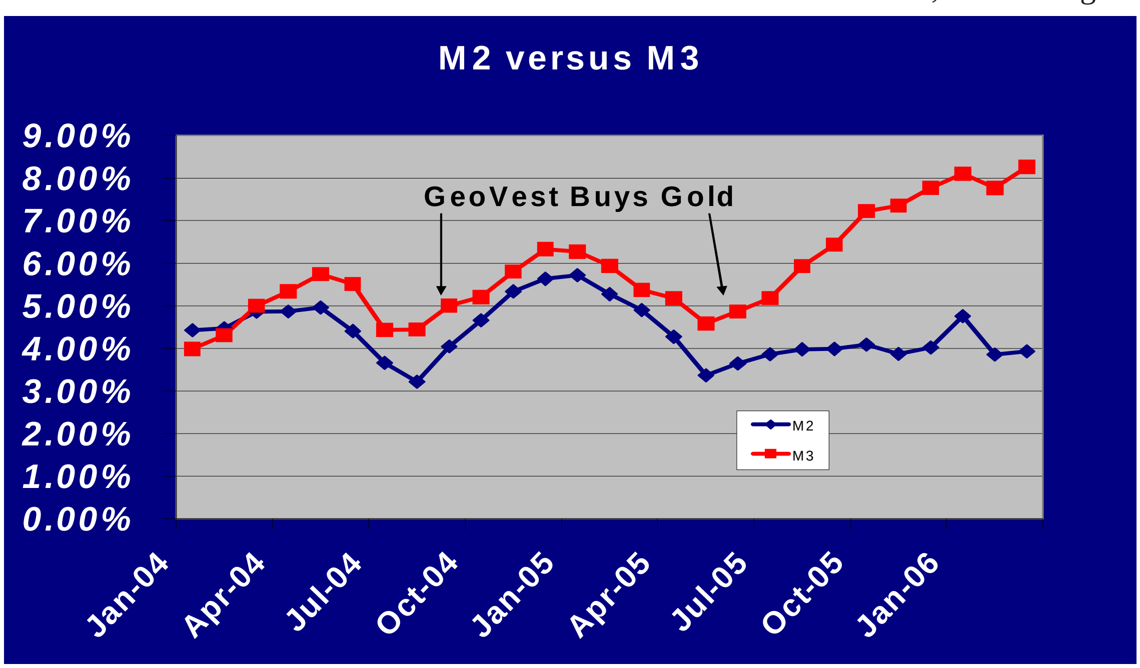
If you follow current events, your head is probably swimming over the mixed messages that you're receiving. On the one hand, the stock market continues to advance while on the other hand, home prices have topped out. You read stories about higher interest rates and oil prices alongside stories about earnings growth and new millionaires. At GeoVest, we see these mixed messages as opportunity to grow your assets.

We talked extensively in our last newsletter about the investment prospects for gold, and we weren't disappointed in the quarter. The price of gold rose 13% while oil, our second favorite investment idea, rose 10%. This compares to the S&P 500 which rose a little over 3%. We see further opportunity in these two areas.

We see two separate forces converging on the markets, the dynamics of the late-stage of the economic cycle, combined with the Federal Reserves attempts to stave off a recession. The interaction of these two forces promises to make 2006 a year to remember in the markets because in many ways, these forces are opposed to each other. In our view, it's the reason why you are seeing mixed messages and the reason we believe that gold and oil will be very good investments for the foreseeable future.

The Federal Reserve

Last quarter, we talked about how the Federal Reserve was going to stop publishing statistics on M3, the broadest measure of money supply that exists and how they are increasing the money supply as a means of maintaining economic momentum in an increasingly imbalanced economic environment. Below is a chart of the two most important measures of money in the US. M2 measures what is in most of our bank accounts, both savings



Source: Federal Reserve Board and GeoVest Advisors

Table of Contents

GeoVest Advisors, Inc.
245 Willowbrook Office Park,
Fairport, NY 14450
Tel: 800 - 638 - 5050
Fax: 585 248 8789
www.geovestadvisors.com

and checking, while M3 is M2 plus large corporate bank accounts and trading accounts.

We started getting more aggressive with gold about a year ago when the two measures of money supply started to diverge. We interpreted the chart to mean that while money is flowing into the capital markets, the relatively slow growth of M2 indicates that money is not flowing into consumer's pockets.

Normally, when the Federal Reserve raises interest rates, the growth of the money supply slows because it costs more to use that money. A simple example would be for a home buyer. If you can borrow $500,000 at 4%, it would cost you an extra $600 per month if rates rose to 6%. If the extra $600 is not in your budget, you can't buy the house, thus money supply would not grow.

The fact that M3 money supply is growing rapidly at a time when the Fed is raising interest rates, combined with the fact that the Fed will no longer furnish the information on M3, leads me to suspect that the Fed is saying and doing two separate things. They are trying to keep inflation under control by raising interest rates but they are also allowing money supply to grow very rapidly to ensure that the capital markets are not hurt by these changes. This creates a mixed message.

The Economic Cycle

The economy runs through cycles like the weather runs through seasons. Internally, we use an economic clock to tell us where we are in the economic cycle because we are making decisions in client accounts that are based on the future instead of the past. We also look at the relative strength of various stock sectors to tell us if other investors see the same things.

A typical cycle starts in recession and moves its way through the years of expansion where new businesses are opened and people are increasingly employed until it can't get any better. At this point, the Fed has been raising interest rates to avoid inflation, and new investment starts to slow. The ultimate end to every cycle is a recession.

Looking over the sectors of the stock market that are doing the best, energy and basic materials are the two strongest areas. Historically, when these two sectors outperform the rest of the market, it's an indication that we are late in the cycle.

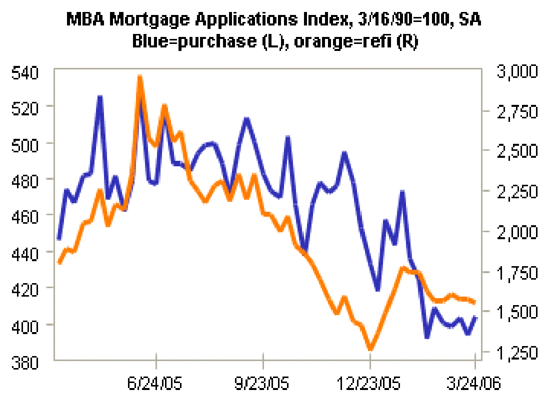
Today, we believe we are at the top of the cycle where things are the best they will be. Inflation has risen sharply, interest rates are higher, and consumer spending growth is slowing. But we believe that the Federal Reserve is trying its best to keep us at this point in the cycle, which is why we believe oil and gold will continue to perform very well.

Housing

Our current economic cycle has been an odd one, driven mostly by the strength of the housing market. I've seen estimates that suggest that between 30% and 80% of all the new jobs created over the past few years have been tied directly or indirectly to the housing market. I've also seen estimates that show somewhere around $2.5 trillion has been withdrawn from home equity since 2001, half of which has been spent on personal consumption.

These two statistics tell us that the strength of the housing market will go a long way towards determining the future course of our economy. Consumers, who make up over 70% of our economy, have adjusted to very slow income and employment growth by extracting equity from their homes. If home prices stop rising, we'll be hard pressed to make up the difference in consumption.

Recent housing data suggest that our economic clock is keeping time. Home sales are slowing and inventory of unsold homes is rising. With interest rates continuing to rise, and home affordability at its lowest level in 15 years, future price increases are doubtful. The chart below shows applications for new mortgages, which is a great future indicator for home sales.



Source: Economy.com

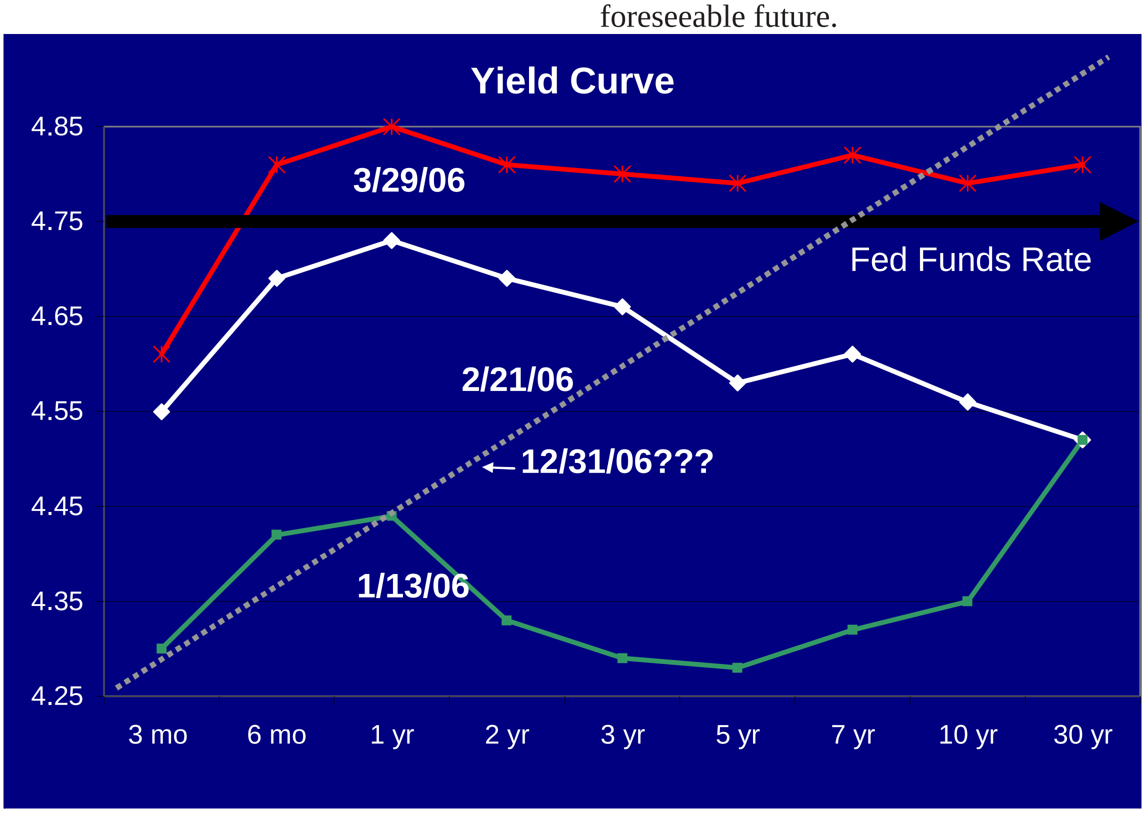
The Bond Market

The bond market has had a tough year and the difficulty will likely continue. You can see from the yield curve provided below, interest rates have risen since early January. As we described in our last newsletter, a yield curve that is either flat or inverted has historically been a sign of future economic weakness. It was both, during the past quarter.

We anticipated higher long term interest rates, which is why our new purchases of bonds have largely been in very short term maturities or in Ginnie Mae's which outperform similar bonds when interest rates rise.

Because we believe the Federal Reserve will be forced to start cutting interest rates later in the year, we expect short term interest rates to be getting close to their top. But if they do cut short term rates, we believe the bond market will view this as a potential source of new inflation which will cause long term interest rates to rise further.

At the end of the year, we expect the yield curve to have steepened as short term interest rates fall and long term interest rates continue to rise. This is why we'll continue to buy short term bonds for the foreseeable future.



Source: US Treasury

Alternative Energy

We believe alternative energy sources will power America's future since oil and natural gas are proving to be in short supply. In our last newsletter, we provided a chart that showed the relative cost differences between oil and alternative energy sources. As the price of oil continues to rise, alternatives such as fuel cells, ethanol, and biodiesel become more compelling but are still a long way from wide-spread use.

We'll use enthanol to further our point. Ethanol is an alcohol that can be burned like gasoline to produce energy. But unlike gasoline, ethanol is corrosive which is why we would need extensive adjustments to our vehicles before it can be used. In addition, gasoline can be shipped across country through existing pipes where ethanol shipments would require all new, corrosion-resistant alloys.

Another issue is the supply/demand features of the energy markets. The primary determinant of energy usage is economic growth. If the global economy goes into a downturn, energy demand will temporarily fall. If this happens, oil prices will fall, but alternative energy prices will fall further as users would shift back to oil because it's still cheaper to use.

The point of this discussion is that investing in alternative energy is not easy. This is why we've invested in ethanol and biodiesel in a different way that you may not have realized. We purchased an agriculture company, at a very reasonable price, that supplies the corn, sugar, and vegetable oils that are used in the making of alternative energy. And here's the best part - if consumers don't use this produce for energy, they can always eat it.

The GeoVest Approach

We are buying securities in our portfolios that are unlike the securities you would normally see because we see the present conditions as warranting a different approach to investing. We are operating under the assumption that investors will buy things that are scarce and sell things that are plentiful. Metals and oil are scarce but long term bonds and houses are in abundance.

As we've said before, we are a forward-looking organization. We are anticipating the future by means of global economic and company analysis and sometimes our forecasts will differ from what you may see from mainstream sources. Right now, our portfolios reflect those expectations and we are confident that our clients will be pleased with the results.

This quarter, you'll notice that we've made some changes to our statements. We've received some terrific feedback from clients concerning what they would like to see and what they don't want to see. Nancy Wagner, our new operations manager, has done an outstanding job in improving the look and the content of our statements. The changes this quarter are relatively minor, but she is working on some exciting new changes that we hope will meet your high expectations for GeoVest.

These changes are possible because some of our clients expressed their wishes. 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

GeoVest Advisors, Inc.
245 Willowbrook
Office Park,
Fairport, NY 14450
Tel: 585 248 5050
Fax: 585 248 8789
www.geovestadvisors.com