On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Dangerous Rally

We're experiencing a bear market rally with a dramatic 20% turnaround off the lows experienced on March 9th. Bear market rallies are pretty common and if unprepared, you'd swear that a real improvement in the economy is at hand. They normally start when someone says something positive at a time when investors are almost universally negative. Next thing you know, short sellers are taking gains and people holding cash feel obligated to jump back in. Some of the most ferocious bear market rallies occurred during the Great Depression.

This one started with a "leaked" internal memo by Citigroup claiming that they made money in the first two months of this year before charge-offs for bad debt. The funny part was that this memo was leaked when Citi's stock was trading under a dollar and it looked like it was going to be nationalized. Other banks followed suit by claiming that they were making money as well and that they would no longer need government assistance – except for the continued guarantees that keeps their borrowing costs close to zero.

Next came some claims that the economy is improving based on some spurious interpretations of economic data – we'll debunk those later. And lastly, Congress forced the Financial Accounting Standards Board (FASB) to change the way banks account for bad assets so they can give the appearance that they're still solvent – they're not.

Dangerous?

The reason I consider this to be a dangerous rally is that none of the problems with the global economy have been fixed. The government's plans indicate that they collectively believe we are experiencing a *confidence* problem and not a problem driven by excessive usage of debt relative to our ability to generate income. I liken it to a contractor hired to fix the foundation of your house that puts a thin layer of mortar over the crumbling bricks to make it look good and proclaims the job completed. If you move back into the house, someone's going to get hurt.

Instead of closing down the insolvent banks, the government is pumping hundreds of billions of dollars into them, letting them lie about earnings, and printing money to keep long term interest rates low. Foolishly, this implies that if banks lie about their precarious financial position, then all of their problems will be solved. This is the kind of irrational thinking that got us into this mess in the first place.

The Treasury is also trying set up the ultimate insider's network to trade those bad investments leaving taxpayers on the hook for 85% of the risk. Now here's the funny part – now that banks can lie about the value of the loans and securities on their books while financing those bad loans at almost free rates of interest, why would they sell them unless prices rise to grotesque levels over their true market value?

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The Stock Market

We prepared for this rally by taking gains on some of our hedges and by making a token trade on the S&P500 index. It wasn't much, but since our accounts are largely positive for the first quarter compared to a 12% decline in the S&P500, we don't have to "chase" the market. Our target upside on the S&P500 is around 900 for this little rally.

I continue to believe that the S&P500 will "bottom" somewhere below 500, or 40% to 50% lower than current levels. Looking at the chart below, this would take us back to levels last seen in 1995, before much of economic lunacy took place.

If you refer back to our January newsletter aptly titled "The Confidence Game", you'll recall that our biggest issue with the market is the return generating capacity of our consumer economy. The companies that make up the stock market are largely designed to sell stuff made outside our country to consumers who lack the income to continue spending.

In fact, a huge part of corporate earnings come directly or indirectly from financing purchases. Therefore, when we say we're negative on the market, we're really saying that most companies that make up the stock market lack the real earnings generating capacity to entice us to risk our client's hard-earned capital. There are exceptions and we are busy researching them.

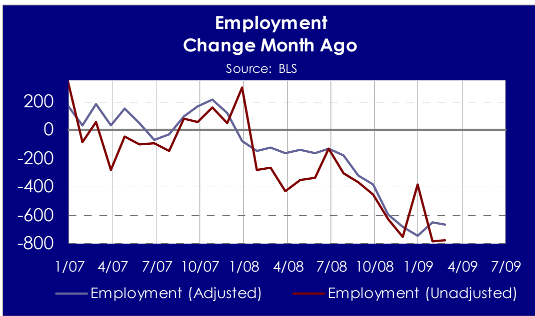
The Economy

The government is doing its best to try to turn things around but I'm afraid they're taking the wrong approach. In essence, they're trying to recreate asset bubbles to support consumer spending, but there aren't any assets that are suitable for expansion. Besides, asset bubbles inevitably pop, evidenced by the Internet Bubble, the Housing Bubble, and now the Commercial Real Estate Bubble. In fact, the final bubble out there is the government debt bubble, which we will discuss later in this piece.

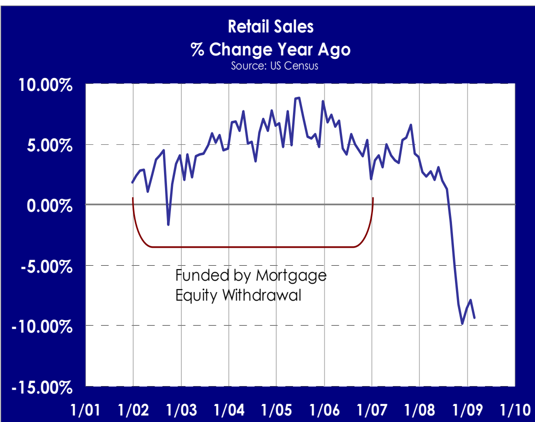
Fortunately, an undercurrent of intelligent dialogue is coming out of Washington that acknowledges the structural problems that plague our great nation. There also appears to be a growing number of people who realize that the financial services industry, rampant with self-servicing oligarchs, is a failed industry and not one to build a recovery around.

But until these voices get stronger, we're forced to endure nonsensical analyses suggesting a recovery in the global economy based on minute improvements in some pieces of data while ignoring the overwhelming negativity that continues to dominate the environment. A slight uptick in sales of new homes, after a 20% drop in prices, isn't a sign of impending economic expansion.

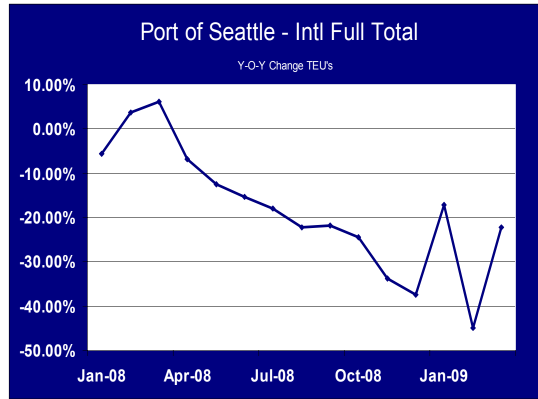
I try to avoid the "talk" and concentrate on what's actually happening and it's clear to me that we are losing jobs rapidly and that means there are fewer people to buy new homes, to pay back the old loans, or to load up the cart on the next shopping trip. The chart below reflects job losses in thousands where the red "unadjusted" line reflects what the data looks like without some highly optimistic assumptions made by the Bureau of Labor Statistics.



One possible explanation for the positive data is that the government appears to be doing some funky things with seasonal adjustments. Notice the chart below of seasonally adjusted retail sales, which are falling rapidly, an average of 8.5% for the first quarter of this year compared to 2008. The chart also suggests that February showed a nice improvement. But if I showed you a chart of retail sales that weren't seasonally adjusted, the decline is over 10% for the quarter with February down 11.5%. Wall Street hailed that little jump in February as a sign that things are improving, but the truth is that it was merely a statistical trick.



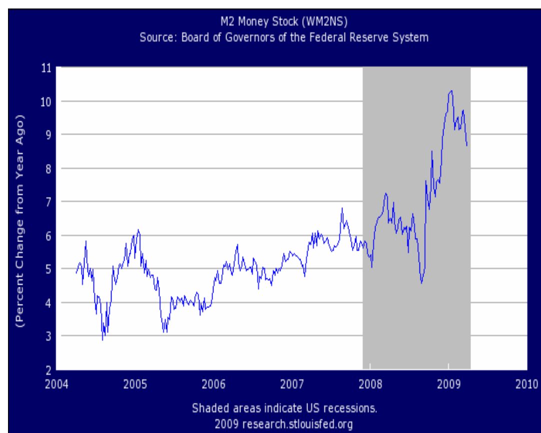
When looking at the economy, I like to look at things like rail traffic, port traffic, truck traffic, and orders from our international suppliers. In that vein, it appears that there is no sign of positive change on the horizon. The chart below is from the Port of Seattle, which offers timely updates on traffic each month. Newspaper articles that cite other ports such as Long Beach and Houston indicate similar chart patterns.



Clearly, this isn't a good sign. In addition, anecdotal evidence from China indicates that orders from US customers are scarce and that many Chinese factories have already shut down. If things are really improving, as suggested by public officials, Chinese factories would be receiving orders right now for the 2009 holiday season – and they're not.

The Bond Market

The Federal Reserve finally panicked and announced that they are buying long term bonds to drive down interest rates. In essence, the government is buying its own debt and will print money to do it. Unfortunately, printing money is the same as creating inflation because it makes the currency in our pockets worth less. Notice the chart below where the Federal Reserve has ramped up the money supply in this country even as banks are cutting back on lending.



We believe this will ultimately result in a sharp jump in long term rates because the math is inescapable. The US has a $1 trillion deficit right now which should jump to $2.5 trillion by the end of the year. Currently, foreigners are buying around 50% of our Treasury debt which means they'll have to ramp up purchases from $500 billion per annum to $1.25 trillion per annum in just one year while we increase domestic demand for our Treasury bonds an equal amount. With that kind of supply increase, there is no way interest rates stay at these levels.

Notice the two charts below of the ten year US Treasury Note and the US Dollar where on March 19th, the Fed announced their intention to buy long bonds – rates fell from 3% to 2.5% while foreigners aggressively sold the dollar. Also notice how rates moved back up despite the Fed's aggressive efforts to keep them down.

The dollar fell because foreigners don't like to own currencies that are inflating their way out of economic difficulty. Given that we'll need to call on foreigners to more than double their purchases of Treasury bonds, does anyone else believe they'll demand higher rates of return?

I believe the Fed's efforts to inflate the currency and keep interest rates absurdly low will fail and it's the reason why we are waiting for higher rates of return before embracing greater risk in our bond portfolios.

The GeoVest Approach

The US economy needs to restructure in order to recreate a profitable business environment. Unfortunately, the Wall Street bailouts are taking valuable time and resources away from the real problems in our country. I can understand why the new Administration is trying this approach because to do otherwise would invite social unrest and a few years of misery. But this is the same choice the last Administration made when they inherited the post Internet economy and it brought us to our present situation. The current Administration's choice will produce the same result.

One of the things I love most about our country is that we adapt to policy errors and find ways to prosper despite them. The upcoming environment won't be any different.

Our investment returns have been terrific. In 2009 we've been steadily adding new clients thanks to referrals from current clients; it's the best compliment we can receive. Thank you and it is our privilege to serve you.

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