

ON COURSE

A QUARTERLY NEWSLETTER FROM
GEOVEST ADVISORS

The Hollywood Recovery II

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Special points of interest:

- The wrong kinds of jobs are being created in the US.
- China could spark a global economic crisis.
- Rising inflation may lead to higher interest rates.
- The risk to the markets has increased.

George Soros made a fortune by finding faulty premises and betting against them. We're not a hedge fund, but I believe in borrowing concepts from people that have achieved greatness and using them to improve client returns. Today's faulty premise is that we are in the midst of a strong, sustainable economic recovery.

No one can argue that the economy is pretty good right now. People continue to buy homes, shop at WalMart, and drive new cars with 0% financing. In fact, if I limited my analysis to current economic data, I might conclude that the economy is doing well and that there are no foreseeable problems in sight.

Fortunately, my approach to economic analysis is to understand the root causes of the economic environment, for only then can you accurately predict the future. When I take a deeper look at the drivers of our current strength, consumer spending and Chinese fixed investment, I conclude that those drivers are unsustainable.

The Economy

The jobs data for March was very strong on the surface. 308,000 new jobs is a pretty good month (not great) for an economic recovery. The problem is that these are not the kind of jobs that improve the economy by creating wealth for Americans – they are the kind of jobs that help us to spend our wealth.

By my calculations, only 3.5% of the net new jobs created allow us to compete in global markets. In other words, jobs that could have been filled anywhere in the world, but created here because of some American competitive advantage. Instead, the vast majority of jobs created were temporary, part-time or governmental. And the common denominator of 87% of the new jobs created is that they are a result of low interest rates.

23% of the new jobs created were in construction. While these jobs pay well, they are project dependent – once the project is done, the job is over. In addition, these jobs don't allow us to produce something that can be sold in global markets, which means that they don't reduce our current account deficit.

9% of the new jobs created were restaurant jobs. Typically, these jobs are part-time, and rarely include health insurance. 10% of the new jobs created were by government and we all know that government doesn't create wealth, it merely provides basis services.

Manufacturing had a great month for jobs. For the first time in 44 months, we didn't lose any additional manufacturing jobs.

Don't get me wrong. I'm happy to see job creation, but the jobs that typically mark an economic recovery are noticeably absent - jobs that create the things that we buy or make us more efficient. These jobs are the ones going overseas. The Chinese added 13 million new jobs last year, yet the US is

economic recovery are noticeably absent - jobs that create the things that we buy or make us more efficient. These jobs are the ones going overseas. The Chinese added 13 million new jobs last year, yet the US is the only country with which it enjoys a trade surplus. Basically, our low interest rates are creating jobs in China, not in the US.

If you are one of the people who believe that it is a good thing that we are moving away from manufacturing, keep in mind that India has created over 600,000 new Information Technology jobs over the past year, while we continue to lose them.

Economists call this phenomenon the global labor arbitrage and suggest it is a good thing. Perhaps so, but we are trading \$60,000 a year jobs for \$20,000 a year jobs at a time when we are sitting on a pile of debt, both publicly and privately, as a nation.

As I've mentioned in previous newsletters, I'm

China

worried that the Chinese economy is at risk of sparking an international crisis. For those of you that don't follow international economics, China has been the growth story of the past decade. The Chinese are building factories at an aggressive pace, and are quickly becoming the manufacturers for the world. To see the extent of their gains, pick up a few products when you shop at WalMart or Target next, and you will see that most of these products are made in China.

Along with the US consumer, the Chinese manufacturer has been the driver of global economic growth. To build all those factories, the Chinese are buying extreme amounts of steel, cement, oil, and computers. Much of the growth in the earnings of US companies has been the result of selling things to the Chinese.

The problem is that the Chinese are trying to grow too fast. They are borrowing so much money and buying so many commodities that they are causing serious economic imbalances in the global economy. It will get worse later

this year when people realize that Chinese companies are not making money with all these investments. Since the majority of the capital supplied to build these factories is coming from bank loans, and that the likelihood of paying back these banks is low, it means that there banking system is at risk of falling apart.

Wen Jiabao, who is the Premier of China, is aware of this problem and has publicly vowed to slow down the rapid rate of growth in China to a slower, more sustainable rate. The problem is that the Chinese banks have not been listening. Instead of slowing lending, they actually increased lending to factories by 43% in the first three months of this year. This suggests that the Chinese Premier will have to employ very harsh tools to enact his economic policy directives. When that happens, Chinese investors will cut back on purchases of metal, computer chips, and a lot of other products that has allowed global companies to report profits.

Inflation

Jobs sustain our ability to spend. We can leverage our income by using debt, but ultimately we have to earn money to spend. The recent jobs report suggests that we are only experiencing a roughly 2% increase in wages. Unfortunately, that wage growth has to be adjusted for inflation, which is running around 2% at present.

Anyone who consumes in our economy realizes that prices are starting to rise for the first time in a long time. Oil prices are rising as OPEC cuts production to adjust for the decline in the dollar – essentially they don't want to earn less money because the dollar is dropping in value. Home prices continue to skyrocket, making it more expensive for new buyers to enter the market. Food prices are rising as farmers try to pass along their higher costs of energy. Healthcare prices continue to jump at double digit rates, which are forcing employers to pass along these higher costs to employees.

For manufacturers the problem is worse. Not only do they have to pay higher energy costs, they also have to pay higher costs for chemicals, metals, and plastics. Then there are ship-



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they also have to pay higher costs for chemicals, metals, and plastics. Then there are shipping costs. Moving anything across the ocean now costs roughly 30% more than a year ago.

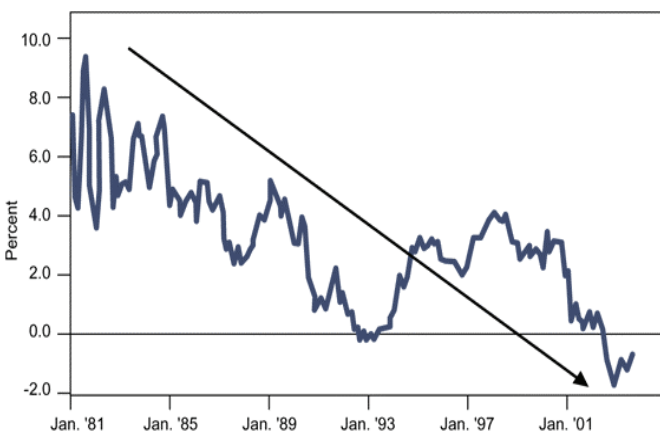
Up to this point, the US consumer has been sheltered from this problem as foreign producers have chosen to eat the higher costs instead of passing them along. The problem is that they cannot do this indefinitely. At some point, even heavily subsidized Asian companies have to earn their cost of capital, or go out of business. When this happens, recorded inflation in this country will rise. There is one chart that, for me, tells the whole story of this recovery. The Fed Funds is the

Monetary Policy

rate, set by the Federal Reserve, which banks charge each other to borrow money overnight. It is the benchmark from which all other rates trade, and it is the rate most impacted by Federal Reserve policy. Real Fed Funds measure the rate after inflation, which is officially 1.7%. The Fed Funds rate is currently 1%, which makes the Real Fed Funds Rate equal to 1% minus 1.7% = minus 0.7%. In other words, the Federal Reserve is holding its benchmark rate below the rate of inflation.

Historically, the Federal Reserve only drops the Real Federal Funds Rate to zero or below

Real Fed Funds



Source: ISI, Portfolio Strategy Report, January 29, 2004

during times of economic emergency such as during the Great Depression. The reason the Fed rarely resorts to dropping Fed Funds this low is because it usually results in excess consumption and investment, which usually leads to inflation.

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Normally, this kind of monetary stimulus results in new investment in our economy as it is cheaper for companies to invest in their businesses, but not this time. Instead, this cheap money has led to the greatest housing market in the US. Since the year 2000, we've added \$6.5 trillion in debt as a nation, both public and private, yet only \$1.2 trillion in GDP growth. In other words, we spend \$6 to generate \$1 in GDP growth.

The winners of the great Federal Reserve monetary giveaway are the Asian workers. As I mentioned earlier, China added over 13 million new jobs last year. This means that the actions of the Federal Reserve are working, if you live in China. The problem is that China is creating engineering jobs while we create retail jobs.

The Stock Market – Risk

Academically, there are two forms of risk – systemic and company specific. Systemic risk is risk to the system. September 11th was an example of a systemic risk, as was the crash of 1987. Company specific risk is as the name implies, it is the risk of a major drop in company's valuation brought on by an event that impacts a company or industry but which has no effect on the general market.

For practical purposes, at GeoVest, we consider a third form of risk, which is valuation risk. Theoretically, valuation risk would partly fall under both systemic and company specific risk, but we break it out because it a variable that is easily quantified.

At GeoVest, we believe strongly in the concept of risk/reward. We believe that strong long term returns in the capital markets are a function of finding securities that offer favorable risk/reward trade-offs.

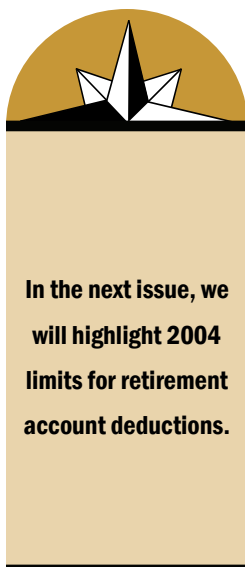
Currently, the capital markets offer a high degree of systemic risk, company specific risk, and valuation risk.

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In a nutshell, we see a greater probability of terrorist activity as a result of our efforts in Iraq. We believe it is likely that the Federal Reserve has failed to spark a sustainable economic recovery, despite offering extraordinarily low interest rates. We see how good jobs are moving to Asia from America at a time when national, state, corporate, and household debt has jumped dramatically. We see extraordinary levels of competition in many industries that reduce earnings for all market participants. We see stock market valuations that rival, in many cases, the absurd levels last seen during the Technology boom of the late 1990's. In short, the level of risk inherent in the markets is greater today than at any time in my investment career.

While our work suggests that the probability of an adverse event has risen, it doesn't mean that an adverse event is imminent. The distinction is crucial. As rational investors, we require a higher potential reward for the securities that we buy than what we would normally require. This would entail buying stocks and bonds at relatively cheap prices. Because valuations are presently high by historical standards, there are very few securities that currently compensate us for the inherent risk in the markets.

This has led us to search for alternative vehicles for compensating for market risk. Cash and short term Treasury notes are the obvious choice, and we have been adding to both positions but we believe we can do better. We started taking positions in investment vehicles that act as a hedge for the equity portfolio in that they are expected to rise when the market falls. This allows us to confidently maintain equity positions despite our market concerns.



In the next issue, we will highlight 2004 limits for retirement account deductions.

CBDE 10-YEAR YIELD
as of 21-Apr-2004



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The Bond Market

I've been bullish on bonds since the early 1990's and it has been proven to be the right course, but now, I've changed my opinion and expect interest rates to rise over the next ten years.

I've included a long term chart of the 10 year US Treasury Bond at the bottom of the page to give us some perspective. I see inflation pressures starting to rise in the global economy brought on by unsound global monetary policies. If you look back at the chart I provided on Fed Funds, the reason the Fed rarely drops rates this low is that it generally leads to high inflation. Rates have been at 1% since last July, and we are starting to see the warning signs.

To counter the effects on your portfolios, we are making some fairly dramatic changes. We are currently in the process of shortening maturities, while improving the overall credit quality of the issues we purchase.

We are currently selling most of our positions in Fannie Mae and Freddie Mac, the two large mortgage companies. Both have experienced reporting problems in recent earnings releases brought on by poor oversight. Given our expectations for higher interest rates, we believe these two companies offer high risk with little reward.

The GeoVest Approach

The changes you are seeing in your portfolios today are the result of months of preparation. Our approach to investing is to anticipate changes in the global economy before they become headlines and to structure your portfolios to benefit from those changes.

- Philip M. Byrne, CFA

