



Time for a Change

Our clients are having a very good year. The vast majority of our accounts are enjoying low to mid single digit returns year to date. That might be a surprise given that the global markets are down and some managers are reporting astonishing losses, but it's true. Not surprisingly, I sense a lot of confusion in the ranks of money managers who don't know whether to "buy the dip" or to "sell into rallies". Watching them on television, I've noticed that the most confident are also the least knowledgeable.

Please excuse me if this sounds like the rapid exhortations of the financial planning community to "buy the dips" or "stay the course" because I don't advocate anything of the sort. Instead, I view the present environment as being the start of a shift away from a consumer economy back to a production-oriented economy as a combination of higher transportation costs, weak dollar, excess consumer debt, and higher commodity prices make our present economic structure untenable. The global stock markets are only starting to discount this eventuality.

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In my opinion, we're in for a secular decline in the averages, meaning a multi-year decline. The stock market is a reflection of our economy and I believe that an important part of our economy is at the beginning of a long term decline. But as an investor, it's not a bad thing. To quote Dickens: "It was the best of times, it was the worst of times." This can be a great time for investors to take advantage of change. By this I mean that the stock market averages may drop but it doesn't mean all stocks will drop.

Consumer Economy

In the meantime, we're left with miles of big box retailers and housing tracts that are the assets of yesterday's boom. Just this morning, Starbucks, the official caffeine supplier of the shopaholic community, announced that they are closing 600 locations. The party is over on profligate consumption and we're left planning the next party – the party where we say no more to the mercantilist exporters like China and Japan, and start beating them in the global markets.

But first, we're going to have to clean up after the last party. I believe a number of banks will go under, along with many retailers, restaurant chains, consumer electronic suppliers, and some of the sellers of consumer toys like boats, RV's, and other non-essentials.

The chart on the next page of consumer discretionary stocks, companies that sell things we want but don't necessarily need, tells the story more effectively than words.



The good news, if there is any, is that our trading partners, who supplied much of this stuff, will get hit disproportionately hard from this outcome. Because corporate America has been effectively downsizing for ten years, farming out the operating risk to our trading partners, I believe we'll be in good shape to make the necessary changes and bounce back faster than others.

Global Economy

Early on, I was very negative on the Chinese economy but I continue to believe that their forthcoming downturn is going to make our restructuring look gentle by comparison. It appears that inflation and resource scarcity is hitting them especially hard, to the point where social unrest appears to have picked up. Recent Wall Street Journal articles have reported how regional governors have been sacked for making poor investments and police and other administrative buildings have been ransacked by angry mobs for various causes.

Those people who view China from the romantic perspective of a great old culture finally claiming its rightful place in the world are in for a rude awakening when they discover that much of China's growth was a product of governmental directives instead of profit motivation.

Early investors in China have done extraordinarily well but I'm afraid that the Chinese miracle is well on its way to following the Internet miracle – with the same results. The same can be said for those asset allocators (passive investment strategies that rely on diversification) that moved money into Europe, Japan, and South America. It was a nice ride, but if you don't know why you bought in the first place, you won't know when to get out.

Commodities

I believe we are in the blow-off, or end phase of the commodity boom. Chinese demand is the primary reason why commodity prices are so high and when Chinese demand softens later this year, so too will commodity prices. My guess is that we would have seen more softness in commodity prices already if not for the Federal Reserve's low interest rate stance which makes it relatively cheap for speculators to hold positions.

Food prices may stay high for awhile but I believe industrial metals are in danger of a massive sell-off because private hoarding has driven prices higher than they otherwise might have gone. Many speculators buy with perceived impunity as they believe that demand from China is immune from economic cycles.



Dr. Copper, the commodity with a Ph.D. in economics hasn't yet capitulated but certainly isn't enjoying the soaring demand that it experienced a couple of years ago. If I was a commodity speculator, I wouldn't make any strong bets in this environment.

Oil

We're getting close to the end of the spike in oil prices, which is why we are slowly reducing our positions in client accounts and realizing gains. Remember that analyzing the prospects for any commodity requires a focus on both supply and demand. As adherents to the Peak Oil Theory, we continue to believe that we'll never pull more oil out of the ground than we are today. But the demand side of the equation is where the action will be over the next year, and I believe that demand for oil will drop aggressively as a result of a very weak global economy.

Demand in the US has already fallen 4%, and it's only a matter of time before the rest of the world cuts back aggressively on consumption. We'll maintain a healthy weighting in oil stocks, but we hope to take some additional gains off the table for now.

As you can see from the chart, oil is moving up aggressively. A small part of the move is speculators betting on higher prices. They can afford to be aggressive because oil is in short supply, and unlike industrial metals, it's very expensive to hoard oil. Generally, it's been my experience that whenever speculators start going crazy in an asset class, it's time to start looking for the exit.

I won't be surprised to see oil continue to move higher for the next few months, especially if we get an active hurricane season, but high oil prices are hurting global economies which ultimately leads to demand destruction. A year from now, I expect oil to be cheaper than it is today.

Future Ideas

A correction in oil probably won't bring us back to the days of \$2.00 per gallon gasoline, so the future will have to accommodate higher transportation costs for individuals and goods. Other variables that we believe will shape the investment landscape will include limited access to bank credit, higher unemployment, and reduced international trade.

Since most businesses are still working off the old consumer-driven, service economy model, there is limited





opportunity to take positions in some of these ideas this year. But since we are looking for ideas that we can exploit for the next ten years, considerable research and analysis needs to be conducted before taking big positions.

We expect domestic manufacturing opportunities to dominate our portfolios over the next ten years. We have a highly capable workforce that is being underutilized in the Midwest, a valuable natural resource base, extensive existing infrastructure, and now a cheap currency to allow us to develop global comparative advantages.

Some of the areas that intrigue me at this point include light rail, high mileage cars, alternative energy, agriculture, defense, logistical services, and capital equipment suppliers. Hopefully, our research will produce profitable ideas from these areas but more likely, we'll be directed to adjacent areas that feed into the above industries.

For now, we continue to like gold, defense, and electric utilities. If we get the correction we're expecting, oil will become intriguing once again.

The GeoVest Approach

At GeoVest, we believe in a simple investment discipline; know what you own and be careful of how much you pay for it. For bonds, it means knowing where the revenues are generated to support the payment of interest and the repayment of principal. For stocks, it means knowing why someone would buy the products sold by the company.

In the current environment, this means looking at companies that have the potential to take advantage of the changing landscape over the next ten years and waiting for them to trade at the right price to compensate our clients for the risks they assume. It doesn't mean waiting for yesterday's winners to get cheaper because yesterday's winners will continue to get much cheaper.

We're doing our best to grow our client's capital during these challenging times and we're excited about the future opportunities that inevitably follow these downturns. With the glamour of international investing combined with the partisan bickering that dominates our political landscape, it's easy to forget that we live in the greatest country the world has ever produced. The stock markets measure the economic might of our great nation and while they may face periodic setbacks, the long term always looks positive.

As always, we look forward to your feedback because at GeoVest, we never forget that it is our pleasure to serve you.

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