On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Cross Currents

Investing is like swimming in the ocean. When you swim with the current, you make excellent progress with little effort. But when you swim against the current, you've got to swim like mad to avoid a setback. Asset allocation, where we choose the right security classes for client's risk/reward parameters, involves the art of anticipating the changing currents in order to ensure you progress with the current.

During the months of May and June, the market was clearly swimming against the current. The S&P 500 fell 1.5% for the quarter while the Nasdaq fell 7.2% over the same period. Only the Dow Jones Industrial Average was able to eke out the smallest of gains.

Even gold, our favorite investment idea fell 25% from its highs in May of $720 per ounce. As anticipated, it has recovered strongly.

If you owned emerging market funds, you probably did far worse. Over the past several months, the United Arab Emirates fell 65%, Saudi Arabia fell 54%, India fell 22%, Argentina fell 21%, Brazil fell 17%, and Mexico fell 15%.

We haven't compiled all our returns yet, but from what I've seen, our performance is positive in a down market. Despite swimming against the current, I'm still optimistic that we can end the year with very good returns.

A Confluence of Factors

There isn't just one thing that caused the market's recent challenges; it has been a host of different things too numerous to discuss in this newsletter. For starters, we have a new Federal Reserve Chairman who continues to raise interest rates into the face of a slowing economy. We have global inflation fears, rising energy prices, and global martial conflict. But the

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

precipitating event, in my mind, has to have been the Bank of Japan tightening their money supply in May. This forced hedge funds that borrow money in Japan at low interest rates and buy global securities to sell their positions before the cost of borrowing rises.

The Federal Reserve

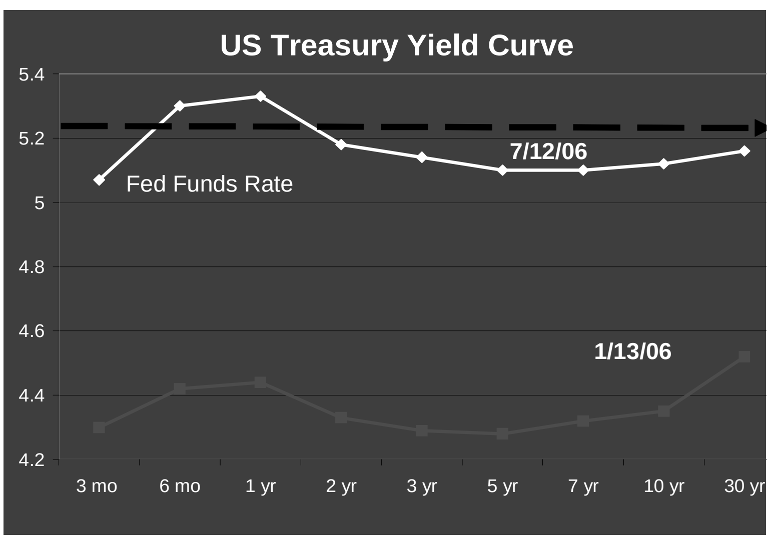
With the ascendancy of Ben Bernanke to the chairmanship of the Fed, our central bank has lost a lot of credibility with the markets. Where Alan Greenspan was once given the benefit of the doubt when setting policy, Bernanke is increasingly scrutinized and questioned.

Bernanke set himself up for this difficulty four years ago when he made the famous "helicopter statement." In that statement, he basically said that the Federal Reserve had the ability to get us out of economic difficulty by essentially printing money and dropping it from a helicopter. Since printing money causes inflation, Bernanke has to prove himself to a market that fears inflation. With inflation currently rising, Bernanke has a lot of convincing to do.

Besides these comments, the Fed is in a pickle because they are forced to serve two masters – the global currency markets and the economy. Because we don't have enough savings in this country to fund all of our debt, foreigners provide the difference which equates to around $900 billion each year. They do this by buying our debt in the market. With inflation rising, they need higher rates to maintain the purchasing power of their investments. This is the main reason why I believe that Bernanke has continued to raise rates.

Unfortunately this means that our economy is a secondary consideration, and Bernanke has taken over the Fed at the end of the business cycle which generally requires softer interest rate policy to keep the economy from weakening further. My personal opinion is that the Fed should have stopped raising interest rates after the Fed funds rate got to 4.50%, and now it appears that the market agrees with me.

Notice how the black dotted line, which is the Fed Funds Rate, is above the current yield curve, or the white line. This tells us that the market is again setting interest rates and not the Federal Reserve.



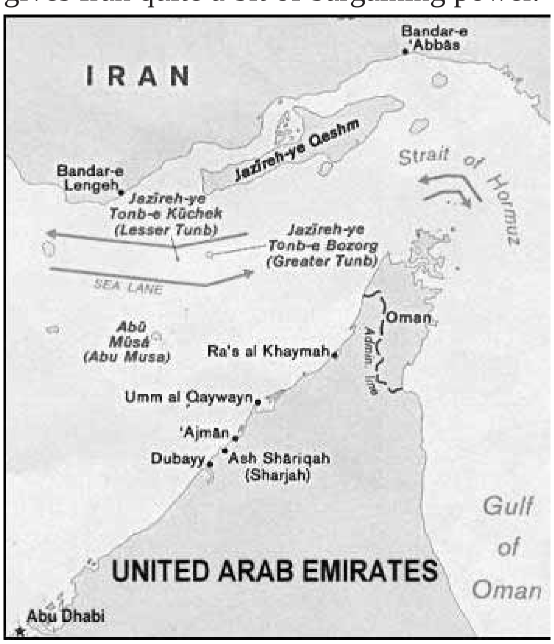
Source: Federal Reserve Board and GeoVest Advisors

Geopolitical Unrest

Another factor that is hurting the markets is the various outbreaks of violence throughout the world today. The short list includes Iran, Iraq, North Korea, Israel, Lebanon, Nigeria, and Indonesia. The two worst regions are Iran and North Korea because they involve nuclear weapons.

Everyone knows that Iran is developing nuclear weapons and that the US, Europe, and Israel all want them to stop. Unfortunately, Iran appears to have the backing of Russia and China, two geopolitical heavy weights. At some point, someone is going to bomb their nuclear development sights, and I suspect that someone will be Israel as they will be directly in harm's way if Iran succeeds in developing nuclear weapons. Besides the risk of nuclear war, unrest in this region has a huge influence on oil prices.

Roughly 30% of the world's daily allotment of oil moves through the Persian Gulf. This oil needs to get past the Strait of Hormuz, a channel that is only two miles wide and which can be closed if Iran decides to use its newly purchased Russian missiles to attack shipping. This gives Iran quite a bit of bargaining power.



Source: Wikipedia.org

North Korea is the second worst region after they recently tested 10 missiles, including one that is capable of reaching our West Coast. Personally, I thought the tests showed more of a lack of capability than a threat, but the Japanese are so incensed that they are proponents of military action against the North Koreans.

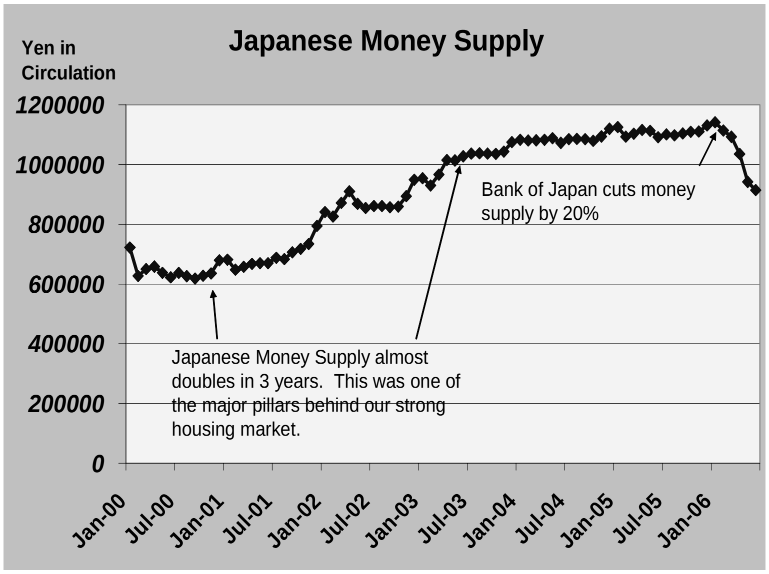
As you can tell, we're watching the situation very closely, but for now, we're not changing any of our strategies other than to favor energy companies with domestic assets.

Japanese Money Supply

Japan is a major economic power, and changes in Japan have a global impact. I believe the biggest cause of market weakness in May and June can be attributed to the Japanese central bank's decision to reduce money in circulation as a means towards reducing inflation pressures.

One of the major underpinnings of both our stock market and our housing market has been the willingness of the Japanese to buy our debt. Hedge fund managers could borrow aggressively at rates near 1%, then buy US debt at rates ranging between 3% and 6%. This is called the Yen carry trade, and it effectively reduced our interest rates earlier in this decade, without which, our housing market would never have exploded upward.

The problem with excess money supply is that it results in higher prices of everything it touches, which is why the Japanese are trying to reduce some of this excess supply. Based on our analysis of the Japanese economy, we don't believe they can continue reducing their money supply without returning to a devastating economic recession. This is why we plan to maintain our investments that benefit from inflation such as gold and oil.



Source: Bank of Japan and GeoVest Advisors

The Future

There are three general positions held by investors today. On the most extreme end, the deflationists believe that an imminent global recession will result in a rapid decline in all asset classes, but particularly in real estate and stocks. These investors own Treasury bonds, utilities, and cash.

The mainstream investors believe that the Fed is finished raising interest rates and that the global economy will continue on its merry way with only a few minor setbacks. This view dominates the ranks of professional managers.

On the opposite end of the deflationists are the inflationists who believe that the global central banks are increasing money supply (inflation) as a means of perpetuating global economic growth. These investors own metals, energy, and cyclical stocks.

At GeoVest, we talk about all three positions on a weekly basis, but I believe we'll get inflation followed by deflation.

The GeoVest Approach

Dominating our strategies is a belief in the cyclicality of the economy and that if we structure our portfolios to benefit from changes in the economy, we'll be able to produce strong long term returns for clients.

The cross currents that we are experiencing in the markets will provide us with some excellent long term investment options that have not been available in a number of years. As a means towards keeping our clients abreast of what's happening, I've started updating our website on a weekly basis.

If you go to our website, www.geovestadvisors.com and click on News/Publications, you will find my weekly updates. I urge everyone to use this added service. 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