



On Course

# GeoVest Advisors

*Growing Your Portfolio While Managing Market Risk*

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## What Recovery?

As I mentioned in the last newsletter, bear market rallies can inspire people to unwarranted optimism and this bear market rally has been no different. Desperate to find anything positive, economists have been focusing on the second derivative (change in the rate of descent) of economic data since February – looking for evidence that our downturn is “less bad” than the previous month. The mainstream media now reports economic data along with the question of what it means to the economic recovery. At the risk of being obtuse, when did this so-called recovery start?

It’s a politico/media construct that I refer to as a confidence game and we covered it extensively in our January newsletter. It’s nothing more than wishful thinking on the part of our political and financial leaders as well as blatantly obvious attempts to hide the true extent of the problem hoping that confident consumers will fix everything.

It’s dangerous because our government has spent considerable time and resources on what equates to a public relations campaign to give the impression things are improving instead of attacking the problem head on. They’ve bailed out the major Wall Street banks that created the problem, ostensibly to reboot the system so we can go back to creating asset bubbles as the core driver of our economy.

Originally our plan was to slowly start building positions in industrial assets this summer however, the new Administration has shown no commitment to re-energizing the US industrial base to compete in global markets. Instead, by focusing aid on the big Wall Street banks, they’ve chosen more of the same consumerist model of the past 20 years that does nothing to expand employment and wages. The result has been ten years without employment growth and negative returns in the market.

### Table of Contents

Stock Market	2
The Economy	2
Commodities	2
Bond Market	3
Value Investing	4
Geo Vest Approach	4



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## The Stock Market

The Bear Market Rally encompassed March, April, and May. It hit our price target of 900 on the S&P500 and now appears to be in the early stages of another move down.



The blue line at the bottom of the chart shows the volume, or amount of shares traded in the companies that make up this index. Since the rally started in March, the amount of shares traded has fallen by around 40%. This suggests to us that this move has reached its conclusion.

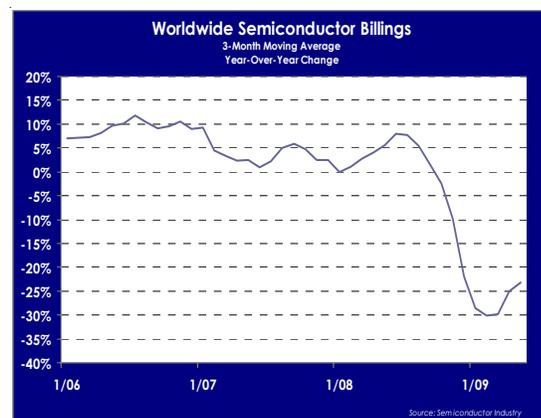
You may be wondering why we've done little to take advantage of this rally. The reason is that to have bought aggressively would have been tantamount to gambling. The strength of our approach to investing is that we take a clear, objective look at economic and corporate fundamentals. This approach results in us normally being early in anticipating real market moves.

I've been watching for true signs of a recovery since 2008, but all we see are attempts to sell us on the idea of an economic recovery instead of a recovery itself. Corporate insiders, CEO's and other individuals who manage corporate America, seem to agree with us as they have been massive sellers of stock into this rally.

## The Economy

Having a clear understanding of the global economy is critical to wading through this downturn. Selecting a few improving variables from US data really doesn't tell us very much about the state of the world economy. For instance, the "green shoots" PR campaign was built on a few pieces of data that were "marketed" as being good.

Conveniently forgotten are things like rail loadings and truck tonnage being down 20% and 11%, respectively, on a year over year basis. Goods delivered to US ports are down over 20% for the year. Japanese exports are down 43% in the past year. Chinese exports are down 29%. Even worldwide semiconductor sales are down over 20% from last year.



Since 70% of our economy is made up of consumer activity, these numbers are telling us that things are not as rosy as others would like us to believe.

## Commodities

It seems that speculation is not dead. Commodities have had a massive run this year thanks to misallocation of capital by Chinese authorities. China, as we've discussed many times, is an economic mess. To combat this downturn, the authorities in Beijing forced Chinese banks to lend around \$1 trillion, or roughly 25% of their GDP, to mostly state-run industrial companies. Because China is presently suffering from over-

capacity in just about every industry, Chinese industrialists largely used this money to speculate in the stock market and in the commodities markets.

Notice how the price of copper has almost doubled since the beginning of the year, while global exports are falling over 20% per year. If we're right, commodity prices will crash again, but this time, it could take the Chinese economy with it.



The market has reacted to Chinese efforts by assuming that a strong China will pull the global economy out of its downturn. Instead, I view the Chinese response as a desperate act of a government that has misallocated capital for a decade.

Rising commodity prices can be a sign of economic improvement and a lot of investors are taking it as such. But rising prices can also be a sign of uncontrolled speculation, much like the rise of oil to \$150 per barrel last year – just before the global economy went into a terrible tailspin.

Nobody really knows for sure, but one thing I know is that government leader's don't force the equivalent of 25% of their GDP into the system unless they are scared to death. If the Chinese are this frightened, are commodity prices a sign of strength or something else?

## The Bond Market

We continue to believe that interest rates will spike to levels much higher than present. As you know, the US government is spending trillions of dollars to prevent the banking system from imploding. They are also pumping tons of money into the economy in the form of tax cuts and higher payouts to Social Security recipients to stimulate the economy. The Federal budget deficit has gone from under \$1 trillion a year ago to an expected \$2.5 trillion run rate by the end of the year. This extra money needs to be borrowed in the markets.

In simple terms, the US government gets most of its money from consumer taxes which are falling because we've lost 7 million jobs since 2007 and because wages aren't rising. Also, since corporate America is levered to selling to US consumers, weak consumption means corporations are not generating taxable income to share with the government.

This means that absent an economic recovery, the federal government will borrow at ever increasing levels. From a supply/demand standpoint, supply will be rising aggressively, yet there is no growth in savings to put into bonds. The result will be very high interest rates in the future, regardless of whether we experience inflation or deflation. Notice the chart provided below that reflects rising interest rates all year. Those who bought these bonds when yields were 2.2%, are presently losing a lot of money.





## Value Investing

Determining a proper value for the securities that we buy is the backbone of all of our strategies at GeoVest. We judge each security relative to Treasury Notes, determining whether the potential return rewards our clients for the inherent risk assumed by the security in question. In short, are we getting paid for that risk?

Unlike most other firms, we add another twist to our security selection in the form of global economic analysis. If you really know what's happening in the global economy, and not just following the garbage that comes out of Wall Street and Washington, then it's possible to come up with a fair assessment of what assets are worth.

The goal of our economic analyses is not to provide accurate GDP forecasts or for developing fancy econometric models that will allow us to accurately trade the market. We do the work because we want to understand why people make the buy and sell decisions that are at the heart of an economy. We want to know what they're doing to generate income and what they're doing with the income they generate. In essence, this work gives us insights into the stocks and bonds we purchase for clients. It's this added dimension which I believe is at the heart of our success.

Technically, an asset is worth the cash flows it can generate. In the case of corporate assets, demand for the product those assets produce is an integral part of the value of corporations. Over the past ten years, the flow of unlimited credit to consumers made corporate assets worth more because consumers used that credit to buy the things corporations sold. That credit is gone which means that corporate assets will decline in value, regardless of what the Federal Reserve does to interest rates.

## The GeoVest Approach

Be careful when interpreting news out of Washington and Wall Street. Washington is about power and Wall Street is about money. The inhabitants of both regions have made some serious mistakes over the past ten years and they're trying their hardest to paper over those mistakes.

The rally and the "Green Shoots" campaign is an attempt to paper over those mistakes. Neither will last and the people who designed the campaign will suffer lost credibility.

Ultimately, our economy will right itself and the people who made the mistakes will be swept aside. But for now, we're charged with the responsibility of growing our client's money.

Because we continue to suffer from inane economic policies, our plan for purchasing industrial stocks this summer has been shelved. Instead, we'll be moving aggressively into consumer staples because we believe those stocks have the potential to make a lot of money for clients over the next year. We'll continue to favor gold and utilities but we are cutting our oil exposure until we believe a real bottom has been achieved in the economy.

We have enclosed a chart of our ten year performance on the first page of your reports. Our returns over this period put us among the very best managers in the country, especially when you consider that our returns were delivered with 25% less risk than the market. Thank you for investing with GeoVest Advisors. It is our pleasure to serve you.

***Philip M. Byrne, CFA***  
***Chief Investment Officer***