GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

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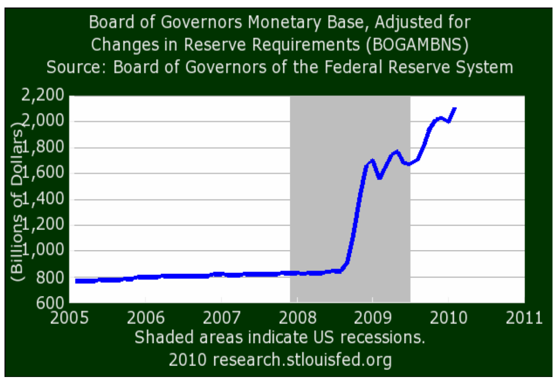
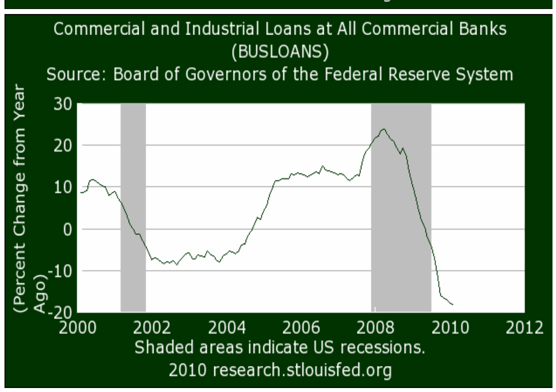
The Lazarus Market

The stock market continues to defy rigorous analysis and keeps rising to levels I never dreamed possible a year ago, despite problems in the global economy that I believe are insurmountable. But on closer inspection, it is clear why the market has risen from the dead but even clearer why we will ultimately be proven correct by doubting the longevity of this rally.





In simple terms, the market is rising because the Federal Reserve has expanded the base money supply while banks are resistant to lend in the economy. That money flows into the market and the best way to make money in the market is to force short sellers to recant their evil ways and buy back the stock they originally sold short.

The stocks that have performed the best are the ones that have the worst outlooks for the future such as banks, technology companies, and real estate trusts, primarily because traders can make quick gains in these names. Ultimately, these companies will have to produce cash flow to meet operating needs and expand for the future. With the real economy starved for credit, we should start to see signs that we're correct before the end of the summer. Until that time, we plan to go along with the crowd while remaining vigilant.

The Global Economy

In the past, I offered a simplified description of the global economy based on two dynamics: the US consumer and the Chinese industrialist. In recent years, the US consumer has been able to satisfy any and all material whims by borrowing money, either on a credit card or against his/her house. Fortunately, that game is over and US consumers are forced to spend what they earn, which has been falling at the median. As a driver of global economic growth, the US consumer has been forced to take a well-deserved time out.

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The Chinese industrialist, on the other hand, has been force-fed credit by his government. China, which sports a roughly $4 trillion economy, forced $2 trillion in new loans, on top of $585 billion in government stimulus efforts in 2009 for a combined package of roughly over half their gross domestic product. To put this in perspective, the Chinese were formerly suffering from excess industrial capacity in steelmaking, aluminum making, cement, and a host of other areas, so to fix their problems, they decided to build more capacity.

But they didn't stop there – to use up this excess capacity, and to keep people employed, they built cities, towns, malls, skyscrapers that now stand empty. Check out the city of Ordos in northwestern China. It's a city that can hold 5 million residents, but nobody lives there. If you look, you can find many similar moves throughout the country.

If there is one thing we should have learned from the collapse of our housing market, it's that speculating on assets that can't be sustained by income is a recipe for disaster. It appears to me that China gambled that we'd be able to fix our economic problems in a year and that they would be sitting pretty on a hoard of increasingly valuable commodities, new technology, and industrial capacity.

Economists and other learned pundits have lauded these efforts by the Chinese as proof that they are truly a force to be reckoned with in the 21st century. These are the same people who took delight in our Tech bubble and our housing bubble and who thought Japan would have the biggest economy in the world by now based on trends in the late 80's. Personally, I can't think of better proof that the Chinese economy is on a collision course with economic reality.

When you put all the pieces together, and I have, we are seeing the crest of a tidal wave of money, a tidal wave that can't be duplicated. The Chinese spent $2.6 trillion to grow their economy by roughly $400 billion. In the US, we spent $1.5 trillion to grow our economy by roughly $200 billion.

The Recovery

There never was an economic recovery in 2009, in the true sense of the term. Instead, the government spent $1.5 trillion plus monetized (printed) $1.5 trillion to stop the decline of our economy. It worked but the cost was enormous and will hurt our chances for real recovery for many years.

The data that gets used to paint the rosy picture is highly flawed. Unfortunately, I don't have the space to explain why in this newsletter, but I would be happy to explain why if contacted.

In essence, we have two economies. The half of our economy that benefits from government and large corporate involvement is showing signs of improvement – this is the part of the economy that benefited from the $1.5 trillion in deficit spending and from China's desperate gamble to reflate their economy. The other half, which is primarily small businesses is suffering through a depression. Guess which half of the economy is more highly weighted when collecting economic data?

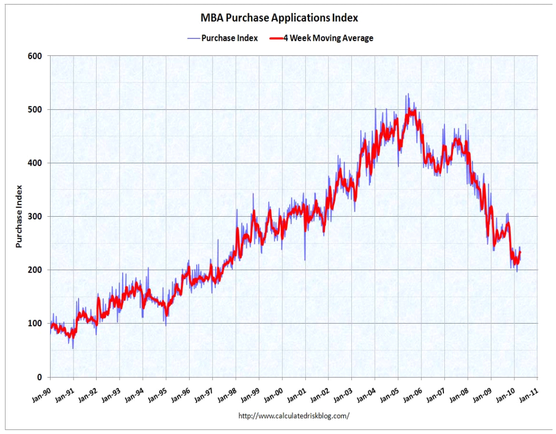
Since small businesses represent 70% of private sector employment, it's no wonder why a year after "green shoots" were supposedly seen, we have 2 million fewer jobs. To give you a sense of the veracity of government data, until February, the government steadfastly claimed that the 2 million lost jobs were only 1 million. How long until they admit that the strong growth they claim occurred in the second half of 2009 never happened? My guess is three years.

Tax receipts tell the real story. Federal and state tax receipts continue to fall, making governments at all levels more indebted. Take the state of Illinois, their budget calls for spending $28 billion this year despite a $13 billion shortfall on expected tax revenues. The fact of the matter is that the private sector provides the taxes that allow governments to operate and the private sector continues to contract, despite what the questionable statistics tell us. The longer this continues, the harder it will be to truly revive the economy.

The problem is that nobody looks at the economy in a comprehensive way. Gross Domestic Product, or GDP, is an awful way to measure the economy, in my opinion because it measures sales but not the source of liquidity for the sales. Since 1999, GDP has risen around 40% while household debt is up 111%, state and local debt is up 100%, and federal debt is up 112%, yet the number of people working in this country is the same. We've doubled our debt outstanding with no increase in employment, while increasing our population by 10% and the government has the nerve to tell us that our economy is bigger? The only thing we have to show for the past ten years is a gigantic mortgage.

The Housing Market

The degree of misinformation that pervades our main stream media is astounding. The newswires have been touting the housing recovery since last summer based exclusively on the effects of the $8,000 tax credit. Notice the surge in mortgage applications in late 2009 – that was when the original credit for first time home buyers ran out. Now look at it – despite the government's expansion of the tax credit, applications for mortgages have collapsed – exactly like we expected.



The reason is that you can't sustain a housing market without employment and apart from some government statistical games, there are no new jobs. The result will be a continued leg down in home prices, until people can easily afford a house on their real incomes.

But the real interesting part of the housing story is who is not paying. Moody's estimates that there are six million home owners that aren't paying their mortgages today and that equates to $96 billion in annual payments that aren't being made. Anybody care to guess who is picking up this cost? The taxpayer is picking up the lion's share, despite the fact that many of these "squatters" are still employed.

Those people will ultimately be foreclosed on, and when that happens, someone will have to be in a position to bid on those homes. Given that at least 15% fewer people are applying for mortgages today versus a year ago, I think it's safe to assume that prices on homes are going much lower.

We know there are a sufficient number of homes for Americans but the truly important question is whether those homes are in places where people will need to work? Heavy growth in places like the inland empire of California, or Nevada, Arizona, Florida, or even Colorado looked good for a decade but these places are both high cost and are far from most sustainable industries. Warm weather is the common denominator and while nice, these regions need jobs to support their housing markets.

Neither housing, nor the financing of housing are sustainable industries, yet that's exactly where the government has focused its attention.

Europe

Europe is a mess, southern Europe in particular. We've been saying this for years and finally, thanks to Greece, it's getting some attention. This region has lost market share in its basic industries for decades yet never dialed back their social promises. Becoming part of the euro in the late 90's gave them the benefit of lower interest rates, a boon that could have allowed these countries to reorganize their economies but they squandered it on asset bubbles and more social promises.

I don't believe there is any way that Greece will be able to stay in the euro past a year. At some point, I expect them to re-introduce the drachma, then promptly devalue their external liabilities. I wouldn't be surprised to see other nations like Spain and Italy follow suit.

The result will be much higher interest rates and potential trade wars. Once massive change starts to gain momentum, it's impossible to predict the outcome. The only thing I do know is that I don't want to own European bonds under these circumstances, except maybe short term German bunds.

The GeoVest Approach

The past year has been a massive trading opportunity that we've largely missed. To have done really well, we would have had to purchase companies that we believe are low quality and which represent terrible bets on the future. But like in life, investments don't always follow our carefully crafted plans and strategies.

The markets reacted to a tidal wave of money from China, the US, and to a lesser degree, Europe – money that bears a strong resemblance to having been "printed". Other than China, the majority of that money has hit the markets, not the economy. Regardless of the use, we don't see any lasting benefits from these desperate efforts. Before long, the market will discover how poorly the money has been spent.

From what I can tell, we are not alone in our concerns for the market this time. I believe a lot of managers are waiting to sell this market for many of the reasons I've identified, but are afraid to sell because the market keeps going higher. Individual investors seem to have the same concerns as they have been taking money out of domestic equity mutual funds since August of 2009. If I'm right about this observation, there will be very little time to react when the selling begins.

Ultimately, we'll get past these uncertainties and return to what we do best – invest in companies with great long term potential. The future is cloudy because the government panicked and tried to maintain a financial system that is at the end of its life cycle. Our goal is to ensure that our client's capital is whole and ready to be deployed when those true opportunities present themselves.

Over the past ten years, we've done what very few managers have been able to do – outperform the markets. We've been able to do this because our clients believe in long term value, not short term trading gains. Thank you for investing with GeoVest Advisors, it is our pleasure to serve you.

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