GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

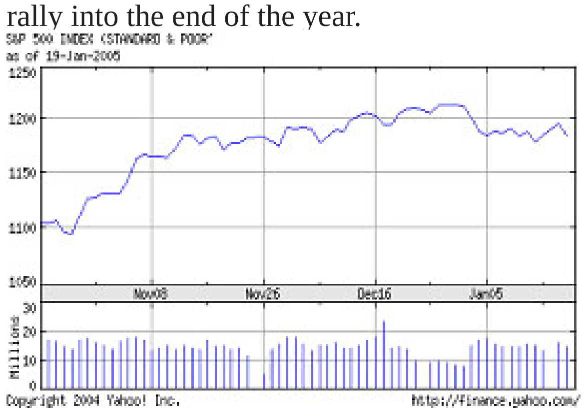
On Course

Volume 6, Issue 4 January 2005

2005: The Year Volatility Returns

2004 was a rewarding year for GeoVest Advisors and our clients. We were able to produce good returns with very low levels of risk by adding companies to our portfolios that produce very stable revenue streams at attractive prices. It wasn't sexy, but we managed to make money for clients while protecting against a market correction.

We didn't get a correction in 2004, but it was very close there for a while. In fact, through the first three quarters of the year, the markets were negative. They were negative because it became clear in 2004 that our economic recovery lacks the staying power of past recoveries. Only in the fourth quarter of 2004 did the market shrug aside its concerns for the future to rally into the end of the year.

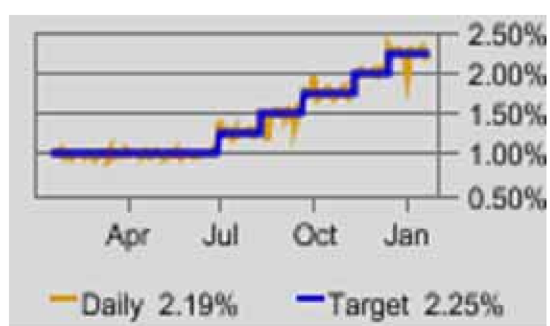


We chose not to chase that rally because we view it as transitory and because it would have required us to put aside our discipline to purchase securities at unrewarding prices. In a way, the decision was akin to leaving a roaring party at 9PM instead of 2AM in the morning. It wasn't as much fun, but we're able to start the next day on a solid footing. Because we follow economic fundamentals closely, we knew that there was no fundamental improvement in the economy or in investor's expectations for corporate earnings that would justify the rally, therefore we chose not to "play" with your money. Early indications in 2005 suggest that we may be right in our assessment. We'll know more in the next few months.

The Economy

As mentioned, the economic fundamentals, which create the base for the stock market, are getting weaker. In fact, it has become abundantly clear to me that the sharp drop in interest rates orchestrated by the Fed hasn't resulted in a lasting economic recovery. Now that the Fed is being forced to raise interest rates due to higher inflation, there is a chance that the economy actually moves into recession in 2005.

The rule of thumb is that changes in Federal Reserve interest rate policy takes between 6 to 18 months to have an impact on the economy. Now, look at the accompanying chart of the Fed Funds rate, the rate set by the Federal Reserve, from which all other interest rates move. You'll notice that the Fed has increased interest rates from 1% to 2.25% since July. History would tell us that the economy should weaken going forward from current growth rates.



Source: Federal Reserve Board

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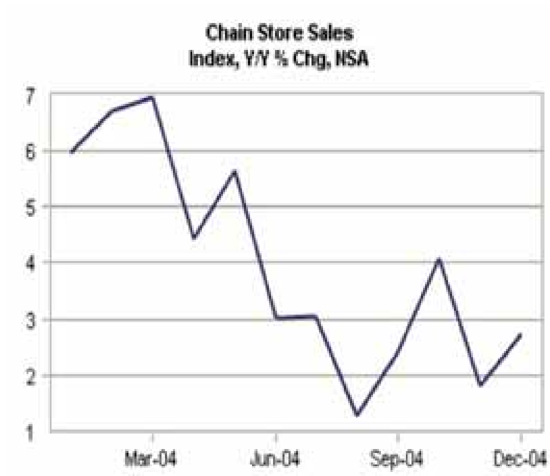
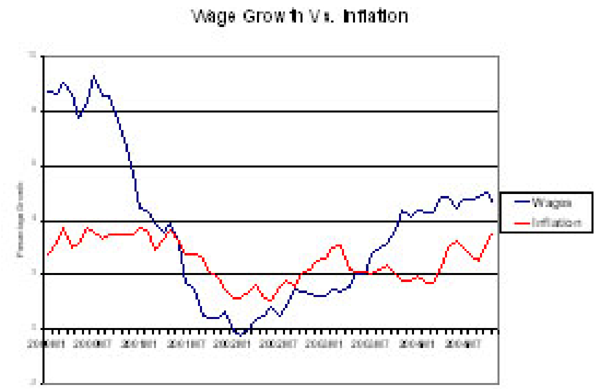
Below, we've included a chart of Chain Store Sales, which measures the sales from stores like WalMart, Target, Kroger, Best Buy and other national chains. By this chart, it should be clear that the growth rate in retail sales is starting to slow as consumers burn through the money they've borrowed from their homes by refinancing or tapping a home equity line of credit. Also notice that the big drop came last Spring when the tax rebates ran out.



Source: Economy.com

So now we know that interest rates are moving away from being a stimulus to being a deterrent for economic growth and that government is no longer mailing out tax rebate checks, so we need to look to employment and wage gains to support spending.

This next chart shows the change in wages we've experienced over the past five years. Notice how wage gains are still weak by historical standards. This suggests that employees don't really have the bargaining leverage to command higher wages at this time. In addition, notice the gap between inflation (red) and wage gains (blue). Normally, a wide gap suggests an improvement in our standard of living while a small gap suggests no improvement.



Source: Economy.com

What this combination of charts is ultimately telling us is that we are not experiencing enough real income growth to sustain our current spending levels without taking out more debt. In the recent past, consumers were able to take out more debt to sustain their lifestyles, but with rising interest rates, that avenue may not be as attractive as it had been previously.

This final chart is the clearest way to explain our lack of enthusiasm for the sustainability of the growth in the US economy. It shows how employment generally grows dramatically following a recession. If you consider 2001 to have been a recession, then we should be experiencing a fairly dramatic increase in new jobs. Instead, we are experiencing stagnation. What's more, we are losing good manufacturing and engineering jobs and replacing them with lower wage jobs.

The Currency Market

The currency markets have been making news over the past year as the value of the dollar has fallen versus the European Euro, the Canadian dollar, and the Japanese yen. Currency changes are extremely important, but they are so complex that most people fail to consider them.

In general, when a country's currency falls in value, it makes imports cost more because sellers from other countries still want to be compensated in their own currencies. Therefore, when the dollar drops versus the Mexican peso, Mexican producers will require more dollars from consumers to make up for the loss of value of the dollar relative to the peso.

The chart below shows how the value of the dollar has fallen versus a basket of currencies of our trading partners like Europe, South America, and Asia.

Source: Stockcharts.com

Changes in the currency markets can generally be attributed to one of two things: either a change in interest rates or a change in the growth rate of the economy. Generally, when interest rates rise, it attracts more capital to a country thus making the value of their currency rise.

In general, when an economy grows faster than previously expected, the country attracts more capital, thus the currency rises. Over the past couple of years, the dollar has been falling versus a global index of currencies despite rising interest rates and despite strong *reported* economic growth. Either the markets are haywire or the world does not believe that we are growing as rapidly as reported. Given my previous writings where I've referred to our economy as the "Hollywood Recovery", you can readily see that I agree with the currency markets that US economic growth is slowing.

Now for the confusing part – we expect the dollar to stop falling over the next six months if not appreciate somewhat. The reason is that our research shows that the growth rate of the European economy is slowing, as is the rate of growth in Asia. Stated differently, while we expect the US economy to slow over the next year, we expect these other economies to slow even more. This means that the slowdown we've forecasted for the US economy is likely to be global in nature.

The Stock Market

The aforementioned analysis is the reason why we have maintained a low risk portfolio for client accounts. Internally, we call it our low elasticity of demand strategy where we favor companies that have pricing power in both inflationary (strong economic growth with higher interest rates) and deflationary (weak economic growth with lower interest rates) environments. If you look at the companies that are represented in our portfolios, you'll find companies that largely sell products that will be part of everyone's household budget regardless of whether the economy is expanding or contracting.

It also explains why we placed hedges in most portfolios. These hedges are designed to appreciate in price when the market retreats. By design, they performed poorly in the 4th quarter of 2004 when the equity markets were expanding, but have done very well in the first couple of weeks of 2005 when the market has been weak. Another way to look at these hedges is as insurance for your portfolio. We've articulated a credible reason for being cautious and these hedges are a way to protect your money from a sudden decline in the value of equities.

We are optimistic about GeoVest's ability to make money for clients in 2005. Regardless of the situation, there is always an opportunity to make money, you just have to be prepared and willing to take the necessary steps.

The Bond Market

Our bond portfolios did well in 2004 because we allowed the maturities in our portfolios to remain a little longer than economic fundamentals would have dictated. Our analyses of the major Asian economies was key to this decision. In general, the Asian economies are following the same policy – increase exports. The academic definition of these policies is mercantilism and it means that a country tries to sell as much to its neighbors as it can while limiting what they import in return. This enables them to amass significant amounts of gold and currency, with which they can make strategic investments to improve their competitive positions even more.

With every other country trying to sell as much as possible to the US to take advantage of our strong consumer spending, the world has become awash in dollars. If these countries were to sell those dollars in favor of their home currencies, the value of the dollar would fall, forcing interest rates higher to attract investors to a lower value currency. Instead these countries have purchased US Treasury bonds with those excess dollars which has resulted in lower interest rates in the US.

Knowing the motivations of foreign central banks has allowed us to earn higher returns by using longer dated bonds in client portfolios but as we mentioned in previous newsletters, we're starting to see signs that foreign central banks are getting ready to reduce their purchases of US Treasury bonds because inflation is starting to rise in the US. This suggests that we may be at the end of the great bond bull market that has made everything from autos to houses more affordable in the US.

Below is a chart of the 10 Year US Treasury Bond. You can see that rates have moved up from the lows reached in 2003 but are still at historically low levels.

From the chart of inflation versus wages on page 3, you can see where inflation has picked up in this country. As you know, inflation eats away at bond returns, forcing interest rates higher. If not for Asian government purchases, I suspect that interest rates would be at least 5.5% if not higher.

The GeoVest Approach

We are committed to growing our client's portfolios over the long term. We believe a disciplined, methodical approach that requires our security selections to meet risk/reward guidelines is the best way to achieve that objective.

We are also committed to serving our clients and to that end, we are currently rebuilding our website. When completed, you will be able to get more timely commentary on our expectations for the markets and the economy by accessing our website. We are committed to constant improvement and would appreciate any suggestions you may have on how we can serve you better.

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