On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

Volume 12, Issue 1 January 2010

The Turning Point

2009 was a year of unprecedented government involvement in our economy and our markets. It was a watershed year where the US government chose to absorb the losses brought on by Wall Street decadence while paying them exorbitant bonuses for this privilege. The early returns suggest that they've been successful as the total return of the S&P500 was 26.46% for the year but we leave the decade with virtually zero total return in the markets for the 2000-2009 timeframe – the worst decade ever.

As we said in the last newsletter, this is the final bubble – for the housing market, the bond market and the stock market. If we've learned anything from the past decade it's that bubbles don't work as economic strategy – they lead to bankruptcy. The fact that the government has taken the extraordinary measures to backstop this strategy (for want of a better description) tells us it's over.

Government Intervention

Starting with the housing market, the Federal Reserve has purchased $1 trillion in mortgage-backed securities while the Federal Government now backs 90% of all new mortgages through Fannie Mae/ Freddie Mac/Federal Home Loan Banks/ FHA because the market won't buy mortgage backed bonds without government guarantees. In doing this, the Fed has moved away from being a central bank to being a commercial bank, which now introduces the risk of insolvency.

To put this in perspective, the US government/Fed is now on the hook for much of the problems in the housing market, having relieved major financial players of this burden. If housing prices continue to fall, as I expect they will, the US Treasury and the Federal Reserve will absorb those additional losses, which could be massive.

On Christmas Eve, the government announced that they will bail out Fannie Mae/Freddie Mac to the tune of $800 billion, up from the $400 billion they agreed to absorb early in 2009. The only thing I can surmise is that they want to virtually "guarantee" this agency debt so buyers will return to the market.

Moving on to the bond market, when the Fed instituted their $300 billion of quantitative easing (literally printing money to buy bonds), it was designed to lower interest rates for both the federal government and the housing market. In addition, banks have aggressively purchased Treasury bonds because they are afraid to make more bad loans. Also, since banks aren't making loans, they've lowered deposit rates to the point where savers are pulling their money out of the banks to buy bonds that pay higher rates. It worked like a charm as these savers bought bond funds which ultimately

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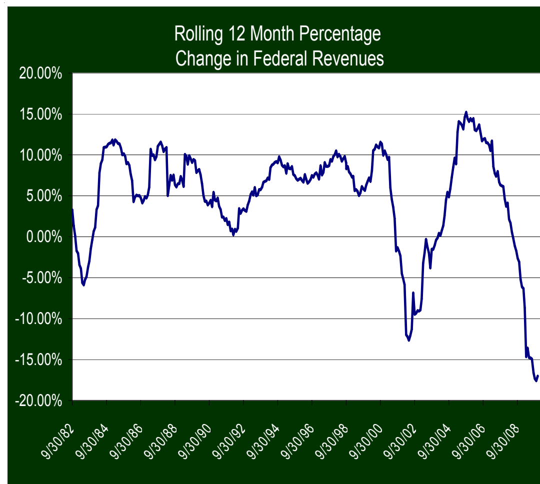
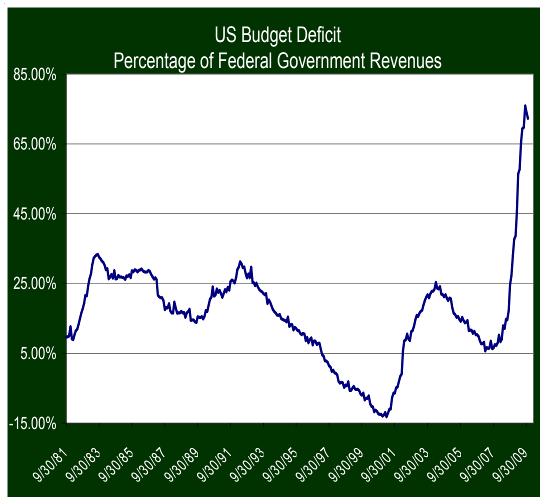
lowered rates across the board – including much of the risky garbage that got us into trouble.

Lastly, by design or accident, some of the money created by the government has found its way into the stock market. This money isn't going to worthy companies to expand production and create jobs, it's going to speculators. Anyone want to guess how this will end?

The price tag for these strategies is enormous. The two charts below put things in perspective. The first chart shows the drop in federal government revenues.



The second chart shows our current budget deficit which equates to 10% of gross domestic product, a number that is simply staggering in size for a country such as ours.

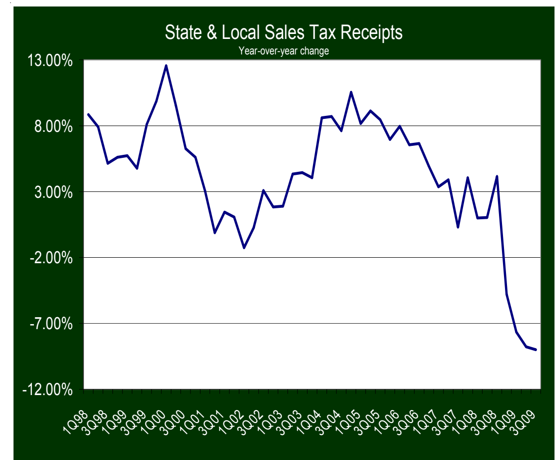


These two charts are telling us that the US is becoming a "subprime borrower". We, as a nation, are the equivalent of someone who earns $50,000 per year and spends $85,000 per year. This would be manageable if the US economy could return to a growth trajectory but can it…

The Economy

We are presently experiencing what I've started calling a "statistical recovery" in the economy. The government is producing positive data in some areas but I can't validate the data through my other sources. In fact, my other sources indicate that we've achieved nothing more than a temporary end to the decline.

For instance, in the gross domestic product report, the main source for determining growth in our economy, 70% comes from measuring consumer activity. In the most recent report, the government claims that consumer activity is flat, yet state sales tax revenue actually fell 9% from the previous year.



As you know, the state taxes virtually all retail transactions, except food. Does the chart really indicate growth? No it doesn't. Also, since much of what we purchase comes from Asia, the Port of Long Beach is a great indicator of what's really happening and it was down 15% year over year in November.

The essence of the "recovery" has been government spending over $1.5 trillion or 10% of GDP to stop the decline of our economy. Combined with a spectacular public relations campaign, they hope to instill confidence in our ranks, so we start spending again. Unfortunately, the reality is that bank lending continues to fall, manufacturing jobs continue to be lost, gasoline usage continues to fall (9% in the 3rd quarter), and housing foreclosures continue to rise. These are not the metrics of economic expansion.

The Bond Market

We expected Treasury rates to go much higher in 2009 but that hasn't materialized yet. We got the conditions right when we forecasted a huge increase in the amount of Treasury debt outstanding, as well as a lack of buying by foreign entities during the year, but this was offset by banks and the Fed's efforts to purchase $300 billion through their quantitative easing program.

As we reflected on page 2 of this newsletter, the US government is going to have to sell a lot more debt in 2010. I've seen some estimates as high as $2.2 trillion, or 15% of our GDP. If true, our expectation of aggressively higher interest rates will likely be met, to the detriment of the housing market, the bond market and the stock market.

Higher rates were an obvious and easy call a year ago. The only thing I missed were the interventionist games being played by the government and the banking industry, which ultimately proved decisive in keeping rates low. We may get more of the same games this year, but if we do, the money will come from the "real economy" which means that fewer businesses will get loans and that means more pressure on the economy.

One notable development that started in 2009 was that retail investors are running to buy bond funds, believing they are less risky than stocks. Wrong! They are jumping out of the frying pan and into the fire. People seem to forget that we are still in the midst of the worst downturn since the 1930's with a credible threat that the government will inflate our way out! The only debt securities I want to own are short term US Treasury obligations.

Notice the chart below of a high yield bond fund. High yield bonds are also known as "junk bonds". People are flocking to them and they're likely to get slaughtered because they face the duel threat of higher interest rates(which bring lower bond prices) and credit default.

Our Gameplan

I continue to believe that the government's actions will set up the stock market for another crash, perhaps worse than 2008, primarily because I believe it's impossible to keep spending 10% of GDP and keep interest rates low at the same time. But there are companies that I really like for the long term and I'm just waiting for a better buying opportunity to purchase.

The problem is that we don't see a long term trend in our economy that is sustainable other than the core food and energy names. Technology has been hot but it's almost entirely dependent on an expanding China and China is playing the same "bubble games" that our government is. Retail is dependent on expansion of consumer credit which we believe is impossible at this point. Financial services are not an option because of highly questionable accounting practices – we don't know what these firms are really worth.

A year ago, we were formulating a plan that called for re-industrialization of our economy but subsequent efforts by the government have dissuaded us from that plan. Instead, we are adopting a plan to buy companies that should do well in either inflationary or deflationary environments, while picking up market share to produce a growth element that others lack.

While cash has performed better than stocks over the past ten years, we believe the government will have no choice but to aggressively inflate our money supply to devalue the crippling amount of debt and future liabilities that are crushing our economy. It's our gold thesis and despite gold being the best asset class over the past decade, we believe the best returns are in front of us. This being the case, we expect to hold much less cash over the next decade than we held the past decade.

Another reason we don't want to hold cash much longer is a new rule being proposed by the SEC that may make it possible for money market funds to withhold funds during market crises. While I don't believe this will adversely impact our portfolios because we are specifically choosing the highest quality money market funds available to us, I fear a more heavy handed approach from our government. Therefore, I'll be happy when all of that money is invested, preferably when we get a deeper market downdraft.

The GeoVest Approach

Sticking to our convictions has given us great long term performance but it's difficult when the stock market is the new bubble. It's even harder when the government makes the blowing of bubbles its implicit strategy.

A year ago, we called this a "confidence game" and told you exactly what "they" were going to do and that's how it has transpired. Washington and Wall Street are attempting to maintain the status quo at an exorbitant cost to our country's future, without making any changes that may actually yield a positive outcome. In effect, they're returning to a strategy that has given us two market crashes in ten years. The result has been ten years of poor stock returns for the average investor, zero growth in employment and mind numbing levels of debt.

We believe we are at a turning point in our economy and we believe we have the right strategy for our clients to prosper during this transition. Thank you for investing with GeoVest Advisors, it is our pleasure to serve you.

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