



On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

Volume 11, Issue 4

October 2009

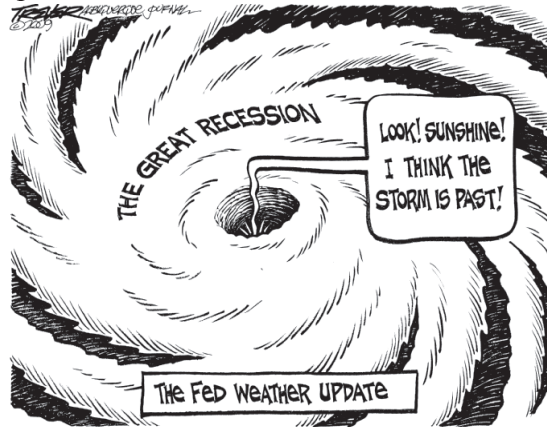
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The Last Bubble

The markets have enjoyed a massive rally off March's lows thanks to a boost of monetary adrenaline courtesy of the Federal Reserve's Quantitative Easing program. In its basic form, Quantitative Easing is the equivalent of printing money and the money they're printing is going to keep interest rates low as well as providing the liquidity that is driving this market higher.

The government is telling us that the downturn is over and market pundits are telling us that this rally may go higher. The housing market has been magically fixed and banks are now in good shape. Economists are even expecting a 3% annualized growth rate in GDP for the 3rd quarter.



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On paper, it all looks good, as long as you don't take a close look at the data. If you'll recall from the January Newsletter, I wrote about the "Confidence Game" and how it was the only strategy left to the folks in charge on Wall Street and in Washington. They've played it brilliantly – much better than I anticipated, but it remains nothing more than a desperate gamble, that equates to an attempt to push our problems off into the future.

It's also extraordinarily dangerous for our economy, our markets, and ultimately our nation.

The Economy

Nothing substantive has been done about our economy. Instead of real reform, or a vision of what our country can achieve if we put aside our spendthrift ways, we get "cash for clunkers" and "the \$8,000 tax credit for first time home buyers". Both programs are designed to pull future demand forward so that we give the appearance of improvement – neither helps our over-reliance on debt or our lack of jobs.

Cash for clunkers makes consumer spending, manufacturing orders, manufacturing surveys, and the all-important gross domestic product look better for a quarter. It was ingenious because it led to an improvement in enough economic statistics to give some credibility to the claim that we've exited the recession. Unfortunately, these stratagems are transitory in nature - auto sales rose to 14 million units per annum in August but dropped back to 9 million units per annum in September – it was brief but nothing more than a respite from the bad news.

The \$8,000 tax credit for first-time home buyers was a bit more insidious. In truth, it doesn't really help home buyers as much as it helps Wall Street. The reason is that if left alone, home prices would have kept falling to a clearing level where new buyers could comfortably afford them. Instead, by offering the credit, the

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government puts an immediate floor under home prices, which only helps the holders of housing debt and straps a huge debt on people who lack the financial discipline to buy a house on their own merits.

Besides, our problem isn't home ownership, its job losses and excessive debt. We've lost 8 million jobs since December 2007, if you incorporate soon to be revisions to past data that has been overstated by the Bureau of Labor Statistics. This means that we have roughly the same number of people employed in this country as we did in November 1999 when GDP was \$11 trillion, mortgage debt was \$4.5 trillion, and personal debt was just \$1.5 trillion. Today, the same number of workers must support GDP of \$13 trillion, mortgage debt of \$10.4 trillion, and personal debt of \$2.5 trillion, on wages that have barely kept up with inflation over this time period.

Consumers can't manage their current level of debt, let alone expand consumption by borrowing more at the bank. Small businesses have it much worse. Not only are consumers more cautious which cuts into revenue, but it's extremely difficult for small businesses to get access to new credit. Given that 50% of national employment and 38% of GDP come from small businesses, we're in for some tough sledding.

Lastly, I've seen estimates that indicate that we've either spent or guaranteed \$12 trillion dollars to provide this little economic spark which roughly equates to \$100 billion in GDP growth in the 3rd quarter. That's a lot of money for such a small reward. And since it took this extraordinary measure to induce stability, we're fooling ourselves by referring to this as a recovery as it's better categorized as life support.

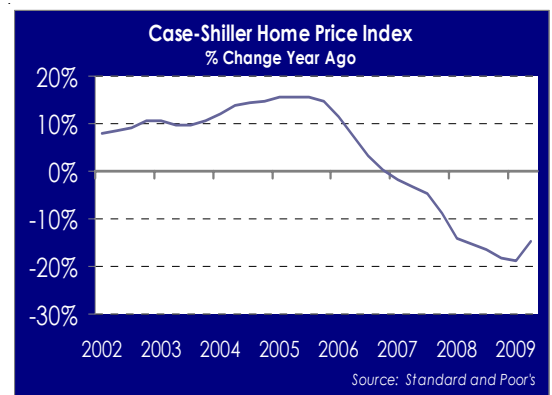
Housing

Can we create another housing boom from the ashes of our last one? Can we re-inflate the value of suburban property so it can once again be used as an ATM machine to generate cash for discretionary purchases?

The answer is no. We simply don't have the income or employment levels to manage it again. That doesn't mean that Washington/Wall Street won't try – it's what they're doing right now, but when you've got the federal government on the hook for 80% of new home loans, it has long ceased to be a market economy. And the government is paying a very high price for their involvement – over 24% of all FHA loans insured in 2007 and 20% of all loans insured in 2008 have already gone bad.

Suburban home ownership is an expensive proposition for most of us. Interest costs, property taxes, upkeep and maintenance are all very expensive, especially during a time when job losses are rising and wages are falling.

But housing is the area our government has chosen to "fix". Now there is serious talk of providing a \$15,000 tax credit for home buyers, up from \$8,000. Again, this isn't designed to help new buyers as much as it's designed to artificially hold up house prices. Notice how the \$8,000 tax credit has put a temporary floor under home prices.

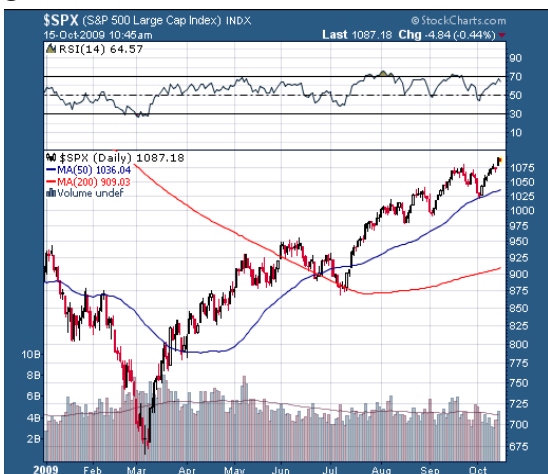


Now here's the reality of our housing market – homes are selling at a rate of 5 million per year while we're experiencing 3.5 million foreclosures per year. Rising delinquency rates at FHA of over 20% and continued massive job losses suggest that foreclosures may match home sales at some point in the future.

I predict that given our ultra high levels of bad mortgage debt and weak employment that it will take more and more tax credit plans to hold home prices at current levels. Left to the market, home prices would continue to fall to a point where people can afford them. Other than putting a few broken banks into receivership, what's so bad about that?

The Stock Market

The stock market is extremely dangerous at current levels. In essence, we have a stock market at levels that only a very strong economic recovery can support and the chances of a strong recovery are too remote to take seriously given the fragile state of the banking system, consumers, municipalities, and our federal government.



Stocks are grossly overvalued at current levels. They can remain this high for some time, maybe even go higher because the stock market has become a casino, bearing little relation to the underlying corporate prospects that support these stocks. We know this because corporate insiders, the people who know their

companies the best, have been massive sellers. Insider selling, as measured by Financial Visualizations, is running around \$28 in sales to \$1 in buys.

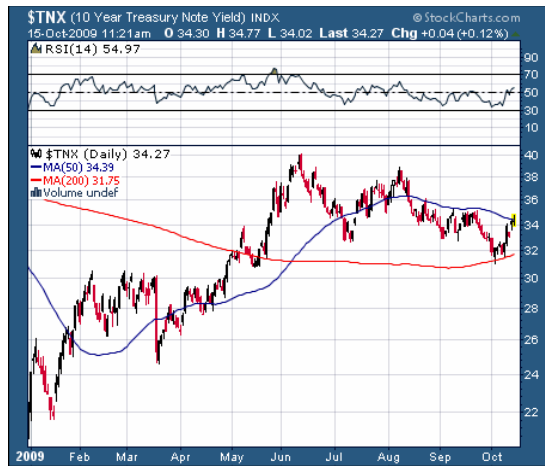
Given the lack of volume in this “historic” move, my assumption is that this is nothing more than an “orchestrated short squeeze” where stocks with heavy short positions are targeted by speculators to force the short sellers to buy back the stock they’ve shorted leading to sharp jumps in prices. As reference, short selling is where you sell a stock that you believe will fall in price, hoping to buy it back at lower levels. Considering the gravity of our financial collapse and how they’ve intervened in the Treasury markets and the mortgage markets, I have little doubt that the government is somehow involved.

Ordinarily, I would support such actions if I believed they would result in a positive outcome for our economy but not this time. Instead, I see these actions as attempts to push our problems into the future with dire consequences. Because of these actions, I have never been more certain of a stock market crash than I am right now. And the next time will lead to lows that are dramatically below March of 2009.

The Bond Market

This is another dangerous place to invest, although it has a better chance of working out than stocks. In our last newsletter, I expressed my expectation that long term rates would rise aggressively based on the belief that nobody in his right mind would buy long term debt when a central bank is printing money. I still believe rates will rise but I missed the impact that actions by the Federal Reserve to purchase more than half of all long term Treasuries issued since March would have. They have also purchased over a trillion dollars in mortgage-backed securities to artificially drive down rates.





The chart of the Ten year US Treasury shows how the Federal Reserve has been successful in keeping interest rates lower than I believe is warranted by their aggressive actions. In essence, the impossible is happening. The value of the US dollar is falling, along with interest rates. In practice, when a country's currency falls, interest rates rise because foreign lenders need incentive to buy our bonds given the losses they're taking on the currency translation. That's not happening this time.



But I missed an important dynamic that explains this unnatural phenomenon – global central banks need to maintain access to our consumers despite their current fragility. China in particular seems to be playing this game aggressively as a falling dollar makes their exports more competitive in global markets because they have pegged the yuan to the dollar.

The GeoVest Approach

Global central banks are trying to re-inflate global asset values by printing massive amounts of money. The strategy is similar to the one that created our ill-fated housing bubble but this time, the bubble is in stocks and bonds, neither of which provides a positive impact for the economy. In essence, they're trying to cure a problem of excessive debt and speculation with dramatically more debt and speculation.

These bubble games have left people with enormous losses over ten years of investing and a hollowed out economy. I don't want to play these games but I'm forced to maintain a defensive posture because of the damage done to our once great economy.

Investing is about looking to the future. It's about careful analysis that allows investors to control their decisions based on fundamentals and expected outcomes. It's not about rapid trading and trying to outguess the market on a daily basis.

The current rally has far exceeded my expectations but it's nothing more than a last ditch effort to sustain an unsustainable debt-driven existence. As opportunities present themselves, we'll continue to add companies to our portfolios that have strong balance sheets and sustainable demand for their products. We will also continue to protect that capital from predatory market forces. Thank you and it is our pleasure to serve you.

Philip M. Byrne, CFA
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