GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

Volume 7, Issue 1 April 2005

It's Getting Interesting

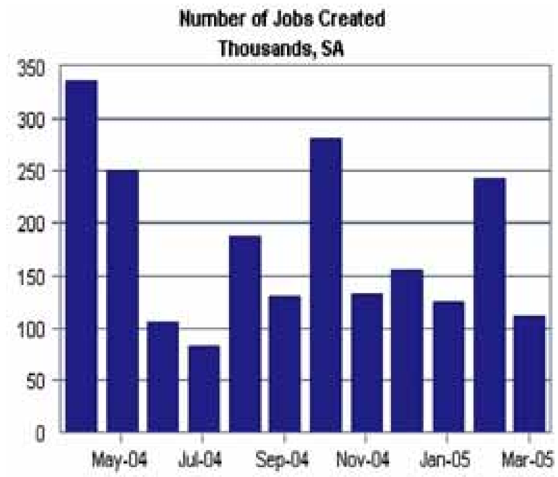
The first quarter was a tough start to the year in the stock market. All of the broad indices lost money for the quarter. We were fortunate at GeoVest to earn positive returns in most accounts despite market turmoil because we have been anticipating this turmoil for some time.

Those of you who have been reading our past newsletters know why things are getting challenging – the global economy is weakening and inflation is rising. Usually, these two variables don't go together because inflation is usually a product of a strong economy but the past few years have truly been an aberration in economic fundamentals.

The Economy

Since 2000, consumer spending has been very strong in the US, despite a lack of wage growth because credit has been so widely available. This is the heart of the aberration in economic fundamentals. If I told you in 2000, that our economy would lose good jobs to Asia, and replace them with lower paying jobs would you have expected a housing bubble to form? I doubt it. But that is exactly what has happened. Furthermore, people have tapped into the higher value of their homes to supplement consumption instead of relying on higher wages.

All of that is now history, but that history is the base of our present reality. Today, we are supposedly in the midst of an economic recovery, but recoveries usually mean a growth in jobs and wages. On April 1st, the Bureau of Labor Statistics released the payroll report which measures the number of jobs created in our economy for a given month. Keep in mind that we need roughly 200,000 new jobs a month to keep up with our rising population. The payroll report indicated that we added just 110,000 new jobs of very low quality in March, yet we are supposed to be experiencing a strong economy.



Source: Economy.com

Notice, on the chart we've provided, that apart from a few months, we are not even keeping up with our growth in population. If you were to analyze this data closely, you would also be aware that 179,000 of the 110,000 jobs, or 163%, came from a little known statistical tool called the birth/death model. This model attempts to approximate the number of new jobs based on the number of companies that went out of business during the month. The belief is that when a company goes out of business in our economy, it is replaced by another. At GeoVest, we find the concept far-fetched, but consider its ramifications. These are jobs that the BLS reports as being created where they have no proof that a job has been created. If not for this unverifiable tool, we would have lost a lot of jobs in March. That's not the sign of a strong economy.

You can counter this argument by pointing to the strength in gross domestic product, or GDP, and how it grew by 3.8% in the fourth quarter of 2004. It's a good argument until you closely analyze the data. There are a number of inconsistencies with this data, but we'll just focus on inflation.

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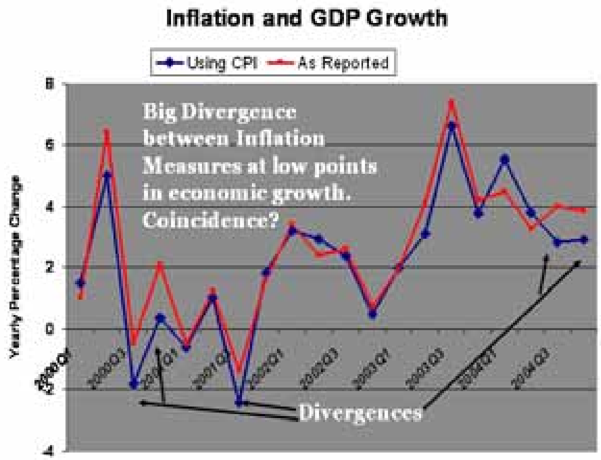
Inflation is a rise in prices, but something has to cause prices to rise and that something is debt. Take a man who makes $50,000 per year. He can buy $50,000 worth of goods. Sellers of goods make enough to sell that man $50,000 worth of goods. But what if that man goes to the bank and borrows $10,000. He now has $60,000 to spend, which means that some sellers can raise prices on goods that are in short supply, like oil. In addition, where there was $50,000 in circulation, there is now $60,000. This is a very simple example but it gives you an intuitive understanding of how new money is created and inflation gets pushed higher.

As we mentioned in our September 30th newsletter, inflation is likely higher than the reported statistics would indicate. If you refer back to that newsletter or read it on our new website, you'll see where the government takes some liberties when measuring prices that results in lower reported inflation. Still, if you look around at things you buy every day like gas for your car, food, or building supplies, you'll see higher prices and those prices are a function of inflation.

Getting back to gross domestic product, which is a broad measure of the output of our economy; the government collects statistics on all the final sales in our nation, then reduces that amount by the growth in inflation to get a true estimate of the growth of our economy. The Bureau of Economic Analysis uses an inflation measure called the GDP deflator that they derive themselves instead of using the commonly available consumer price index (CPI) created by the Bureau of Labor Statistics.

Notice the chart we've provided below. This chart shows the reported economic growth as depicted by the blue line and what the growth would have been if the CPI had been used to measure inflation. Notice how the two lines are identical except at points where our economy was particularly weak. We can't prove it, but it appears as if the government statisticians were looking to massage the growth numbers a little to give the appearance that our economy was doing better than it actually was.



Source: Bureau of Labor Statistics and Bureau of Economic Analysis

The Stock Market

As we mentioned at the beginning of this newsletter, the stock market has had a rough time in the first quarter. To illustrate why it's getting difficult, we'll get a little technical. Most investors are familiar with a stock's Price to Earnings ratio, or PE. The inverse of the PE (1/PE) is what's called the Capitalization Ratio. Right now, the market's PE is 17.5, for a capitalization ratio of 5.7%. Essentially, this tells you that your expected return on this year's earnings is 5.7%.

Generally, this capitalization rate falls when the market expects earnings to grow in the future because investors try to buy stocks early based on the expectation that future growth in earnings will reward them for "paying up" today. This happened in 2003 and late 2004, which is why they were pretty good years in the market.

To tie this discussion to economics, earnings for companies generally rise when the economy is strong and fall when the economy is weak. This is why we spend so much time studying the economy because it tells us what growth in earnings to expect in the future.

As we've been saying for the past year, this economy is not as fundamentally strong as most investors believe, which is why we've focused heavily on risk reduction. In the first quarter of this year, investors started to realize this, which led to the weak market returns.

The rising awareness of inflationary pressures makes matters worse. Returning to the capitalization rate, when you reduce this 5.7% by reported inflation of 3%, you get a very meager 2.7% return on your investment. But what happens if inflation is actually 4% or 5%? Your return falls closer to zero. As you can see by this illustration, rising inflation and falling economic growth are potentially negative for the stock market.

If you refer back to our last newsletter, we discussed our “low elasticity of demand” portfolio strategy. We have been buying companies with relatively high capitalization rates, or high returns on current earnings, that also have pricing power to raise prices on their products in the event that inflation accelerates from here. For the most part, it has worked very well, with a few exceptions. We will maintain this strategy until the economy changes, which will dictate a change in the portfolio.

The Currency Market

Besides quoting the price of gas, the major networks have started to regularly discuss the currency markets. At GeoVest, we watch the currency markets because they are vitally important, not because they are temporarily interesting. In fact, when currency markets actually get interesting, it’s usually a sign of trouble for the global economy.

If you refer to our last newsletter, we talked about the importance of the currency market on international transactions, so we won’t revisit that aspect. Instead, we’ll talk more about why we don’t believe the dollar will fall in the near term.

While the currency markets are very complex and absolutely fascinating, we believe that near term changes in the value of the dollar will involve one simple variable – the intentions of the Asian and European central banks – nothing else matters. This is because their economies are almost completely dependent on the ability to export more than they import. The economic term is called mercantilism. When you consider that the US is the only place where consumers are ready, willing, and still barely able to load up a shopping cart, you can see how it is very important for the rest of the world to maintain their current levels of trade with the US.

Source: Stockcharts.com

If you need more proof, here it is. Japan has a huge trade surplus with the US, yet they have fallen into recession because their consumers have pulled back on consumption so much that they are now consuming at the same level that they did in 1986, and no, that is not a typo. Europe isn’t quite as bad, but their growth in retail sales is essentially flat, while Germany, Europe’s biggest economy, continues to experience declining retail sales. If you are an Asian or European central banker, knowing that your country’s industries need a buyer for its goods, you do the only thing available to you, you make sure the dollar is strong enough relative to your currency to ensure access to US consumers.

The Bond Market

Like the stock market, the bond market had a pretty volatile first quarter. It started off strong with long term interest rates falling in the first half of the quarter, only to rise pretty dramatically over the second half of the quarter.

When you look at the bond market, you essentially have to break it into two different markets – the short end of the yield curve (short term interest rates) and the long end of the yield curve (long term interest rates). With the Fed aggressively raising short term interest rates, the short end of the yield curve rose in dramatic fashion.

Source: Stockcharts.com

Notice the chart above where the 3 month US Treasury Bill rose in yield from 1% to 2.75%. That's a very big move. Now look at the chart below of the ten year US Treasury Bond where it moved from a 4% yield in February to a 4.4% yield recently – quite a bit less.

Source: Stockcharts.com

A purist reading of these two charts can only conclude one thing – the market believes that our current round of inflation is temporary and that it won't last much more than a year. The only way this happens is if the US economy falls into a recession.

Given our belief that inflation is currently understated, it would be imprudent for us to lengthen durations at current levels in the bond market. But if long term interest rates rise another 1%, there is a good chance that we will buy longer term bonds, because like the bond market, we believe that these higher levels of inflation are temporary.

The GeoVest Approach

Our strategies are a product of our expectations for the future. We analyze the global economy, the domestic economy, and corporate financial statements to understand both the opportunities and the threats that are part of the investment horizon. Besides our investment strategies, we game plan for all identifiable contingencies because we strive to never be surprised by change. We believe you can make money for clients when you are prepared for change, but you lose money when you react to change. We want our clients to understand our investment strategies and to gain comfort from our work on their behalf to make the complex world of investing understandable.

As we mentioned in our last newsletter, we have been rebuilding our website for a few months and expect that it will be available by the time you get this newsletter, or shortly thereafter. We would like to hear your suggestions on how we can make it better. Thank you and it is our pleasure to manage your money.

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