GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

Volume 12, Issue 4 October 2010

On the Edge

We've started to setup our accounts for a nasty sell-off in the markets that we believe may happen anytime between October and early next year. As I wrote about in the last newsletter, we're getting the rally we've been expecting, thanks to an interventionist Federal Reserve. I have no idea whether they will succeed – nobody does – but it's clear that a higher stock market is central to their plans for an economic recovery.

The Fed's goal is to create artificial price support for assets such as stocks, bonds, and real estate so banks can continue to claim they are solvent and so consumers will feel "wealthy" and spend. They seem to miss the fact that it takes "income" to consume and invest and that income is in short supply.

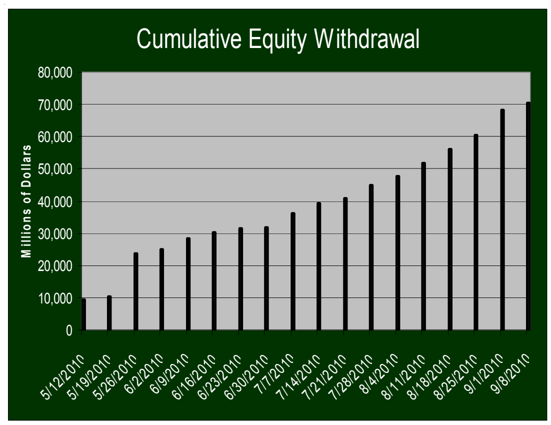
We are 20 months into their zero interest rate policy (ZIRP) and we have nothing to show for it except frustration among savers. At its core, ZIRP destroys the value of savings because the Fed is effectively saying that money no longer has value – remember an interest rate is merely the price of money.

The government has gone to great lengths to "sell" us on the idea that our economy is recovering. In an effort to preserve the status quo, they've gone to great lengths to try to force us to put our money to work in situations that offer a ton of risk for very little reward. Americans are starting to figure this out which is why they are increasingly withdrawing capital from risk assets.

The Stock Market

I like the stocks we own for our clients but I don't like the stock market in general. As I said in the last newsletter, we're buying stock in companies that we'd like to operate in this challenging economic environment and avoiding industries whose profitability we believe can't be sustained in the future.

Americans are increasingly pulling their money from the stock market. Trading volume is down 20% from a year ago as individuals pull between $2 billion and $7 billion a week out of domestic stock funds. Notice the chart below that shows cumulative changes in stock funds.



At some point over the past 20 years, the stock market went from being a place where the majority of participants went to own shares in companies they believed undervalued, and a minority of participants bet on the direction of the markets. Now it's the opposite, especially when you consider that people who invest in "index funds" are making a passive, uninformed bet that the market will always rise. Guessing the direction of the

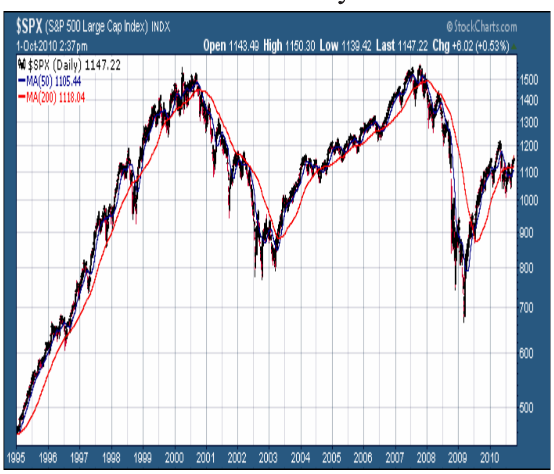
Table of Contents

GeoVest Advisors, Inc.
245 Willowbrook Office Park,
Fairport, NY 14450
Tel: 800 - 638 - 5050
Fax: 585 248 8784
www.geovestadvisors.com

market over the short term is now where most energies are spent.

Not coincidentally, corporate America has adopted a similar short term approach by failing to re-invest in domestic operations and instead, investing in cheap locales throughout the world. For the first time since the early 1950's, corporate America has invested less in its future, in the form of capital expenditures, than their annual depreciation expense (the part of capital expensed each year) – a move that makes today's earnings higher but ensures lower future earnings.

Observe the following chart that shows the market over the past 15 years. How does the direction look to you?



Fortunately, GeoVest has done much better.

And yet this is precisely where the government's energies are focused. Does anyone doubt that the Fed's announcement in late August to start up Quantitative Easing (printing money to buy Treasury debt) had anything to do with the economy? Only indirectly because the government truly believes that a rising stock market will make us feel good, so we'll go out and run up our credit cards, which is precisely what caused our current mess.

I routinely hear the argument that corporate earnings are good and the market is cheap. But it's not the number that matters, it's the quality and the sustainability. The people making this argument don't seem to understand the vital connection between the economy and corporate earnings. These supposedly good earnings are a product of three factors. The first is aggressive accounting in the case of financial services which is around 35% of S&P 500 earnings. The second is cost cutting which is effectively eliminating US jobs. The last is growth from emerging markets which is totally unsustainable given their ultimate dependence on US consumers. None of these factors portend improvement in American operations.

The result is a stock market that is over-valued based on the cash flow it can realistically produce. We like the stocks that we own but we've hedged them because we believe a rapidly weakening economy will result in a lower stock market. This runs counter to the efforts of the Federal Reserve but I believe their actions will prove to be disastrous.

The Fed

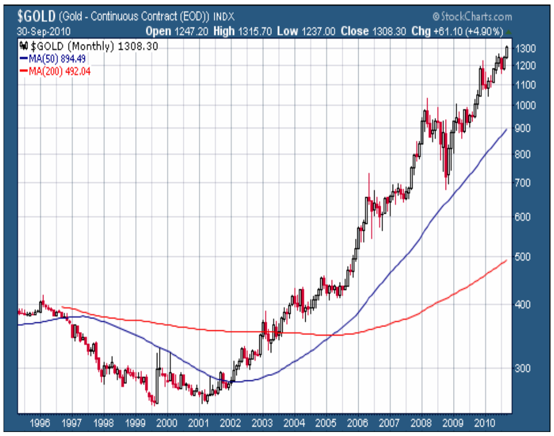
The Federal Reserve is a bank whose primary mission is to control the supply of money in the United States. Historically, it has acted as a lender of last resort to banks in trouble. But when called upon to lend to troubled banks, it always required pristine collateral, at least until Ben Bernanke took over. Now, the bank's balance sheet is full of much of the garbage that took the economy down in 2008.

In many ways, you can argue that the Fed is trying to play the same role that Fannie/Freddie played in the 2002 to 2007 time frame when they expanded their balance sheets to make the housing bubble possible. Today, the government is forced to pump billions of dollars each quarter into the struggling monolithic agencies. Is a similar bailout in the Fed's future?

The answer is no because the Federal Reserve owns the printing presses and they have proven that they are willing to literally print money when needed. I fully expect them to print money when some of the investments on their balance sheet go bad and that brings me to gold.

Gold

We started buying gold stocks in client accounts when the shiny metal was $429 per ounce and now it's trading at $1,300 per ounce and we believe it has the potential to go much, much higher.



You could say that gold represents the Fed's report card – the kind of report card they want to hide from their parents. We anticipated the Fed's current actions as far back as 2004. Our investment thesis is absurdly simple. The world is suffering from a massive debt hangover and the only politically acceptable approach is to devalue that debt. Since gold has historically maintained its value through the innumerable currency devaluations throughout history, it will likely increase to the same proportion that the Fed devalues the dollar.

Currency Wars

One story that has been largely missed by the media but which represents enormous future change is the fact that South American economies such as Brazil and Mexico are actively trying to devalue their currencies to a falling dollar. You know it's bad when South American central banks, maybe the worst central banks outside of Zimbabwe, are intervening to support your currency.

Even the euro, from the land of insolvent countries, is rocketing higher versus the dollar, despite clear danger from Greece, Ireland, and Portugal. The Japanese, who started the cheap currency for exports trend, are actively intervening to keep the yen low versus the dollar – to no avail.

The term currency war is taking on a whole new meaning following the House of Representatives vote to give the President the power to impose sanctions on the Chinese for manipulating their currency versus the dollar. The Chinese are scared to death of a rising yuan versus the dollar because it would cut into their export market at a time when they have excess manufacturing capacity.

Again, this currency war is something we anticipated years ago because it's the logical conclusion to an unbalanced economic structure that depends on the whole world selling to US consumers, on credit, while stealing jobs and industries from the US. The global trade that underscores this structure wasn't the kind of trade that benefited all involved. Instead, it was a structure that leached the vital elements of the US economy so a few at the top of the food chain could benefit. And now that it's clearly finished, everyone is scrambling to sustain what's left. They are not allowing the remnants of the old cycle to die a peaceful death; instead they are violently trying to keep it on life support.

A Long Cycle

I've read an enormous number of pieces from people with varying perspectives, all trying to explain our current situation and how to fix it. Personally, I've spent 13 years trying to understand it and I have concluded that we are at the end of a long cycle that began with the end of WWII.

The US enjoyed an enormous peace dividend for having won WWII. Our country was intact while our economic competitors were in ruins. We lost a half a million men but it was a much smaller number than what was lost from the battlefield countries throughout Europe and Asia. We also enjoyed the intellectual breakthroughs in science and manufacturing that allowed us to win but could now be applied to the production of consumables. In short, we had no real competition.

By the late 1960's, the world started to catch up with our advantages. Europe and Japan were rebuilt and were now viable competitors. The US countered by developing and exploiting the consumer debt instruments that allowed Americans to front-load consumption. Over the next three decades, consumer debt allowed the US economy to expand by continuously front-loading growth through ever increasing personal and institutional debt. There are limits to debt growth and we have finally hit them.

The government has been ineffectual in their attempts to re-start the economy because they are literally attempting to sustain the unsustainable. The only thing they are accomplishing is to run up enormous national debts that will have to be eliminated by inflation.

There is literally no conceivable way that we can salvage the consumerist economic model in the US which means we are headed for a major restructuring of our economy. This restructuring will have a terrible effect on our trading partners, most particularly China. As long term investors, it's our job to make sure that our clients are positioned to benefit from these changes.

The GeoVest Approach

We see the problem clearly and we have a gameplan for navigating it. Unlike the past, we can't simply "go to cash" because it's highly likely that the Federal Reserve will choose to "devalue" that cash.

I outlined our gameplan in our last newsletter and we have started preparing for some turbulence in the markets that we believe will come. The only way to thrive during this period is to embrace the turbulence by owning things that are necessities, regardless of the economic backdrop while hedging against systemic risk. I'm confident that we are prepared and that our strategies are the right ones. Thank you and it is our pleasure to serve you.

Philip M. Byrne, CFA
Chief Investment Officer

GeoVest Advisors, Inc.
245 Willowbrook
Office Park,
Fairport, NY 14450
Tel: 585 248 5050
Fax: 585 248 8784
www.geovestadvisors.com