



On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

Volume 13, Issue 4

October 2011

The Waiting Game

We're having a pretty good year on an absolute basis but a terrific year when compared to the market. Most of our accounts are positive on the year while the market is down around 9%. It seems that everyone is worried that we're back in a recession, something I've been saying that we never left.



A downturn in the markets won't last for long. I may be negative on the economy, but it's become crystal clear to me that our Federal Reserve Chairman Ben Bernanke views keeping the stock market at an artificially high level as one of his most important tasks. So we're just waiting for him to start printing money again before we take a more aggressive stance in the portfolios. And he will print money again because it seems as if that's the only thing he knows how to do – if all you have is a hammer, everything looks like a nail!

Confusion Reigns

I don't think I've ever experienced a time when people were as confused about the future as they are today. They're confused about the economy, the stock market,

politics, interest rates, their employment prospects and the state of our great nation. Fortunately, we have spent years preparing for this confusing environment and the plethora of mixed signals that are bombarding us on a daily basis.

Companies claim to be recording record profits but are reluctant to use those profits on hiring additional workers. The stock market is up 500 points one day and down 500 points the next day. Our national debt is going through the roof yet we have the money to help bail out Europe and our own wayward states like California and Illinois. Long term interest rates are down to 2% while inflation is raging at 7.5%. No wonder most people are confused.

Even the Federal Reserve is confused. Chairman Ben Bernanke admitted that his strategy of printing money has been ineffective. Dallas Federal Reserve Bank President Richard Fischer admitted that his colleagues are all confused as to why 0% interest rates have failed to work. So if you're among the many who are confused, at least you're in good company.

What's Happening?

It's actually very simple. We're on the downward curve of a long term economic cycle. It's a cycle that we've been postponing for decades through every sort of intervention imaginable but like a hurricane, it's going to pass over your house whether you're ready or not. And with every intervention, the force winds of

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the hurricane get stronger and stronger until they can no longer be held back.

In 2000, we didn't have much of a housing problem, at least not a problem that lower rates couldn't fix. But instead of freeing up household cash flow with lower interest rates, the Fed pushed for a housing bubble that is now threatening our banking system.

In 2000, Europe was a slow growth socialist state with a manageable demographics problem and by manageable, I mean that retirement packages would have been cut back to accommodate stretched budgets. Instead, the Europeans pushed banks to buy Southern European debt to lower borrowing costs so their socialist states could be expanded. Now those banks that bought Southern European debt are largely insolvent. Belgium's Dexia Bank appears to be ready to go under with many more to follow.

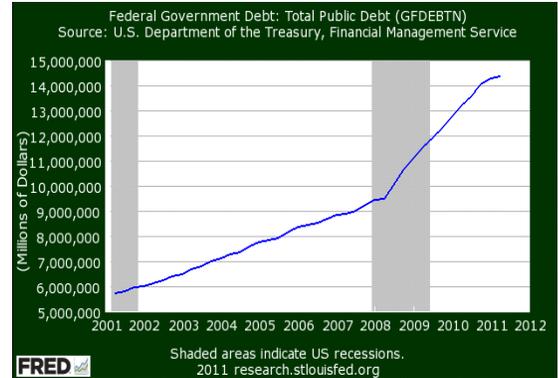
In 2009, the Chinese, unwilling to admit that their economy was built on bad loans, set out on a home building spree that makes our housing bubble look intelligent by comparison. The Chinese have built whole cities that are unoccupied, yet pundits galore have cheered the insanity.

These are some of the things that happen when government thinks it's smarter than the market. To them, it's a changed assumption on a spreadsheet that creates a "desirable" short term outcome. They experiment and we pick up the pieces.

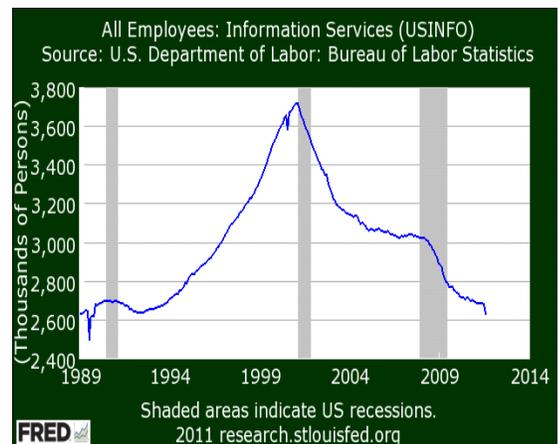
The Economy

Over the past three years, our economy has been held together by massive federal government spending. As mentioned, the Federal Reserve can't seem to understand why low interest rates haven't succeeded in restoring economic vitality – or their version of vitality which is simply blowing bubbles. They've added to our

debt levels by \$5 trillion with nothing to show for it.



The answers are obvious if you look in the right places. I did a study in September where I looked at employment levels in key sectors of our economy. I observed that key sectors like information technology and manufacturing are in secular decline while we've experienced growth in healthcare, leisure/hospitality and until recently, government workers. In other words, the industries that produce real things are in decline. Notice how information jobs were the future. They were – for India.



I've used this analogy before but please bear with me. The economy is like a farm. The farmer plants seed to produce a sellable product. The more he invests in seed and land, the more produce he can sell. The more he sells, the more services such as mechanics, trucking, and energy he consumes, which employs people.

The problem with our economy is that we have stopped investing, allowing the

Chinese to produce everything for us. We no longer have an engine for growth because collectively, corporate America stopped investing around 2000 and have been “farming” out that investment to China, and other places, since.

The solution seems simple enough though – reduce our trade with China. But if we choose that route, a host of industries that rely on cheap manufactured items will suffer, making our employment situation worse. Companies like WalMart and Target will suffer because higher priced American-made items will mean that consumers can buy less stuff which eliminates the need for all of those monster stores.

The Fed, in its infinite wisdom, believes that if we just make credit cheap enough, we’ll simply borrow more money to buy all of the stuff at our local Target. Great idea, except we already did that and now we can’t pay the bills on last year’s shopping spree.

The biggest structural problem that we’re facing is our trade with emerging nations such as China. By trading with them, we have lowered the price of a lot of things but we’ve effectively destroyed the value of labor in this country so our ability to buy those things has been compromised. To illustrate, assume we have 50 million people in this country that can do manufacturing work and further assume that based on supply/demand in our country, the prevailing wage is \$20 per hour.

Now open trade with China where hundreds of millions of workers would willingly work for \$1 per hour. Pretty soon, industries leave the US and the prevailing wage falls dramatically. Those American workers rapidly fall from the middle class to the lower class and can now buy much less. That’s our future and

we can thank companies like General Electric for perpetuating this trend.

We could solve our employment problems very quickly – lower the prevailing wage scale for everyone and “voila!”, production would shift from Asia to the US. Unfortunately, we would no longer be able to afford our suburban lifestyles, our multiples autos, our vacation time-shares, or very many of the things we’ve come to expect on a daily basis.

Europe

Europe’s banking system is set to collapse and there is nothing they can do about it. Europe has the same problem as us – they made the mistake of trading with China. Like us, Europe has no means of expanding employment as they’ve allowed the emerging nations to steal their industries and intellectual capital in exchange for cheap imports. Like us, they’ve spent fortunes borrowing money and giving it away to people who have lost their jobs. Like us, they tried to blow a real estate bubble to make everyone who owns a home “feel wealthy”. Unlike us though, they can’t print money for now because they belong to a currency union and money printing is against the rules of the union. Sit back and watch this one because it’s going to get interesting...



Belgium's Dexia Bank appears close to bankruptcy...





The Bond Market

It really shouldn't be referred to as a market because it's more like an administered rate. I didn't think it was possible but the Federal Reserve has succeeded in taking the 10 year Treasury Note under 2% at a time when the consumer price index is rising by 7.5% per annum.



Long term bonds are a terrible long term investment but that doesn't mean that rates can't go lower – they can and probably will. They're a terrible investment because if the Fed succeeds in creating inflation, these bonds offer very little potential reward. Right now, I view stocks with steady dividends as being safer long term bets than US Treasuries for those companies that sell necessary items that can benefit from the Fed's inflation efforts. I'd rather own a stock that has the potential to increase dividends than a bond that will pay the same amount of interest regardless of the macroeconomic backdrop.

The Next Year

I believe that the next year could be extremely volatile in the markets. It appears to me that the Federal Reserve is doing everything in its power to bring down the input prices that reflect rising inflation. Commodities such as corn, copper, oil, etc., have all fallen rapidly in

price recently. Apart from a weakening global economy, I've seen evidence of a concerted effort to reduce these prices on the part of the commodity exchanges. If I'm right, they are setting the stage for the world's central banks to print money aggressively later this year or early next year. The result should be a very sharp rise in equity markets and commodity markets.

Please don't mistake this stance as an indication that we are no longer vigilant in evaluating downside risks. Instead, I view it as an acknowledgment that we live in extraordinary times and that the governing bodies will go to extraordinary lengths to create the illusion of prosperity...

The GeoVest Approach

Economies run in short term cycles, intermediate term cycles, and long term cycles, yet all that most people focus on are the short term cycles because they are much easier to understand. The really big returns are made by understanding the long term cycles.

We're at the end of a long term cycle that started in the 1940's and it was a great one – like a party that we never want to end. The most dangerous part of a great party is leaving and getting home safely when surrounded by so many revelers. Think of GeoVest as your designated driver. Like the rest, we enjoyed the party but we knew it would eventually end, so we prepared. In order to enjoy the next party, we need to make sure our client's capital remains intact.

Up to this point, we've been successful and I see no reason why we can't continue our success. Thank you for your continued patronage and it is our pleasure to serve you.

Philip M. Byrne, CFA
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