GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

Trust the Fed?

Just like we expected, the Federal Reserve gave us QE3.0 in September. The market rose 8% for the quarter but it was a very shaky rally on low volume, falling earnings, and lousy global fundamentals. It was proof that the Fed can manipulate markets – something they largely admit to – but it can't do anything to improve the fundamentals that support markets.

Sure, we saw this coming but the opportunity to trade didn't match the growing risk in the markets. First of all, as we were tracking the global economy, it became increasingly obvious that things are weakening all over the world. In fact, many of the same economic problems that surfaced in 2008/2009 have returned including collapsing transportation prices, falling earnings, and social unrest everywhere except in the US. Notice the chart of the Dow Transportation Index, a key sub-index of the stock market, it fell 2% in the quarter despite obvious Fed actions.

In a centralized world where much of what we consume has to travel from the other side of the world, weakness in transportation companies is a huge red flag. Other transportation issues include falling Suez Canal traffic, a 10% decline at the Port of Los Angeles (our busiest port), the collapse of the Baltic Dry Index (which measures global shipping prices) to levels below the depths of 2009 and a 2% decline in US gasoline usage in August.

In addition to the above, volume during the second quarter in the stock market was down 40% to 50% from a year ago, while people pulled between $2 billion to $5 billion out of domestic equity mutual funds each week! These are extraordinary occurrences, more so because it happened while the market was rising.

The last thing to consider is the fact that each time quantitative easing drove the stock market higher, there were speculators betting that the market would

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fall! When QE worked in the past, there were loads of speculators who were forced to change their bets, effectively buying stocks to move the markets higher! The chart below is a good representation of the betting practices of speculators and it's clear that nobody was betting against the Fed this time.

When the Vix, or Volatility Index, is trading around 15, it means that very few speculators are betting that the market will fall, since it measures the amount of stock options used for betting on a falling market versus rising market. When it's above 30 or more, it means that speculators anticipate a market correction.

Quantitative Easing, or printing money, is not a magic elixir for raising the level of the stock market. It works when perceptions are negative and when there is an engineered improvement in the economy about to become evident. None of those conditions were met this time.

Panic

The Fed panicked, in my opinion. They succeeded in elevating the markets but I'm not sure they can keep them elevated because the fundamentals that normally drive the markets are turning negative – and in some cases, very negative.

I don't trust people who panic because they tend to make "spur of the moment" decisions that palliate the present situation but leave long lasting damage. It's clear to me that they didn't have the conditions lined up to make this latest round of money printing successful, yet they did it anyway. Why?

It's only conjecture on my part but I believe it was a combination of rapidly falling global trade and major weakness of Europe. They shouldn't have been surprised. I've been tracking global trade flows on a daily basis since March as well as following the rapidly weakening Chinese exports to Europe, and the evidence of a global slowdown has been out there for six months.

Another reason why I label it panic is that they made the decision at a time when food prices are rising sharply due to the ongoing drought. Notice the chart below of the price of wheat and how the Fed moved in the past after wheat prices dropped. Thanks to the drought, the price of wheat had just jumped 50% with similar moves in corn and soybeans. Printing money will only exacerbate a difficult situation for those of us who eat.

If the Fed is trying to help the economy, they've got a funny way of showing it as they've succeeded in raising the price of food and fuel, things that we depend on in our daily lives.

What Is QE?

The Fed is a bank that lends money to other banks. When they announce a quantitative easing, it means that they increase the money supply by buying assets in the market using money they create. It's this increase in money supply that normally causes inflation. I use the term "normally" because our present environment is anything but normal.

The way it affects the stock market is a little less clear since the Fed isn't supposed to be buying stocks. Instead, besides Treasury bonds, they're buying mortgage backed debt which is supposed to lower mortgage rates so houses become more affordable. Theoretically, when an investor sells his/her mortgage bond, that money is available to be re-deployed in the stock market. I use the term "theoretically" because that's what they say is happening, not what is really happening.

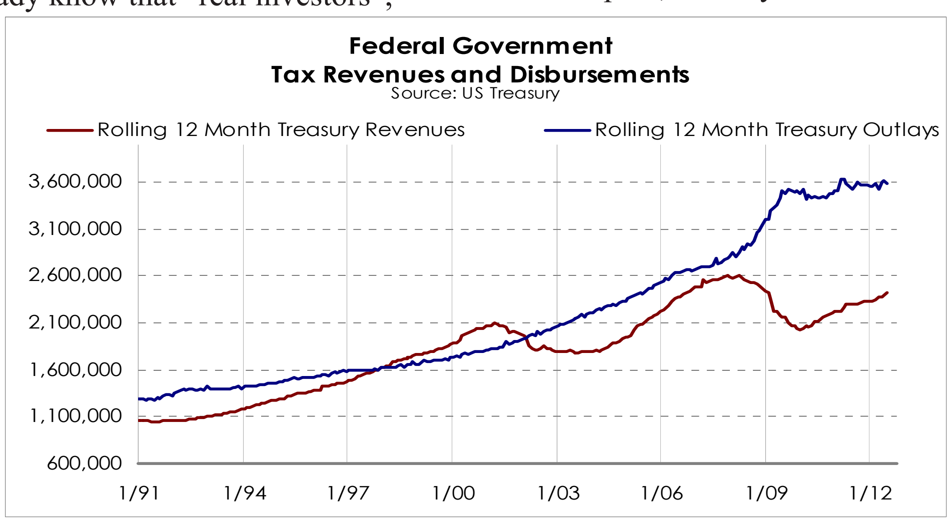
Instead, speculators become emboldened when the Fed prints money and seek out other speculators who are "betting" against the market by selling stocks instead of buying them. Those are the evil "short sellers" that you've read so much about. As I wrote above, those evil short sellers didn't show up to this party, having learned their lesson from previous efforts to separate them from their money. Since we already know that "real investors", people like us who invest for the long term, are increasingly leaving the stock market, it suggests that this recent rally in the market is nothing more than the Fed's efforts to manipulate the market higher. We know this because just about every positive day in the market last quarter, someone at the Federal Reserve or the European Central Bank made an announcement about how they were getting ready to "print" a lot of money.

Inflation

From the above explanation, you'd be hard-pressed to explain how their efforts cause inflation. The answer is discussed on the evening news every night. Very simply, the Federal Reserve is funding our government's budget deficit.

The biggest increase in government spending is entitlements. Roughly 1/3rd of our population is benefiting from some form of Welfare – either food stamps, welfare, Medicaid, etc. This doesn't include Medicare and Social Security. **1/3rd!**

The government sells bonds that the Federal Reserve buys with newly printed money. The government writes the check, people cash it to buy food which increases the amount of money used for necessities, thus pushing up prices. The next time you wonder why we own a company that makes Spam, here's your answer!



Notice how Federal government revenues are still at levels last seen in 2006. It's why the whole discussion of a recovery is nothing more than misdirection intended to fool the uninformed. To use math, our economy (GDP) is growing at 1.5% per year while we spend 8% (of GDP) to prevent it from falling further. Since we ran a 1.5% of GDP deficit before the crisis, we take 8%, subtract 1.5% for growth and 1.5% for our previous deficit to give us how much the "real" economy is contracting each year – 5% per year.

China

As you know, I'm not a fan of China. It stems from the Chinese government's impact on their economy – governments and business only mix well in small doses. In China, local governments run local economies like a Mafia Don runs a city and answers only to Beijing.

How many of you were kicking yourselves for not investing in China? Hopefully, none of you!

You can build factories but if those factories don't produce earnings, what good are they? Corporate profits in China continue to fall and there are rumors of cities on the verge of bankruptcy – and I'm not referring to the empty cities that they built like Ordos. I'm referring to huge cities like Dongguan which is a stone's throw from Hong Kong and which houses a mall bigger than our very own Mall of America.

The moral to the story is that if you make money cheap enough, nobody makes money because the moment you've got a profitable business, you'll have ten competitors. That's the story of China. Its economy was destroyed by too rapid growth and too little profit.

The GeoVest Approach

Unlike China, I continue to be highly optimistic about some sectors of the US economy in the long run, particularly oil and chemicals. The reality is that we have oil, gas, and cheap chemical inputs such that there is no reason why we can't dominate as a manufacturer again. But it's crazy to buy these sectors aggressively with a cyclical downturn in front of us – we'll wait for a better opportunity.

Still, the Fed has proven that they are desperate to elevate the stock market which is why I'll continue to watch for the conditions to line up for a trade – one that is supported by disciplined buy and sell signals. In the end, while I won't fight the Fed, I certainly don't trust them.

The Fed is playing a dangerous game that they can't possibly win but while they are playing, we will look for opportunities to generate returns for our clients. Thank you for choosing GeoVest Advisors. It is our pleasure to serve you.

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