GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

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Socialist Markets

As we predicted in our last newsletter, the Fed chose not to "taper" or reduce the rate at which they buy Treasury and mortgage securities in the market each month. Apparently, there was great dissension in their ranks but ultimately they decided that the economy wasn't behaving as well as they expected.

The simple truth is that the Fed can't reduce their purchases of securities without crashing the stock and bond markets. Markets adjust to change and the Federal Reserve has pushed bond yields down and the stock market higher. If they change what they're doing, the market will adjust to that change – it's that simple.

In the bond market, the Fed has been a buyer of bonds which acts to bring interest rates down by removing bonds from the market which makes the remaining bonds scarcer. I've written extensively on how they use the leverage of speculators against them in the stock market as there is no evidence that the Fed buys equity securities. But more than anything, there is an implied guarantee from the Fed that it won't let us lose. It's the equivalent of a Las Vegas casino telling gamblers that as long as they make the bets the casino wants them to make, the gamblers can't lose. In effect, they take the chips from the gamblers who don't do what they want and give them to the gamblers who bet as the casino wants. The problem is that the Fed can't make good on their promises.

The Bond Market

Bond investors had a rough 3rd quarter evidenced by the sharp rise in interest rates on the 10 year Treasury bond.

The sharp rise in yields from 1.6% to 3.0% produced losses for those who sought the relative safety of bonds over stocks. If you bought the bond at rates of 1.6%, it will probably take three to four years to recoup your losses on the value of the bond through interest payments. In effect, you won't get a positive return on your money for a few years.

Worse yet, bonds were where the Federal Reserve wanted people to put their money. The Fed was investing alongside the general public in these bonds yet the unthinkable happened – they lost despite the Fed's implied guarantees. Is it possible the Fed isn't all-powerful after all?

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It appears that Chinese and Japanese investors were a bit miffed about the way they've been treated. I'm guessing but it seems to me that they were happy to hold our bonds as long as we were increasing trade with them but as our economy has stagnated, orders for their goods failed to materialize. This left them holding our bonds while the Fed devalued those bonds by printing money.

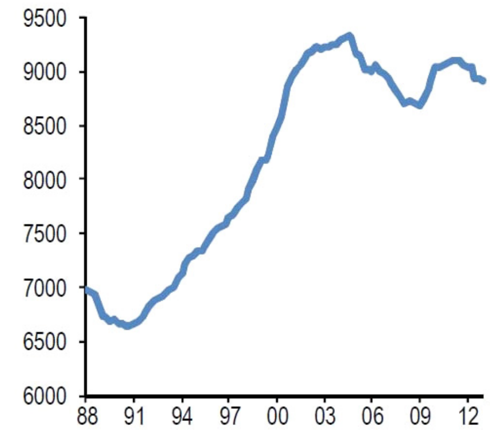
It seems that the 1.6% Treasury bond rate wasn't a market-based rate of interest after all. The 1.6% rate last seen in May was a rate of interest created *artificially* by a quasi-government entity, the Fed. It represented a form of socialism in the markets where the government set compensation for its own borrowing costs and not the market. But socialism in the markets doesn't last for long as evidenced by the big losses incurred by those who bought long term bonds prior to May. We avoided that hit because we understand the fragile nature of market intervention. As value-based investors, we didn't see value for our clients – and we still don't. In a world where central banks have no choice but to devalue money – and make no mistake about it, Quantitative Easing is devaluation – it's not advisable to own long term bonds.

The Stock Market

The nonsense over the debt ceiling and Obamacare aside, the stock market is having another great year despite the continued absence of earnings growth. Corporate earnings have risen only a tiny amount since 2011 and most of those increased earnings came from companies buying back their own stock, from lower interest rates on their debt, from continued cost-cutting, and from banks releasing past reserves for bad loans. In short, the miniscule increase in earnings over the past couple of years has been marked by extreme low quality.

Figure 5: S&P500 Index Divisor

bn of shares, quarterly data, last obs is Q1 2013



Source: S&P

We correctly identified this topping of corporate earnings based on economic work that we did. We even invested in the few areas where stable growth is possible – food and energy but we didn't invest in the areas that experienced meteoric rises. Put simply, we stuck to our disciplines and invested based on fundamentals and not where the casino wanted us to bet.

Netflix is the perfect example of this kind of stock. It offers a good product but a lousy business model and is valued at $18 billion. The stock trades for 380 times earnings! Anyone else see shades of 1999?

Speaking of which, this market reminds me a lot of 1999 where speculators knew that the markets were grotesquely overvalued but easy money created a frenzied atmosphere where negative speculators got crushed trying to time the top in the market. But unlike 1999, we have far more intervention in the market which is why we've gotten such a smooth ride to the upside as compared to 1999. And unlike 1999, small investors haven't been jumping in for quick profits. Instead, small investors have been removing their money from the markets for years.

We've got a market that's going up without buyers, without rising earnings, without real economic growth, and without positive long term prospects. My conclusion is that we have a market that's going up because the government needs it to go up. But why?

The Fed

The Fed has morphed from being a bank for our nation's banks to being the economic overseer of the world due to their role of managing the world's reserve currency. To be clear, the US dollar is the world's reserve currency which means that just about all trade takes place in US dollars. For world trade to expand, US banks and the Fed itself need to expand the number of dollars in circulation and this can only be accomplished through making loans and done correctly, making loans is profitable. Have you ever wondered how the US banking system acquired so much political power? This is why.

Since 2008, banks haven't been making as many loans due to the weak global economy which is why the Fed has resorted to printing money. Loans are better because normally they fund economic activity where printing money simply invites speculation in the markets. Instead, our government has expanded spending by a trillion dollars a year by borrowing money through Treasury bonds and the Fed prints the money to buy them.

Prior to 2008, US consumers were happy to borrow money to buy all sorts of things that were made in different parts of the world. Our trade partners were happy because their factories were humming, our consumers were happy because they were living large, and our banks were happy because they were making a lot of money on loans. But as I wrote repeatedly over the past ten years, consumers lack the income to service those loans.

It's worse today than in 2008 because median household income has been declining for a decade. While the government tells us that jobs are once again growing, those jobs are predominantly part-time and low quality – not the kinds of jobs that allow workers to consume at past levels.

The Fed knows this yet they're powerless to change things. They've made money cheap but instead of investing in the future, our corporations are buying back their own stock and cutting employment. Instead of making loans to fuel growth, our major banks are speculating in the markets where they act as the casino operators. From the standpoint of the economy, the Fed is slowly making matters worse.

In my opinion, they've orchestrated this stock market rally to create confidence so people will start borrowing money to buy things. It hasn't worked. The stock market is now grotesquely overvalued and they're afraid that if they stop printing money, it will crash. Like the bond market, the stock market is an *artificial* market. Just like a socialist government manages its national economy, the Fed has created a socialist market where they hope artificial wealth will lead to higher consumption.

Gold

Apart from higher asset prices, most of which are temporary, the Fed hasn't succeeded but they are certain to maintain this policy. Janet Yellen has been designated to succeed Ben Bernanke as our next Fed Chair and she's a proponent of easy money. In short, she's a gold buyers dream.

Yet the price of gold is languishing near lows for the year as the yellow metal is brutally sold on our Western exchanges. Someone is breaking all of the rules of trading by dumping huge orders on the market in slow trading periods as if they're trying to drive the price lower. I was a professional trader for five years and I can tell you that nobody trades like this unless they have an objective to crush the market price.

But an interesting thing is happening. Gold is disappearing from western bullion banks and moving to the East and Middle East. Inventories on the Comex, the main US exchange for trading gold, have been more than cut in half since January which is a sure sign of scarcity. Under normal circumstances, the price of gold would be shooting through the roof.

I have a theory on why this is happening. I believe that our trading partners are very angry with our monetary policy and are threatening to stop using the US dollar in trade. The President alluded to this fear in a speech in late September. To keep them from moving away from using the dollar in trade, I believe we are selling them our gold at discount prices. We'll see if I'm right.

Regardless, I continue to believe that gold represents the single most attractive asset to own during a period of time when central banks around the world are printing money. Market manipulators have succeeded in the short run but ultimately, the price of gold is going to be among the best investments over the next ten years. From January 1975 to the end of 1976, the price of gold was cut in half. Anyone remember what happened next? It went from $100 per ounce to $800 per ounce. I believe today's opportunity in gold is even better.

The GeoVest Approach

Bond investors placed their faith in a Socialist Market and got badly burned. I believe that stock investors have a little more time before things get bad. We are experiencing the same bubble dynamics as 2000 and 2008 and the results will be just as bad, if not worse.

Markets are supposed to reflect the economy you have and not the economy that you want. Policymakers have lost sight of this and the result will be more future dislocation.

Our game plan is sound and we've gotten the fundamentals correct. When you have intervention in the markets, it's impossible to know with confidence how high they can go and how long they can endure. The only thing we know for certain is that the markets will ultimately reflect the underlying fundamentals, which is why we remain confident in our strategy. Thank you and it is our pleasure to serve you.

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