GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

Volume 16 Issue 4 October 2014

Monopoly

I started in this business in 1989 and in that time, I've experienced some whacky markets but the current one takes the cake in so many ways. Just like 2000 and 2008, the market will crash again because the valuations are simply unsustainable but unlike those two years where the underlying economics prompted the crash, the next crisis will come when the manipulators can no longer keep the market elevated in the face of weakening fundamentals.

It's entirely possible that we're in the early stages of the next crisis as half of the stocks in the Nasdaq are down more than 20% on the year and it's the same for the small capitalization stock index – the Russell 2000. This means that a lot of people are already losing a lot of money. But while fundamentals dictate a sharp drop in stocks, government efforts to manage the economy are dependent on maintaining a strong stock market. Despite their best efforts, the S&P 500 is only up 1.5% for the year as of 10/13/2014 on a price basis – dividends add slightly to this number.

The problem is the red line in the chart above – it's the 200 day moving average of prices and if the market stays below that level, it means an important indicator for technical analysis has been broken. It's entirely possible that a decisive failure at the 200 dma is enough to spook market participants such that selling overwhelms the tools that the manipulators have to maintain the upward move that we've enjoyed for five years. It's also possible that we rally off this key level as those in charge of manipulating the market throw everything they have into supporting it. We're willing to wait for now because we own very high quality stocks as well as some protection in the form of inverse funds.

Source: Zerohedge.com

Perhaps the factor that is most responsible for the recent weakness is the above chart that shows the relationship between the Federal Reserve's efforts to inject liquidity into the markets on a daily basis by buying US Treasury bonds and mortgage backed bonds in an operation knows as "quantitative easing". There are a large number of market participants who believe that "QE" is directly responsible for the

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market's upward move over the past five years but as most of you know, the Fed is planning to stop this daily buying later this month. There are many who believe that the market will "crash" as a result.

While this is possible, I don't favor this interpretation – at least not yet – because keeping the stock market elevated is critical to government efforts to spark an economic recovery. For this reason alone, I'm willing to wait.

Monopoly

I see a lot of news stories on how the wealthiest 1% in our country are benefiting at the expense of the rest of us. While it's certainly true that the wealthiest in our nation are benefiting from our government's policies to keep the markets elevated, I ascribe these benefits to being in the right place at the right time with the right asset base.

Think of it like the board game Monopoly where the winner usually has a few choice assets, like Boardwalk and Park Place, along with hotels and houses to force the unlucky to pay them rent. By the end of the game, the winners have usually accumulated all of the best assets on the board along with the most money which is not unlike our present environment.

But is it a conspiracy or something else? I vote for something else, namely the Federal Reserve Board. Think about it, since 2008, we've effectively given the Fed *carte blanche* to fix our ailing economy but the Fed is really nothing more than a bank for banks. The only thing it could do was drive down interest rates while injecting money into the banking system by buying as much of the "safe" assets as was practicable.

The Fed seems to be able to direct where money is parked in the markets but they've had no impact on the real economy, apart from a watered down wealth effect. While they've made it cheaper for the US government to borrow money, government's aren't particularly good investors – normally quite the opposite. Instead, the Fed has made it cheaper for the government to borrow money to make transfer payments to those without jobs in the form of unemployment, food stamps, and a myriad of other programs collectively known as the social safety net.

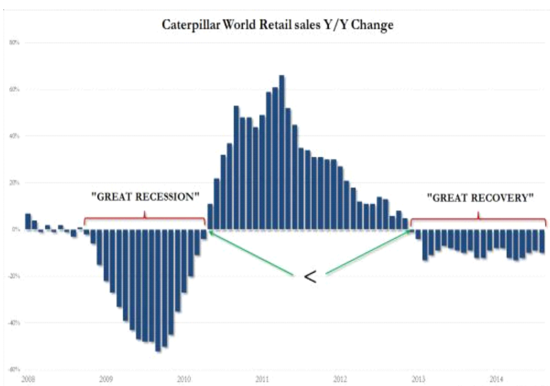
The result has been the equivalent of "economic life support" where we don't get a major contraction but we don't experience a real recovery either. The top 1% is getting the lion's share of the benefits but like the rest of us, they have few viable options for the money they're presently making and when the next crash comes, the top 1% is likely to experience the greatest losses such that their "good fortune" will likely prove temporary.

Bad Assets

The Fed has stripped our banking system of the highest quality assets – government bonds and mortgage-backed bonds and left us with some of the lowest quality debt in the history of our nation, in my estimation. Would anyone like to guess how corporate earnings seem to be rising? The answer is that earnings are rising on a "per share" basis because corporations have been buying back their shares while borrowing at cheap interest rates to fund these purchases.

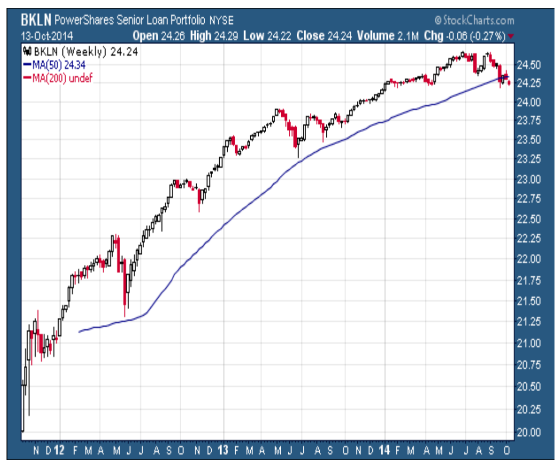
Let's say you really like Caterpillar, the earth moving equipment maker and you're willing to purchase their 10 year bond which yields around 3.5% because if offers a higher return than a Treasury bond. Know that the money you effectively lend to Caterpillar is going to buy back their stock to raise their reported earnings per share and not to invest in new businesses to generate future cash returns with which to pay you back with interest. In essence, they added risk to bond holders by benefiting stock holders.

But worse than that, Caterpillar has been experiencing a year-over-year sales decline every month for close to two years! This means that there is increasingly less revenue with which it can service their debt and for this risk, you're getting a paltry 3.5% rate of interest. And Caterpillar is likely to be one of the better performing corporate bonds in the future, because compared to many of the others, things are rosy.



By comparison to the $830 billion levered loan market, Caterpillar looks like a Treasury bond. Using the Powershares Senior Loan Portfolio ETF as a proxy, we've got securities that are yielding 4% in aggregate yet are below investment grade – in other words they're rated as junk bonds. These are the bonds of small companies, usually owned by private equity funds, where banks have increasingly lent money to the owners of the company so they could pay a cash dividend to themselves and where the bank has turned around and sold the bonds to bond funds who are desperate for yield. Not only is each bond highly illiquid, meaning they're hard to sell, because there are few firms that deal in such small debt issuances which subsequently means that very few credit analysts are looking at the company financials.

As an experienced financial analyst, I can say that I've rarely experienced such an utter disregard for the safety of a client's capital than in this asset class. If you own a bond fund that has levered loans in them, my personal belief is that you're likely destined to lose a lot of money in the future because in the next crisis, nobody will want to buy them.



The example of levered loans nicely encapsulates my vision of the way the results of the last five years will eventually play out. If you invested in levered loans in 2011, you've done very well as compared to low yielding Treasury bills but when the next crisis hits, you'll likely give all of your gains back along with a large amount of your initial investment. It's the nature of bubbles – the upside is great but the cost is ultimately a lot higher than you expected.

The Economy

Has anyone else noticed that the world has been a little more dangerous since a year ago? Today we have ISIS in Iraq and Syria, Russia fighting Ukraine, China threatening its neighbors, Ebola outbreak in West Africa, and dozens of minor military skirmishes around the globe. It seems that an increasing number of people are channeling their efforts into martial conflict and away from prospering through commerce, likely because the opportunities to advance through commerce are increasingly limited.

On the consumption side, companies like WalMart appear no longer able to grow revenues through selling to the average American. We tend to think of this as an isolated event but there's a massive supply channel that stretches around the globe that depends on growing demand from companies like WalMart. When WalMart sells less, resource suppliers from around the world sell less.

The Baltic Dry Index is a measure of how much it costs to move goods by ship. As you can see, the cost is falling which is normally a sign that global trade is weakening. Checks on traffic through the Suez and Panama canals reflect weakness in oceanic traffic. It seems that global commerce is stagnating.

Much of the weakness is coming from China where government leaders have decided that building more empty cities may not be a great idea. The Chinese claim that their economy is still growing at 7.5% a year but it's a ridiculous claim when so many indicators of growth are flat to negative. In particular, Chinese electricity usage is down 2.2% from a year ago while the price of iron ore is down 40% from a year ago and 57% from 2011. It's now clear that the Chinese miracle growth engine has stalled and it's having a large effect on the world.

China needs to export its manufactured goods to thrive and retail centers in Chicago, Madrid, and Tokyo are struggling to sell to customers. Putting all of the pieces together, the world economy is rapidly slowing.

The GeoVest Approach

We created a roadmap for the future in 2003 and used it to anticipate the 2008 crash and while the subsequent rally was unexpected, the roadmap continues to prove unfailingly accurate in regards to the global economy. With the global economy rapidly weakening, it's going to become increasingly difficult for the markets to remain elevated.

But intervention has proven beneficial in the short run so I have no reason to believe it won't be employed again which is why I've added this variable permanently to our roadmap. Going forward, I believe we can anticipate when this new policy tool will be used while maintaining a healthy understanding of its limitations.

If we are in the early stages of the next crisis, it's certainly a concern but let's not lose sight of the opportunity that crisis brings. Thank you and it's our continued pleasure to serve you.

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