GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

Good-Bye China

I was a young analyst when Japan's economy first started to falter. Throughout the 1980's, while I was in college, the big topic was the Japanese way of doing things. My professors would compare the Japanese success to America's lack of success and suggest that it was because the Japanese took a long-term view of things. What we subsequently learned was that "long-term" really meant a willingness to make economic bets at long odds and wait a generation to pay for the losses.

China is now at the point where Japan was in 1990 but with far more to lose. As you know, I've been negative on the Chinese economy for over ten years because I've studied their business practices and economic policies and concluded that they were not only unsustainable, they were downright destructive. We've reached the point where the China game is over.

Fallout

China and the emerging nations have been the main drivers of global economic growth over the past 20 years but they're no longer growing. China is no longer buying as much raw material from other emerging nations like Brazil, which means these commodity exporters have less money to buy China's manufactured products. A virtuous cycle has turned into a vicious cycle.

Commodity producers around the world are falling on hard times and some are having trouble servicing all of the debt they put on their balance sheets during the good times. In addition, some major emerging nations like Brazil are experiencing more than a little political unrest. Dilma Rousseff, Brazil's President, is facing impeachment charges as she's become the political scapegoat for Brazil's change in fortunes.

We can see from the chart below that economic confidence in these nations has been on the decline since 2013 - just as China's major investment boom ended. It's not a coincidence.

Over the past ten years, I've read volumes of analyses about the emerging markets and how they represent the future of the global economy - and they are all wrong! These economies grew because they sold raw materials to China and other developing economies - sales that were predicated on bad investments ranging from ghost cities to redundant industrial capacity. As such, there was never a chance that this growth would continue.

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Notice the chart for copper, which is one of our best indicators of global economic growth. The global economy has been rapidly decelerating since 2012 - exactly when we forecasted that it would.

While the fallout is hitting the emerging market economies the hardest, it is also hitting developed market economies like the US. Fortune 500 sales to the emerging markets have been an important source of growth and now it's reversing.

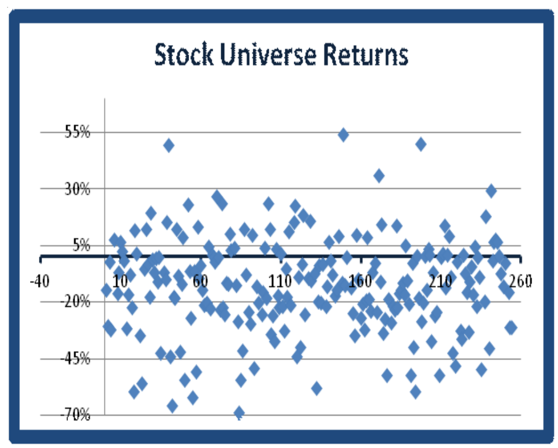
Under normal circumstances, we should have expected a weaker stock market from 2012 onwards. Instead, 2012 and 2013 were excellent years to be in stocks. It seems that central banks decided to get on the slippery slope of ***intervention*** in order to continue the rally.

Stock Market

Now, something is wrong. The market seems to have slowed its rate of ascent and even seems to be at risk of crashing. There is no shortage of market pundits predicting just that!

Normally, this is where you'd expect me to write something negative and while tempting, it looks to me like we may have just a little more upside in front of us. The reason is that intervention by the central banks changes everything. Now, it's not enough to anticipate the timing of when the economy turns negative - we already did that. Instead, we need to anticipate the point where central banks lose the ability to move markets higher. I don't believe it is going to happen when everyone expects it. Markets generally don't crash when people are prepared; they generally crash when people are unprepared. But even now, the typical stock in the market has already crashed. Most stocks are negative on the year even as the indexes have moved higher.

Below is a chart of the 260 stocks that we follow for inclusion in our portfolios. It indicates the returns for the first three quarters of 2015.

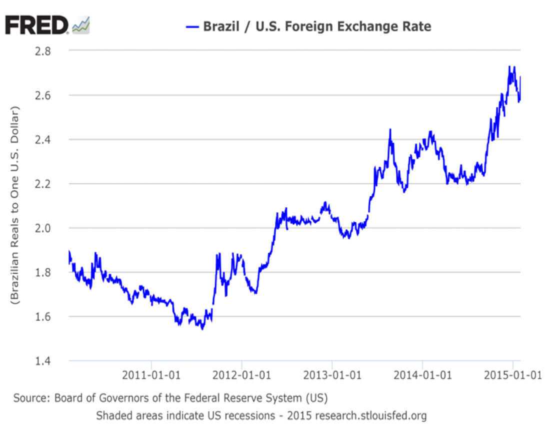


Fortunately, the stocks that made it into our portfolios have performed much better. Nevertheless, it's clear that the typical stock in the market is negative while the indexes are doing much better and this is why we have ***temporarily*** started using index proxies in lieu of some individual stocks. Doing so allows us to diversify portfolios without buying sectors that are being hurt by a weakening business cycle. In addition, the securities that we are using are generally more liquid than stocks, which is helpful for when we decide to cut and run!

Emerging Markets

I often use Brazil as a proxy because it's a big country that exports a broad array of products, making it a good representative for all emerging markets. As you can see from the chart of the Bovespa, Brazil's stock market has been a bad investment for the past few years, but it gets worse.

From January 1, 2013 to the present, you would have lost 20% of your money in the Brazilian stock market but add in the 30% loss on holding a Brazilian Real denominated investment and now you're looking at having your investment cut in half.



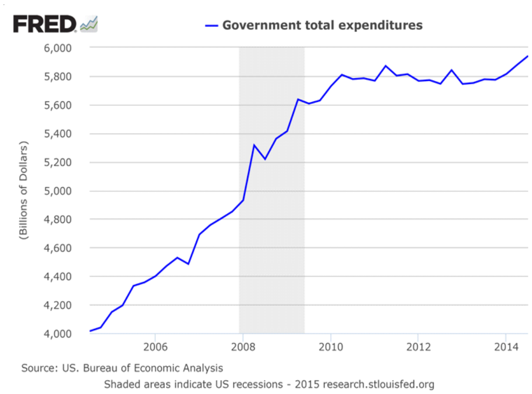
The way to read the currency chart is that it now takes 2.6 Brazilian Reals to convert to one US dollar, up from 2 Brazilian Reals in 2013. I'm afraid that both markets have a lot further to fall which is why I've been telling people to avoid the emerging markets for the past few years.

US Economy

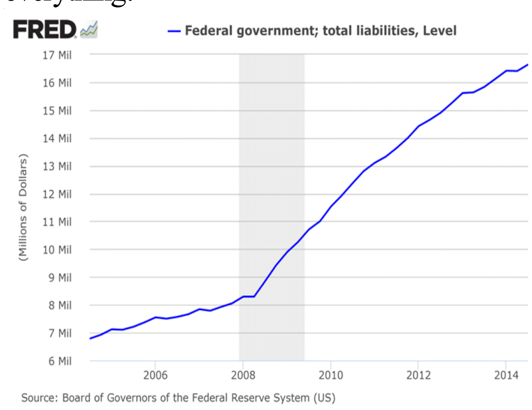
Our economy has changed dramatically over the past fifteen years. Where it was once dominated by private enterprise, it's now dominated by government spending. This has changed the nature of the business cycle and has brought us much closer to the European brand of socialism than many realize.

The US produces cars through GM, lends money to college student, and dominates the health care system in the US through Medicare and Medicaid. Roughly 50% of the population relies on the government for some part of their income and 15% relies on the government for food stamps.

We can see this from the chart below of government expenditures.



And this is how the government pays for everything!



The government dominates our economy and to that end, as long as they can keep borrowing and spending, we'll escape the worst of the oncoming global recession. Yes, our domestic economy appears to be weakening but with the government increasingly acting as the driver of economic activity, it's very likely that our economic experience over the next year will be dramatically better than what the rest of the world experiences.

Bond Market

Until 2014, it was very difficult to lose money in the bond market but since then, losses have started to pile up in high yield bonds, better known as junk bonds, as well as emerging market bonds. This isn't surprising given that the default rate on low quality bonds has jumped from 1.4% last year to 2.5% presently.

We expect things to get much worse in this space as the global economy continues to weaken. In particular, low quality bonds tied to resource companies like oil and copper are among the hardest hit but we expect the contagion to spread before much longer.

The broader indexes are only down around 5% from highs experienced earlier in the year but there are a number of high yield bond funds that are in liquidation-mode due to terrible performance and rising redemptions. Losses in these funds could prove much larger.

However, if we compare the above chart to a chart of US Treasury bonds, we see a different story. Treasury bonds have made money in that time as the market starts to value quality more highly.

When we look forward over the next year, we see the potential for negative interest rates if the Federal Reserve attempts to counter the growing weakness in the global economy. Under this scenario, there is potentially an opportunity to generate strong returns in long dated Treasury securities. It's something we are seriously considering.

Regardless of the interest rate environment, high yield bonds make little sense for the typical investor. The risk/reward trade-off is still unfavorable despite recent losses.

The GeoVest Approach

By jumping on the slippery slope of intervention, the global central banks have completely changed the rules that have guided informed investors for decades. Nevertheless, that doesn't mean that we have to manage blindly.

The key is to study what the central banks are doing and developing theories as to why they're doing these things. The rest is just simple extrapolation and testing. We believe that the work we've done over the past few years gives us an advantage in this area.

Thank you. It is our continuing pleasure to serve you.

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