GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

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Turn, Turn, Turn

In 1965, the Byrds, a folk-rock band, released a song with lyrics from the Old Testament of the bible. It was a mega hit because the words made sense of a chaotic time. "*To everything, there is a season*".

The world has gotten chaotic, to put it mildly. People seem to be getting a bit crazy. Politicians lack answers and in many ways, seem to be part of the problem. Yet, the more I consider things, the more normal the abnormal appears.

The very heart of a cycle is change and people dislike change. People prefer stability and linear trends; they dislike the unknown. This is why, I believe, that intervention in the stock market is tolerated – it gives people what they want.

Nevertheless, there is a price to be paid for everything and today that price is an overvalued stock market that is virtually guaranteed to produce a loss for investors at some point in the future. However, the evidence of our *"Great Game Thesis"* continues to pile up, suggesting that the market will stay elevated a little longer.

The Great Game

As we discussed in our last newsletter, the elevated stock market is part of the "*Great Game"* which I believe is being played for control of the global reserve currency. Today, the dollar is used to conduct trade in global markets but China and Russia want to break the dollar's monopoly on world trade as doing so will weaken the US immeasurably.

The game has been heating up of late with more action in Syria, the South China Sea, and increasing verbal threats from both sides, thus the need for more stability on the home front. We even have evidence of social unrest in the US, but the stock market is telling us that all is well.

Economy

The economy appears to be in the midst of a downturn. S&P500 earnings have fallen 18% from cyclical highs and are now roughly at the same level as December 2005. Meanwhile, the growth rate of real retail sales has fallen to near zero and well below historical norms.

As I've been writing for years, the private sector of our economy seems to have peaked in 2006 with all subsequent growth a function of extraordinary federal government spending. Below, you can see how federal government liabilities ballooned from $8 trillion to $18 trillion. The national debt stands at $19.5 trillion. In effect, we've been living off our national credit card and not growing our economy.

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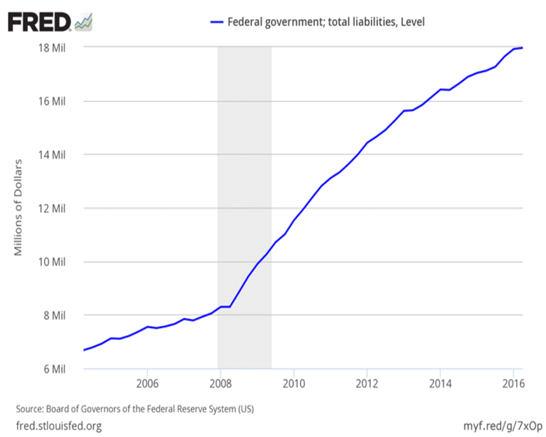
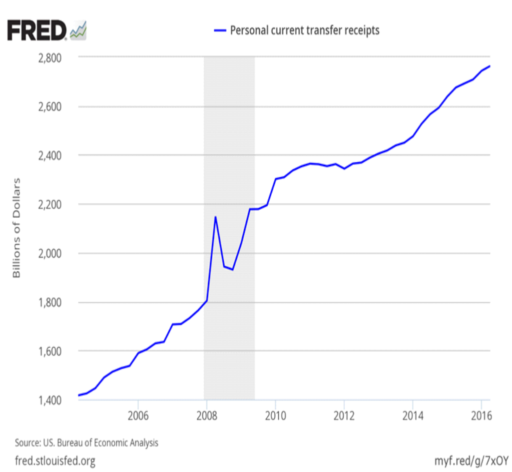
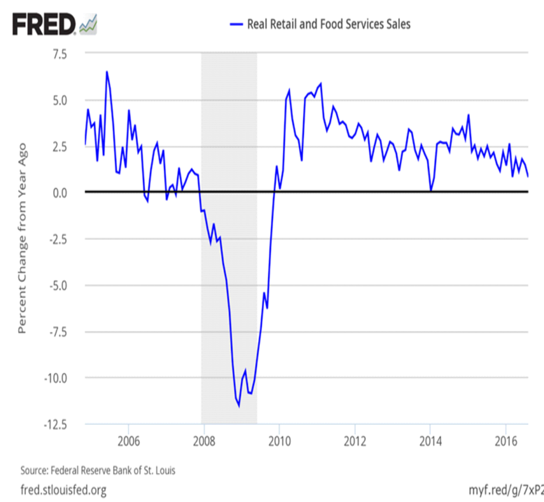


Much of the increase in government spending has been in the form of transfer payments, which include Social Security, Welfare, Medicare/Medicaid among others. You can readily see how government spending supports retail spending and health care. Nevertheless, despite this extraordinary spending by our government, the economy continues to weaken.

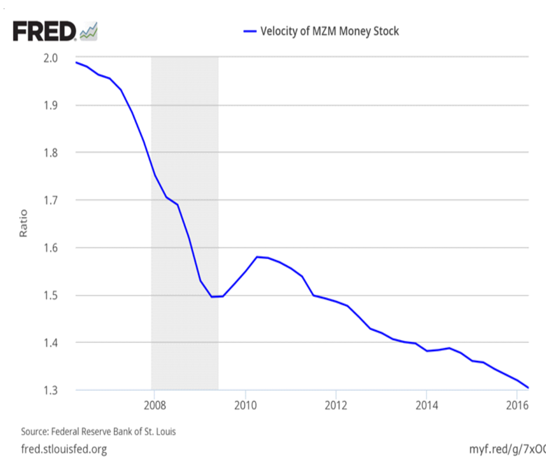
We are the only nation that can grow its debt seemingly without limit thanks to the US dollars position as reserve currency for foreign trade – foreigners have to buy our dollars (and thus our debt) to purchase necessities like oil and food. This is why the *"Great Game"* is so critically important and why our enemies want to negate this advantage.



Much of those transfer payments went to support retail spending, yet growth is negligible. This suggests that the private sector is acting as a drain on our economy.



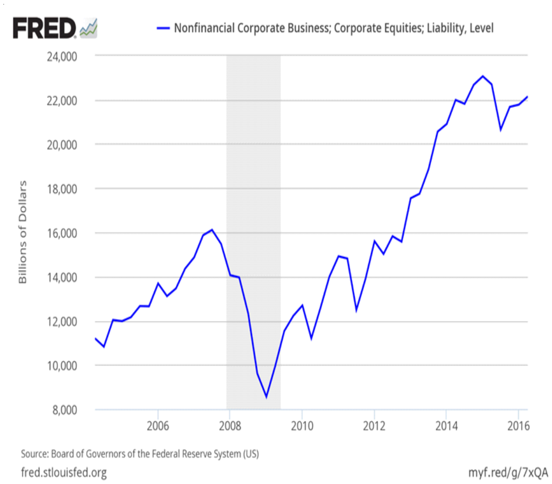
The Federal Reserve continues to flood our economy with new money but it's no longer working. The velocity of money shows the number of times one unit of money is traded during a given time period. In other words, the Fed keeps creating new money but that new money isn't being used in the real economy but it does appear to have propped up the asset markets in the US.



Stocks

Hopefully, you can see why it's critically important to keep the stock market elevated. The economy is weak but it would weaken much more rapidly if the stock market were to decline in value as it would force people to reduce their consumption of goods and services even more.

But it's not enough to depend on the intervention efforts of our national government; we still have to invest to take advantage of the underlying economic cycle. This is why we have favored either government suppliers or companies that produce necessities that aren't impacted by the economic cycle. But there is another reason…



In order to produce those "record" earnings, which were really just earnings per share, not total earnings, US corporations effectively substituted debt for equity on their balance sheet. They borrowed money to buyback shares in their companies. A simple way to think about it is that debt is risky while equity reduces risk because debt involves a fixed obligation – interest and principal has to be paid back to the lender where equity does not.

US corporate earnings are back to the same level as 2006 on a per share basis yet those companies are much riskier than ten years ago. Do we want to invest in riskier companies that are much more highly valued than ten years ago amidst a weak economic climate? No way!

We can accept the necessity of taking advantage of a temporary floor under stocks but adding to risk in this environment would be imprudent.

Stock Selection

Shares of stock are nothing more than a portion of ownership in a business. Once upon a time, analysts took great care to know the business before recommending purchase of a company's shares. Nowadays, a robot can execute a program trade to buy/sell in less than a second. Is that progress? Or something else?

My personal opinion is that it's a form of parasitic behavior as its sole purpose is to take advantage of real investors. I believe it's tolerated because it allows authorities to intervene in the markets for political purposes. Regardless of the morality, it's presently accepted in the marketplace and thus, implicitly part of any investment decision.

Computers can make split second decisions but they can't think ahead of the curve; they can only act on what's presently known in the market. Computers lack perspective.

Perspective is critical in this environment and I consider the GeoVest perspective to be a strong competitive advantage at the moment. Where computers run off mathematical relationships between variables, we incorporate cyclical analysis with sound economic analysis. *To everything there is a season*.

If you refer back to the economic charts on pages 2 and 3, it should be clear that government spending is critical for our economy. It's also clear that consumer spending is not growing in a meaningful way. This is why we are invested heavily in government service providers, consumer staples providers, and electric utilities. They're the right kinds of companies for the season our economy is in.

In a weak economy, we'd rather own companies that administer Medicaid, or protect government computers against cyber attack than owning a steel producer. At least we are confident that the government suppliers will be able to keep growing through the current malaise.

But there is another reason why we favor companies where we have a high degree of confidence that they'll continue to grow in a weak economic environment - interest rates. We continue to believe that interest rates have more room to fall. Companies with steady to growing earnings are worth more as interest rates fall.

Yes, the Federal Reserve keeps hinting that they are considering raising interest rates at their next meeting. They've been saying the same thing for 18 months and only raised interest rates once. We believe their words are simply part of the *"Great Game"* and not indicative of their future plans. This has been the correct perspective for most of the year.

The GeoVest Approach

It appears that we're in the beginning stages of some major changes in the global economy and perhaps the markets. People are either, blaming others, defending their records, stirring up trouble, or expressing consternation over the uncertainty. I expect that the most profitable course will be to calmly analyze the environment and plan for the opportunity that change brings. No amount of hand wringing will hold back the future.

For now, we like the securities in our client portfolios and when the future arrives, we expect to change along with it never forgetting that there is a way to profit through every season. Thank you for investing with GeoVest Advisors. It is our continued pleasure to serve you.

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