GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

Everything Has Changed

Three months ago when I wrote the January newsletter, the stock market was moving unstoppably higher as everyone talked incessantly about higher interest rates and a growing global economy. I called it a "melt up" rally which often presages a decline in stocks. At the time, Amazon, Netflix, and Facebook were the darlings of the market and the volatility index (VIX) which measures market risk was telling us to expect clear sailing.

I warned that people and funds "selling volatility" were the reason for the market's strength but also that the strategy was "extremely risky". Since February, the folks following this strategy have lost a ***LOT*** of money. Some funds have gone out of business. As of this writing, the S&P500 is down around 10% from its January highs and presently in negative territory for the year. What changed?

The biggest change has been in the volatility index. Not only is it a measure of risk expectations, it also acts as an important input into portfolio management models. When the VIX was trading at 10 last year, it was signaling to portfolio managers to add risk to their portfolios, preferably in the form of borrowing money to buy stocks.

When the VIX started to rise in late January, it signaled to portfolio managers to reduce risk by selling their levered stock positions. It's why the move was sudden and somewhat violent. So why did the VIX start to rise in January?

There are two primary reasons I ascribe to explain this move – rising credit risk and the threat of a trade war. I believe the rise in credit risk is the bigger of the two reasons.

LIBOR

The chart below shows LIBOR – or the London Interbank Offered Rate (red) and the Federal Reserve's overnight rate on funds deposited at one of their regional banks (blue). LIBOR is the index that most floating/variable rate debt is priced off since it's the rate at which banks will lend excess reserves to each other. As such, it has a credit risk component where the Fed funds rate does not since there is no reasonable chance that the Federal Reserve defaults on its liabilities.

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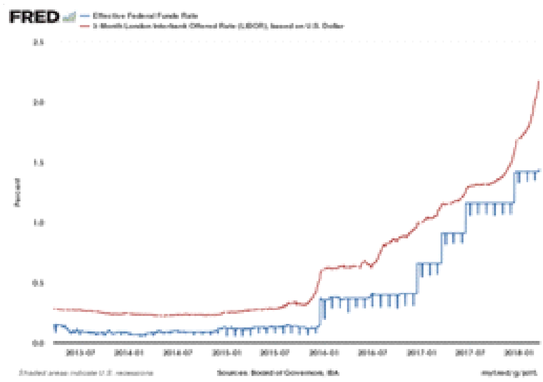


The narrative espoused by the Fed is that they're attempting to prevent inflation from being reignited. I don't buy that explanation. Instead, I believe they're trying to hide the growing credit risk emanating out of Europe.

LIBOR started to rise around January of 2015 – the same time that the European Central Bank was setting their own overnight rate at negative levels – forcing depositors to pay banks to hold their money. You only go to such extremes if you believe your banking system is insolvent. It seems that three years of negative interest rates in Europe hasn't fixed the problem.

The sharp rise in LIBOR in January is telling us that Europe's banking system is actually getting worse. The timing of this latest rise in LIBOR matches the sharp rise in volatility/ risk as measured by the volatility index.

Trade War

One of Donald Trump's campaign promises was to re-balance trade with China. If you've been reading this missive for the past fifteen years, you'll know that I've referred to China as a ***mercantilist*** which is a country that lowers the value of their own currency in order to develop an advantageous trade imbalance with another country. For the past 30 years, China has been siphoning off our major industries, seemingly with the blessing of our government.

The ugly truth is that we've never had free trade with China or Japan. We've opened our markets to them while not insisting on reciprocity. The result is a hollowed out US economy that is dependent on government spending. Factories across the Midwest and southern states are a testament to our former short-sighted trade policies.

To make good on his campaign promise, the President is threatening a 25% to 30% tariff, or tax, on a number of products exported by China to the US. It's going to hurt US consumers but I expect it to devastate China because China's banking system appears to be even worse than Europe's.

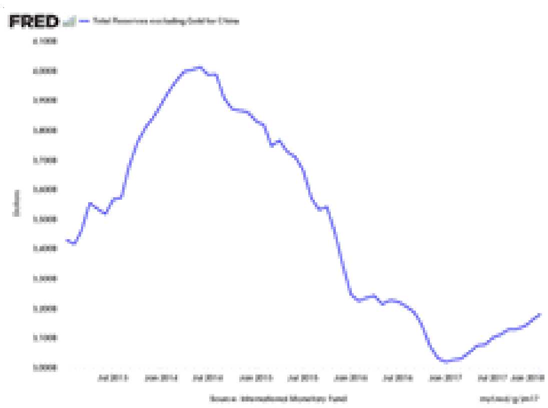
China

China's great rise from third world country to major industrial power in a short time was made possible because Chinese bankers were willing to make all kinds of loans that would have been unacceptable for bankers in the West. I've been outlining these abuses for years – empty cities, roads that go nowhere, and extraordinary excess capacity in basic industries such as steel, cement, and aluminum. Lending for home ownership in China makes our subprime lending standards look gold plated.

China knows it has a big problem, one which will require a leader with enormous power. It's why they reversed a law that limited their leaders to two terms – 10 years – in order to make Xi Jinping the de facto Emperor for life. Xi now has power equivalent to what Mao Tse Tung once had.

Furthermore, China is attempting to break America's domination of the global oil trade by creating an exchange that trades oil in yuan, not dollars. If the Chinese are successful in trading oil in yuan, their fragile financial system will accrue tremendous power. This is a very serious attack on US hegemony in financial markets, one which ultimately threatens our ability to sell our debt at advantageously low rates of interest. They are being supported by Russia and Iran. It's an act of economic war.

If the tariffs are successful in reducing China's exports to the US, we can logically assume that China's foreign exchange reserves will start to decline once again. China is able to accumulate these reserves, mostly held in US dollars, from global trade, particularly with the US. This is why they're forced to buy our Treasury bonds. Think of it as the mechanism that allows China to keep its currency artificially low versus the dollar.



This is significant because a decline in their reserves will make it difficult for China to convince global central banks to hold yuan instead of dollars. Central banks hold reserves of dollars and European euros so they can buy necessary commodities such as oil, gas, and food in global markets. As long as China holds a large amount of dollars in their reserve account, it tells the world that the Chinese have enough money to meet their international financial obligations.

By making the yuan appear riskier to other central banks and investors, the hope is to prevent China from ultimately dominating trading for oil and agricultural commodities in the future. The hope is to make global central banks unwilling to hold Chinese yuan debt due to risk.

This is a long winded but necessary explanation of why the tariffs may prove beneficial to the US in the long run.

Stock Market

I'm not as nervous about the stock market as others. While risks have certainly increased, so too has the necessity to keep the market elevated.

For the US to succeed in changing the trade imbalance with China and to prevent China from making further headway into unseating the US dollar as the world's dominant currency, the stock market has to remain elevated. This is because it reflects confidence in the US economy and a big part of maintaining that confidence lies in maintaining the value of stocks.

Twenty years ago, this would have been nearly impossible but today's market is dominated by trading computers. The result is a far less liquid cash market – the market where shares of stock are traded – with much of the trading taking place in the options and futures markets.

Instead of selling all of his/her firm's shares of a stock, driving the price down in the process, a portfolio manager may choose to hedge his/her position in the options market – sort of like buying insurance on the value of the stock position instead of selling it. The reason the manager chooses this transaction is that buying and selling stock in the cash market is expensive and time consuming. The options market is cheaper and easier.

We've learned over the past ten years that it is relatively easy to manipulate stock prices through the options market. A few positive comments from someone in the White House or from the Federal Reserve and the trading computers drive the markets instantly higher.

This doesn't mean that we are oblivious to the present risk – far from it. Instead, we believe that our stock selections in mostly domestically oriented companies continue to have the potential to make gains for our clients.

Interest Rates

I believe the Federal Reserve is going to need to reverse course and slash interest rates before much longer to prevent negative economic and financial fallout from rising credit risk and trade wars. A further sharp drop in junk bond prices, shown below, could be the catalyst for forcing the Fed to act.

Lower interest rates, combined with a tumultuous economic environment could be a great environment for stable growth companies such as electric utilities, food producers, government suppliers, and defense companies. The best performer is likely to be the 10 year US Treasury bond, which historically has beaten all other asset classes in this kind of environment because it represents the ultimate flight to safety combined with present high yields.

The GeoVest Approach

The easy money seems to have already been made in the global capital markets. It appears that making money going forward is going to take a little more effort; real investing is never easy. Too many investors base their strategies on approaches that worked in the past. This is going to be a problem for some as the past ten years have been a true aberration in the study of markets and economics. Everything has changed.

We're still going to need to understand the motivations and the means of market manipulation because geopolitical necessities dictate an expansion of these policies. It's why I believe that certain industries still offer value in the stock market, even if the broader indexes are constrained by growing risks.

We will continue to watch these changing developments and act appropriately. Thank you for investing with GeoVest Advisors. It is our continued pleasure to serve you.

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