GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

On Course

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Just Waiting

The stock market has eked out a small gain for the first six months of the year. Apart from a few massively overvalued technology stocks, the majority of stocks in the market are roughly flat to lower at the midpoint of the year. It's as if most investors are waiting for something to happen.

Trade War

The biggest thing happening right now is the burgeoning trade war between the US and China. This has been a long time coming because China's trade restrictions have bordered on criminal for over 20 years. Why our nation agreed to them in the first place is beyond me.

In effect, we gave them our manufacturing base, our most advanced technologies, and a significant amount of intellectual property worth trillions of dollars. We elevated them to nearly our level and now they want to replace the US as the preeminent financial, economic and military power.

Fortunately, China is vulnerable. In order to grow as rapidly as they did, China had to rely heavily on their banking system and in doing so, they've saddled domestic banks with bad debt the likes of which is incomprehensible in the US.

A trade war with the US has the potential to put so much stress on the Chinese economy that the banking system implodes under the weight of all of those bad loans. Unfortunately, the bad news is that hurting the Chinese economy will result in hurting the global economy.

Interest Rates

JP Morgan, possibly the greatest banker in US history, once said that "a man has two reasons for doing a thing; one that sounds good and the real reason." The Federal Reserve has stated that they've been raising rates to "normal" levels to head off inflationary pressures but I believe the real reason is to crush China's efforts to replace the US dollar as global reserve currency.

Up until a few months ago, oil was traded exclusively in dollars but now, you can buy oil on a Chinese commodity exchange for yuan and have that oil shipped anywhere in the world. This means that global central banks can hold Chinese government bonds instead of US government bonds to ensure they have the necessary currency for purchasing oil in world markets.

This may not seem like a big deal but it is. The sole reason why the US government can borrow and spend as much as it does is because the rest of the world finances our

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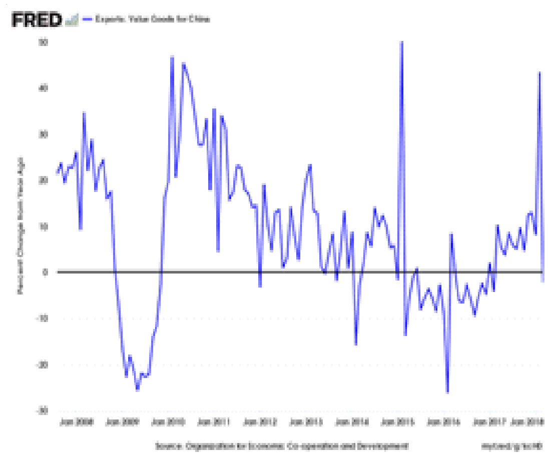
budget deficits because they need dollars to trade in global markets. It's the reason why we can spend more on our military than all of the other countries on Earth combined.

But here again, China is vulnerable. They've pegged the yuan to the US dollar so that it rises and falls with the buck. In order to make this work, the Chinese central bank has to essentially match the moves by the US Federal Reserve when the Fed changes interest rate policy. Otherwise, the yuan would rise and fall versus the dollar.

By raising interest rates, the US is effectively raising interest rates for the Chinese economy at a time when China's banking system is vulnerable to bad loans. Rising interest rates is making the US dollar rise in value but it also forces the Chinese to elevate the yuan in value – and they can't!

China is dependent on exports by virtue of amassing such an expensive manufacturing base. If they allow the yuan to rise, the rest of the world won't be able to afford their manufactured products. We can already see that China is having a difficult time growing exports.



You can see from the above chart that the dollar that the dollar has risen around 6% from its lows in February of this year. Over the same time period, the Chinese yuan has fallen 6% versus the dollar. With a currency peg, that's not supposed to happen.

What it's telling us is that China's economy is presently too fragile to handle a corresponding rise in interest rates such as the rate increase we're experiencing in the US. This is a signal to global central bankers to keep their currency reserve accounts invested safely in US Treasury bonds and not Chinese government bonds.

Emerging Markets

The result of the growing weakness in China and the Fed's rate tightening policy is that emerging markets are getting hammered. Below is a chart of a fund that invests in global emerging market stocks. It's not having a very good year.

Emerging market bond funds are joining in the rough times.

It could get much worse from here depending on whether the Fed keeps raising interest rates and whether the trade war with China becomes an ugly affair.

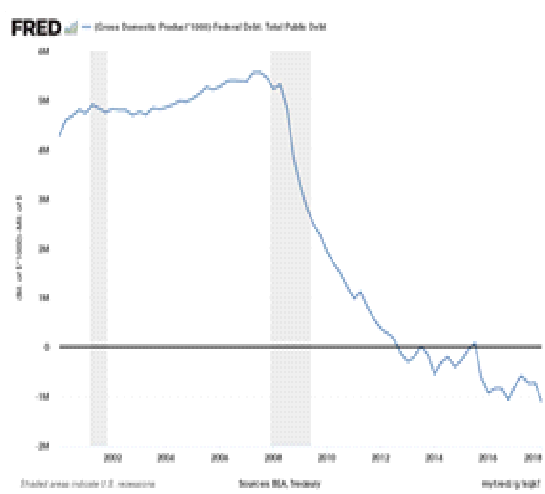
The chart below shows South Korean export growth compared to global earnings per share. Since South Korea trades heavily with China, South Korean exports have become a very reliable indicator for the global economy. Things don't look good at the moment.

Given the Fed's rate tightening cycle, the Chinese don't have much they can do in their domestic economy to reverse this slump unless they want to risk letting the Chinese yuan fall against the US dollar in currency markets. Doing so would unleash a wave of inflation in China because imported goods would cost more yuan and historically, inflation has led to uprisings in the Middle Kingdom.

US Economy

Ultimately, these higher interest rates will hurt the US economy and that's why we continue to buy long term bonds in our portfolios. When things weaken, the Fed will need to cut interest rates once again while bond money will flow to the safety of US Treasury bonds. But that said, I don't expect a sharp deceleration in our domestic economy for one very simple reason – government spending continues to dominate our economy. The global economy, as mentioned previously, is another matter entirely…

I've included the chart below in previous newsletters but it warrants an additional look. Since the financial crisis of 2008, the US government has borrowed and spent such that it has provided a stable base for the economy.



This chart measures our federal debt minus GDP or gross domestic product. Since 2008, the amount of federal government debt has more than doubled to roughly $22 trillion. From the standpoint of the economy, it's been an enormous cushion. And it's increasing rapidly again thanks to the recent tax law changes that slash corporate tax rates.

For now, the good news is that it has put a floor under the stock market because corporations can use their tax savings to fund stock buybacks. It also leaves our economy a little less vulnerable to the negative aspects of the trade war, higher interest rates and weakening global economy.

This puts the US in a very good position to vie with China and Russia in this quasi economic war. As stated above, China lacks the ability to stimulate their economy without driving the yuan lower in currency markets.

Stock Market

As I wrote earlier, the majority of stocks are simply meandering around break-even for the year. The majority of the gains have come from some drastically overvalued technology companies such as Amazon and Netflix.

I love the convenience of Amazon but Jeff Bezos would need to control just about all retail in the US to justify a value of $851 billion. For a company that isn't terribly profitable yet has a lot of debt outstanding and very little free cash flow, the valuation is beyond absurd.

Given their lack of free cash flow and their dependence on heavy capital investment for growth, the company is highly dependent on the junk bond market for future financing (and success!). Those aren't the dynamics that warrant such an absurd valuation but we don't live in normal times.

Amazon and Netflix are benefiting from being among the few supposed growth stocks in our no-growth world. Much like the market leading up to the year 2000, investors have lost their sense of perspective when evaluating these companies. The result is a level of absurdity that goes well beyond the Y2K technology market.

In short, the risk/reward trade-off from owning these stocks makes little sense for disciplined investors. Yet, these stocks could easily double from here or just as easily be cut by 70% in market capitalization. The last 20 years have taught us that things can remain crazy for a very long time.

The GeoVest Approach

I don't believe these highly manipulated markets will fall in the next three months; they're too critical to our national economy and to our ability to maintain global financial hegemony. But the present level of control won't last forever and is subject to instant change based on new developments.

This is why we continue to favor a more defensive approach in companies that provide strong dividend coverage. When the global economy weakens further, these companies should continue to thrive.

Thank you for investing with GeoVest Advisors. It is our continued pleasure to serve you.

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