



On Course

GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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Beltway Blues

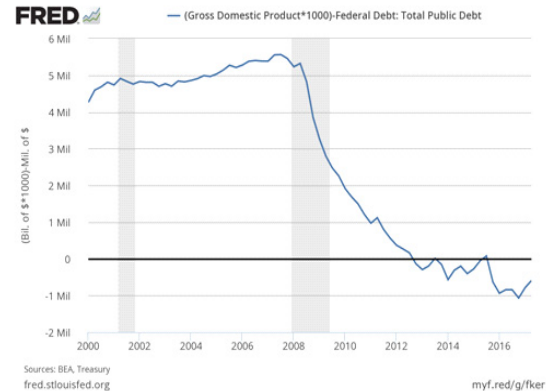
We're having another good year in the stock market. The S&P500 is up 12.5% year to date while our accounts are somewhere in that neighborhood. You can see from the chart below that's been a veritable straight shot up since the depths of early 2016.



With the continuation of these strong returns, you'd think that everything is going gangbusters in our economy but that isn't the case as we're still in the throes of what is best described as stagnation. There are still winners and losers, of course, so we're concentrating on finding the winners even as we continue to develop a clear understanding of what's really happening in our economy.

Government

A good way to describe our economy is that the private sector continues to weaken while the US government continues to become a bigger portion of our economy. I've been writing about this for years in this newsletter so this is nothing new but the chart below gives us a startling look at how pervasive it has become.



The chart is a bit unclear but it reflects Gross Domestic Product (GDP) minus federal government debt. From the chart, it is clear that since 2008, government spending is increasingly replacing the private sector in our economy.

There are some people who are happy with this development and some who are very unhappy. For me, this is the best way to describe the origins of the social divide that presently plagues our great nation. Of course, the media portrays the divide quite differently because doing so has become a major profit center for many in this country.

Our investment process is all about understanding the major drivers in our economy and taking advantage of the beneficiaries of these trends. As such, we have migrated towards companies that benefit from government spending. Healthcare, defense, and companies that administer social programs are well represented in our portfolios today and

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thankfully so because the majority have done quite well for our clients.

These investments meet our needs for today but I hesitate to characterize them as long term investments – the type we plan to hold for ten years. The reason is that there is a limit to how involved the government can be in the economy.

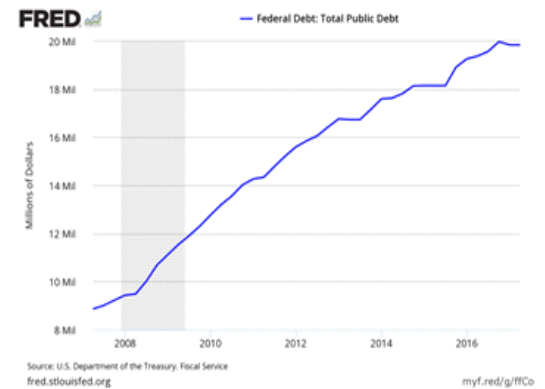
History is replete with examples of nations that went economically astray by too much government involvement in the economy. Venezuela is the latest example of a socialist dream that has turned into a nightmare for its inhabitants.

The good news is that we're taking advantage of the realities of our economy today. The reason we are confident for the long term is that we are currently aware of both the present opportunities this engenders as well as the long term threats that may one day evolve from the present make up of our economy.

Federal Reserve

We've done a good job of understanding the complexities of our economy and the environment in which it operates but sometimes the simplest of things escapes us. The Federal Reserve's effort to "normalize" interest rates is one of those examples of missing the obvious.

As our economy has become more dependent on the US government, it has become less interest rate sensitive. This is a huge point, yet I'm not aware of anyone else who has figured this out.



Unlike a company, the US government has seemingly unlimited borrowing power. When considering the chart above, realize that the private sector of our economy – the part that supports the government's ability to borrow – really hasn't grown since 2008 apart from government spending. Over this time, we've more than doubled the amount of federal debt without any growth in our ability to service that debt, yet we continue to borrow.

The reality is that the US government will continue to borrow and spend regardless of the level of interest rates. Since we know that government borrowing and spending continues to become a bigger part of our economy then logically, our economy is becoming less interest rate sensitive. In our opinion, this is why the Fed can raise short term interest rates without harming the economy in a noticeable way. It's so simple yet so obvious once you put the pieces together.

Besides, it's not as if the private sector has been using these low interest rates to borrow and spend on capital investments. The only areas of growth were in auto lending and student loans, two areas that are already showing signs of topping out.

We've paid a very heavy price for stagnation - \$12 trillion to be exact. The chart below

reflects the number of full-time jobs over the past 10 years. From the peak in 2008 to August of this year, we've added 2 million full-time jobs, or a mere 3% increase as compared to the peak in 2008. That's not enough for a population that is growing just under 1% per year.



Immigration is generally a good thing for a melting pot nation such as the United States but pushing immigration in a stagnant economy where capital investment is on the decline is not a good thing because it takes capital investment to create new jobs. The only thing it does is to push down wages for the lower end of our economy because there is more competition for those jobs.

So now we understand why the Fed can get away with raising interest rates but that doesn't answer the question of why the Fed is raising interest rates. The answer is that it's all about perception. The Fed wants us to think that our economy is strong. And since the Fed would only raise interest rates if the economy is strong, logically it must be. Vladimir Lenin once said that "a lie told often enough becomes the truth".

Stock Market

In my opinion, the stock market is critical to managing the perception that our economy is strong. It's the reason why I believe the stock market keeps going higher with only small, shallow pull backs.

Looking at the chart below, notice how the depth of pullbacks has gotten increasingly smaller each year, particularly since 2012 where pullbacks have become largely imperceptible on a long term chart. This is no coincidence, nor is it sustainable forever.



It's a good thing for now but US companies won't be able to deliver the earnings and cash flow in the future to sustain these levels indefinitely. There are two primary reasons. The first is what I've written many times before – US companies have not been reinvesting in America. Instead, they've been buying back stock or paying dividends with any and all cash flow they generate. This is great for the stock market but not for the economy.

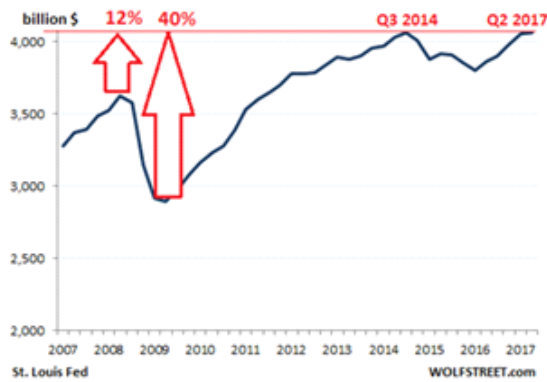
The second reason is that US companies have added a lot of debt to their capital structures. Since 2008, they've added 35% more debt, making them much riskier in the future, while only growing revenues by 12%.

Debt, Nonfinancial Companies Bonds, C&I Loans, Commercial Paper





Total Business Sales in the US, Quarterly



Over nine years, total business sales have grown a mere 12%, or 1.3% per year, which is lower than the current inflation rate of 1.9%. Business sales aren't even keeping up with inflation! Without growth, why should we expect these companies to be able to pay back their debt?

This is why we're sticking with companies that we believe can grow sales in this weird economic environment because it will take growth to keep shareholders and debtholders happy. Since we don't believe the economy is growing outside of government involvement, we've focused heavily on government suppliers. So far, it's been a simple yet effective strategy.

A second reason why revenue growth is important is that too many companies are relying on cost cutting to report earnings growth. Cost cutting is a smart move when your operating expenses are bloated such that your operations are uncompetitive but cost cutting is like losing weight.

When you're 20 pounds overweight, losing 15 to 25 pounds is healthy but lose 50 pounds and you become unhealthy. It's the same with companies when they keep cutting costs to make earnings expectations and fail to reinvest in themselves. They lose the

dynamism and muscle that made them competitors in the first place.

On a different note, we are also trying to use stocks instead of exchange traded funds or ETF's to the greatest extent possible. ETF's are a useful tool but at some point, things are going to get challenging and when they do, I suspect that owners of ETF's are going to learn that they're not as liquid as the underlying stocks they represent – at least not in a downturn.

In addition, ETF's represent indexes, not particular companies. We're picky when it comes to the companies that we want to own for clients, which is why we try to avoid indexes as much as possible and only use them for specific applications.

The GeoVest Approach

We're enjoying these strong markets even as we watch for signs of stress. It may not be wise to look a gift horse in the mouth but it's less wise to depend on that horse for a thousand mile journey.

We remain an "investment" firm more than an "asset management" company. We invest in individual companies and other economic entities for a specific reason based on our own analyses and expectations for the future. We're not relying on flawed academic studies regarding diversification, Wall Street research, or wishful thinking.

It's why we're different. Thank you and it's our continued pleasure to serve you.

Philip M. Byrne, CFA
Chief Investment Officer