GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

The US Remains Strong

What a difference two weeks can make? We went from new highs in the stock market to only being up a small amount for the year.

There are reasons to be concerned and while some people are starting to panic, I don't believe the time is quite right to call the end of this great bull market. Yes, the Federal Reserve is raising interest rates which is a negative factor for financial assets but the impact of stock buybacks by listed corporations is still strong.

The Tax Cuts and Jobs Act of 2017 lowered corporate tax rates such that much of the tax savings have been put into stock buybacks. Corporate stock buybacks in the first half of 2018 have risen to a record $384 billion versus $259 billion in the first half of 2017. These buybacks keep a bid under the US stock market.

The positive economic aspects of this new law have effectively blunted the negative economic aspects of the Federal Reserve's interest rate increases on the US economy. But this tax law makes things much worse outside the US because it allows US corporations to repatriate their foreign holdings of dollars back into the US at much lower tax rates. This has left a void of money that can be used by the global banking system to stimulate economic growth.

Eurodollars

Eurodollars are US dollar deposits in banks outside the US. They're not subject to US banking rules but the Federal Reserve does set the price, or interest rate, for these deposits by their US interest rate policies. Because the US dollar is the currency that 65% of global trade transactions are denominated in, global financial entities rely heavily on the dollar for foreign investment.

This is why rising US interest rates have a far-ranging effect on the world. If a region in Argentina wants to build an electric power plant using a Japanese turbine, they need to borrow dollars in the Eurodollar market because the Japanese equipment producers will want to be paid in US dollars and not Argentine pesos.

LIBOR, or the London Interbank Offered Rate, is the base interest rate for Eurodollar loans because it's the rate at which banks will trade with each other. Corporate borrowers will pay LIBOR plus some premium to compensate for risk. This is why the chart below is so troubling for the global economy.

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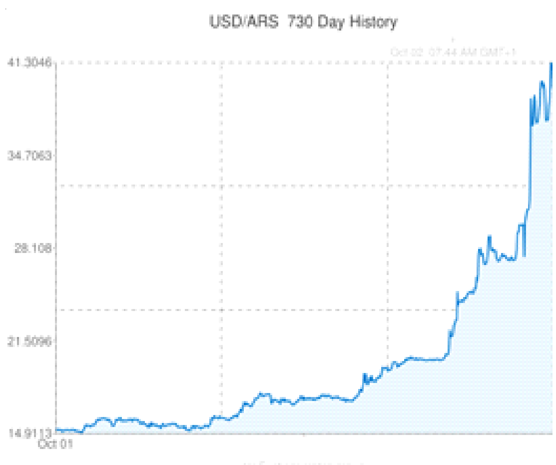
The cost of borrowing dollars has risen at least 1200% since late 2015 – 0.2% to 2.4%. How much tougher is it to build that power plant today versus 2015? Unfortunately for Argentina, it gets much worse.



Over the past 2 years, the Argentine peso has crashed versus the dollar. A year ago, it took 15 pesos to buy a dollar and now it takes 38 pesos to buy a dollar. Therefore, it will take more than twice as many pesos generated by the electric power plant in sales to their customers to satisfy their debt obligations in dollars.

If the owners of the power plant borrowed dollars at an interest rate of 5%, now they are effectively paying more than 10% because their pesos are now worth less than half of their former value. That's a big increase and this kind of increase is playing out all around the world thanks to a strong dollar.

The Federal Reserve may not have hurt the US economy in any obvious ways to date but they've taken a hammer to the rest of the world.

Emerging Markets

The cost of future growth in the emerging markets of Asia, Africa, and South America has grown dramatically over the past few years which is why there are growing examples of stress in their economies. Brazil, Argentina, Turkey, India, and China are among the countries that are experiencing economic headwinds as a function of higher US interest rates.

We can see from the chart below that the markets haven't been kind to emerging stock markets. Contrast this chart with the chart of the S&P500 on the first page.

People are willing to embrace the extra risk that is inherent in the emerging markets because they believe that emerging markets are where the growth is. But no longer thanks to the Federal Reserve and their rising interest rate policy. Without cheap money to fund capital expenditures, the emerging market growth story appears over.

The sharp drop in the price of copper is validating the drop in the emerging market stock prices and portends further weakness in their economies. We've been steadfast in avoiding the emerging markets, knowing that any increase in interest rates would elevate risks while destroying future returns.

US Dollar

We don't spend much time discussing currency markets because it's the fastest way to make someone's eyes glaze over with boredom. But there are times when the market is too fascinating to ignore and we're presently in such a time.

I've been reading for decades about how the world is going to stop using the US dollar in trade because Washington can't control spending and yet the dollar is still strong. The chart below looks pretty strong and viable to me.

The thing people seem to ignore when they bash the dollar is there is nothing suitable to replace it in trade. The European Union makes our Congress look like misers in regards to spending so the euro isn't suitable. The Japanese economy has been holding on by a thread for the past twenty years so the yen isn't a suitable replacement. And the Chinese economy is a "Wild West Show" of excessive debt and risk taking so the yuan won't be able to replace the dollar.

But perhaps the biggest development has been the tapping of the shale oil fields in the US because it allows us to buy our own oil instead of oil from other countries. This reduces the amount of dollars leaving the US for foreign shores. Notice the chart above where the dollar started to rise aggressively in 2013 – about the time our shale fields started expanding rapidly.

Now we have the growing weakness in the emerging markets that will likely result in a shift of capital from weaker countries to the relatively strong US markets. It's the main reason why I'm still positive on the US equity markets.

Stock Market

Normally weakness in the emerging markets would lead to weakness in the US stock market but there is NOTHING normal about the stock market over the past ten years. Stock buybacks, 0% interest rates, index funds, program trading, and algorithmic trading have all distorted the relationship between stock price and value.

Some people characterize it as a bubble – and it is – but it's unlike any bubble from the past that was a function of irrational exuberance. Apart from a few crazy sectors like Canadian marijuana stocks, investors seem quite rational in the collective. The emotional aspect seems to be missing.

No, the present bubble seems more like an experimental bubble created by central bankers and government to delay or even eliminate the myriad of problems in front of us such as unfunded pension liabilities and excessive domestic debt levels. As long as equity prices continue to march higher, potential economic problems have been kept at bay.

So the real question is whether this can continue indefinitely or will the weakness in the emerging markets prove the undoing of this great bull market cycle? Personally, I don't believe the answers lie in studying stock market history as this is an unprecedented combination of forces. Instead, I believe the answer lies in understanding these forces and what will allow them to continue.

Interest rates have already risen but with money flowing back into the dollar, it appears that the good times can last a while longer in the US. But since the present strength in our economy can be largely attributed to the 2017 tax reform act, we have to be careful to watch whether those benefits are starting to dry up or if we can get a new round of stimulus to supplement the positive trends in place.

This is why it will be important to watch the upcoming elections. If we end up with a divided Congress, the chances of passing new stimulus measures declines. As I see it, a divided Congress won't pass the kinds of stimulus measures that are presently allowing the US to buck the growing global trend towards economic weakness. The level of partisanship is simply too high at the moment for collaborative effort.

Our stock selection reflects this uneasiness. We remain fully invested but largely defensive with a smattering of growth characteristics in sectors that are beneficiaries of government spending. This is the reason why our portfolios have held up better than the market averages during this recent sell-off. Emerging economies may continue to weaken but it should have a minimal impact on the operations of the companies in our portfolios.

The GeoVest Approach

Intervention in the capital markets has made it possible for people to make money in securities that never would have been acceptable to seasoned investment professionals twenty years ago. Back then, you had to know what you owned – you had to understand how the security generated cash flow and how to value that cash flow.

Today it's fashionable to place money in the riskiest securities with little to no understanding of how those securities will function in difficult cycles – and there will always be difficult cycles. They call it "chasing yield" and it works until it doesn't work. That's when the media writes stories about how so-and-so lost everything and never saw it coming.

At GeoVest, we know what we own for clients and why we own it. It's why we've historically made money for clients in both good times and bad times. While it's possible that we are at the cusp of another one of those bad times, we believe the high-quality characteristics of our security selections and our forward planning will allow us to continue to grow our client's wealth. Thank you and it is our continued pleasure to serve you.

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