Aspera Review

Intelligent, Independent Investment Management

Third Quarter 2009 – Bubbles Beget Bubbles

Aspera Financial, LLC is an independent registered investment advisor.

Aspera offers independent fee-only investment management and advisory services throughout the Triangle area and nationwide.

Every client portfolio is separately managed.

The securities and strategies discussed in this Bulletin may not apply to every client portfolio.

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The rewriting of history is well under way. Bernanke is now a genius. Everything would have been fine if only Lehman had been bailed out. Our large banks didn't really need any government help. AIG was an anomaly. The recession was just a hiccup, and we're once again off to the races. This would all be rather humorous if the implications weren't so serious.

It's clear that, as a country, we learned nothing from this latest recession and credit bubble implosion. It's a travesty to have gone through such tumult for naught. There were valuable lessons aplenty, and the downturn provided a long-needed catalyst to finally address the tremendous economic and financial imbalances that have blossomed in the past decade. Instead, our leaders took the cowardly way out. We delayed a true reckoning and merely kicked the can a little further down the road. Once again, political expediency won out over economic rationality.

Our government and the Federal Reserve (Fed) have become serial bubble blowers. In past crises, they were the quiet drug distributor behind the scene, pushing product (easy money) to the dealers on the street (financial institutions). Today, the Fed is producing, marketing, distributing, and even aggressively *buying* its own product. (Disclosure: my knowledge of both the drug trade and cigarette boats comes exclusively from *Miami Vice* re-runs.)

The Fed, the Treasury, and Congress have long been playing from the same playbook despite the Fed's supposed independence. It's been essentially the same story from the Asian currency crisis to the collapse of Long-Term Capital Management to the technology bubble and now the housing/credit bubble. Loose monetary policy, easy credit, and rising fiscal deficits contribute to asset bubbles, structural imbalances, and excessive risk taking. Once each bubble begins to collapse and the self-correcting forces of capitalism begin to kick in, the authorities interfere and rush in with the next ever-larger dose of stimulus to spur the consumer to take on more debt, encourage businesses to further expand, and incent investors and traders to speculate.

What a thoughtful strategy. No matter what the problem, the solution is always the same. Print, borrow and spend! Forget about savings and real investment. Jack up your credit card, take out your home equity, and get a bank loan to pay for an unaffordable lifestyle. But it really is a little different this time. The consumer is tapped out. In its stead, the Fed has had to step in as the borrower of last resort. The Treasury sells bills, notes, and bonds to fund massive government deficits, and the Fed creates new money out of thin air (inflation) to buy that debt.

Make no mistake. This is a Ponzi scheme of epic proportions. The game has been allowed to continue this long only because we control the world's reserve currency and have been able to print new dollars virtually at will. As in any Ponzi scheme, Washington has responded to each subsequent crisis with ever-larger "hits" of stimulus. Despite massive leverage in the system, they believe the prescription is the same. Collapse interest rates and print money in an effort to encourage more borrowing and spending. As I've been ranting for some time now, you don't fix a debt problem with more debt. Congress may be appalled by what occurred at financial institutions in the past few years, but the federal government's accounting and financial management are no less crooked. I struggle at times to understand the difference between Fed chairman Bernanke and Ponzi fraudster Madoff.

The $64,000 question is: How long can this continue without serious ramifications? How long can we continue to print money and borrow trillions of dollars before investors balk at current low interest rates. Unless you're expecting a prolonged depression, the idea of lending the U.S. government money for 30 years at a mere 4.0% when they've made it clear that they're going to devalue your currency strikes me as terribly risky (we're now short U.S. Treasuries).

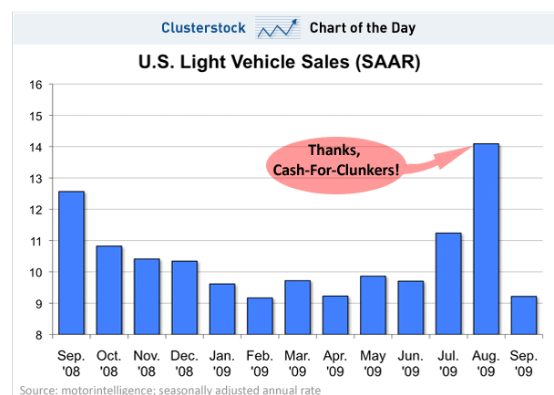
Economic Recovery?

Since the last quarterly review, we've heard much talk of an improving economy. My lack of a social life can partially be explained by the fact that I examine the data underlying economic releases as opposed to just the headlines. Apparently, "Did you see the U-6 figures from the latest nonfarm payroll release and the collapse in consumer revolving credit?" isn't a great opener at baby play dates. Nevertheless, I remain underwhelmed by recent economic data.

It's hardly surprising that we've seen some signs of "improvement." With Washington (and much of the rest of the globe) flooding the economic system with stimulus, it would have been shocking to see no impact. The key point to grasp, however, is that the improvements we've seen are mostly attributable to government largesse. I've yet to see any convincing signs of a *sustainable* rebound in the *private* sector.

The Cash-for-Clunkers program and the $8,000 credit for first-time homebuyers are terrific examples of this. We saw a large jump in car sales in August due to the $3,500 - $4,500 credit offered by the government. As much as I hated to let my '96 F-150 go and as wasteful as it is to destroy a perfectly good vehicle, the investment adviser in me just couldn't pass up getting 4 times the value of the truck. You just can't find that kind of risk-free return anywhere. Unfortunately for the U.S. taxpayer, many of these sales (mine included) would have occurred even without the incentive.

These incentive programs are pulling demand forward. Some of the sales that would have occurred in the next couple of years were pulled into August. We're simply stealing sales from the future. The chart below shows the dramatic decline in car sales last month after the Cash-for-Clunkers program ended.



The incentive for new home sales is likely having a similar effect. Again, the price will be fewer future sales and money wasted to benefit many people who would have bought anyway. With another wave of foreclosures in the pipeline, a huge shadow inventory of property, and the recasting of Option ARM loans on the way, any real sustainable recovery in housing is still years away. Ultimately, the solution to the housing bubble is lower home prices and growth in new household formation. Incentive programs which serve to prop up prices simply prolong the downturn.

This is the same philosophy that Washington has employed with the banks. The smart move would have been to quickly liquidate all of the insolvent banks and recapitalize the healthy remainder. Instead, we've chosen to pretend that the banks are solvent, and we'll now be writing off bad loans for years. Personally, I'd rather get my flogging over with all at once than be waterboarded every day for a decade.

In a normal recession, the current low interest rates, printing of money, and the massive deficit spending would have a powerful and fairly quick impact on the economy. What the experts still seem to be missing is that *this is a balance sheet recession* (see last quarter's review for a more detailed discussion).

The private sector is struggling with falling income, increased joblessness, and excessive debt. The private sector needs to reduce debt, but much of the stimulus is geared toward incenting the consumer to borrow further. That dog no longer hunts. The excess borrowing capacity that existed in prior downturns is gone. There is little home equity to borrow against, lending standards are stricter, banks are reducing lending activity to focus on maintaining adequate capital for future losses, and we're still burdened by too much excess industrial and manufacturing capacity.

When examining a company's earnings, it's important to look at the growth in earnings, but it's equally important to look at the quality of those earnings. It's exactly the same when it comes to the economy. We'll see an "improvement" in GDP figures simply because the private sector is no longer rapidly deteriorating while government spending is ramping up. The recent decline in the dollar will also give a boost to the net export (exports minus imports) component. This, however, constitutes fairly low quality growth. If your child improves his math grade from an F to a D, he's showing improvement, but you're probably not calling Harvard's admission office just yet.

Stimulus, inventory restocking, and a temporarily improving export situation (thanks to a falling dollar), will lead to some improvement in economic activity. Once the stimulus is decreased, however, private sector deleveraging will ground the economy back to a halt. Barring another large bailout from Washington, the odds favor a double dip recession at some point next year. Regardless, we should brace ourselves for an extended period of anemic economic growth in the coming years until this balance sheet (debt overhang) issue has been substantially addressed.

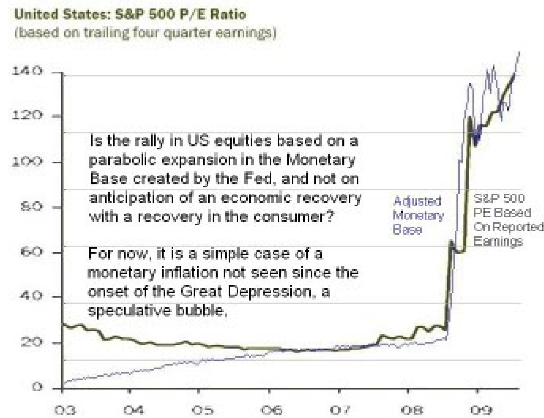
Why Is The Market Rallying?

Even if you live under a rock (hopefully not financed with an Option ARM), you're probably well aware that the market has staged an extremely impressive rally in the past 7 months. The pertinent issue is whether this is the beginning of a new long-term secular bull market or the mother of all head fakes.

The bulls are claiming that the stock market rally is forecasting a very strong increase in the economy and earnings in the coming years. My stance on that should be clear. In addition, the stock market's track record with such predictions is spotty at best. At times, the market does correctly predict where the economy is headed, and at times it misses badly. Let's recall that the stock market was useless in predicting this latest recession.

If the market is indeed predicting a strong and *sustained* economic recovery, we need to see some evidence of that soon. More specifically, we need to see strong and sustained improvements in consumer and corporate spending (private sector) to justify the rally. Perhaps I'm missing something, but I just don't see how this will happen.

What I see is a speculative market being driven by massive global stimulus. Central banks from around the world have dramatically lowered interest rates and injected money into the system. With short-term interest rates near 0%, banks less willing to lend, and consumers less able to borrow, much of this stimulus appears to have moved into risky assets.



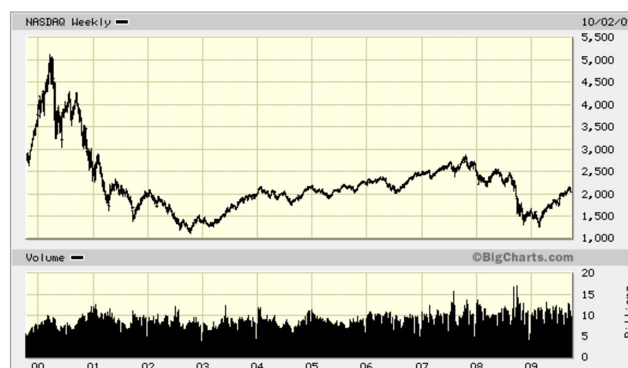
How long can this continue? I've learned over the years that these bubble dynamics can last longer than you expect. As I've shared with many of you, my analysis showed most tech stocks to be overvalued in late 1998, yet they soared to ridiculous levels before crashing. I looked like an idiot for about 16 months. The housing/credit bubble was similar. It would be foolish to underestimate animal spirits in a world of zero interest rates and "free" money.

If this does continue, it is likely to end badly, as does every bubble. The other option is for markets to move sideways for an extended period of time while the fundamentals eventually catch up. Either way, market risk is back to elevated levels. Valuation is high, corporate and government revenue is still falling, corporate insiders continue to be huge sellers of their stock, sentiment is too positive, dividend yields are back to bearish levels (very low), mutual fund cash levels are near record lows, and volume is low on the up days and strong on the down days. These are not signs of strength.

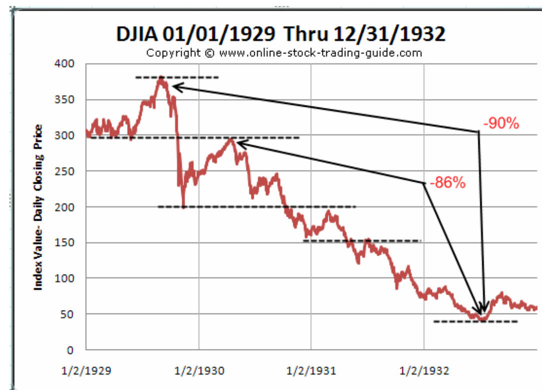
For the time being, valuation and fundamentals don't matter. Not to get too technical, but we are squarely in "silly" territory and any strong rally from these levels will tip us into the "stupid" sphere.

Echo Bubbles

It's important to realize that markets often rally strongly following a substantial collapse in a bear market. Let's revisit the tech bubble in the chart below. After quickly falling 35% from its peak in 2000, the NASDAQ staged an impressive 30% rally in the following months. That proved an excellent time to sell.



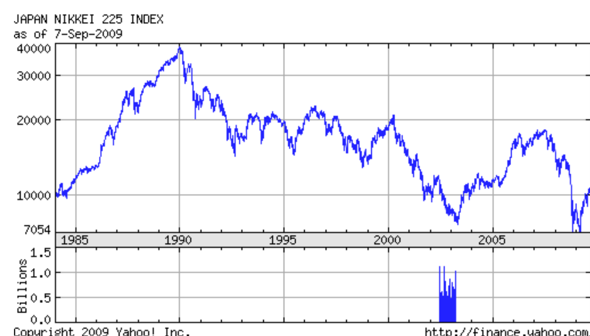
The next chart shows the performance of the Dow Jones Industrial Average between 1929 and 1932. Note again that following a 45% decline in 1929 the market roared back over the next 6 months with a 50% gain. You can see what happened afterward.



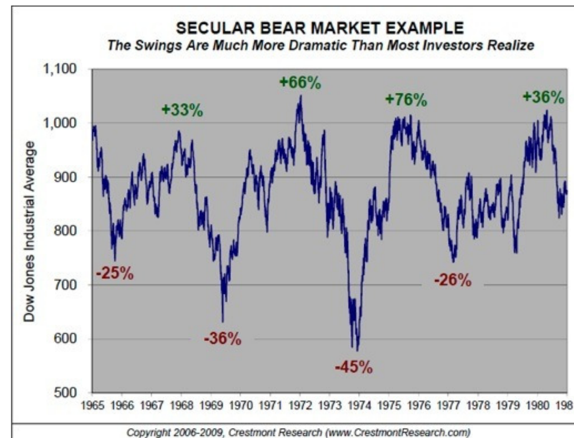
Of course, it doesn't absolutely have to play out the same way this time. We are in uncharted territory. The challenges we face today are not the same as in 2000, 1965, or 1929. There is always some chance that this is the start of the next great bull market in financial assets, but it's important to recognize that strong rallies following severe declines are the norm, not the exception.

Secular Bear Markets

I still believe that we're likely still mired in a long-term bear market and that we'll look back on this year as the mother of all dead-cat bounces. The best contemporary example of a secular bear market that we have is that of Japan, and it's instructive. The Japanese stock market peaked at roughly 40,000 at the beginning of 1990. It closed this recent quarter near 10,000 for a decline of 75% over the last 20 years. So much for buy-and-hold. Despite this 20-year secular bear market, you can see in the chart below that the Nikkei experienced a number of powerful 50% rallies and quite a few 20% rallies. There's even a 4-year 140% rally from 2003-2007. Despite those strong rallies, the index hit a new low as recently as this past March at which point is had declined 82% from its 1990 peak.



Another example is the 1965-1981 U.S. bear market, illustrated in the chart below. You would have lost money in equities over this 16-year period. Factor in the high inflation of the 1970s, and the real value of your portfolio would have been decimated. Still, notice the huge moves within this secular bear. There were a number of huge rallies during which everyone thought a new long-term bull market was underway.



Considering that the U.S. stock market has returned less than 0% (much worse if you look at the NASDAQ) over the last decade, it isn't too far-fetched to imagine that we are in the midst of a secular bear market. With so many economic and financial headwinds facing us and with valuation stretched, it's difficult to believe that the environment is ripe for the next secular bull.

Secular bull markets are partly fueled by P/E expansion. As such, they tend to start from low P/E levels. This one has not and is therefore suspect. You make your money when you buy, and current valuation levels do not bode well for long-term returns. Corporate earnings will register growth near-term as spending cuts continue to boost margins. My focus, however, has been and continues to be on revenue. We have seen no revenue improvement this year. At some point, companies will need to grow revenue in order to generate earnings growth. I'm in "show me" stance. I need to see evidence of sustainable and strong revenue growth to get more constructive on the U.S. equity market, and I need to see more reasonable valuation.

We should expect to see these types of powerful rallies even in a secular bear market as the authorities print money and reduce rates to stimulate the economy. This stimulus will find a home, and in the foreseeable future it's likely to be in asset markets. We're actually likely to see rolling bubbles in various asset classes, sectors, and countries as hot (speculative) money chases performance in less liquid markets. We should also expect to see those bubbles deflate whenever the juice is removed. Risk management is critical.

A Bubble In Government Debt

There is an interesting divergence underway. While the private sector is gradually beginning to address its debt overhang, the story out of Washington couldn't be more different. Washington is tripping over itself in an effort to increase spending to make up for the "shortfall" from the private sector. In doing so, we're seeing unprecedented levels of deficit spending, borrowing, and monetary stimulus. Rather than letting economic activity fall (a natural and healthy economic process) to a level that can be supported by current revenue, Washington is increasing our debt by nearly $10 trillion in the coming decade in a misguided effort to support an economy which was largely built on debt in the past decade. Washington is in the process of shifting the credit bubble from a private sector issue to a public sector phenomenon.

To be clear, our government is selling massive amounts of debt to fund their spending. The Fed is then turning around and buying some of this debt. The government gets to sell its bonds at a low interest rate, and the Fed then prints up new money (out of thin air) and uses it to buy Treasury debt. By buying these bonds, the Fed is injecting cash into the system. This is called "monetizing the debt," and it's inflationary.

This can be confusing, and few people really grasp what's going on. This inflation isn't showing up in consumer goods prices or wages. It's showing up in commodity and equity prices. It also helps explain

why the dollar has been weak this year. Money is like any commodity. The more there is of it, the less valuable it becomes.

Let's look at a Treasury bond purchase from the perspective of a foreign buyer. Let's assume someone in France buys $1000 worth of Treasury bonds that yield 4%. They earn $40 each year from interest. But if the dollar falls 4% against the Euro, they lose $40 when they convert their dollar interest back into their stronger currency (Euro). In this example, they've earned nothing. If the dollar depreciates against the Euro at a rate greater than the yield on the bond, they actually lose money.

With the federal government borrowing at an unprecedented rate and with the Fed printing money (debasing/devaluing the currency), investors are justifiably starting to worry. Unless we change our path, it is just a matter of time before investors demand a higher interest rate on their Treasury purchases to compensate them for the increasing risk. The current rate of 4% on 30-year Treasuries is most certainly not providing much margin of safety.

I recently spent some time going over the current White House budget. The projected federal debt in 2011 is $15.65 trillion. The government is projecting an interest cost of $283 million that year. That works out to an average interest rate of just 1.8%! I'll take the over on that bet. If interest rates start moving up, the interest cost on the debt will begin to spiral upward. This leaves less money in the budget for discretionary spending (defense isn't terribly discretionary). Congress and the President would likely respond by borrowing even more to plug the gap, but this would put more upward pressure on interest rates. Talk about a death spiral! I have many concerns, but this one makes my top 5 for the upcoming decade.

The Fed is stuck between a rock and a hard place. On the one hand, if they withdraw their stimulus too soon (the smart choice), the economy is almost certain to relapse into recession. But, if they provide too much stimulus for too long, they risk serious inflation, a further collapse of the dollar, higher interest rates, and a relapse into recession. The chance of the Fed successfully walking this fine line is remote.

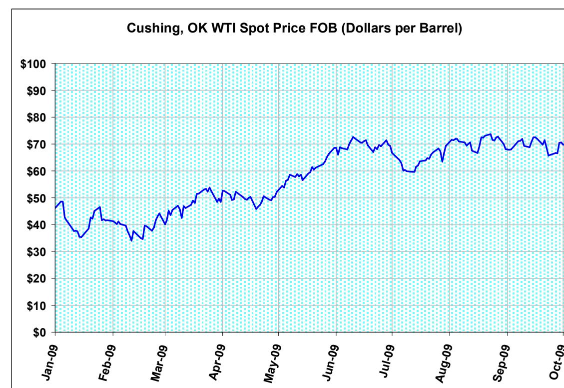
Performance

This was a dart-throwing monkey quarter. Virtually all risky assets continued to rally in the third quarter as you can see in the table below. In fact, the uglier the security, the better it did. The closer you came to bankruptcy, the better your security did! Clearly, this isn't a normal or healthy environment.

Index/Market	**Q3**	**YTD**
S&P 500	14.98%	17.03%
DJIA	14.98%	10.66%
Nasdaq	15.66%	34.58%
Vanguard Total Stock Mkt	15.82%	19.78%
Emerging Markets	21.09%	63.47%
China Shanghai A Shares Index	-6.62%	52.57%
iShares Aggregate Bond (AGG)	3.05%	2.72%
DJ Commodity Index (DJP)	3.82%	9.58%
Gold (GLD)	8.41%	14.25%
Oil	0.92%	57.98%
U.S. Dollar (trade-weighted)	-1.85%	-4.92%

The clear winner for the quarter and for the year-to-date period was the emerging market index. This comes despite a 6.6% decline in the Chinese stock market for the quarter. Also, note that China has again entered bear market territory recently (defined as a decline of at least 20% from the peak).

U.S. stock markets registered another quarter of impressive gains, bonds posted a solid performance, and gold showed some signs of life in the second half of the quarter as the dollar continued to weaken. Commodities lagged as oil has slipped into a trading range of $60-75 in recent months following a strong first half of the year.



Most Aspera accounts posted flat to fairly modest gains in the quarter. This shouldn't come as a surprise as I cautioned in last quarter's review that, "If the market continues to rally strongly, our defensiveness will hurt our relative performance."

All in all, I'm satisfied with the quarter. We took very little risk due to our significant cash holding as well as our fixed income, options, and short positions. All of these were a drag on relative performance in the quarter, but they served their intended purpose of providing downside protection.

Furthermore, one of our larger positions (UNG) was a clear underperformer in the quarter. This was actually welcome as it allowed us to average down. I'll sacrifice short-term performance to build a compelling long-term position any day. All in all, we generated a modest return without taking much risk while boosting exposure to a favored position.

As I always caution, any one quarter's performance is little more than noise, as is any one-year figure. Nevertheless, our 2009 performance has been very solid, with most aggressive accounts up 15-30% range and most conservative accounts in the 10-15% range. *Most importantly, these returns were achieved without taking much risk.*

After the past 18 months, it should be very clear that our performance will not be closely tracking any particular market or asset class, particularly in the short-term. This should not be surprising since I don't follow a buy-and-hold type strategy. I'll continue to position portfolios appropriately based on the risks and opportunities present, and performance will continue to take care of itself over time.

Trading Activity

In general, I continued to modestly reduce risk across portfolios during the quarter as the rally continued, while opportunistically adding to a few positions.

China

We liquidated one of our core holdings last quarter - our exposure to the Chinese stock market. This was bittersweet. The Chinese market had doubled in a few short months (the sweet part) and was trading at 36 times earnings, a very rich multiple. Furthermore, I had and have serious concerns that another bubble may be forming in China as their stimulus program and loose monetary policy has led to renewed real estate and stock market speculation. China remains very export-dependent, and the export market has fallen off a cliff. Still, they're continuing to expand manufacturing capacity. Their focus on maintaining employment to keep the populace subdued may be exacerbating the global manufacturing glut and leading to a future bad debt problem.

Like our sale of India earlier this year, this sale was also a little bitter in that I had hoped that these securities would be long-term core positions. I still believe that China is likely to be the next super power, and it will experience strong growth in the coming decades. However, we will wait to reinvest in Chinese shares until the valuation is more reasonable.

Foreign Currency

Another significant portfolio change occurred in the foreign currency area. During the quarter, we sold our Australian and Canadian dollar positions and soon thereafter added a U.S. dollar position (UUP).

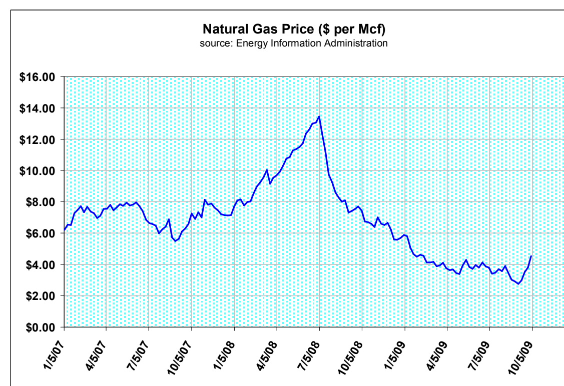
Our Canadian and Australian dollar positions both worked out well in a fairly short amount of time. However, bearishness against the dollar has become overwhelming. Over 90% of experts/traders expect the dollar to keep falling. With sentiment so lopsided, it was time to temporarily switch teams.

There are a number of potential catalysts for a dollar rally. An increase in long-term interest rates, competitive devaluations of other currencies (as we recently saw with the Swiss), an end to the Fed's purchase of Treasury securities, and a flight to quality (watch Eastern Europe) are a few leading candidates. With so many traders betting against the dollar, any reversal has the potential to be dramatic (for currencies) and highly disruptive to the markets.

Longer term, I remain bearish on the dollar, but I suspect we'll be able to rebuild that position at a better price at some point. In the meantime, our gold holdings will benefit from any continued decline in the dollar. Also, this position adds excellent diversification and lowers portfolio risk further as it's likely to move counter to risky assets.

Natural Gas

Our natural gas and energy-service *equities* continued to perform well despite natural gas prices reaching a 7-year low in the quarter. [The equities are more closely tracking the stock market than natural gas prices currently.] Natural gas subsequently rallied about 30% from those lows. For the quarter, however, natural gas was an underperformer.



As I wrote in my June Bulletin on natural gas:

"I don't know if natural gas has bottomed. If it has, then we got a little lucky with our timing. If it hasn't, and if it moves significantly lower, you should expect to see additional purchases. The lower it goes, the more compelling it becomes."

As promised, we did in fact add to our natural gas position on weakness in the quarter. I remain very positive on the natural gas story. Since June, I've seen some positive developments. In June, storage was 30% greater than in the prior year and 22% greater than 5-year average. Currently, storage sits at 15% above last year's level and the 5-year average. Slowly and steadily, the storage surplus is coming down.

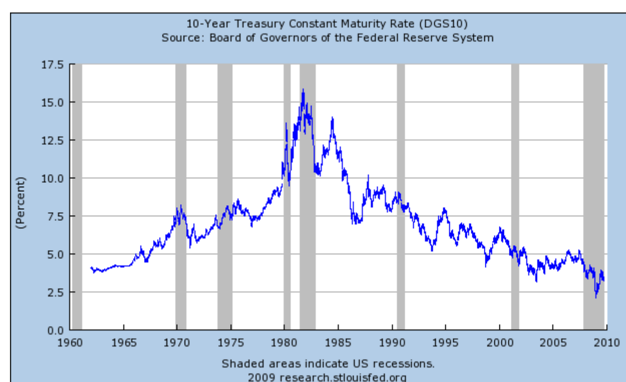
Still, natural gas will remain volatile. Despite the relative improvements in the storage situation, on an absolute basis, storage is close to full. There is certainly a chance that natural gas prices could experience another large drop should storage fill up before winter heating demand kicks in, although this is hardly a secret in the industry. If storage does fill up, wells will have to be shut-in. This has no bearing on our long-term investment thesis. If this results in significantly lower near-term prices, I will be a buyer.

Treasury Bonds
In last quarter's Review, I wrote the following:

"Actually, my biggest disappointment this past quarter was having missed shorting the long end of the Treasury curve. We had successfully entered and exited this trade (TBT) in December 2008 and January 2009, and I've been hoping for another shot at it. We had a very brief chance at the beginning of the quarter, but it was very brief, and I missed it. Fortunately, the recent rally in Treasury bonds has brought TBT back from its highs of early June. Should we have another stock market sell-off, we may get a good entry point yet again back in the low-$40's or better as investors flock to the perceived safety of Treasuries."

Although the stock market didn't sell off, Treasury yields did come back down by the end of the quarter, and we were able to add a position in TBT. As a reminder, TBT is an ETF which moves twice as much as longer-term Treasury bond yields. When yields rise, TBT increases twice as much on a percentage basis.

The chart below shows the yield (interest rate) on 10-year Treasury notes since the 1960s. Two very strong trends are apparent. The first is a secular bond bear market that ran until the early 1980s. The inflation of the 1970s was a primary cause of this. The second long-term trend has been a 30-year bull market in bonds that began with Paul Volcker's (the only good Fed chairman we've had in over 50 years) taming of inflation in the early 80s. I believe this long-term bull market in bonds is near its end. That doesn't mean it ends today. It could run for a few more years, but yields are much more likely to move higher over the coming decade than lower given our economic fundamentals.



At any rate, I'm very pleased to have been able to get back into TBT at these levels. This security will provide us with some additional inflation protection, portfolio diversification, and added protection from

currency risk. The biggest risk to this position would come from an outright economic depression or a panic back into the safety of the dollar. I will add to this position if we see yields come down due to a flight to safety back into the dollar and Treasury securities.

Yield

Speaking of bonds and yield, I still struggle to find attractive yield opportunities given my macro concerns. In general, I still prefer safety and shorter-term maturities in the current environment. Unfortunately, the yields on these types of securities remain paltry.

Fixed income securities have done well this year as investors have flocked to debt and as the Fed has added its buying power to the mix. Despite modest yields on investment grade securities, capital appreciation has boosted total returns for most bonds to pretty healthy levels. Given the concerns I have about the economy, the Fed, and the stimulus, I remain very concerned about a future rise in interest rates. If I'm right about interest rates, we could see a rout in the fixed income markets.

The corporate bonds we own in less aggressive portfolios have performed well. To the degree that we own corporate bonds, my preference remains with commodity-related bonds, and I'm hesitant to extend maturities out too far.

Our TIP (inflation protected bonds) position has performed well this year. I'm quite pleased with its return relative to its low risk. I anticipate that we'll own this position for some time, but it's ultimately a source of cash should risky assets return to compelling levels.

One of my preferred ways to add some yield to more conservative portfolios has been through limited partnerships. This past quarter, we added a new position in this space. Brookfield Infrastructure Partners (BIP) is a limited partnership which invests primarily in electricity transmission systems and timberland. These are fairly stable cash flow generators. BIP was yielding over 8% when I purchased it. After its recent appreciation, it's still yielding just over 6%.

We also selectively added to Enterprise Products Partners (EPD) after a pullback in September. This is another limited partnership, but this one invests primarily in energy distribution (pipeline) assets. We first invested in this security back in March and April of this year when its price was in the $18-22 range and it was yielding over 10%. At its current price, this security is yielding 7.5%.

In this environment, I'm more interested in these types of yield plays. The limited partnership structure does complicate tax filings for taxable accounts (so I try to own these in tax-deferred accounts when possible), but the combination of attractive yield and solid operating assets in attractive industries is difficult to find.

These securities certainly would fall in price should the market roll over, but their cash flows should remain fairly steady and their distributions (dividends) secure. I would be a buyer on weakness.

Outlook & Strategy

"In the short-run, the market is a voting machine, but in the long-run, the market is a weighing machine."
Benjamin Graham

Perhaps I can rephrase the above quote for the present time. In the short-run, the market is a liquidity-driven, manipulated, overvalued, disaster in the making. In the long-run, the market is a weighing machine.

Ultimately, valuation and fundamentals matter. Buying risky assets with weak fundamentals at inflated valuations in the hope that someone less intelligent will come along and take those securities off of your hands at an even higher price is not investing. It's gambling.

Like Japan, we are headed down a path in which we keep kicking our problems down the road rather than facing them. This will manifest itself in further economic and market upheavals, and we may very well be facing a prolonged period of sub-par economic and earnings growth. At any rate, the ingredients for a new secular bull market are not in place, and I am not the least bit inclined to chase the stock market or to chase yield in this environment.

I'm fond of saying that Aspera clients should never be surprised, so let me be explicit. If the stock market continues to rally strongly, our portfolios (mine included) will lag in the short-term. I think the bond market (particularly Treasuries) is in a bubble, and the stock market is overvalued. It is certainly very possible that the stock market will continue to move higher, perhaps significantly, for some time still. This could be powered by investors rotating out of fixed income investments and into equities. We should never underestimate animal spirits, massive global stimulus, or capital flows.

I've built my track record over the years primarily by buying out-of-favor assets inexpensively and by avoiding disasters. I have a good nose for sniffing out developing bubbles and dislocations, but predicting how long they last and how high they will go is very difficult. I feel strongly that we are not getting adequately paid to take risk right now. I prefer to invest with the tailwind of attractive valuation and improving fundamentals, but that gentle breeze has passed. I don't worry about what the market has recently done or what it may do in the near-term, nor should you. That's not something I can control, and worrying about it can only lead to poor decision-making, ulcers, hair loss, and alimony payments. The important thing is to make sure we have a chair when the music stops.

We've been able to capitalize on some good opportunities during this rally, and I have little doubt that more will develop regardless of which way the markets go. We'll continue to manage risk prudently and pick our spots carefully when putting money to work.

One housekeeping note for those of you with taxable accounts: You should expect to see some tax-loss selling between now and year-end. This will primarily be in some of the short positions that we own that have losses. The proceeds from these trades are likely to be rolled into other defensive positions (shorts or options) to maintain the same degree of protection in the portfolio.

On that note, happy early Halloween. I hope that you don't encounter anything quite as scary as this letter over the holiday. As always, don't hesitate to contact me with any questions or concerns.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

10/08/09