Aspera Bulletin

Intelligent, Independent Investment Management

8 Short Weeks

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Ah, the fickleness of crowds. 8 weeks ago, Armageddon was nigh, but today it's rainbows, puppy dogs, and daisies. These past 8 weeks provide us with a terrific opportunity to think about risk.

Back in early March, there was a great deal of investor fear and concern about corporate earnings, bank solvency, and the economy. Sentiment was atrocious as even the most fervent bulls could be found cowering in the fetal position with their fingers on the "Sell" button chanting, "It's only a loss if I sell." I think it's safe to say that most people viewed the market as very risky as we entered March.

Fast forward to today. The U.S. stock market has now risen for 7 of 8 weeks. Investor sentiment is very positive, we've seen some very modest improvement in some economic indicators, and a number of large banks claim to be on the mend. There is a palpable and growing sense of relief, and the previously-silenced permabulls have revisited the Wizard and have once again found their courage (if not their brains). Most people would probably say that the stock market is less risky today than it was 8 weeks ago.

The reality, however, is very different from the perception. The "risky" market of 8 weeks ago was, in fact, the least risky it had been in many years. Stock prices had already been hammered and more than reflected the negative economic and earnings environment. For those of us looking out at least a couple of years, the risks to buying select equities at such attractive levels were relatively modest. While most were selling out of fear, we were buying due to valuation. Most Aspera accounts were essentially fully invested by the time of the most recent market bottom.

Today, however, the risk profile of the stock market is markedly different than it was 8 short weeks ago. This can largely be attributed to the fact that stock prices have jumped nearly 30% in just two months. Investors, in general, are now bullishly optimistic and are moving money back into the stock market. Although the stock market may feel safer today, it is actually much riskier than it was in early March since the valuation support it once enjoyed is now gone. The market could certainly continue higher in the near term, but there is a very good chance that recent buyers will ultimately be disappointed.

A few of my concerns include:

- Valuation is no longer compelling.
- Earnings growth and economic recovery are likely to disappoint.
- A good deal of the rally has been driven by short-covering. This buying wasn't done by investors who were bullish on the market. They simply needed to get out of losing positions and had to buy shares in order to unwind their short positions. Interestingly (and a bit suspiciously), it has become quite a bit harder to find shares to short of late.
- Trading volume has been weaker than the historic norm following major market bottoms.
- The critical process of deleveraging (reducing debt) is still in its infancy and will take years to run its course, limiting consumption and investment.
- Longer-term Treasury yields have been moving higher and are likely to continue moving higher over time. This will provide another economic headwind as well as stiffer investment competition for equities.
- Corporate insiders have been heavily selling stock in recent weeks.
- There is another wave of foreclosures fast approaching from homeowners who took out Option ARM loans.
- Commercial real estate is a mess. Vacancies are rising, there's too much supply, and property prices are rapidly declining.
- This rally has been led by the most speculative stocks. Greed is still alive, and we never hit the revulsion state characteristic of most major market bottoms.
- Despite press headlines to the contrary, the banking industry is still a mess. The "strong" earnings reported by many banks were driven by one-time events, inadequate reserving for future loan losses, and perverse accounting gains. The stress test results to be released this week are recognized as a farce by the smart money.
- The economy is unsound and is absurdly dependent upon government credit to function. Just as the economy was dependent upon ever-increasing levels of private sector debt to grow from 2003-2008, the government has now stepped in to fill this void. This is ultimately unsustainable.

The Economy

A further comment about the economy is warranted given all of the talk in the press of "green shoots." 2 months ago, there was a near obsession with talk of the next Great Depression. Investors are now suddenly more concerned with missing out on an impending economic recovery and the next "Great Bull Market."

As I said earlier this year, with Washington throwing over $10 trillion at the economy, it would be foolish not to expect to see some short-term positive impact. In addition, market forces have been at work to help correct some of our economic imbalances.

That we're now seeing some modest economic improvement, albeit mostly a slowing in the rate of deterioration, is hardly surprising. The real question is what happens to the economy now. It appears as though newly-confident investors are now anticipating a normal post-recession recovery in economic activity and corporate earnings. They will be sorely disappointed.

We simply have too much debt, too much excess production capacity, and too much government meddling for a normal recovery to ensue any time soon. I expect these "green shoots" of recovery to be clipped before long. Once the reality of the magnitude of our economic headwinds becomes more apparent to investors, I would expect to see the stock market struggle yet again.

Strategy

As a result of my concerns, I have no intention of chasing this market. Valuation was compelling back in February and March, so we were buyers. Today, it is much more difficult to find attractive buying opportunities. The valuation case is much harder to make, particularly in light of the fact that underlying fundamentals haven't improved much (if at all) for most companies.

Still, we have been able to selectively add exposure to gold, currencies, TIPS, oil, and natural gas in the past few weeks at attractive levels despite the rally. I'm especially pleased with the position we've been building in natural gas (UNG) over the past couple of months. This is now one of the largest positions in most accounts (though still less than 5% in all accounts).

While a number of our energy-related equities have performed extremely well of late, UNG (which tracks the price of natural gas) has been a laggard. While the price could certainly fall further before bottoming, I expect it to at least double in the next few years as a severe fall-off in the rate of drilling and a high well depletion rate eventually result in a rapid curtailment of natural gas supply.

UNG, unfortunately, is one of only a few compelling long positions I've found in recent weeks. The reality is that it is much easier to find sale candidates given the strong appreciation in many securities. For this reason, we have been selling our shorter-term tactical positions as this rally has progressed. In addition, we have been gradually building some short positions. The net effect of this activity has been to reduce risk exposure and to raise cash levels.

Just as I was a little early in adding risk exposure back in February, this move to a more conservative positioning has also been early. I didn't know when the market would bottom in March, and I don't know how far this current rally will run, so our moves are incremental. The more overbought this market becomes, the more defensive our portfolios will become. As this rally continues, our focus is once again shifting back towards wealth preservation. I suspect more investors will soon join us in focusing on how not to give back the gains of recent months.

Best,

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President
Aspera Financial, LLC

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