ASPERA BULLETIN
Intelligent, Independent Investment Management

Dollar/Gold Irrationality?

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.

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One day, the Dow rises nearly 300 points. The next day, it gives it all back. In the morning, Lehman opens up double digits. By the close, the stock is down 40%. United Airlines is down 99% one minute. A few hours later, it's back to even. Bernanke is forming complete sentences at the start of the day...

Fear rules the day. There is a general liquidation underway. About the only things increasing in recent weeks are the U.S. dollar, U.S. treasury securities, alcohol sales, and irritable bowel prescriptions. As for the dollar, there has been speculation that the dollar rally is the product of coordinated intervention from the U.S., Europe, and Japan given recent reports of just such a plan being drafted back in March. Given the fundamentals in the U.S., I wouldn't rule this out.

Aside from possible government intervention, the best thing the dollar has going for it right now is that it's not the Euro or any of the commodity-based or emerging market currencies. People have to keep their money in some currency, and as money is extracted from markets around the world, investors are choosing to move it to the "safe" U.S. dollar. Although this dollar rally has been powerful, its sustainability needs to be seriously questioned given the following:

- The U.S. government is now on the hook for future Fannie/Freddie losses. Total losses will depend on the severity of the housing/credit debacle, but it isn't a stretch to imagine losses in the $1 trillion range.
- The U.S. budget deficit in August alone was $112 billion.
- The U.S budget deficit is forecast to be $407 billion in 2008 and a record $438 billion in 2009.
- The $438 billion for 2009 does not include any funds used to "conserve" Freddie or Fannie or any new fiscal stimulus package, and it doesn't account for the full cost of the Iraq War (let alone any new incursion into Iran, the Caucusus region, or Pakistan/Afghanistan).
- About the only thing supporting GDP growth in the past 2 quarters has been net exports, thanks to the falling value of the dollar. The recent strength in the dollar is likely to blunt this tailwind.
- The risk of competitive currency devaluations is very real as every country battles for a piece of the shrinking pie of investment and consumption spending.

- The Fed continues to swap high-quality Treasury securities for garbage securities.
- U.S. unfunded liabilities range from $50 trillion to $95 trillion (depending on the assumptions used).

Of course, we don't have the money to pay for any of these items since our national debt exceeds $9.6 trillion, and we're already running an annual budget deficit. So, our over-leveraged government will have to rely even more on the kindness of strangers to fund our spending.

A borrower living beyond her means. Using her "home" as an ATM. Deteriorating credit score. Stagnating real income. Dependent on low-cost borrowings. Sound familiar? It's comically implausible that our financial obligations will be repaid with dollars worth anything close to their current value. (The dollar has lost 95% of its purchasing power since the Federal Reserve system was created in 1913. Given our current debt situation, this trend is certain to continue over time.) The difference between the U.S. Government and a subprime borrower is that the government controls the printing presses. There is little doubt that the presses will be working over-time in the years to come.

As history has shown, all fiat currencies are ultimately doomed. The temptation to devalue the currency is just too great over time. The dollar may continue its near-term rally as investors search for "safety" and/or if government intervention is indeed underway. Ultimately, however, the fundamentals will matter again.

Our Chinese Renminbi and Japanese Yen exposure have held up fairly well this year, but the "currency" position that we find the most intriguing currently is one that has stood the test of time and held its value for hundreds of years. This solid currency has been caught up in the recent wave of asset deflation and is now off its recent peak by about 25%.

I'm talking about gold (and silver). As I always caution, trying to pick bottoms is futile, as is trying to time short-term moves. In the current environment, the curtailing of risk, fund redemptions, and losses on a variety of securities is forcing the sale of virtually all liquid assets, including precious metals. However, given the poor and deteriorating financial condition of the U.S., the need for our government to continue depreciating the dollar over time, the historical track record of all fiat currencies, the recent pullback in the price of gold and silver, and the supply constraints facing mining companies today, this may well prove to be another excellent long-term opportunity to add to gold and silver. We are increasing exposure in most portfolios at these levels.

Best,

Ken Bell, CFA, CFP
President
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