ASPERA BULLETIN

Intelligent, Independent Investment Management

Et Tu, Europe!?

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.

919-622-2076
Cary, North Carolina
ken@asperafinancial.com

"Investing is unlike many other fields of endeavor because uncertainty is lodged in its heart. When we think we know the future, we are setting ourselves up for trouble. Trends are not destiny. We are no more able to extend smooth lines into the future than a sailor can observe what lies ahead on a choppy sea."

Peter Bernstein

"The dramatic reduction in market volatility over the past year is lulling many into a false sense of security and complacency, but it's always most calm before the storm. The value of our focus on risk management will eventually be once again borne out."

1Q10 Aspera Quarterly Review

Investment News, an industry trade magazine, sent an e-mail questionnaire out early in the week asking advisors if they felt the need to reach out and reassure their clients following the temporary collapse of the market on May 6th. I've spent the past 9 months reassuring all of us that our increasingly defensive positioning was warranted in light of the growing risks. I'd better not need to reassure anyone when the market does fall! Since no one has contacted me for any hand holding or comforting hugs these past few weeks, I will assume that you are either blissfully unaware of the market volatility or you've actually been reading my writing. By the way, you know that day when the market fell as much as 9% before closing down 3.5%? The day that has apparently necessitated widespread client coddling? Most of our accounts made money that day.

If we're intentionally giving up some of the upside offered by an increasingly schizophrenic and dysfunctional market, we should be able to sleep better at night, fairly confident that we won't be the mattress during the next bout of investor bed-wetting. [My apologies as my analogies will likely be closely related to my daughter's stage of development.] It's been difficult to test this theoretical trade-off in recent months as the market has largely continued to churn higher on low volume, drunk on the fumes of negative real interest rates engineered by the same disastrous Federal Reserve policy largely responsible for our last two bubbles and collapses.

April 27th and the days since have finally provided an opportunity to test the effectiveness of our fairly conservative positioning. In just the past couple of weeks volatility has spiked as markets around the world have sold off on concerns about excessive sovereign debt and the sustainability of recent growth. Just as the walls appeared set to collapse in on themselves, Europe stepped to the plate with a massive bailout of their gangrenous extremities. I'll circle back to this momentarily.

The issue at hand is how our portfolios performed in this stomach-churning environment. Were we the mattress, or were we the rubber pants? Fortunately, we weren't anywhere near the bed. Our primary focus on wealth preservation was both justified and effective these past few weeks. Our portfolios held up well on each of the days the market was hit hard as our defensive and hedge positions performed as designed. Our short positions, long volatility position, inflation-protected bonds, and long dollar position all performed well on the big down days. More importantly, our precious metals positions held up very well.

Gold Breaks Out

> *"The best environment for us would be one with a modestly declining equity market and strong precious metals performance. Since the precious metals positions have been largely moving with the equity market, any decline in equities will probably mean a decline in our metals positions in the short-term. Eventually, we expect to see a divergence between the metals and the general equity market."*
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> 1Q10 Aspera Quarterly Review

Overall, the past few weeks have been marked by generally lower equity markets and a strengthening precious metals sector. There is no guarantee that this will continue, but for the time being this is a nice environment for us. Critically, the price of gold and silver have both finally started to diverge from the general equity market, the commodity market, and the U.S. dollar. Gold in particular climbed almost every day that the market fell these past few weeks, culminating in a 3.5% increase on the very day that the market fell 3.5%. You can see this relationship in the chart below. Gold and the S&P 500 had been moving together up until the end of April when the trouble in Europe escalated.

S&P 500 (SPX) vs. Gold (GLD)

This is a very bullish development as it demonstrates that gold is being perceived as a distinct currency and not just a component of the broad commodity universe. More and more investors are beginning to grasp the value of gold that I've been harping on for many years. Gold is the ultimate store of value with zero counterparty risk in a world of monetary and fiscal mismanagement (see the "All That Glitters" Bulletin). With central banks around the world demonstrating their willingness to devalue their currency in an effort to spur growth and with short-term interest rates at zero, the appeal of gold as a safe haven is growing.

S&P 500 (SPX) vs. Junior Miners (GDXJ)

The chart above shows the performance of the more speculative junior mining firms relative to the market. The juniors have performed well since the market rolled over, but as I've cautioned before, their performance is very volatile. In recent weeks, they've tended to decline when the market has been down significantly and then rally strongly when the market is flat to up. 5-10% daily moves in both directions are not atypical with these names. We will be selectively adding to these names on pullbacks as they will ultimately be the biggest beneficiaries of this gold bull market.

In no way do I want to suggest that gold is going straight up from here. Each rally tends to attract some weaker short-term traders who will sell at the first sign that the rally is faltering. The 9-year gold bull market has progressed in a two-steps-forward and one-step-backward fashion, and this is the most likely case going forward. As such, we'll continue to take advantage of pullbacks. The bull market in precious metals isn't likely to end until governments and central banks finally get serious about repairing their balance sheets and defending their currencies. If anything, the news out of Europe demonstrates just how far away from that we are.

Europe Capitulates

Sunday, May 9th was a sad day for Europe and the world but a wonderful day for gold bulls. The Europeans announced a roughly $1 trillion bailout package to try and stem the tide of rising interest rates and a falling Euro that was threatening to imminently destroy the flawed Euro experiment. Once again, political expediency won out over economic rationality as the Europeans in one fell swoop violated the Lisbon and Maastricht Treaties on which the European Monetary Union was built.

Although bond investors are being blamed as evil speculators responsible for Europe's problem, this couldn't be further from the truth. The higher yields that the bond market was finally imposing on Greece was precisely the discipline needed to force it to finally and seriously address its debt problem as well as the structural imbalances which exist in the country. Europe, however, is choosing to blame the market rather than critically look at its failings and short-comings. Greece (and many others) was provided with capital inflows and low interest rates when it was admitted to the EMU, but it was up to Greece alone to make responsible use of that capital and low rates. If a driver gets pulled over for doing 120 mph on a beautifully smooth and straight stretch of highway, he shouldn't blame the state for building the road in the first place.

When bond yields spiked to levels that were predicting a debt default by Greece, the Greeks ran to the EU and IMF for "help," and they were unfortunately obliged. When talks of a $30 billion bailout proved

insufficient to calm the market, the figure was ratcheted to $45 billion. When that failed, the number jumped to $145 billion. When that failed, the EU pushed all of their chips in with a U.S.-styled $1 trillion bailout for all comers.

When I wrote the "Mamma Mia" Bulletin, I noted that Europe had no easy solution. The choice was between (a) bailout and (b) weak countries leaving the Euro behind, readopting their prior national currency, defaulting on their debt, and devaluing their currency. Europe made the wrong choice in adopting this bailout -- a choice doomed to fail and one which will likely lead to the end of the Euro in its current form. This was an act of desperation with little apparent consideration of the eventual economic blowback to come.

Europe has chosen to follow the U.S. model of massive stimulus aimed at solving a runaway debt problem by issuing ever-larger amounts of debt while simultaneously bailing out failed banks at the expense of the taxpayer. Furthermore, this bailout will doom the debt-laden countries of Europe to a decade-long recession/depression as they are left with no mechanism to spur growth. These countries will be asked to adopt austerity measures which are certain to further reduce growth and impede their ability to pay down their debt. There will be plenty of pain with no benefit. Europeans have a rich history of social unrest when times are tough. Times are going to be tough.

Perhaps the saddest news of all is related to the European Central Bank's (ECB) role in the bailout. Through its rhetoric and actions, the ECB had developed a reputation of being a beacon of monetary discipline and a strong defender of the Euro. The institution was widely recognized as being a strong and independent body which couldn't be manipulated by political forces. Those days are now gone. The ECB has caved in to the politicians and is now just another run-of-the-mill hack institution with no economically-redeeming purpose. The damage to its reputation may prove irreparable.

A few other key points about the European bailout:

- This "rescue" does nothing to address the massive debt overhang within Europe. It simply adds more debt to an overly-indebted situation.
- The plan fails to address the structural shortcomings of the Euro such as the lack of competitiveness of Southern Europe relative to Germany.
- This is essentially a bailout of European banks which made bad loans to Southern Europe, and the cost will be borne by taxpayers.
- The IMF is chipping in $250 billion. The U.S. is the single largest contributor to the IMF, which means that U.S. taxpayers are bailing out failed European countries and banks to the tune of $50 billion.
- A trillion dollar bailout will take the pressure off of politicians. Is it really likely that they'll make hard career-ending choices when they can simply borrow from the EU and IMF? I doubt it. The problem is simply being kicked down the road a little further.
- Ireland is instructive. The Irish ran into trouble first and have been busily taking harsh steps to try and right their ship, including serious spending cuts. This, however, is leading to a weak economy, less tax revenue, and a GROWING debt burden relative to income. This is what Greece, Spain, Italy, and Portugal face. The U.K, Japan, and the U.S. will be able to print money to inflate their way out.
- Each EU country is chipping in to fund the bailout. This means that even the most troubled countries like Greece, Spain, and Portugal are supposedly contributing money to fund their own bailout. What a trick! It's like someone who is absolutely broke claiming that everything is fine because he'll just lend himself money that he doesn't have! Say it with me -- Ponzi scheme.
- At the moment, much of the stimulus is on paper only -- a promise. National legislatures will need to approve this, and this isn't likely to go smoothly, particularly in Germany. Merkel

recently lost a key election resulting in an effective vote of no-confidence, in part due to her capitulation on the issue of bailing out Greece for a mere tens of billions of Euros.

Just as with each prior bailout, this latest massive bailout will ultimately fail because you can't fix a debt problem by issuing more debt. At some point, debtors will have to repay or default on this debt. This will end badly with rising interest rates and massive default and/or inflation.

The Euro as it currently exists is doomed. Europeans craved the low interest rates that adopting the Euro offered, but they never addressed the lack of political and fiscal cohesion missing in the original EMU treaties. They wanted to retain fiscal sovereignty AND benefit from a strong currency and low interest rates. For the Euro to survive in its current form, EMU members would have to accept a tremendous loss of sovereignty, and Germans would have to agree to bail out the weaker European nations with whom they share little in common. Expect more social unrest, political upheaval, and pain in the coming months and/or years. The Euro will look very different a few years from now, if it exists at all.

The new permissiveness by the ECB and the uncertainty as to the Euro's future are the key reasons gold has recently rallied. The ECB was once a staunch defender of the value of the Euro, but they've now capitulated to political pressure and, in doing so, have seriously tarnished their reputation. The Euro is no longer a safe haven for one's wealth. Some of the global reserves that had been held in Euros must surely be finding their way into gold. The U.S. dollar has also been a big beneficiary as it is still seen as a safe haven in turbulent times. Once the fallacy of dollar strength becomes clearer, we could see an explosive move in precious metals.

Trading Activity

We've placed a few trades since the end of last quarter none of which should be terribly surprising. They fall into the same trends we've been focused on now for some time – opportunistically boosting our precious metals exposure, increasing attractive yield investments for more risk averse clients, and continuing to increase our hedge (protection) position as the rally continues.

Verizon

We recently added a position in Verizon for our more conservative clients. Although we bought Verizon stock, the position should be thought of more as an inflation-protected bond. Verizon stock is yielding 6.5%. The company has a solid balance sheet, so the dividend should be secure for some time. Let me be clear -- I am not concerned with where the price of Verizon stock goes. This is not a capital appreciation play. If it does appreciate at some point, that would be gravy. We own it for the yield.

This security is very similar to our limited partnership positions. Our limited partnership shares are also equity positions, but we own them for the yield. As such, I am not at all concerned about whether the share prices rise or fall. Furthermore, these positions are more attractive than simple corporate bonds because the dividends and distributions should increase over time as the firms grow their cash flow.

Hedge Positions

In our more aggressive taxable accounts, we added a call option on the VIX index early in the quarter. The timing was fortuitous as the position has since doubled. The VIX index is a measure of volatility, and clearly volatility has increased in recent weeks. This is a tactical position intended to provide a little more short-term protection to our portfolios.

We also recently added EPV to most portfolios. EPV is an ultrashort Europe ETF. Essentially, it can be expected to move twice as much as European stock markets but in the opposite directions. We added this position last Monday when Europe was staging a huge relief rally on the news of the massive trillion dollar

bailout. EPV was down 16% that day. I believed investors would quickly grasp the likelihood that the bailout would prove insufficient and the markets would reverse. So far, that has proven to be the case.

Precious Metals

Silver took a dive at the beginning of the month, and we took advantage of the pullback to increase our position somewhat. I mentioned in the last Quarterly Review that I had more appetite for this metal, and we were fortunate to get another crack at it. The metal didn't stay down for long. Currently, JP Morgan is being investigated for manipulating the price of silver lower. This is a very thin market that could fairly easily be moved. IF JP Morgan (or anyone else for that matter) was indeed pressuring silver prices lower, an active investigation should discourage further manipulation, at least for a while. We do NOT own silver simply in the hopes of benefiting from an end to any possible manipulation, but it would be a nice bonus if true.

Chart of Silver Price

We also boosted exposure to the junior mining space. We added to Entrée Gold (EGI) and Extorre (EXGMF) recently. As mentioned earlier, this is a very volatile space, and I anticipate adding on weakness in individual names. Should the price of gold and silver keep climbing, these junior miners should perform strongly as a group.

Summary

There is a battle underway. On one side we have the reality of a growing debt bubble, an increasing threat of inflation in countries which control their printing presses, and an increasing threat of deflation in countries which don't control their currencies. Reality also has a fragile banking sector, massive deficits, a weak private sector, and unattractive valuation behind it. On the other side, we have zero percent short-term interest rates and massive stimulus. This stimulus has been encouraging speculators to move money from cash to risky assets, thereby fostering unsustainable asset bubbles. There is no doubt that reality will win out in the end, but we can't know when this will happen. It may be happening now, but there's a chance that it may not really begin to happen until central banks finally get serious about raising interest rates. If so, the rally could certainly have legs as there are few signs of monetary discipline anywhere outside of Australia and China at the moment.

The bulls should be very concerned that trillions of dollars of global stimulus have been able to engineer such a meager economic rebound. Of course, it's no surprise that activity bounced, but we really haven't

bought that much growth with all of this money. The authorities had hoped that the massive stimulus would buy some time for the private sector to start growing again, but we haven't seen much traction thus far. Instead, we're building an economy ever more dependent on government stimulus and handouts. How long the bond market will continue to allow this bankrupt government to continue providing this drug is the key question and will ultimately determine when the sovereign debt bubble in the U.S. will implode.

We'll continue to tread carefully in what are clearly fraudulent and manipulated markets. Strong days continue to come with weak volume while big down days are accompanied by very heavy volume. Recent news that 4 of our nation's largest banks managed to generate trading profits on every single day of the first quarter is simply astounding. As Jonathan Weil highlighted in a recent Bloomberg article, the odds of this happening are breathtaking. If you assumed that these trading desks had a 70% chance of making money on any given day (a number any investment professional would kill for), the odds that all 4 banks would make money on every day of the quarter works out to one in 5.7 billion.

Fortunately, our portfolios are doing what they're designed to do. We have modest exposure to the upside should this bear market rally still be intact, but more importantly, we should be reasonably well protected if the wheels are indeed coming off. Our focus remains on wealth preservation, and we'll continue to take advantage of opportunities than an increasingly volatile environment is likely to present.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

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