ASPERA BULLETIN

Intelligent, Independent Investment Management

Score One For The Inflationists

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

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In recent months, many "experts" and the media have firmly planted themselves in the deflation camp with dire warnings that we were headed towards a deflationary spiral and another Great Depression. Just as it was fashionable to buy tech stocks in 2000 and real estate from 2003-2007, it is now fashionable to call oneself a deflationist and issue apocalyptic warnings of impending doom. If you listen to these folks you'll soon be convinced that, before long, we'll all be living in caves, marrying our cousins, and subsisting on tree bark and free-range squirrel.

Despite these dire warnings, I've been much more focused on the prospect of future inflation. The big news this past week only served to confirm and heighten my concerns. On Wednesday, the Federal Reserve announced that it would be printing another $1 trillion of "new money" to fund the purchase of Treasury and Agency securities.

The Fed would like us to believe that this is a temporary measure to restart the economy and that as soon as the economy is on sound footing it will easily be able to remove all of this new money. Unfortunately, printing money is easy. Removing it is more challenging. If the Fed doesn't remove the money, then inflation will be the likely outcome. If the Fed does remove the money, it will slam the brakes on whatever growth/rebound we might eventually experience. Until then, this flood of money at some point will work its way into the economy and give the impression that a solid recovery is underway.

The Fed's announcement that it would be directly buying Treasury securities shouldn't have surprised anyone since they began telegraphing this move months ago in various speeches and communiques. Market reactions, however, suggested otherwise. Fortunately for us, we were positioned well for this. The dollar fell dramatically while gold, energy, and commodities soared.

The performance of gold deserves particular attention. Gold had been down as much as $30/oz just prior to the Fed announcement. That's a healthy 3% decline. You can see in the chart below that gold spiked higher right after the announcement. It climbed about $60 (7%) in just a matter of minutes.

With the Fed now artificially attempting to keep a lid on longer-term interest rates by buying Treasuries, we have to wonder what kind of appetite our foreign benefactors (mainly China and Japan) will now have for additional Treasury purchases. They've essentially financed our deficits in recent years by purchasing our government debt on a massive scale.

The tremendous drop in yields on Wednesday was a one-time windfall for holders of these securities (prices and yields move inversely), but purchasers may think twice going forward about buying low-yielding securities that are artificially and temporarily being propped up by the Fed at a time when the prospect for future inflation is increasing. They also should be more concerned now about another leg down in the dollar and the impact that will have on their returns.

With the huge issuance of Treasuries to be auctioned this year and with foreign purchasers likely to retrench, I would expect additional announcements in the future from the Fed detailing even larger purchases of Treasuries. They've now become the purchaser of last resort. Still, this can only continue for so long. We shorted the long end of the Treasury curve once already, back in December of last year, and we covered that trade at the end of January for a nice gain. I'm hopeful that we'll get another crack at it soon, but we may not if enough other players share my concerns. Either way, buying Treasury bonds at current yields strikes me as one of the worst possible investments available today.

The key takeaway is that there should be no doubt now in anyone's mind that the Fed is prepared to pump as much money as necessary into the economy to try and revive it. The more they create, the harder it will be to absorb it later on. The first thing to watch for is whether the banks accelerate their lending and start pumping that cash into the economy. If so, it will be interesting to see where that money goes. Given our heavy weighting towards commodities, I'm obviously betting that a good deal of that money finds its way back into real assets.

The Recent Rally

I was hoping to send this out Sunday evening but was delayed. With it now being Monday evening, I thought I'd comment on today's market action and the recent rally. Both have been nothing short of impressive. The market rallied 7% today and is now up 23% in just the last two weeks. Fortunately, we went into this rally with accounts at their heaviest equity percentage since they've been under management at Aspera. Most aggressive accounts were 90-100% invested.

The rally can be attributed to a number of factors. First of all, the market was oversold on a short-term basis after falling about 25% since the beginning of the year. A bounce was due. In addition, valuation was finally attractive. Renewed hope (yet again) in the Fed's latest attempt to stimulate the economy also boosted sentiment. Finally, today we received some details about the Treasury department's plan to help banks dispose of their toxic assets.

In last week's Bulletin, I wrote the following, "Whether we’ve seen the bottom or not, I fully expect to be doing some selling should this market climb much further." With the market no longer oversold and with valuation a bit less supportive than it had been, I used today's rally to begin pulling some money out of the

market, as planned. No one knows how strong this rally will be. Recall that the Great Depression witnessed a 50% rally before stocks went on to make new lows. This could be the beginning of the next bull market or it could be just the latest bear market rally.

Either way, I plan to gradually decrease our market exposure should the rally continue. We own a number of core long-term positions that will not be sold any time soon, so there is certainly a limit as to how low our exposure will drop, but my bias is now once again towards selling. We may well soon be initiating some new short positions as well, particularly in the finance sector, if the rally continues. As always, I plan to patiently take advantage of whatever opportunities the market provides us.

Best,

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President
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