ASPERA BULLETIN

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Mamma Mia!

Now that was an interesting week and a bit of a relief personally. How long can a person caution about elevated risk and a lack of attractive opportunities in the face of ever-rising asset prices before his credibility, intelligence, and competence are called into question? I was running the risk of making the boy who cried wolf look like Paul Revere. This doesn't mean that the markets are headed straight down to new lows, but hopefully any question about my sanity has at least been given a short reprieve.

2010 was off to a quick start with the equity market tacking on a healthy 3% in just the first two weeks of the year. That brief sprint has since been followed by a decline of 7.3%. The equity market fell 3% on Thursday alone, its worst day since last April. It had the feel of early last year when investors were selling everything that wasn't tied down and flocking back to the "safety" of the U.S. dollar and Treasury securities. The supposed benefit of asset class diversification was once again shown to be MIA. The S&P 500 is now back to levels seen as far back as September.

Is this finally the beginning of a new leg down or merely a hiccup and a "great buying opportunity" as the CNBC crowd is crowing? Alas, I'm a poor hoister of manure. The simple if unsatisfying truth is that I don't know and that time will tell. Regardless, risks and valuation remain elevated, and it's finally becoming more difficult for the bullish masses to keep their heads in the sand. So, what changed?

Slipping Through My Fingers

In recent weeks, we've seen some of the concerns I've been highlighting come to pass. The current major headliner has been the debt and deficit disaster that is southern Europe. The focus is currently on Greece, but Portugal and Spain (and Ireland and the U.K.) are also in serious trouble. Ah, Greece. Such beautiful islands. Such wonderful beaches. Such a rich history. Such a financial basketcase.

Greece is being forced to reduce spending and raise taxes in order to reduce its unsustainable budget deficit and debt burdens. This is certainly not going to spur economic growth in the near future. Countries used to rely on the ability to devalue their currency (to stimulate exports) as an offset to such fiscal austerity, but the adoption of the Euro has eliminated this policy response for much of Europe.

Greece offers a glimpse of the debt death spiral that I've been warning about. As the Greek situation has deteriorated the market has demanded higher yields on their government bond issuances. This results in a growing interest expense for the country. With pressure to reduce deficits, this results in less money being available for discretionary spending. As a

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consequence, the country either needs to increase borrowing (which won't be allowed by their European partners or the bond market) or further lower spending and raise taxes which will just exacerbate the economic downturn. As fiscal tightening takes hold, we should expect increased social unrest. The pain hasn't even begun, yet the farmers are on strike and blocking roads, and public employees are protesting even modest reductions to their pay and ranks. Even the prostitutes staged a strike (so I read) last month.

I believe that the odds of Greece fumbling along for years in a deflationary environment as they responsibly cut back spending and raise taxes are fairly low. I seriously doubt the populace will be willing to endure the years of pain that this current solution will bring. That leaves a couple of other options. First, Greece could be bailed out by the European community, which really means France and Germany. A bailout is politically tricky because it would essentially mean that the taxpayers of Germany and France would be rescuing the imprudent citizens and politicians of Greece. That's unlikely to play well in Germany and France. If a bailout of Greece does occur, we can be sure that Spain, Portugal, Italy, and Ireland will immediately be looking for similar generosity.

Another option is for Greece to default on its debt, drop the Euro, and revert to the Drachma which it can then devalue. Greece has a long history of defaulting, so this would hardly be unprecedented. Should Greece default, Spain, Portugal, Italy, and Ireland may not be terribly far behind. Their citizens may struggle to accept that they should suffer higher taxes and deflationary pressures if their Greek neighbors have washed their hands of their debt.

The European Monetary Union is facing its toughest challenge to date. We've already seen a 10% decline in the value of the Euro since the first of this year as concern has grown. This weakening Euro is exactly what the troubled countries of Europe need, and a further significant devaluation could temporarily offer a reprieve. However, everyone in the world hopes to export their way out of their economic troubles. Even Obama stated a ridiculous goal of doubling exports in the next 5 years in his State of the Union. Does he think that U.S. companies aren't currently doing everything they can to increase exports? The only way this goal can be reached is through another significant decline in the value of the dollar, but that's the rub. Everyone wants a weak currency to boost exports! I can't figure out who exactly is supposed to buy all of these exports. In this world, any significant devaluation of a major currency will only be tolerated for a short while. A competitive devaluation (each country taking turns devaluing its currency) and increased trade barriers are huge risks in the coming years. There is no easy solution to the current European problem, and the contagion risk is very high.

Let's hope that the U.S. and Japan are paying close attention to the lessons that Greece is providing. The most important lesson is that **you can continue to party, finance your deficits, and refinance your debt**

at low rates…until you can't. At some point, the market will demand higher rates to compensate for the increased risk of default or increased risk of inflation (money being printed to pay down the debt and finance deficits). It's impossible to say when this day of reckoning will come for any one country. Greece's day has arrived. Spain and Portugal aren't far behind. Japan, the U.S., and a number of other developed countries will face this same reckoning if politicians don't accept the need for some near-term pain.

Money, Money, Money

"Buy on the rumor and sell on the news" is not the tag line for the National Enquirer. It's a well-known investment maxim. It also aptly describes the market action over the past 10 months. The rally we experienced from March through December of 2009 was driven in part by an expectation of an improving earnings climate for companies. Considering that the earnings for the 500 largest U.S. companies collectively amounted to -$23.25 per share (yes, that's a **loss** of over twenty-three dollars) in the fourth quarter of 2008, it wasn't difficult to predict some improvement. Indeed, earnings-per-share improved to $7.52 in the first quarter of 2009, $13.51 in the second quarter, and the third quarter looks to be about $15.00 per share. Last year, the market correctly anticipated an improvement in corporate earnings.

If the last three quarters of 2009 were the "rumor," then the past month is the "news." My concern increased (again) in recent weeks as it became clear that the market was responding to better-than-expected corporate earnings reports with profit taking. This was a clear sign that much of the good news had finally been fully reflected in share prices. The market is now looking ahead to the second half of 2010 and may finally be grasping some of the headwinds that I've been discussing. Revenue growth is still absent, earnings comparisons will get more difficult as the year progresses, and the Fed has stated that it will be done buying mortgage-backed securities in March. And importantly, valuation remains above long-term averages. Perhaps the market is finally coming to grips with these realities.

SOS

The emerging market arena has been the most impacted by this latest return to risk aversion. The iShares Emerging Market ETF (EEM) has fallen 14% from its peak in early January. China, India, and Brazil are all down roughly 10% in the past few weeks. The Chinese ETF (FXI) that we sold at an average cost of $40 between June and August of last year is now trading at $37.57. The Indian ETF (EPI) that we sold last June for $19 is just $1 shy of that price 8 months later. If the current pace of deterioration continues, we may be rebuilding those positions in 2010.

China is particularly interesting. I cautioned in the last quarterly review that the Chinese economy, particularly real estate and the export-oriented manufacturing sector, is far less healthy than generally perceived. The authorities in China have recently taken some very modest steps to reduce bank loan growth. We'll see if the Chinese government has the backbone to significantly rein in fiscal stimulus and credit growth given their fear of rising unemployment and social unrest. I suspect they'll attempt modest tightening until signs of a slowing economy become evident. At the first sign of a slowdown the temptation to reignite credit growth may be too tempting to resist. Eventually, accumulating bad loans will have to be dealt with. China, too, has a reckoning in its future. When this comes to pass, we will likely be aggressive buyers.

Take A Chance On Me

With an overvalued market still rising in the face of serious risks and a poor market response to some fairly good earnings report, I recently took further modest steps to reduced risk in our portfolios. Earlier in January, we sold Chesapeake Energy (CHK). Chesapeake had announced another partnership for its shale gas properties, this time with Total E&P USA, Inc. Chesapeake has a number of these joint ventures in place. Partners get access to production from Chesapeake's shale fields while Chesapeake benefits from lower drilling expenses in future years. These partnerships, however, take away some upside from CHK shares as they dramatically reduce the chance that CHK will be acquired. In addition, I have serious concerns as to the ultimate profitability of shale gas wells once all costs are factored in. CHK had popped on the announcement of this latest joint venture, and we sold soon thereafter. CHK has since dropped 13%. Despite this sale, energy is a sector we want exposure to this decade, and I'll be looking to add to this space on weakness.

More recently, I added RWM to portfolios. This is a short ETF which tracks the inverse of the Russell 2000, so this is a hedge position. This security increases in value as the market falls and vice versa. The timing here was rather fortuitous as I added this position this past Wednesday, one day before the 3% decline in the market. As much as I'd like to attribute this timing to brilliance, it was simply luck. Let's call it brilliantly lucky.

When All Is Said And Done

Our hedge positions have helped during the recent pullback, as they should. They will help to cushion any damage should the market decline continue. These positions include VXX, SEF, SKF, SZK, RWM, our short equity positions, and our put options. Our dollar position (UUP) should continue to serve as a hedge if the current environment continues, but our short Treasury position may continue to weaken (TBT) due to a knee-jerk rush back into the safety of Treasuries in times of turmoil. With a tremendous amount of debt issuance ahead in future years and the increasing chance of future inflation, my bias still strongly favors shorting long duration Treasuries. We will be adding to our short if yields continue to decline in the near-term.

The real determinant of our performance in all but our more conservative portfolios is likely to boil down to the results of our precious metals positions. Should investors panic again and rush to sell all risky assets as they did in late 2008, early 2009, and last Thursday, then we should expect to see a further pullback in our precious metals position, and this will negatively impact our performance in the near-term Gold and silver have both pulled back recently, as a strengthening dollar has typically meant near-term weakness in the metals. The mining stocks are more volatile than the metals. A look at XRA is telling. On Thursday, the security was down roughly 13%, but it rebounded 12% on Friday. Such volatility in our metals positions is likely to continue. This is a key reason why I emphasize not reading too much into any one quarter's performance. Our precious metals positions will ultimately drive performance and strong moves in this sector tend to come in bursts and are followed by a period of retrenchment and consolidation. How long the current retrenchment and consolidation lasts is unknown, but I remain confident that our patience will be rewarded.

At some point, I believe that investors will look to gold as a true safe haven as it represents a claim on no one. Instead of simply selling gold whenever the dollar rallies, I expect to see the correlation between gold and the dollar eventually erode. Our precious metals holdings are largely core positions for us, and I have no intention of selling in the hope of buying again later at a lower price. The reality is that the current turmoil facing the Euro, the structural imbalances facing much of the developed world, global credit excess, the risk of a slow devaluation spiral, and continuing monetary and fiscal stimulus all bode well for gold.

Additionally, despite the President's pride in finding $20 billion worth of cuts in the proposed 2011 budget and his new focus on fiscal prudence, the fact remains that the 2011 budget calls for $3.8 trillion in spending, and it will generate another massive deficit of $1.3 trillion. How can anyone seriously tout a "savings" of $20 billion while having to borrow $1.3 trillion? $20 billion is a mere one-half of one percent of the $3.8 trillion budget! Gold is a hedge against government mismanagement. There is no reason for us to sell gold at this point.

It should come as no surprise that I will look to increase the risk in our portfolios should this decline continue. The first step will likely be the reduction/elimination of our hedge positions. This would be followed by increasing our long exposure. This, of course, all hinges on the opportunities that arise and the depth of the current pullback. I'd like to think that we're at the beginning stage of a significant pullback which will once again give us the opportunity to shift our bias to growth from wealth preservation, but it's also possible that the rally may yet have some life remaining. In the meantime, as we wait for events to unfold, the vacation-minded may want to start taking a look at Europe given the recent weakening of the Euro. Greece could use the help.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

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