ARKY&MILLER
FINANCIAL GROUP, LLC
PLANNING MEANINGFUL FUTURES

2Q 2011 Quarterly Review: Entering The Air Pocket

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Planning Meaningful Futures

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Every client portfolio is separately managed.

The securities and strategies discussed in this Review may not apply to every client portfolio.

"I've got all the money I'll ever need, if I die by four o clock."

Henny Youngman

Let's start with some good news. The Rapture was predicted to occur on May 21st of this year by Mr. Harold Camping, a popular religious radio broadcaster who is particularly fond of applying numerology to the Bible to conjure up dates for the End Times. On May 21st, the righteous were supposed to soar to heaven, leaving the rest behind to suffer hell on earth.

We must admit that we weren't surprised to still be here on May 22nd. Rather than admit his third failure (he also predicted the End Times would occur on May 21, 1988 and September 7, 1994), Camping instead proclaimed that a "spiritual" judgment had actually occurred and that the date of the actual Rapture had been pushed back to October 21st of this year on which day God would also destroy the entire universe. (And we thought we were bearish!) Ah, the beauty of never having to admit you're wrong. Mr. Camping would have made a wonderful Wall Street strategist.

We're happy to report that we weren't alone in our skepticism of Camping's prediction. Not one of you cashed out of your investment portfolio prior to May 21.

More good news? We discovered that the brilliant Sir Isaac Newton apparently calculated that the Apocalypse could not happen before 2060. Fortunately, by then, we'll all be dead or extremely senile. It will simply be one more problem we'll be passing along to our children and grandchildren. At least the enduring nightmares of global insolvency, Ponzi economics, market manipulation, and Lady Gaga will seem less pressing.

Since we can't count on the End Times to resolve our retirement plans, we must remain focused on our investment portfolios. So, let's turn our attention to something slightly less disastrous than the end of the world.

Ode to a Grecian Earner

Since last February we've discussed how hopeless the current path is for the Greeks and that Greece would inevitably default in some manner. How bad is it in Greece? Their former defense minister is now in charge of the finance ministry (this is true).

Last year, Greece went hat in hand to its European "partners" and the IMF and borrowed 110 billion euros ($159 billion). In return, the Greeks promised to raise taxes and slash spending. The world was assured that the problem was solved and that Greece would quickly rebound. One year later we can see just how effective the "bailout" and austerity measures have been. In a resounding demonstration of success, the governing party in Greece just narrowly won a vote of confidence, and a new loan of 115 billion euro ($166 billion) is hastily being thrown together with a new package of tax increases and spending cuts for the Greeks to choke on.

Clearly, the initial "bailout" did nothing to help Greece. Rather than admit failure, however, the powers-that-be are doubling down and cobbling together a new package that looks eerily similar to the first failed package. We'll refer to this as Camping Syndrome. At best, it demonstrates a shocking lack of creativity on the part of Europe. What does Greece get out of this new old bailout scheme? Well, for one thing Greek GDP in 2010 was $350 billion. In just two years, the Greeks will be adding debt equivalent to 100% of GDP. How can we put this clearly and politely? That is absolutely, ridiculously, jaw-droppingly insane. There is no way that debt will ever be paid back completely. There is a reason that 2-year Greek government debt was recently yielding nearly 30%. The market knows that Greece will restructure in some fashion. Eventually, the politicians will realize the same thing, and they'll expedite the process for fear of being souvlaki'd by the voters.

Let's be clear. These bailouts of Greece will not bail out Greece. They are intended only to bail out the large European banks which made the gross mistake of buying too much bad Greek debt. The Germans are concerned with Germany, and the French are concerned with France. Few really know what goes on behind the closed doors in Brussels, but the image in my mind is of a roomful of tuxedoed and mustachioed pasty-white Northern European diplomats donning top hats, canes, and man purses (technically we keep picturing Rich Uncle Pennybags, the logo for Monopoly) sitting around a table made out of elephant husks and panda ovaries guffawing as they debate whose "bailout" plan will blow up Greece the quickest. They consummate each assignation by playing the Greek version of Monopoly, putting hotels on the Acropolis, renting out Delphi, and trading Greek islands amongst themselves while Greek Prime Minister Papandreou hops around wearing a pill box hat with an organ grinder on his back offering shoulder rubs for 5 euros a pop. Sorry, that just came out. We apologize if we offended any monkeys or pill box hat manufacturers.

There is no painless solution. Right now, the solution is for Greece to suffer while the rest of Europe pretends that the problem will magically go away if they just don't make direct eye contact with it. There will be much more pain. The question is who will bear it and for how long. Up to now, the Greeks have been Europe's whipping boy, but the Greeks have been gradually waking up. Protests have grown and have turned violent. Once it becomes clear that a third bailout is needed, this insanity will end. We can't imagine the Greeks will sign up for ever more indentured servitude given how narrowly this latest farce passed the parliament.

The irony is that all of this foot dragging and bailing outing is keeping long-term investors away from Greece. We have absolutely zero interest in buying Greek debt. It's all for the speculators now. True investors are simply not interested in gambling on the debt of an obviously bankrupt country. Only when Greece has eradicated much of its debt (through default of some type) will long-term investors return to Greece with capital to invest.

There are a number of possible solutions. Perhaps the simplest would be for Greece (this also applies to Ireland) to simply "offer" a 70% discount on the face value of their bonds. Those who refuse will receive nothing. After the Germans finish soiling their lederhosen, it won't take long to reach a real solution. The Greeks just don't seem to realize how powerful their negotiating position is.

We want to emphasize that while the focus of this discussion has been on Greece, there are serious imbalances in Portugal, Spain, Ireland, and Italy as well. Ireland has already imploded and is in the same boat as Greece, but the other countries have been fairly quiet and off the headlines for a little while. We expect this to change.

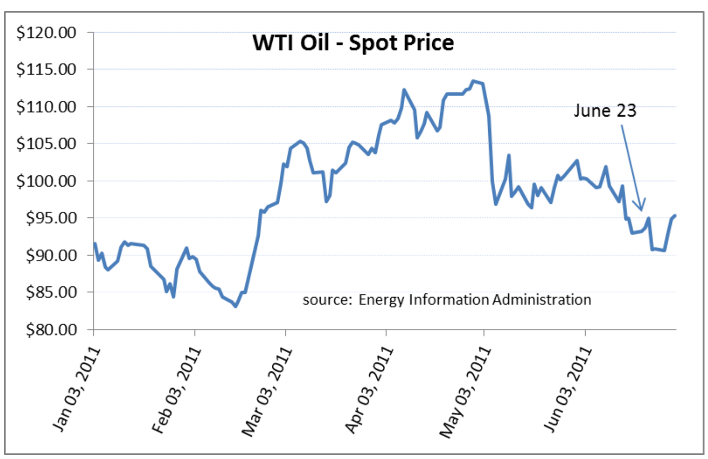
Let's conclude this section with a quote from one of the chief proponents of a centralized European government and a leading member of the "everything that comes out of my mouth is either stupid or wrong" club. Eurozone chief, Jean-Claude Juncker, was recently quoted saying, "The debt level of the USA is disastrous. The real problem is that no one can explain well why the euro zone is in the epicenter of a global financial challenge at a moment, at which the fundamental indicators of the euro zone are substantially better than those of the U.S. or Japanese economy." You know things are bad when you stop arguing that everything is just fine and start arguing that you're less screwed up than someone else.

Strategic Petroleum Reserve = Strategic Political Reserve

The energy space has long been a focus of ours. We still own a number of energy names, but most of our exposure is now in relatively more conservative energy securities. All but one of our higher octane energy service names were sold a number of months ago as our price targets were achieved and our expectation of an economic slowing grew. We've been patiently waiting for another opportunity to significantly boost our exposure to this space, and for a few days it looked like it might come sooner than expected.

On June 23rd, the Obama administration, in conjunction with the International Energy Agency (IEA), announced that 60 million barrels of crude oil would be released from strategic global stockpiles. The U.S. would release half of this total. The oil would be sold at auction and released over the course of July. The Obama administration further said that it would monitor the markets to see if further action was warranted.

We were a bit shocked and taken aback by this news. This oil is supposed to be stored for emergencies. The official word is that this is being done in response to the loss of oil due to the Libyan turmoil. Well, Libyan oil stopped flowing in February. Looking at the chart below, we can see that oil prices did indeed spike following the cessation of Libyan oil sales, climbing from $84 per barrel to $112 per barrel at the end of April. Note, however, that oil prices have been in a steady decline since then. By June 23rd, oil prices were back down to $95, right about where they began the year, before Libyan oil sales had been halted.



So, what exactly is the emergency? The market had already discounted the fact that Libyan oil wasn't flowing, and prices were already in retreat. This doesn't come close to an emergency. An emergency would be if:

- Saudi Arabia erupts in civil war and its oil fields are set on fire

- Israel attacks Iran, halting Iranian oil sales and blocking Persian Gulf tanker traffic
- China invades West Texas
- Saudi Arabia attacks Israel which strikes Iran which attacks China which invades West Texas

We have a very difficult time seeing this as anything other than a political move. Global leaders are struggling with a debt crisis, high unemployment, and a disenchanted electorate. They feel pressured to "do something." Hence, this back door attempt at stimulus. The threshold for emergency has just been dramatically lowered.

As for the real impact of this release of emergency oil, some perspective is necessary. The entire U.S. Strategic Petroleum Reserves hold 726 million barrels of oil currently. In fairness, 30 million represents only 4% of the total reserve, so we're not massively depleting the reserve. Also note that the world consumes 86 million barrels of oil each and every day. The total release of 60 million barrels won't even supply one day's worth of oil consumption to the globe. Keep in mind that these reserves will eventually need to be replenished which will add to oil demand and support oil prices. It's difficult to see how this 60 million barrel sale will do much of anything aside from lowering strategic reserves by 60 million barrels.

When the announcement of the stockpile sale was made on June 23rd, we were disgusted by the politics behind it, but we were also excited by the prospect that a market overreaction could lead to some compelling investment opportunities in the oil patch. Unfortunately, as you can see in the previous chart, the announcement had a short-lived impact. As we write this, oil prices are now back above levels prior to the announcement.

Nevertheless, we can't rule out further political manipulation and incompetence. We know that lower oil prices will temper inflation concerns and give the Fed more room to enact QE3, so there are plenty of powerful people who would like to see lower oil prices. Further evidence of a weakening economy coupled with releases of emergency oil could certainly take a chunk out of the price of oil at some point.

Peak oil is real. Increased oil demand from the developing world is also real. Higher oil prices will be our reality, and we will all see $200 and $300 oil. There will, however, be dramatic declines in the price of oil from time to time due to either overt political manipulation or a slowing in global economic activity. We will take advantage of these declines to boost our exposure to the space. Unfortunately, it doesn't look like that next opportunity is quite here yet.

The Fed - Teeing Up QE3

With the end of the second quarter comes the end of the Fed's second quantitative easing program (QE2). The Fed will still be recycling interest payments and maturities into the Treasury market, but the large purchases are now behind us…at least for the moment. As we mentioned in the last Review, the intention of the Fed to end QE2 at the end of June had been very clearly telegraphed. Because of this, we doubted that this alone would be the catalyst for a dramatic market sell-off. We're sure that some portion of the 6.5% decline in the S&P 500 from late April to mid-June was in anticipation of QE2 ending, but a good part of that decline was made up in the final week of the quarter.

The real question is what happens next. Of course, it's impossible to know with certainty what the Fed will do, but we remain firmly in the camp that believes more easing lies ahead. The questions in our minds are:

1. What will it take for the Fed to act? The Fed has taken a lot of heat for QE2. In order to justify another large monetary stimulus program, the Fed is going to need some cover. Specifically, Bernanke would need to see a drop in commodity prices, continued weak employment figures, a slowing GDP, and a declining stock market. The more of these that occur and the more significant the weakness, the quicker the Fed will act.

As you well know, we do not believe that the economy can stand on its own. With fiscal and monetary stimulus both sidelined, we suspect that the true underlying weakness of the economy will reveal itself. Bernanke has a dual mandate of keeping a lid on inflation and promoting full employment. He has made it clear over the course of his career, in his research and his speeches, that he believes the Great Depression could have been avoided if the Fed had been more aggressive. We expect that he'll get another opportunity to act on his faulty research conclusions.

2. What will the Fed actually do? We don't think we'll see a repeat of QE2, whereby the Fed conjured up new dollar bills to purchase Treasury securities. If they do repeat this, it would likely just be one part of a new easing program. The Fed is currently paying banks interest to keep reserves at the Fed. If the Fed wants to encourage banks to lend this money out (and spur economic activity), it could stop paying interest on these reserves. Better yet, it could charge banks interest on these reserves.

   In addition, Bernanke has mentioned the possibility of interest rate targeting. For example, the Fed could announce that the 10-year Treasury yield will henceforth not be allowed to exceed 2%. The Fed would then print as much money as possible to buy whatever amount of 10-year Treasuries is needed to achieve this. We expect to see further creativity on their part in the quarters ahead.

3. How significant will it be? In a word, very. Whatever the Fed does next, it will have to be very significant if it's to have any impact.

4. What will this mean for the markets? This is tricky. It somewhat depends on exactly what the Fed does and how large it is. We would expect to see a decent rally initially on almost any action, but whether it sticks and for how long are pure guesses. At some point, too much monetary stimulus is sure to backfire. What we do feel very confident predicting is that any new stimulus from the Fed will be very bullish for gold, silver, and the precious metals mining stocks.

For the time being, we're in what we consider to be an air pocket. Fiscal stimulus is on hold as our legislators focus on the debt ceiling and pay lip service to deficit reduction. They seem convinced that the economy is fine and that now is the time to address the deficit. Watch how the rhetoric shifts as they realize that the economy is still very sick and dependent on government largesse. They'll back away from their deficit reduction talk quicker than an Anthony Weiner denial.

Bernanke has been asserting that the economy is on the mend and will strengthen further as the year progresses. Saying it doesn't make it so. Bernanke has clearly focused on employment, and as this goes to press the June employment report just came out and was a disaster. We expect the tone of Ben's message to shift soon as he becomes more open to the possibility of further stimulus. In the meantime, we will likely see some weak economic reports as well as weak earnings guidance from plenty of companies. We'll just have to wait and see how much pain is needed before Obama, Congress, and the Fed start backing away from their newfound professed fiscal and monetary rectitude.

In short, we're seeing global economic weakness. There are always some standouts, but much of the global economy (which is intertwined) is still unhealthy. Much of this is due to the massive credit bubble in the developed world which has actually become worse in the last couple of years. This massive debt makes it more challenging for the developed world to rely on fiscal stimulus to once again artificially and temporarily kick start their economies. As a result, all eyes will be turning increasingly to the central banks to "do their part." This is very bullish for the precious metals. Speaking of precious metals…

Precious Metals Update – A Tale of Three Markets

When we discuss the precious metals group, we are referring to gold, silver, and mining equities. As we've hopefully made clear in our prior writing, these various components do not move in lock step. This can clearly be seen in the first six months of 2011.

Gold has been solid so far this year. After a brief and modest dip in January, the metal has steadily trended higher. As risky assets sold off across the board in early-mid June, gold remained fairly stable. Gold posted gains in both the first and second quarters of the year. This is quite bullish as gold seems to be forming a nice base from which to move higher.

Silver has been much more volatile than gold. Silver also experienced a sell-off at the beginning of the year but then posted an explosive rally through April, followed by a dramatic sell-off in early May. First quarter returns were very strong, but silver posted a modest loss of about 8% in the second quarter. From trough to peak, silver climbed 75% in three short months and then fell nearly 30% in one week. In our view, there was clear evidence of futures market manipulation in early May, but that's a story for another time.

The gold and silver miners have had their ups and downs this year, peaking in early April and then declining nearly 20%. The group began falling in April, even as the price of gold and silver kept rising. For the year, the miners are actually sitting on losses despite gains in gold, silver, and the broader equity market.

The components of the precious metals sector clearly don't move in lockstep. As a result, the relative attractiveness of gold, silver, and the miners shifts over time. We boosted our silver exposure early in the year when we found it more attractive than gold.

After the big run in silver, we began to lighten that position. With silver having rolled over significantly, we've again boosted our exposure.

Despite nice gains in gold and silver this year, the mining group is actually down 10% as a group. A number of junior miners suffered much more severe declines. As a result, we're finding more attractive opportunities currently in the mining equities, particularly the riskier junior mining area. It should come as no surprise that we've been gradually adding to this space recently, focusing on names which we feel have been unduly punished.

We're finally seeing the price of gold trade on its own merits and decouple from the general equity market. This is an important development that we've been predicting would occur now for a number of years. This could always reverse, but gold certainly seems to be maturing into an asset class of its own right. The training wheels are coming off, and this is evidence that gold is increasingly being viewed as an unencumbered currency as well as a safe haven. This is an important phase in the long-term gold bull market.

Another key development will be the decoupling of the mining stocks from the broader equity market. This could still take some time, but we do expect it to occur. In the meantime, we'll continue to tactically rotate between gold and silver and between the metals and the miners as relative attractiveness changes. Ultimately, we still believe there is a strong chance that the growing demand for physical gold and silver will result in some degree of a mania in gold, silver, and the miners.

Performance

THIS SECTION RESERVED FOR CLIENTS OF ARKY & MILLER FINACIAL GROUP

Portfolio Positioning and Outlook

Over the course of the last quarter, we've become more bullish and more bearish. How's that for hedging one's bets? On the one hand, we're still of the view that we're mired in a long-term secular bear market, and we're getting closer to the tail end of a cyclical upturn within the bear market. Most equity and fixed income markets remain overpriced in aggregate and offer little margin of safety. With each passing day, we creep one day closer to the next reckoning. Around the world, we're seeing leaders defer difficult, painful, but necessary action in favor of short-term policies which simply kick an ever-larger can down the road. This can't continue indefinitely, though it's impossible to pinpoint the inflection point. So, from a top-down macro perspective, we are not particularly interested in being heavily exposed to risky assets. Cash remains a terrific asset and hedge until such time as our investment headwinds have been addressed and/or valuation becomes more attractive.

Despite these concerns, we've actually put more cash to work this last quarter. We have a greater exposure to risky assets now than at any time since mid 2009. How do we reconcile this with our top-down pessimism? The increase in our net exposure has come from three primary sources. First, we've reduced our hedge positions as they've become more expensive to implement. Second, we've added inexpensive dividend-yielding securities to our portfolios. Finally, we've boosted our exposure to precious metals, particularly the miners. Our precious metals position certainly qualifies as risky exposure, but we also view it as being defensive since the sector may benefit from the continued policy mistakes of governments and central banks. So, we've become more bullish, but more bullish in a bearish kind of way.

For now, we are in an air pocket during which Washington and Fed optimism will gradually erode. Investors are swinging from euphoria to fear with every economic release, central bank statement, and earnings report, and the markets are following suit. There will be plenty of noise in the months ahead. As always, it is in the best interest of your mental health to ignore the markets and its daily machinations. Turn CNBC off. Ignore the consistently false and misleading mainstream news reports on the economy and markets. Go for a walk or jog. Tend your garden. Read a book. Plan your future trip to a drachma-devalued Greece. Play a game of Monopoly.

Have a great summer!

Best,

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Joe Miller, CFP
Ken Bell, CFA, CFP

Arky & Miller Financial Group, LLC Investment Committee

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