

**A NO WIN SITUATION**

We are becoming increasingly concerned that the fed is running out of ammunition and rates will continue to move up in the face of an aggressive government debt buyback program to push borrowing costs and mortgage rates down. The purpose of this program is to reduce borrowing costs to support an economic recovery, however, investors are starting to see the program for what it is and are demanding higher risk premiums. Now that rates have moved up significantly, investors are beginning to question the feds ability to control a multi-trillion dollar, global market. If the fed cannot control long term rates (we don't think they can) then how far can/should rates rise to discount the risk profile of the treasury's balance sheet.

We view the government's actions and stimulus programs as a shell game. On the one hand treasury is aggressively buying everything under the sun, while on the other hand they are issuing significantly more debt than they are buying, therefore flooding the market with supply. We believe that from a pure supply/demand perspective, there is and will be too much supply for global demand to absorb, without being paid much higher rates.

All of these programs continue to significantly increase the credit risk profile of the treasury's balance sheet. The steepening of the yield curve and widening TWT (tens under twos) spreads is an indication that investors are beginning to demand a higher risk premium to lend money to the government for more than a short period of time. To make this even more clear, there is now talk from a number of rating agencies that debt issued by the US Treasury should no longer carry the coveted AAA rating, yet there are still trillions of dollars that have yet to be issued. This looks like a ticking time bomb to us.

As if these concerns aren't enough, we also need to keep a sharp eye on future inflation expectations. The definition of inflation is, too many dollars chasing too few goods, and the market is certainly being flooded with dollars. We believe that the above factors may point to higher long term rates and could be a significant factor in derailing an economic recovery. As we have stated in past commentary- "Why we should be Terrified" a potential opportunity may present itself in buying Ultrashort 20-year Treasury (TBT) on a pullback in the ETF.

Our absolute, overriding objective is to preserve capital for our investors. We are fortunate to have outperformed the market by a very significant margin last year and this year, allowing us to comfortably manage risk by focusing on capital preservation. Given that our models are now outputting very few long candidates and an overwhelming number of short candidates, we have been sellers into this recent market rally, while gradually increasing our short exposure. This is a time to play very conservative defense and focus on preserving our gains and trying to profit from a decline. So while we have been perplexed by the strength, resiliency, and breadth of this rally, we still believe we are in the middle of a very powerful bear market rally, which will end badly as more and more investors believe the worst is behind this. This complacency is exemplified by the CBOE Volatility Index (VIX) declining to below its September 2008 levels.

The market has simply moved up too much, too fast. What is fascinating is that lower quality companies seem to have moved up the most in recent weeks, in some cases doubling and even tripling. We see this as one of the most clear cut opportunities to short 2<sup>nd</sup> and 3<sup>rd</sup> tier companies that we've seen in this market cycle. Interestingly though, many higher quality companies have turned into story stocks and have also become significantly overvalued. We are seeing this in a number of Obama related healthcare reform and infrastructure companies as well.

On the short side, we are seeing an eclectic mix of companies and industries that look attractive to us, although the majority are consumer discretionary related companies. Many of these stocks have rallied on expectations that consumer confidence will rise and that unemployment rates will be tempered. We expect the opposite to occur.

On the long side we are still extremely bullish on drug/biotech companies. We continue to believe that baby boomers will continue to age and get sick. We also think the Obama health care reform won't be as bad as people think, for top tier drug/biotech companies with strong product portfolios and pipelines, and that margin pressure will be more than offset by volume increases. Given depressed valuations, we believe that this sector provides attractive defensive characteristics as well as upside.

In summary, while these issues are of great concern, our ability to be both short and long, give us the flexibility and opportunity to take advantage of this volatility and to potentially profit from a decline in the markets.

*-Harry Rady, Portfolio Manager of Rady Asset Management appeared on CNBC closing bell on 05.22.09 to discuss the current market environment. Please click below link to view appearance.*



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