Private Wealth Advisory

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The Inflation Trades Heats Up

The market is now screaming "inflation."

Ben Bernanke bet the farm (AKA the US dollar and republic) that he could solve a loose money problem by making money even looser. To date, Bernanke et al have made numerous moves aimed at propping up the financial system. The most significant are:

- The Federal Reserve cutting interest rates from 5.25-0.25% (Sept '07-today)
- Bear Stearns / the Fed taking on $30 billion in junk mortgages (March '08)
- The Fed opens up various lending windows to investment banks (March '08)
- The SEC proposes banning short-selling on financial stocks (July '08)
- Hank Paulson uses the blank check with Fannie/ Freddie spending $400 billion in the process (Sept '08).
- The Fed takes over insurance company AIG (Sept '08) for $85 billion.
- The Fed doles out $25 billion for the auto makers (Sept '08)
- The Feds kick off the $700 billion Troubled Assets Relief Program (TARP) with the Government taking stakes in private banks (Oct '08)
- The Fed offers to buy commercial paper (non-bank debt) from non-financial firms (Oct '08)
- The Fed offers $540 billion to backstop money market funds (Oct '08)
- The Feds agree to back up to $280 billion of Citigroup's liabilities (Oct '08).
- $40 billion more to AIG (Nov '08)
- Feds agree to back up $140 billion of Bank of America's liabilities (Jan '09)
- Obama's $787 Billion Stimulus (Jan '09)
- Fed announces its plans to buy $300 billion of Treasuries (Mar '09)

All of these moves are highly inflationary. However, the last move in particular has kicked the dollar in the teeth. It's also caused some serious rumblings from US Treasury holders, namely, China. Premier Wen Jiabao recently commented, *"We have lent a huge amount of money to the US…Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried."*

Other, former Chinese officials have been less polite in their public statements. Yu Yongding, a former Chinese central bank adviser, told Bloomberg that another global financial crisis triggered by a loss of confidence in the dollar may be inevitable unless the US saves more.

Secretary of the State Hillary Clinton flew to Asia to assuage Chinese concerns, but the market isn't buying it as the below charts attest:

As you can see, oil, like every other asset class except real estate, bottomed in early March and then spiked higher. However, it was the Fed's decision to buy Treasuries that pushed oil from a brief rebound to a full-blown sustained rally.

Ditto for gold:

The Chinese aren't buying the US's "strong dollar" claims. The People's Republic has begun shifting their reserves away from the dollar and into hard assets. China imported 329,000 tons of copper in February, and another 375,000 tons in March. They then bought 57 million tons of iron in April as well as a handful of Australian mining companies: $46 million worth of Terramin Australia's lead and zinc supplies in Algeria, and 51% of Ontario's Liberty Mines, a nickel producer.

Lest you think this is merely about locking in supplies, consider that China is buying MORE commodities now (when it's economy is contracting for the first time in 30+ years) than it was during the boom times. The Chinese are nobody's fools and they know well what is coming:

Inflation.

China's commodity purchases have given a serious boost to the inflation trade. So I'm adding a new position to our portfolio: **the PowerShares DB Base Metals Double Long ETN (BDD)**

BDD is a leveraged industrial metals index. In a nutshell, it returns 2X the return of Deutsche Bank's Industrial Metals Excess Return Fund. So if industrial metals rise 5%, BDD returns 10%. If industrial metals rise 15%, BDD returns 30%.

What are industrial metals? Steel, iron, zinc, copper, lead, and the like. They're the basic components used in production for countless industries ranging from telecom to construction or manufacturing. BDD gives us access to all of them, with the added juice of 2-to-1 leverage.

As you can see in the chart above, BDD shares have entered a strong uptrend bouncing off their 50-day moving average. They have since fallen to test the 50-DMA, but I have a strong feeling we'll see another dramatic bounce here.

For one thing, fundamentals have vastly improved for industrial commodities. As you well know, commodities staged a temporary top last summer. They have since fallen 50% across the board (some, like copper, fell even farther). Today, many commodities, particularly agricultural commodities, are at their cheapest levels (adjusted for inflation) in decades.

On top of this, commodity production is a capitally intensive business. And the credit crisis has made it much more difficult for producers/ miners to take out loans or receive capital. So supplies will be falling in the future.

Finally, commodities have always done well during periods of inflation. And the Feds are currently brewing up an inflationary storm similar to that of the early '70s. The Chinese know this, the market in general knows this, and commodities have begun rallying strongly.

Because of this, I think we're likely to see a major pop to the upside from BDD. It gives us broad exposure to industrial commodities (the very asset class China is buying in record amounts) with the added juice of 2-to-1 leverage: if industrial metals rise 5%, BDD returns 10%; if industrial metals rise 15%, BDD returns 30%, etc.

In simple terms, BDD is the perfect play to capitalize on the rally in commodities. The time to buy is now.

Action to take: Buy the PowerShares DB Base Metals Double Long ETN (BDD)

Company	Symbol	Buy Date	Buy Price	Current Price	Gain/ Loss
Gold ETF	GLD	5/6/09	$89.54	$93.45	4%
Gold Miner's ETF	GDX	5/6/09	$36.86	$41.22	12%
Rogers Agri ETN	RJA	5/6/09	$7.62	$7.88	3%
Lehman 20-year+	TBT	5/6/09	$50.11	$57.14	14%
DB Base Metals	BDD	5/27/09	$7.11	NEW	BUY!

Our original thesis for all of our portfolio positions remains the same: the Feds are creating an inflationary storm, the dollar is headed lower, and commodities and other inflation hedges are headed higher. Until the Feds put some action behind their "strong dollar" words (raise interest rates, stop propping up the banks, etc.), the story remains the same: inflation is coming in a big way.

Our portfolio is beautifully positioned to profit from this and will continue to do so until things change. I'll send out an update when it's time to take our profits in our current positions. Otherwise you'll hear from me next Wednesday. Until then…

Good Investing!

Graham Summers