Sand Spring Advisors LLC

All Hail Rigged Markets & A Look Back at the 1862-1878 Period

by,

Barclay T. Leib

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As long-time readers of these pages know, Sand Spring Advisors LLC has tended over the past ten years to be more right than wrong in our market calls. If I have been at fault it has usually revolved around being somewhat early in espousing market turns, but often this has been just a matter of days or at most a few weeks – not months.

As one example, I can remember dealing with the October 2002 bottoming process where I was bullish, but frustrated that marginal new lows kept transpiring. Eventually I had to send out an e-mail throwing in the towel when prices moved just beyond my key Fibonacci support. The market then promptly reversed higher. I am certainly not without moments of huge frustration. The 2002 low was one of them that sticks out in my memory.

The current market position has every resemblance to October 2002 – but in reverse. Equity prices keep crawling higher – even while cracks in the façade of a healthy global economy appear. The European banking sector is hanging by a thin string, China is steadily tightening credit, the Japanese government is fast on a path to fiscal bankruptcy, and the U.S. government is still involved in two off-balance-sheet wars while finding it difficult to generate any political consensus in Washington to deal with the tough domestic issues of government finance, long-term entitlements, and general tax policy. Printing money to buy financial assets has to date been the only perceived short-term medicine of any substance offered up by the Federal Reserve and U.S. Treasury, but as this has worked to inflate asset prices, the Fed is also inviting future social warfare between those who started asset-rich and those that started asset-poor. In other words, the "wealth effect" of asset prices going up may cause some already-rich people to feel better off, but not the average guy on the street. And no matter how hard the Fed pushes on financial assets, the housing market still feels effectively broken.

In my thirty years of looking at markets, the current time is perhaps the most faux rigged market environment that I have ever witnessed. As I recently tried to deal with my own Sand Spring Fund LP, I found myself in the situation where most of the stocks that I wanted to be long weren't moving very much, while almost every stock that I wanted to be short was vaulting higher day after day. The current market is one being led by a perception that the consumer is recovering – having paid down some debt, but now reverting back to old spending habits. I just don't believe that this view is possible longer term.

What I see instead is a situation where "the center holds until it doesn't." By this I mean that for all of America's problems, capital is still flowing here in lieu of Europe. China and Asia are also increasingly suspect investment destinations. America has kind of been winning in the short-term by default. The dollar has been firm, the Fed accommodative, and the economic numbers and earnings releases not all that bad. What's not to like?

The problem is that this is unlikely to last. For one thing, the political mix within the U.S. is changing, and the initial focus in 2011 in America will be on increased fiscal conservatism. The Board of the Federal Reserve will shift at the end of January to a more hawkish balance, and the Republican-led dialogue in Washington will soon shift toward the espousal of fiscal cut-backs. While some might argue that this will all be good for the markets, I am reminded instead of the push-pull of a prior era of government indebtedness: the post Civil War period.

I recently spent considerable time reading *Forty Years of American Finance: A Short Financial History of the Government and People of the United States since the Civil War, 1865-1907* written by Alexander Dana Noyes and published by G.P. Putnam's Sons in 1909. This was sent to me by a Sand Spring reader, and I am indebted to this reader for passing on this very interesting text.

While comparisons between any two historical periods are always laced with differences, I find some of the comparisons between the post-Civil War period to modern economic times very striking. As a starting point, consider that the U.S. Government was severely over-indebted in the first year of the Civil War forcing it off of the gold standard with the issuance of demand note "greenbacks" that were effectively backed by nothing.

Per one web-based source, piggington.com:

> The first year of the Civil War brought a great crisis to the Northern economy. Though around the country citizens used many and various paper currencies issued by banks and redeemable in specie (gold and silver), the federal government was required by law to pay its debts in specie only. The enormous costs of war borne by the government seriously depleted its reserves of gold, and the uncertainties of war were causing private citizens to hoard vast amounts of the precious metals. When the dwindling precious-metal reserves of banks in New York, Philadelphia, and Boston caused those institutions to suspend paying out specie to back their notes, the Union was on the verge of a calamitous financial disaster that threatened its ability to continue the war.
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> "Immediate action is of great importance. The treasury is nearly empty," Treasury Secretary Salmon P. Chase told Congress on February 3, 1862. The country clearly had to revamp its policies or face financial ruin. The solution was first proposed by New York Congressman Elbridge G. Spaulding, who suggested that the government issue its own paper currency. The paper currency would be considered fiat money that was not redeemable in gold or silver but would be legal tender for all public and private debts except import duties and interest due on government bonds, both of which would still be paid in specie. Because the Constitution empowered Congress only "to coin money", there was much debate about the legality of the proposal, as well as concern that a national paper currency would bring on rampant inflation. "The bill before us is a war measure," countered Spaulding. These were "extraordinary times, and extraordinary measures must be resorted to." [Shades of 2009-2010 Bernanke-sounding rhetoric here.]
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> On February 25, 1862, Congress passed the first Legal Tender Act, which authorized the printing of $150 million in Treasury notes. The bills were printed on only one side with green ink and soon became known as "greenbacks."

While greenbacks became generally accepted, they still traded at as much as a 40% discount to other forms of currency at various points across the following decade. At heart, no one really trusted these government manipulations of the currency, and over the coming several years, gold went soaring higher. By 1869 two New York-based speculators Jim Fisk and Jay Gould launched a speculative buying attack on the gold market. One need only substitute the names John Paulson and George Soros to see a somewhat similar type situation today. In 1869 gold touched the unheard-of high of $165 before the Black Friday reversal of September 24, 1869 sent Fisk and Gould scrambling to draconian bankruptcy survival tactics in the courts.

1869 Gold Room Panic

Of note as well, the next step and stumble lower in the global economy started in 1870 and emanated out of Europe. In both France and the Austro-Hungarian empire of the 1867-1870 era there was a flowering of new lending institutions that issued mortgages for municipal and residential construction, especially in the capitals of Vienna, Berlin, and Paris. Again per piggington.com:

> "Land values seemed to climb and climb; borrowers ravenously assumed more and more credit, using unbuilt or half-built houses as collateral. The most marvelous spots for sightseers in these three cities today are the magisterial buildings erected in the so-called founder period.
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> But the economic fundamentals were shaky. Wheat exporters from Russia and Central Europe faced a new international competitor who drastically undersold them. The 19th-century version of containers manufactured in China and bound for Wal-Mart consisted of produce from farmers in the American Midwest. They used grain elevators, conveyer belts, and massive steam ships to export train loads of wheat abroad. Britain, the biggest importer of wheat, shifted to the cheap stuff quite suddenly around 1871. By 1872 kerosene and manufactured food were rocketing out of America's heartland, undermining rapeseed, flour, and beef prices. The crash came in Central Europe in May 1873, as it became clear that the region's assumptions about continual economic growth were too optimistic. Europeans faced what they came to call the American Commercial Invasion. A new industial superpower had arrived, one whose low costs threatened European trade and a European way of life."

In modern times, does this sound somewhat similar to the Western countries – both in Europe and the Americas today -- dealing with continued competition on pricing and manufacturing prowess out of China?

What happened next in Europe of 1873 was a banking crisis. British banks – unsure which institutions were most involved with the sudden emergence of a European mortgage crisis -- withheld their capital to their continental European neighbors. The European interbank lending rate soared.

Does this sound a bit like the current sovereign debt crisis of Greece, Ireland, Portugal, and Spain of the present era?

Initially this was just a European crisis, but by the fall of 1873, the structured notes of several U.S. railroad companies – inclusive of Jay Cooke's Northern Pacific Railroad – started to fall from grace at an accelerating pace. To our mind this is a bit akin to the recent fall from grace of the U.S. muni-bond market. In both instances investors who had been groping for yield also had little understanding of what protected them in case of default (aka: very little). Over the next five years, between 1873 and 1878, companies that were well financed from the outset survived alright, but there was a real crisis in both long-term and then short-term bank loans – particularly those involving the railroads. Starting in 1873, and in the words of cigar maker Samuel Gompers, "Economic organization crumbled with some primeval upheaval."

> "Between 1873 and 1877, as many smaller factories and workshops shuttered their doors, tens of thousands of workers – many former Civil War soldiers – became transients. The terms "tramp" and "bum," both indirect references to former soldiers, became commonplace American terms. Relief rolls exploded in major cities, with 25% unemployment in New York City alone. Unemployed workers demonstrated in Boston, Chicago, and New York in the winter of 1873-1874 demanding public work." Some of the most violent strikes in American history followed.

As the above image resonates in the back of my mind, I watch increasing student and labor protests currently rippling through Europe (coming to the U.S. soon?), and I view shows such as *60 Minutes* do full features on former Gulf War, Iraq War, and Afghanistan War veterans who currently can't find work and increasingly have become homeless transients.

As another comparison, in Europe of the late 1870's and the early 1880's, there was a push to find scapegoats for the crisis, and a wave of anti-Semitism followed. In the U.S. of 2010, one can sense the general outrage by the average American against Wall Street bankers and brokers who got bailed out by the government in late 2008 and then have gone on to pay themselves lavish 2009-2010 bonuses. And if the bankers aren't bad enough, then calls are starting to abound to hang all those evil hedge fund managers!

Finally, consider that in many ways China is where the U.S. was in the 1860-1870 period in terms of its societal norms and political bents. The 1862-1893 period in the U.S. was the so-called Gilded Age of modern industrial growth -- but it was also a period rife with a huge amount of corruption, bribes, and governmental control from above. It was the era where judges were regularly "on the dole," and in the late 1860's to early 1870's Boss Tweed ruled New York. Now consider in comparison the environment in China that exists today as recently described in the *New York Times*:

> "[There has recently been] a fresh round of hand-wringing over what many scholars and Chinese complain are dishonest practices that permeate society, including students who cheat on college entrance exams, scholars who promote fake or unoriginal research, and dairy companies that sell poisoned milk to infants.
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> "The most recent string of revelations have been bracing. After a plane crash in August killed 42 people in northeast China, officials discovered that 100 pilots who worked at the airline's parent company had falsified their flying histories. Then there was the padded resume of Tang Hun, the millionaire former head of Microsoft China and something of a national hero, who falsely claimed to have received a doctorate from the California Institute of Technology.

> [Then there is] Chen Jin, a computer scientist who was once celebrated for having invented a sophisticated microprocessor but who, it turned out, had taken a chip by Motorola, scratched out its name, and claimed it as his own. After Mr. Chen was [first] showered with government largess and accolades…he [eventually] lost his university post, but was never prosecuted. "When people see the accused still driving a flashy car, it sends the wrong message," [one critic of Chinese societal norms recently commented.]

The list of falsifications and general corruption goes on. There certainly appears to be an overall lack of ethics and general intellectual integrity permeating Chinese society today very much as it permeated America in the Gilded Age of Tammany Hall politics.

Similar to the 1873 collapse of the Northern Pacific Railroad in the U.S., will the definitive sign of China coming undone be something bad transpiring with its own massive railroad network expansion?

The similarities between the two periods are truly striking, but let us return next to what happened in the Congressional debates of the mid 1870s. As with the current era, the price of goods such as flour, butter, and coal had long been outstripping the advance of wages from about 1860 onwards. Various proposals made by then Comptroller of the Currency Hugh McCulloch to retire greenbacks and become more fiscally conservative had all failed in the mid 1860's. But financial markets – particularly that of gold – were becoming increasingly disorderly. The government's response across 1869-1873 was simply to increase even further legal tenders in circulation. In 1871 the Supreme Court upheld the constitutionality of greenback legal tenders, and by 1873 Congress was voting to further increase legal tenders in circulation.

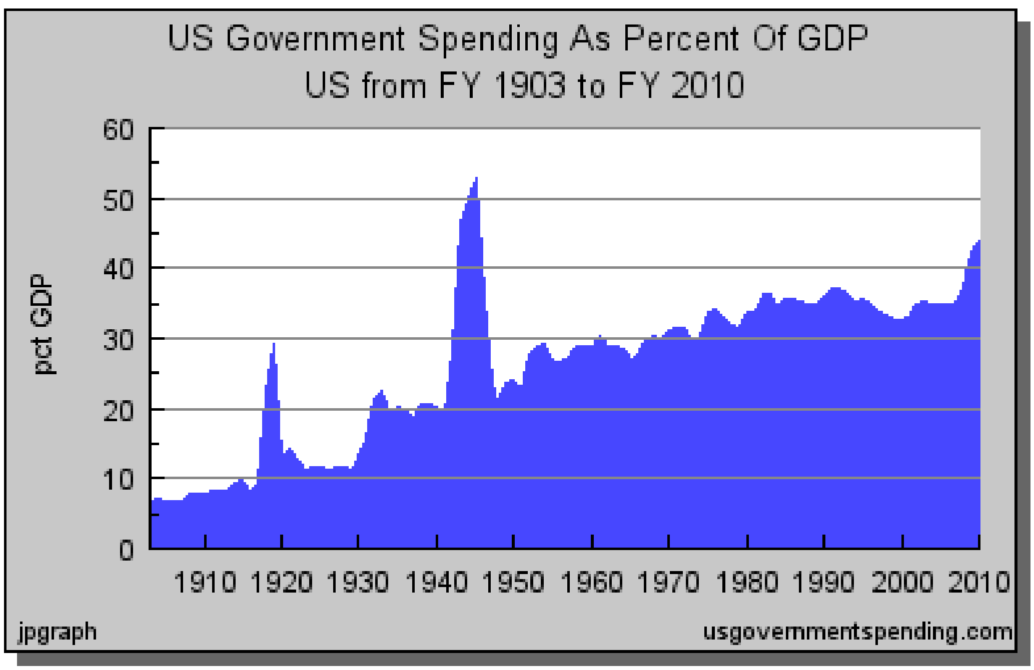
But then something in the political mindset shifted! President Grant vetoed this 1873 bill. Then, in the congressional elections of 1874 that followed, President Grant's Republican party was soundly beaten, and the Democrats were set to take control of the House as of January 1875. A lame-duck period then ensued when the Republicans still controlled the House between November 1874 and January 1875. Per Noyes' *40 Years of American Fianance*:

> "The Forty-third Congress had three months of existence left to it after the vote of November, 1874. Already defeated overwhelmingly at the polls, it had nothing to risk by a move in sound-money legislation, and possibly much to gain. It used this three-months' period to enact a law of the first importance, not only to the nation, but to the Republican Party's future history – a law which must fairly be described, however, under the circumstances of the time, as an expression of *death-bed repentance*. This was the <u>Specie-Resumption Act</u>…submitted to Congress, in December 1874, by Senator John Sherman. It fixed the date for resumption of specie payments at January 1, 1879, provided for the reduction of legal-tender notes from $382mm to $300mm, but made no provision for any further retirement of the notes."

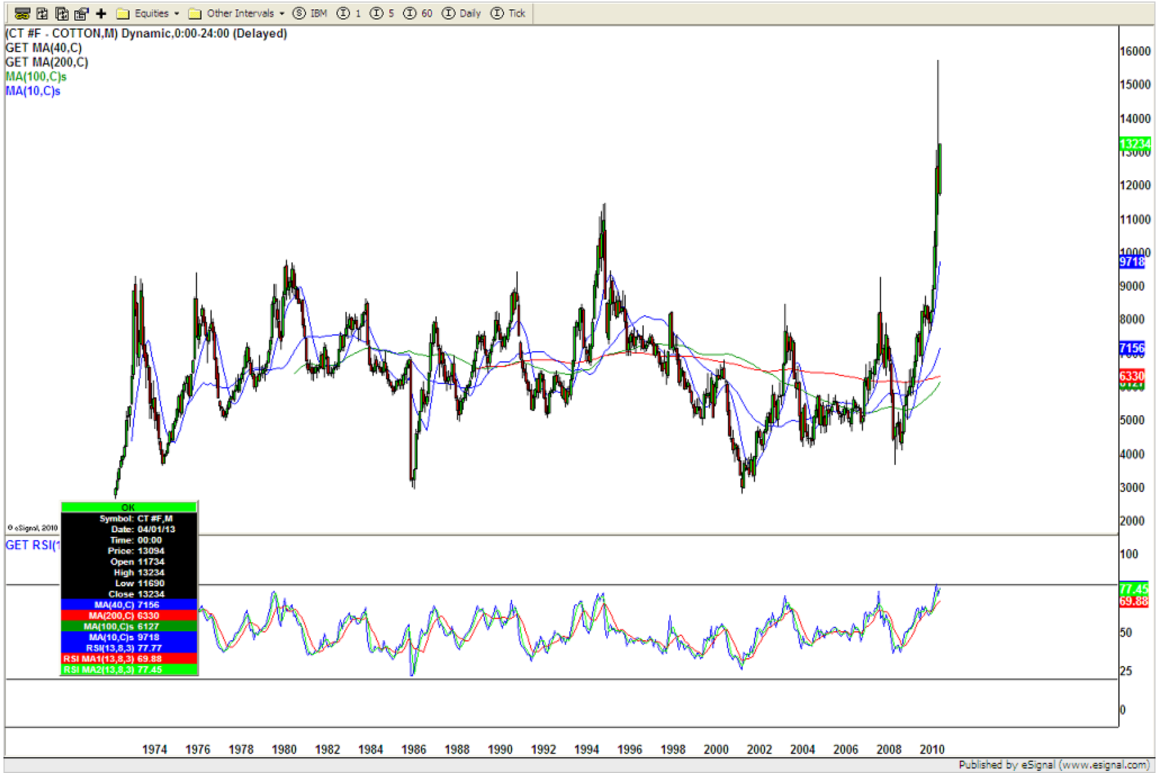
Within the 1875 Act, the Treasury was given broad powers to do whatever was deemed necessary to meet the January 1879 deadline to start making specie payments once again. The same Senator John Sherman who proposed the act, was then made Secretary of the Treasury, and while previously a dove on monetary policies in the mid-1860's, he suddenly turned into something of a hawk in his new appointment – diligently moving to enforce the 1875 Act.

Now here we sit in December 2010 with the incumbent party once again being demoted in the House come next January, a lame-duck session of Congress currently in session, and President Obama suddenly mouthing increased words of fiscal cut-backs in spending (recently announced government pay freezes, etc)., while debate continues to rage on about what to do with the Bush era tax cuts. As the incoming Republicans push for a full extension of the Bush tax cuts, it's almost as if the Obama administration and/or the outgoing House Democrats could have a similar moment of "death-bed repentance" as the Grant administration of 1874-1875 for all the money printed and spent to date.

Here at Sand Spring, I obviously don't know exactly what will happen over the next few weeks with regard to the Bush tax cut negotiations, but if I had to bet, I believe that the next general wave of government rhetoric in 2011-2012 – in a similar fashion as 1875-1878 -- will be a move back toward the espousal of general fiscal prudence. Maybe the outgoing lame duck Democrats will even push back against any soon-to-be-negotiated tax cutting compromise between President Obama and the incoming Republicans. On an overall basis, this new trend toward more fiscal prudence may be bullish the U.S. dollar, but it won't be bullish for general corporate profitability. U.S government spending as a percentage of total GDP currently stands above 40%. If the government pulls in its horns, American business is going to suffer. If the U.S. dollar is to be stronger than the past decade, American corporate profitability is also going to suffer.



As a side-note, I also found it interesting in yet another comparison between the 1860-1870 period and the current period that cotton has just reached highs last seen in the Civil War.



As with current general equity strength, this too shouldn't last long. As the Chinese economic miracle slows, it will soon be seen that commodities are not the perfect safe haven investment either.

In general, we are entering an extremely difficult period to be an investor. Europe is screwed and clearly not a place to aggressively pursue. China is a faux bubble starting to come undone. There is little value in bonds globally. U.S. equities may represent the temporary victor in between, but watch the political winds carefully for a shift away from money printing that will be bearish for our equity markets as well.

When I ran my fund of funds for ten years, I used to say to myself: "Stay away from whatever is particularly hot in the prime broker capital introduction conference circuit. Instead, look for what no one is selling and a strategy area that is hard to find." Along these lines, in 1999-2000, long-biased momentum equity managers were hot. I instead wanted to invest in gold at $260 an ounce, but at the time, had a hard time finding any hedge funds involved in that space at all. I ended up putting some money into a mutual fund as a proxy – specifically the Tocqueville Gold Fund -- and watched that investment double within a matter of months. There were certainly no cap-intro conferences featuring commodity-oriented managers back in 2000. Today such conferences are a hot ticket item.

Similarly across 2004-2005 convertible arbitrage, structured credit, and high yield manager conferences abounded. So too did conferences that revolved around purely quantitative managers. By 2007-2008, all four of these strategy areas had fallen from grace into hard times of poor performance.

Today, if there is one theme (in addition to commodities) that I see being particularly popular within the cap-intro circuit, this would be conferences revolving around Emerging Market and Asian managers. It is *the* hot space. If my short anecdotal cap-intro history is any guide, stay away.

Instead, the best way to invest in hedge funds at present – something really out of favor -- is likely to find managers who really know how to short different assets (particularly in the fixed income area) on a rotational basis. Whether it be shorting mortgages in 2008, or European sovereign debt in 2010 or perhaps U.S. muni-bonds and commercial real estate in 2011, or maybe JGBs even today, this is the difficult-to-find manager of the current era. Unfortunately, the return profile of such managers is also likely to be lumpy and far from smooth and easy to always bear.

As with the prior 1873-1878 period, the victors on the long side will be those who are well capitalized with ample balance sheets and who will be in a position to pick up the pieces when the current faux market environment comes undone.

We're not there yet, but 2011-2012 should still offer such a pi cycle window of significantly lower prices in multiple markets. The short-strokes getting there represents the trickier part, and since I have clearly flubbed my market timing accuracy of late, I will leave discussion of the short-term market set-up to future email updates and monthly missives.

For the moment, I only hope that the above short historical journey into the 1862-1878 period jogs readers to consider whether history does not indeed have a tendency to repeat.

Send us your comments at information@Sandspring.com.

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