Sand Spring Advisors LLC

Another Swing of the Pendulum: The Coming Return of Ron Paul

by,

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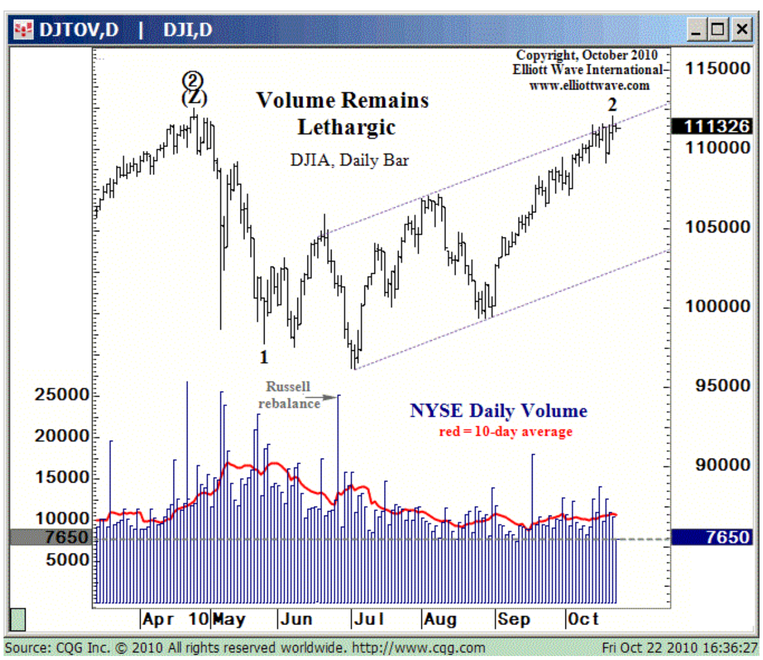
The pi cycle is clear. The spirited upside equity momentum made back on February 24, 2007 (together with historic tights in credit spreads within that same window of time) should yield a significant equity low 4.3 years later in mid-June 2011 (together perhaps with a credit spread accident/default of some sort).

But just as equity prices only made a momentum high into February 24, 2007 and subsequently pushed on to make higher nominal highs into early October 2007, so too on a parallel basis has our recent mini-pi cycle date of September 24, 2007 left only a momentary entropic inkling of a high, with many stocks and equity indices now having pushed on further northward.

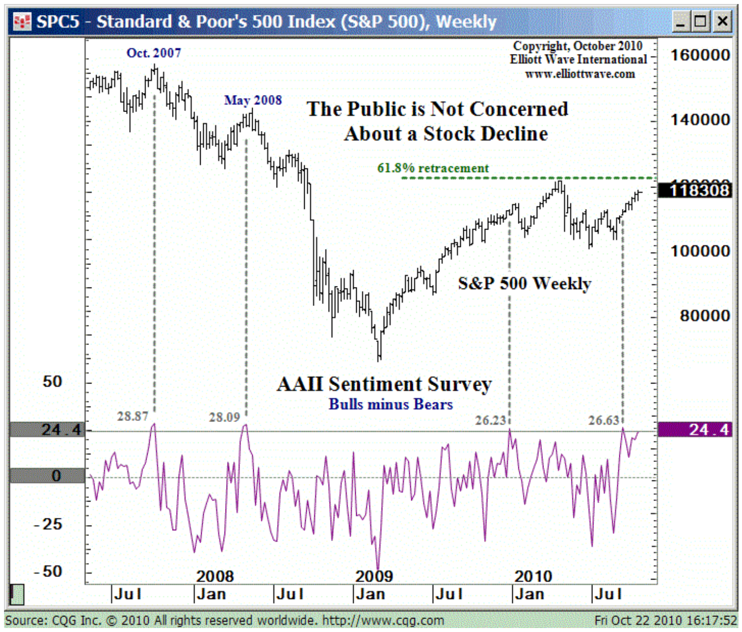
And yet:

- The volume of equity trading has continued to be increasingly anemic. There has once again been the very tentative ascent of the major indices by 20-30 basis points a day – a pattern that also marked the late-March to early April period – just before the "flash crash" occurred.



Source: Elliot Wave Intl.

- The sentiment statistics of the equity market are certainly now extreme. Different services show slightly different levels of ebullience, but we are about as extreme as we were back in October 2007.



Source: Elliot Wave Intl.

- The S&P as a whole continues to reside just under its 200-week moving average that also served to cap prices in mid-April.

- Most Elliot Wave analysts of any substance are once again extremely bearish and attentive to a new impulsive wave to the downside to emerge shortly. Robert Prechter specifically espouses the following wave count on the S&P 500 where a 2-wave is finishing and a violent 3-wave down is expected:

Source: Elliot Wave Intl.

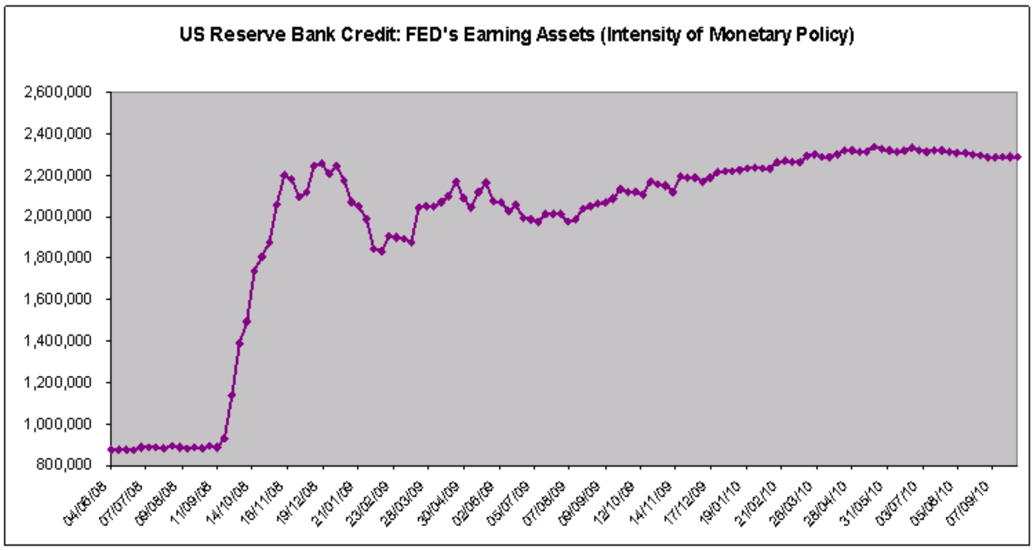
- China – the land of a huge *but ultimately faux* economic growth – just raised interest rates in an effort to curb speculative juices in its real estate market. China has also been changing more and more rules on mortgage lending and property development to try to gently de-fang the construction monster that it has created. Unwinding a bubble is never as easy as creating one. Just ask the Japanese who are still suffering the fallout of their 1989 reversal in property prices.

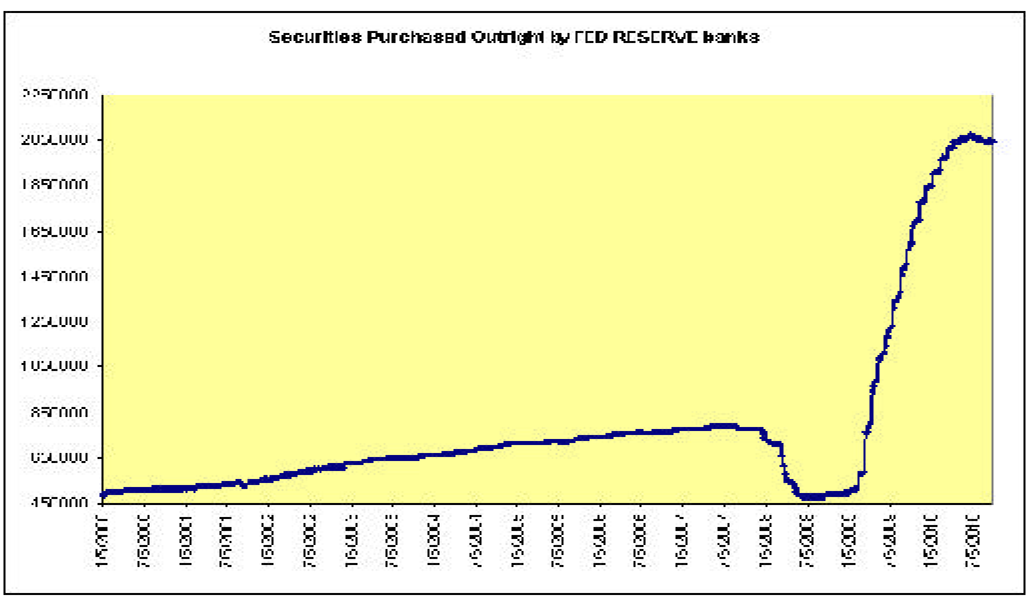
On a fractal basis, we see the Hang Seng Index in Hong Kong as a complete pattern – deserving of at least a retracement.

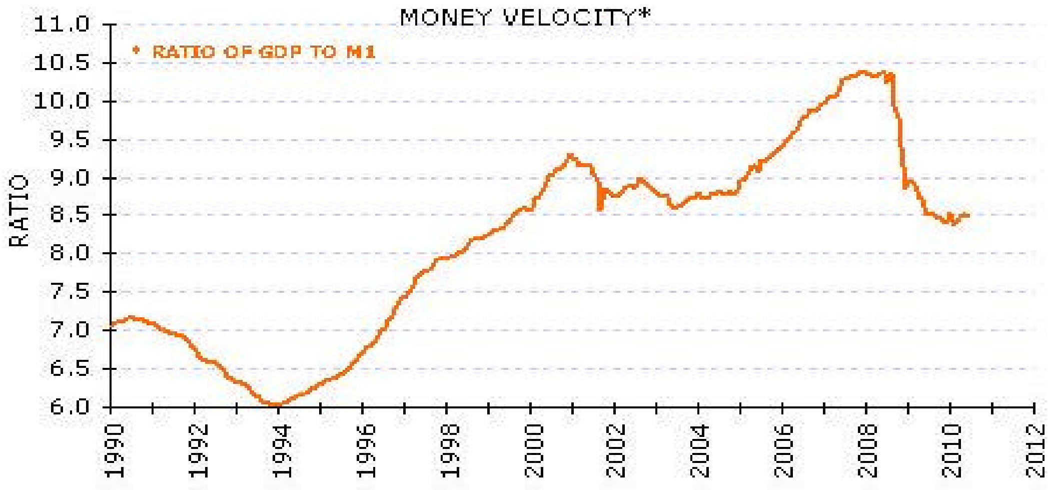
- In the U.S. people have latched on to the promise of QE2 – largely based on comments made by Ben Bernanke back in late August -- as their ultimate savior and excuse to put money to work in the market. And yet the equity market is now 18% higher than when Bernanke simply floated the possibility of QE2. More recently, however, Fed officials have issued comments far less sanguine about the QE2 idea. As pointed out recently by Gavekal Research:

> In the past few days, we have heard Richmond Fed President Lacker state that "a new round of asset purchases would be a hard case to make" and Philly Fed President Plosser state that "I am less inclined to want to follow a policy that is highly concentrated on raising inflation" and that he is "less concerned about deflation risks than some of my colleagues". For good measure, Mr. Plosser also reiterated the point made by Dallas Fed President Fisher last week that "while unemployment is a terrible problem, it is less obvious to me that it is amenable to monetary policy solutions at this point". Combine these statements with the hawkishness of Kansas City Fed President Hoenig and Minneapolis Fed President Kocherlakota and we now have five Fed presidents who have recently questioned the wisdom of QE2.

In addition, to date it has all been just words. Despite the promise of some potential Fed action, the Fed has yet to really do anything except talk, and on the margin, the Fed purchase of securities has actually declined a bit since late August. The velocity of money also continues to decline.







Charts courtesy of Morgan Stanley sent by friends of Sandspring.com

To our mind, even as the Fed keeps filling the punch bowl with monetary stimulus, few are in any position to graciously imbibe. Instead, the already built-up debt burden of the past thirty years combined with capital/investment losses from 2008-2009 capital market declines has overwhelmed any marginal Fed encouragement to increase borrowing. Put another way, the ratio of existing debt servicing to family income may have reached its entropic tipping point no matter how cheap the Fed is making the extension of new credit.

Bernanke clearly thinks he's still in control of economic growth and can influence stubbornly high unemployment. But in reality, he may have already lost control of such.

- Let's add into this equation another point recently made by Gavekal Research: As of early November, the Republicans are likely to retake leadership of the House of Representatives, and when they do, the leadership of all of its sub-committees will change. With a Republican controlled House, Ron Paul will be the new head of the sub-committee overseeing the Fed. Is he really going to stand idly by and watch Bernanke broadly debase the U.S. currency? Or are other fireworks and investigations more likely? Will the pendulum of governmental discussion swing back from big government spending initiatives to at least the verbiage of fiscal conservatism? <u>We think so – at least in the short-term.</u>

Here at Sand Spring we see the above combination of events as an almost <u>perfect set-up for huge disappointment by those currently chasing equity prices higher.</u>

As a reminder, when many people were all beared-up on the S&P 500 last summer when it was down at 1000, we were bullish simply for the reason that the "Head & Shoulders Top" that so many neophyte technicians were looking at was all too obvious. Sentiment stats were also too low at the time for an immediate market acceleration lower.

But the set-up we have now is very different. It is a more perfect situation where bulls are over-confident and complacent. The bulls are more likely now to either get caught in a "fast trap door" of some sort courtesy of some sort of macro event (terrorist attack, earthquake, etc.) or more likely, will experience an initial sharp reversal (maybe caused by disappointment over the size and nature of QE2), followed by another bout of frustrating range trading between 1100-1150 for the balance of 2010. In this latter instance, Q1 2011 would then likely bring a sharp break lower leading to a more important June 2011 low. Let's call this latter path the "1939-40 analog" – with the prospect of increased military hostilities also likely in early 2011. In the latter instance few money managers anywhere will be happy. It will be as if 2010 was a "Mexican standoff" between bulls and bears with no definitive answer or resolution. All those hedge fund and mutual fund managers looking to be a part of the next "directional breakout" – be it up or down – will be forced to muddle on with mediocre performance.

That 2010 may end up as a "muddle through inside year" is not entirely surprising. After the huge bouts of volatility experienced in late 2008 to early 2009, a period of choppier range trading is almost to be expected. Looking back in time, 2010 in equities is a bit akin to the behavior of the British pound post its 1992 ERM crisis. After the initial shock of late 1992, there was a long period of quieter consolidation for the pound across 1993-1994. Indeed, it really wasn't until 1996 that the British pound started to break out of a tight trading range once again.

We recently read a piece by the Bank Credit Analyst (BCA) that referred to current equity market behavior as "slush trading" and this description resonated in our mind. Per the BCA:

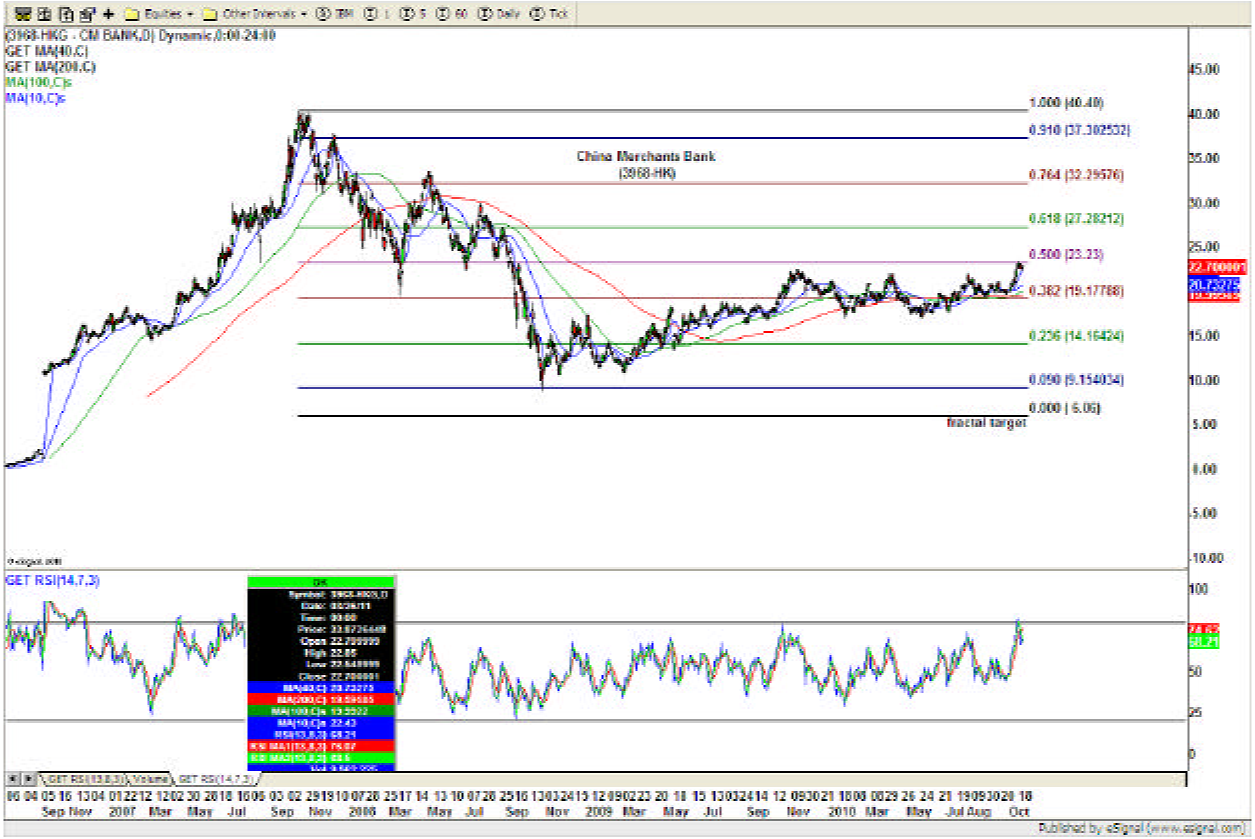
> "Slush" is the natural outcome when the authorities impose massive amounts of stimulation on an economic system that is burdened with huge debt, an overly-leveraged consumer and enormous external and internal imbalances…Although the recession ended more than a year ago, consumers remain stressed and pressured by debt. As a result, they have been preoccupied with saving more and spending less in order to rebuild their lost wealth, and they have had to do so with smaller paychecks, fewer job opportunities and more job insecurity….The shift in American consumer preferences from spending to saving represents a profound shock to the global economic system. With American consumers having entered a new age of thrift, the world economy may also go through a period of dislocations and adjustments.

The core problem amidst this "slush" is in our mind as follows: The Fed still believes that it is in control of the markets – of unemployment, of consumer spending, and of inflation levels. The Fed is still playing by the rules of the "old" economy whereby incremental expansion of consumer credit and rising asset prices enticed overconsumption and excessive leverage. They are trying to perpetuate this type of world yet again. But while the Fed succeeded for so many years in keeping the credit game going and avoiding deep recessions, there was nonetheless a steady deterioration across all the metrics of the Main Street economy such as job creation, household cash flow, and debt to GDP ratios. In the words of analyst Mark Lapolla (associated with Knight Trading): the Fed for ever so long "created its own weather: meaning the macro data were actually distortions created by the unbridled leverage in the financial system and the availability of credit across the entire population." But behind the visible fair-weather clouds of growth statistics, the real fundamentals just kept deteriorating. Ominous thunderheads were actually forming.

What is really controlling our current economic destiny is a huge experiment by the Chinese to create faux growth while they cross their fingers that global growth of demand for their export products comes back with time. As recently pointed out by hedge fund manager Jim Chanos at a *Grant's Interest Rate Observer* Conference in New York (who we paraphrase below):

> Chinese growth is now driven by fixed investment construction that represents a massive 60% of their GDP. But the projects being built are empty cities financed by "Local Government Funding Vehicles" (LGFVs) -- 50% of which are estimated to already involve impaired loans. Vacancy rates in Tier 1 coastal cities already stands at 18%, but construction continues. The buildings being built are high-end properties that only 3-5% of the Chinese population can afford. But the construction continues, and it continues with many Westerners effectively being the ultimate sources of capital -- and thus the real patsies.

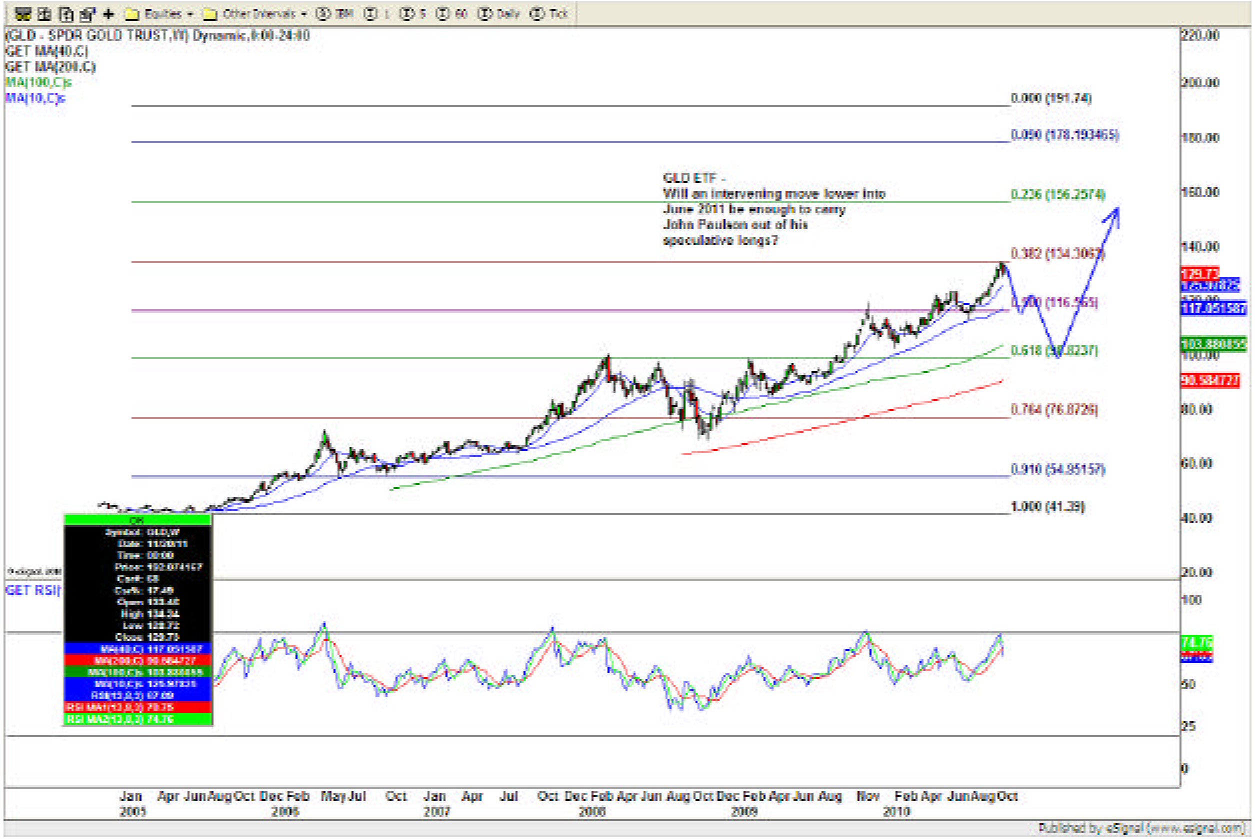
Among the construction financing stocks that Chanos currently dislikes is China Merchants Bank (3968 HK), and we concur that its fractal pattern looks vulnerable to ultimately break its 2009 low.



China is clearly in the midst of a moment of hubris -- trying to buy itself time until the U.S. consumer starts spending again. But as discussed above, due to years of debt build-up, it is highly unlikely that the Fed can accomplish this latter goal. By aggressively pushing on a string to try to create inflation, and artificially support asset prices, the Fed is also exhibiting its own degree of hubris that will likely end in tears. They are delaying the inevitable cleansing moment for the U.S. economy – trying to forestall the pain – but in reality making that future moment of pain that much more problematic when it finally arrives.

Late 2010 equity strength should soon dissolve – at least until mid-2011. As it does, watch for Congressman Ron Paul to reemerge as a force with whom the Fed will have to more closely be concerned.

As a final note, we wrote back in our February 2001 article "Measuring Financial Time with Pi" that the 8.6-year period beginning in late September 2008 and extending into early May 2017 would likely be one where strong growth is offset by rising inflation. Some readers have written us asking how this original view fits at all with the shorter-term view espoused above. Let us answer as follows: The big picture trade is indeed that inflation is likely to swing out of control; at a 10,000 foot level, bonds, not stocks, are the big picture sale of a lifetime. But getting to this point first involves a few swings of the pendulum. The initial swing of the pendulum was toward big government with the election of Barack Obama back in 2008 viewed as a potential savior of America. Now the pendulum is likely to swing back towards the Ron Paul types stressing fiscal conservatism. It is only when the pain of this latter approach proves equally unpalatable (perhaps as soon as mid-2011) that the pendulum will swing back to massive inflationary pressures once again. Gold may easily end up much much higher ($1900 or so per ounce perhaps) but could it revisit $980 first? Certainly. And if it takes such a corrective path sooner rather than later then watch out for the market to front run the hell out of speculators such as John Paulson who may face redemption issues across such a period. Paulson may have great long-term vision, but the path dependency of markets still matters a great deal.



At Sand Spring, we are currently net short gold, net short copper, net short the S&P, and net short the Hong Kong market. We are looking for a dose of deflation first before the real inflation pressures emerge on the other side of our next major pi date – June 14, 2011.

Send us your comments at information@Sandspring.com.

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