Sand Spring Advisors LLC

Big Government vs. Markets

by,

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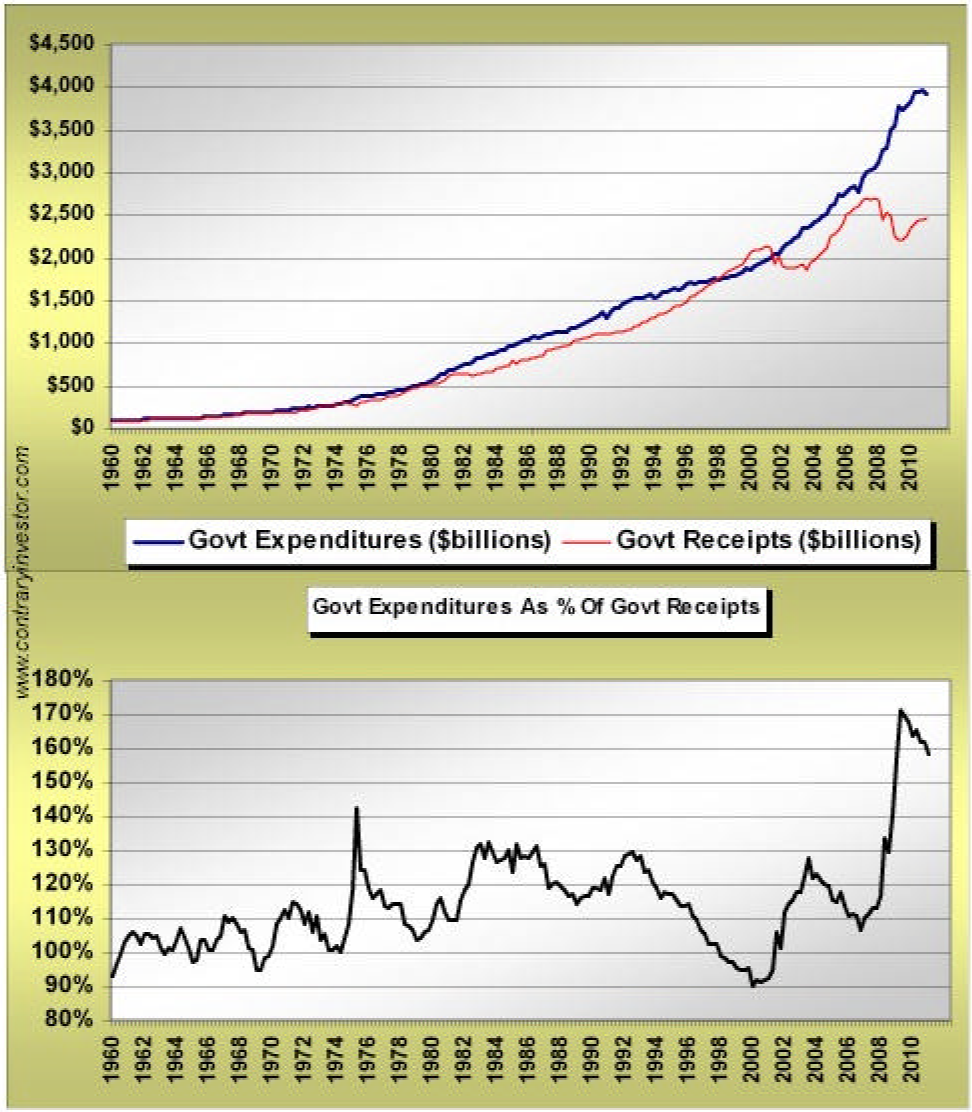
There is a global phenomenon at present that is omnipresent: big government pushing back against the more natural forces of the markets. Maybe there is always some element of this occurring, but this theme is particularly strong at present.

In Europe, IMF, ECB, and other political leaders are pushing back against a sovereign debt crisis that simply won't go away. Leaders such as Jean Claude Trichet regularly espouse that "everything is under control," and "of course" European leaders have enough resources and political will at their command to avoid a debt default. But do they really?

In China, inflation is running at levels beyond the desires of its political leaders, and mal-investment in fixed infrastructure (much of this on borrowed money) is rampant. Yet China's political leaders and financial regulators effectively say, "But of course we can create a soft landing. We are, after all, a command-economy with an extremely strong central government setting the rules."

In America, even as the savings rate has ticked higher, household debt levels remain too high. This structural starting point, combined with chronic unemployment and stagnant wages and ever-present inflation for necessary goods & services, are all serving to pressure the lifestyle of the average American family. Government spending and extraordinary stimulus measures dating from the 2007-2009 financial crisis have been the last props supporting the economy. And now Republican/Tea-Party types want to reign in the deficit spending -- with best intentions perhaps -- but not with a whole lot of economic expertise as to what their restrictive spending actions might actually precipitate. The Obama administration meanwhile is pushing hard to avoid finding out what a significant government downsizing would create, wanting instead to largely perpetuate historical "big government" taxation/spending norms. But as the chart below may show, this is all like a car engine running on fumes. Government expenditures relative to government income are not sustainable at current levels.



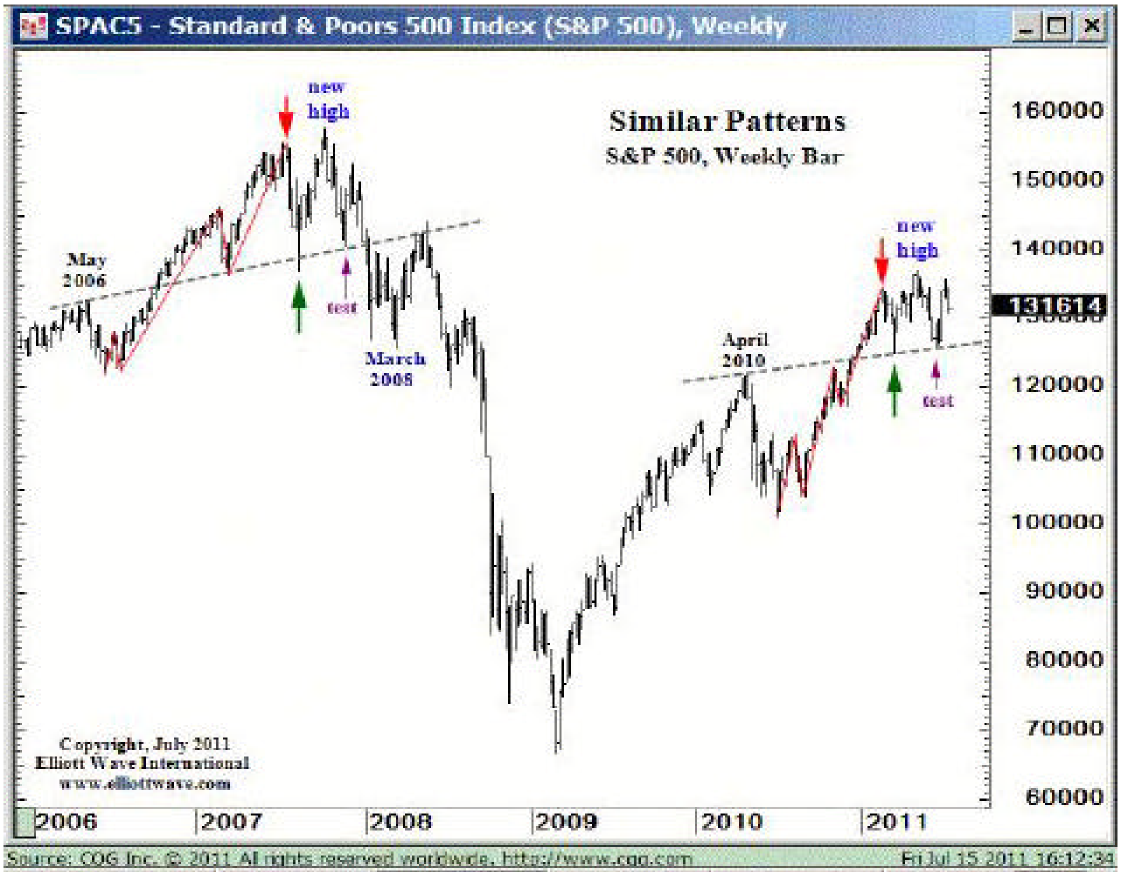
Source: ContraryInvestor.com

If you are the normal long-only and somewhat myopic/naïve investor, you basically bet that the governments of the world will prevail in driving economic policy appropriately and with successful results. Disastrous outcomes will somehow be avoided, and the long-term value of assets – stocks, bonds, commodities, and property – will continue to advance broadly in line with long-term demographic trends. This type of investor is basically betting that big government will sort things out somehow or another. The world carries on.

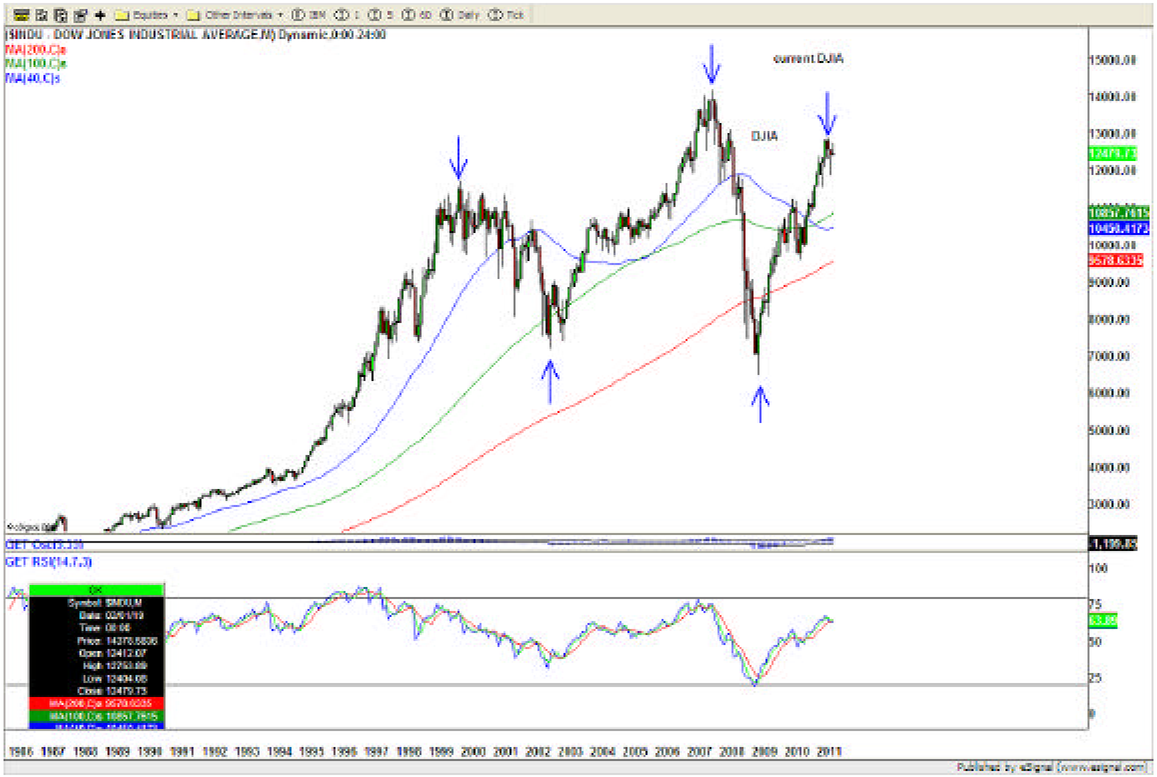
If you are more the well-read cynic about the financial market's current artificiality, you may instead be tempted to be short a variety of assets: various bonds headed for eventual default or at least pressure towards higher yield levels; over-leveraged equities dependent upon ongoing consumer spending; or perhaps over-owned commodities that will fall from grace the moment China implodes. This type of individual basically believes that market forces will eventually over-power government intervention efforts. You can slow down and delay the entropic influences of Mother Nature, but governments can't maintain artificial price levels forever. Within this camp, followers of the famed Austrian economist Ludwig von Mises would further suggest that when the "can-kicking-down-the-road" finally ends, the market come-uppance will be more severe relative to the amount of time that the artificial levels of interest rates and deficit spending have existed.

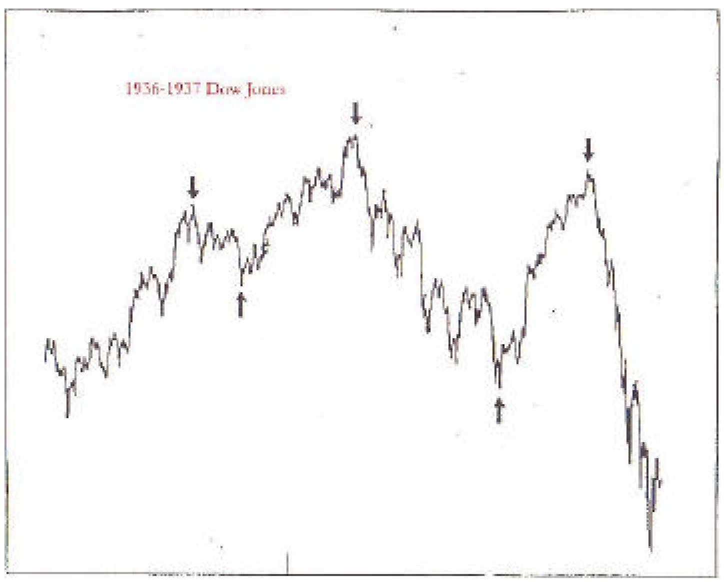
At Sand Spring, we are of course more in the latter camp than the former one, and now the clock is ticking on us. Being early seeing a slow motion train wreck is not always fun. We saw the housing market train wreck-to-be in 2005-2006. But it took until mid-2007 for anything bad to really start happening. We saw the dot-com bubble ending badly, but what seemed ludicrous in November/December 1999 basically perpetuated itself and got ever sillier into March 2000. In between, our mouth was simply agog in awe, even if we did pinpoint the Jan 14, 2000 high in the DJIA (see "Three Peaks & a Domed House" at: http://www.sandspring.com/articles/tp.html) and also wrote a February 29, 2000 article nicely calling for an imminent NASDAQ crash (see "NASDAQ Crash & First Stopping Point" at http://www.sandspring.com/articles/tp.html) which preceded the actual NASDAQ top by just a short period of time.

At present, we basically are focused on the same market structure that the folks at *Elliott Wave International* depict in the chart below. Basically, the past topping pattern of 2007 looks oh-so-similar to that which is transpiring in 2011. Indeed, 2011 appears almost like a fractal "miniature" of 2007 in motion.



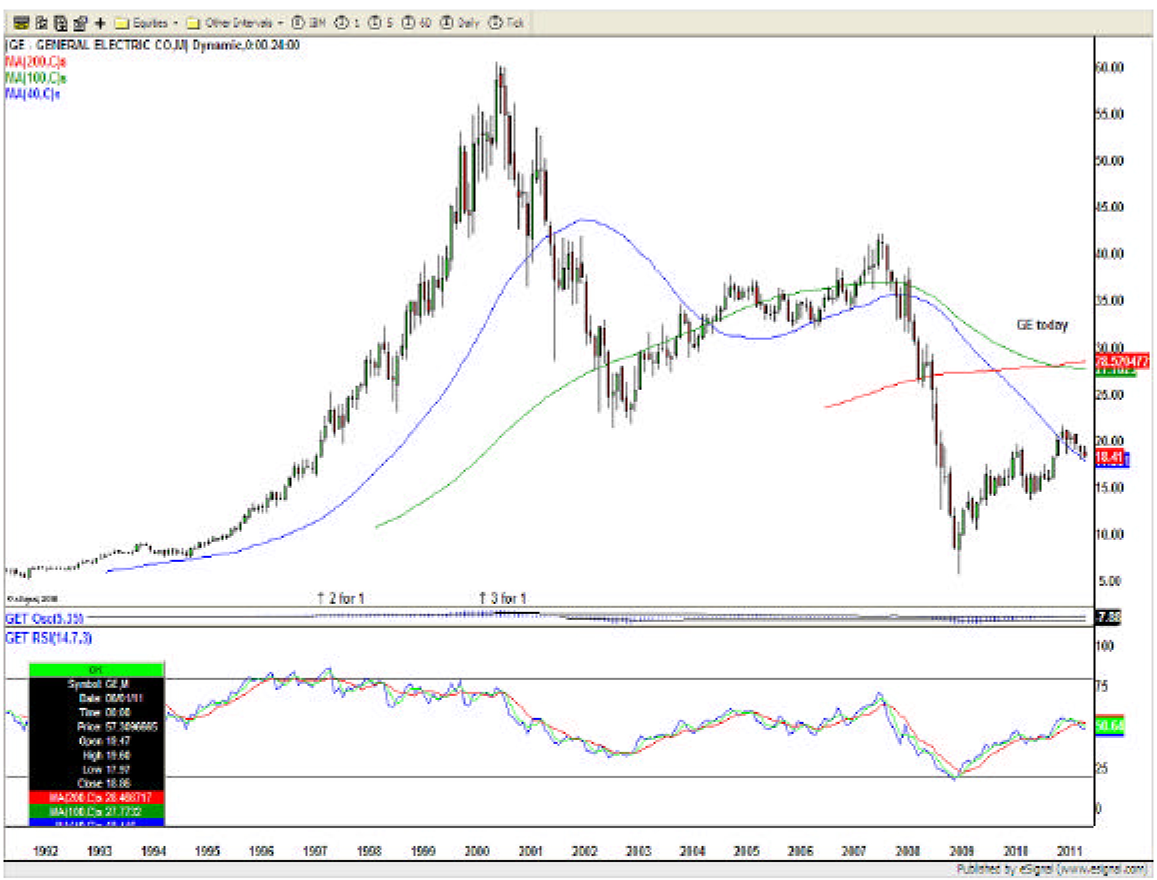
Meanwhile, as previously discussed and on a more long-term basis, there are also striking resemblances between the current 1999-2011 weekly chart pattern of the DJIA and that of the daily DJIA between 1929-1937.



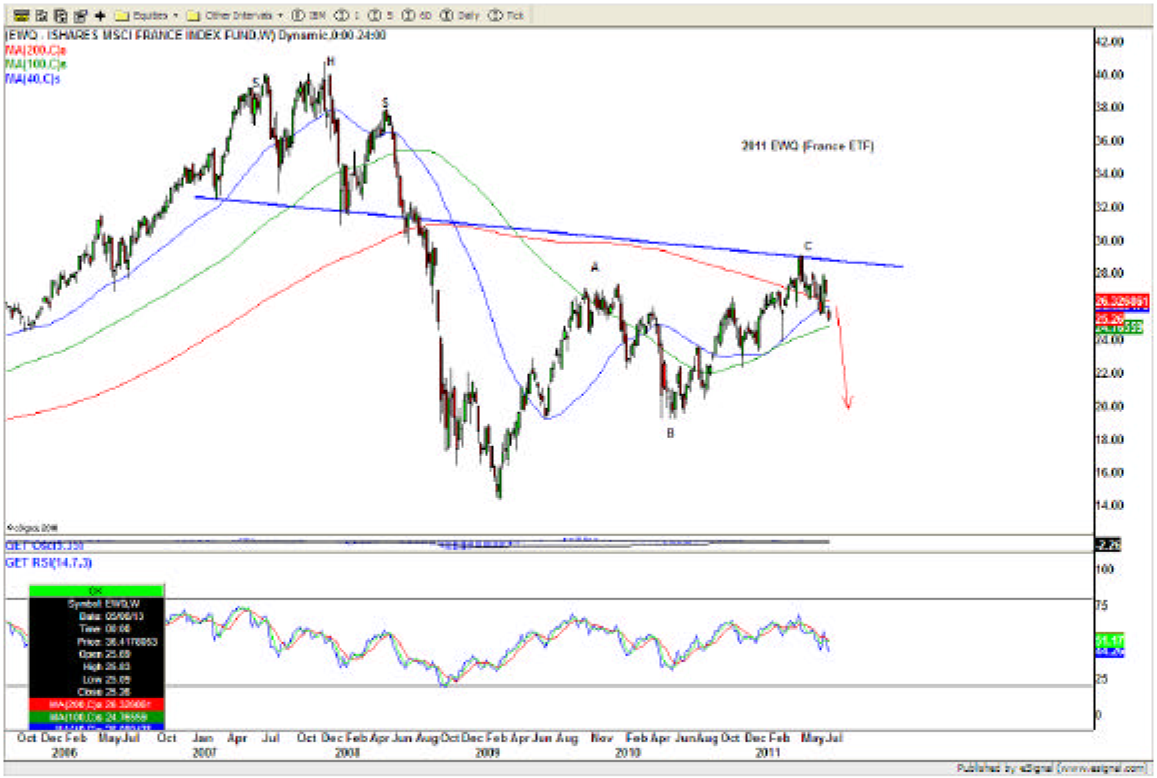


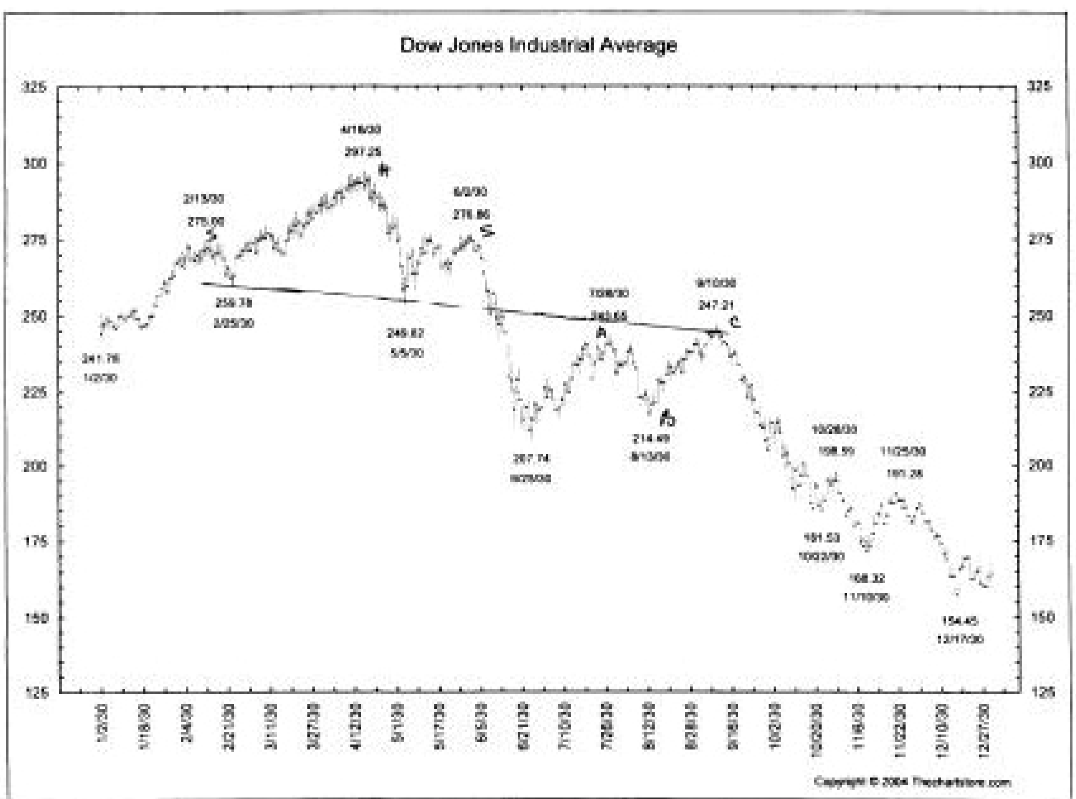
The potential "Armageddon aspect" of the analog chart pattern comparison above can please no one. Were this path to transpire, it implies a tremendous loss of global wealth and societal angst. But we have to show it as a possibility. This is where our technical analysis and general contrarian thought process leads us. If 2011 looks like a *fractal miniature* of the 2007 topping process, it also appears like a *massively larger* fractal version of the above 1936-1937 daily DJIA pattern. As one note, the last time we used the 1936-1937 DJIA as an analog was in June 2001 when comparing the 1937 DJIA to the then current GE chart pattern as shown below (http://www.sandspring.com/articles/ge1.html):

The next chart shows the GE price behavior updated through today. Prices actually have fallen well beyond our initially espoused target near 25. So the above analog comparison between the 2011 DJIA and the 1936-1937 DJIA picture is not a pattern to be quickly scoffed off as impossible.



And then we have the European markets. Over the past week, all of the sharp gains of the prior week in Europe were erased and more. Europe is clearly the market leading the U.S. markets lower. To a certain extent, the U.S. has actually been acting like the relative safe haven when compared to European bonds and equities. We continue to believe in our chart comparison below (previously emailed to subscribers) between the current EWQ ETF and the past 1930 DJIA price action.





As far as gold is concerned, earlier this year in January we wrote:

"The clearest chart pattern that I can find related to gold is the chart of its price denominated in euros where the Fibonacci fractals actually suggest that after the current period of retracement, **gold in euro terms has one more missing high left in it near 1165 euro**. But could that missing high come from gold going sideways for a bit, while the euro falls? Or will gold itself go up, while the euro treads water? Or will there be a bit of both gold strength and euro weakness in a continuation of 2010's general behavior?"

The chart we originally presented was as follows, with an update of it also shown below:

Gold in Euro as expected at the end of January 2011

Gold in Euro mid-July

We will be the first to admit that the retracement we expected before the ultimate "missing high" certainly didn't come close to the 923 Fib line. We also likely got too excited recently when we saw a turn lower from a "three thrusts to a high" top in gold/euro. That move appears to have been just a little 4th wave jiggle before the final hurrah to the upside. None of this detracts from the potential "missing high" importance of 1165 oz/euro.

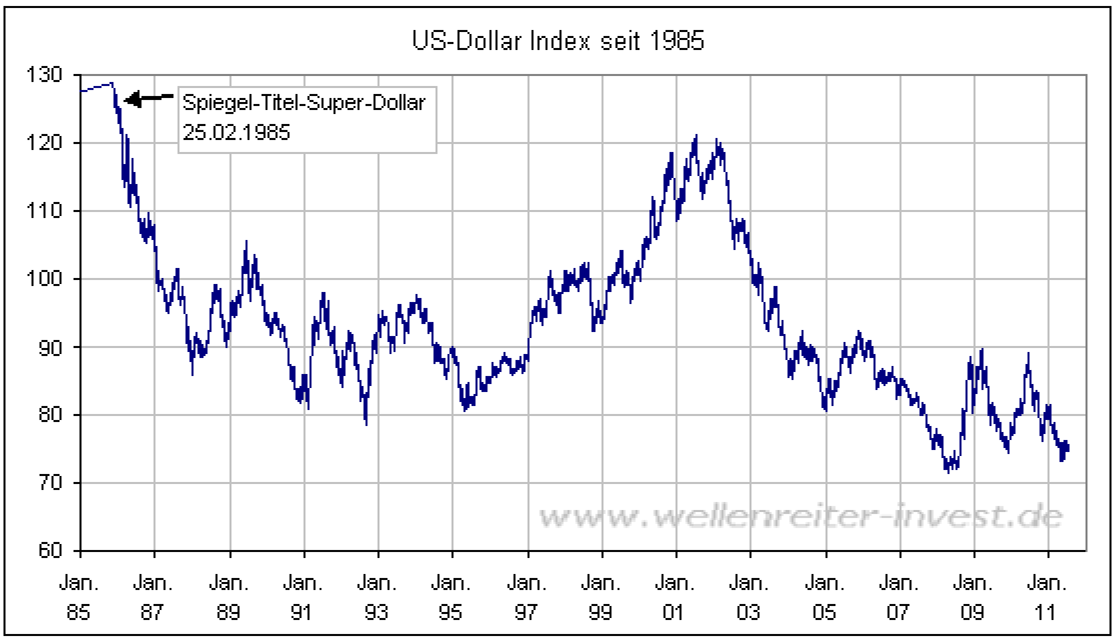
Meanwhile, in U.S. dollar terms, here is a chart that we found in our files, with Fib lines drawn from many moons ago. In USD terms, the first contract of Comex Gold is expected to touch 1615.50 and then turn lower.

Combining 1615.50 oz/USD with 1165 oz/euro yields a euro price of 1.3870 which seems easily possible sometime soon. It is perhaps noteworthy that our targets approximate a Fibonacci ratio 1.382 on the euro side, while gold in oz/usd approximates Fib 1.618 x 1000 = 1618. Wouldn't that be nifty should such a combination transpire.

So if stocks look vulnerable, and gold looks vulnerable, where does the money all go? This is the crazy-ass question that is hard to answer because by comparison, the global bond markets and the excessive debt there would hardly seem like a logical safe haven. Indeed, macro cycle analyst Marty Armstrong has argued that the excess really starts all in the debt market, and since these markets are 20x larger than the equity markets, money fleeing bonds could actually support stocks.

Will money keep flowing into the super-overvalued Swiss franc?

Somehow, we doubt that either gold or the Swiss franc will continue to represent the appropriate safe havens for the current environment. One subscriber was nice enough to recently point out that the current cover of the Swiss business magazine *Bilanz* sports the title "Super Schweiz" ("Super Switzerland"). Is this the same type of contrarian sign as when *Der Spiegel* exclaimed "Super Dollar" in 1985 right before the dollar was to experience a significant fall?



Source: wellenreiter-invest.de

Our answer is instead of hiding in gold or Swiss francs, maybe global **wealth simply gets destroyed**. Almost ALL assets go down. The few people who will make money are those adept at shorting everything on a rotational basis. The 2009-2011 bounce period will soon seem like a real "illusion of prosperity" – which conceptually it really is.

At the end of this crisis, four things will have happened in the U.S. & Europe vis a vis 2007 price levels:

(1) interest rates will be higher than 2007 (particularly in credit markets);

(2) the dollar will at least be back to levels seen in 2007;

(3) U.S. equities will be lower than they were in 2007;

(4) Commodities will have boomed and then busted.

At present, only (3) above is generally true with regard to most equity indices, and some interest rate levels are higher in Europe and in lower grade mortgage bonds. But with more time, big government should lose; natural market forces should win. The true natural equilibrium point of U.S. financial markets would be one where interest rates are higher, the dollar is higher, and equities are lower. Greenspan, Bernanke, Geitner, Obama & Co. have pushed against this eventuality most consistently. They will ultimately lose.

The way this could potentially fit into our pi cycle map is as follows:

If June 13-14, 2011 marked anything, we think **it may well have been a turn higher in volatility that will persist for the next 4.3 years**. Markets in early 2011 have been sluggish and meandering with a great number of false starts in both directions. This is likely changing, and we are ready for more trending price action – trending which we expect to be lower in price, particularly in Europe.

This would set up a plunge period into November 17, 2012 – just after the U.S. Presidential elections. Whoever is elected in November 2012 will then be ultimately hailed as the "hero" and "savior" (whether that person really does much or not) as markets more naturally rebound into an **expected pi cycle high on or around September 30, 2015.**

Thereafter, it will be down again until February 15, 2017 which will mark the end of a 6242 day (2 * pi* 1000) high-to-low cycle which started when the DJIA topped back on January 14, 2000.

2017-2034 will then be a 17.2-year "buy-and-hold" boom time before more trouble erupts in 2034.

That is our cycle roadmap. We previously had hoped and expected that the worst of the bear market would be over by mid-June 2011, but it is almost as if the active government intervention in the markets has delayed this low to only occur further out the pi cycle continuum.

We personally remain short the XRT and EWQ ETFs, and own longer-dated puts on gold (early as always) which we will add to if and when 1615-1618 on gold is seen.

Send us your comments at information@Sandspring.com.

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