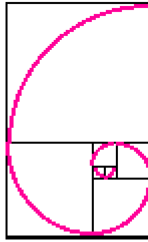


Sand Spring Advisors LLC

Next Steps in Selective Short-Selling Rotation

by,

Barclay T. Leib

October 8, 2011

When I put pen to paper on these pages back on July 16, 2011 in my article "Big Governments vs. Markets," I was massively bearish and pointing towards analog chart patterns akin to 1937 (relative to today's weekly DJIA) and 1930 (akin to today's European markets). I was also pointing towards a gold top and warned that the Swiss franc was likely not going to be a good safe haven.

Since that time, The S&P 500 has declined by over -12%, the CAC 40 in Paris is down by approximately -17%, the Swiss franc got smacked by its own central bank, and gold –while spiking well higher initially than I had imagined – has more recently been causing angst in the hearts of many hedge fund managers and investors. According to public press reports out this weekend, John Paulson, for one, is currently down -46.73% ytd in his largest Paulson Advantage Plus Fund– badly hurt in September from gold's decline, an outcome also predicted previously on these pages.

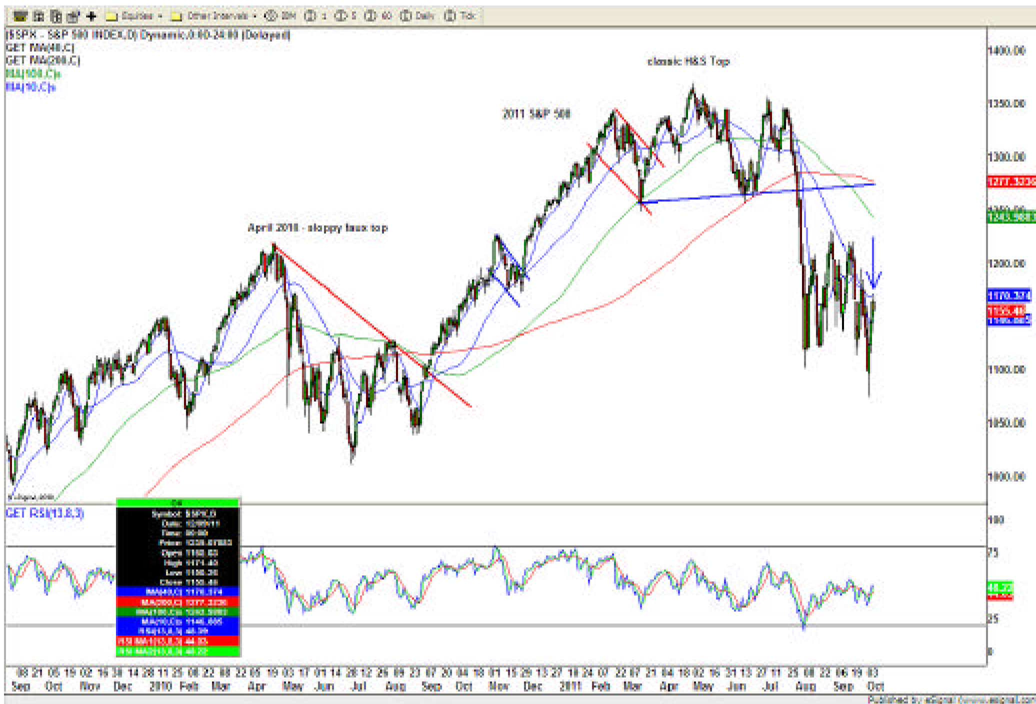
When I wrote again on August 14, 2011 in our article "A Smart Guy amidst the Pabulum of Economic Analysis," I pointed towards "huge fractal resistance at 1233" on the S&P. The bounce high print on August 31, 2011 was just under this level at 1230.71.

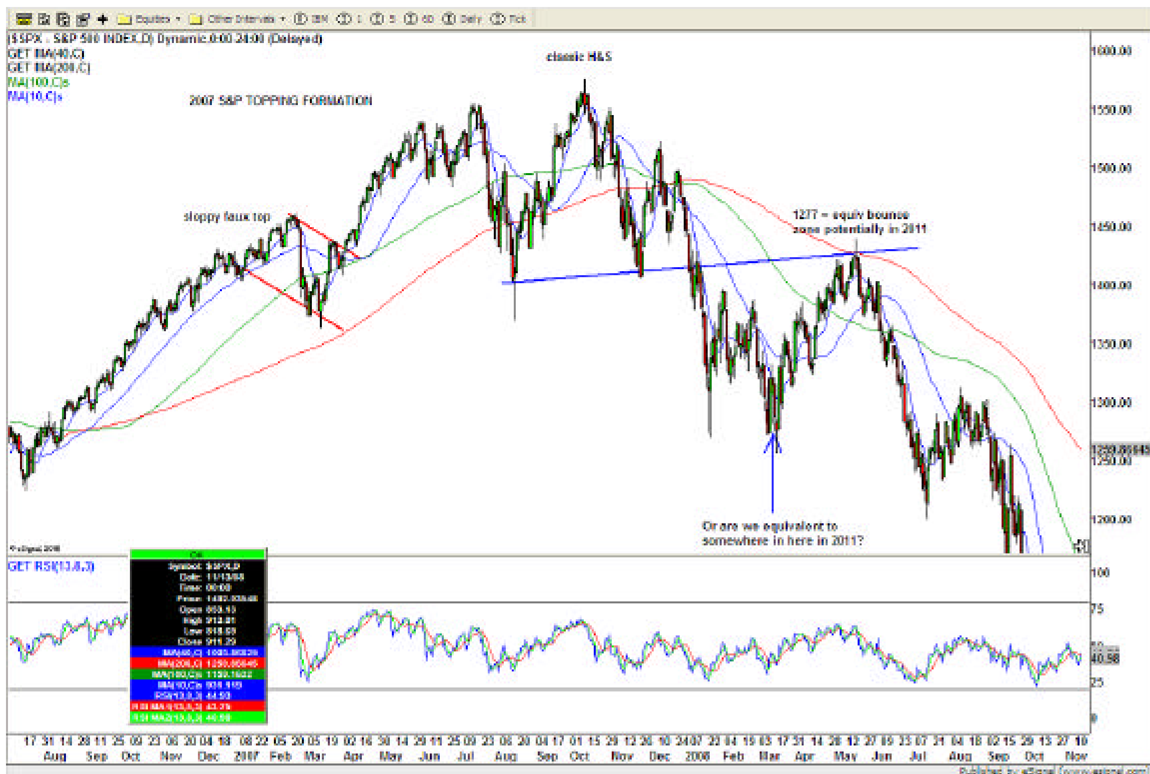
On a personal basis, I have enjoyed this period, catching moves lower at various times over the past 12 weeks in the EWQ, XRT, XLY etfs, and also catching portions of the GLD, GDXJ, GDX and DBB declines. This period has resulted in my personal trading account now having advanced by approximately +30% year-to-date through Friday. I trade in an attack-and-retreat trading manner, constantly looking for the "lowest hanging fruit" of technical set-ups. This causes me to occasionally take off a position for a few days within a larger view of the "big trend." At times, I may happen to miss a portion of a move that I can see developing because it takes too long to get there, and I develop my own personal angst that the move has become too obvious to still transpire. At other times, I may think a market is ready to bounce overnight, and instead it gaps lower. These things happen. Yes, I can be accused and stand guilty at times of being too "cutesy" in my trading. But I never agonize over a missed opportunity, trying to focus instead on the next "easy trade." I am very respectful of the market and the traps that it can set for the naïve technician.

On this basis, when the S&P recently started to break down from what could have been perceived by some as an obvious "flag pattern" with price gaps visible on both sides (which under traditional Edwards & Magee rules can often mark just half of a bigger ongoing decline), I removed all of my shorts instead of adding to them. Bothering me technically and forcing me to at least temporarily reverse my prior bearish views: very high short-interest ratios that have developed, high put-call ratios, and low investor sentiment numbers. Many individual stocks that I follow also reached what I considered both strong fundamental and technical Fibonacci fractal target areas of support.

While the 1937 & 1930 "Armageddon" analog patterns might still transpire -- where markets just never come up for air – it seemed to me that these analogs were now becoming lower probability paths. Instead, as espoused in several short email bursts that I sent across September, I recently started to fixate on

the 1946 chart pattern instead as perhaps a better analog. I also continue to watch the comparison between the 2007 topping formation and the 2011 formation. Interestingly, both the 1946 "bottoming analog" and the 2007 "topping analog" would suggest at least a general bounce period in our near future.



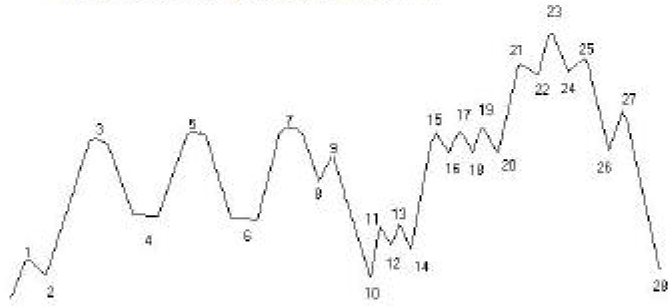


All three of the charts above can be construed to have been classic Head & Shoulders tops. Whether one follows the 1946 pattern or the 2007 pattern to predict the balance of 2011, the short-term implications are the same: *bounce time should soon transpire.*

In terms of the 1946 pattern, that market eventually went on to a multi-year "range trading" chop between 1946-1949, with the May 1946 DJIA high only surpassed come mid-1950. If we were to do the same today, one might imagine a forthcoming 1060-1277 S&P band of continuous chop for the next three to four years. No one will even be bothering to turn on CNBC by the end of that potential see-saw.

In terms of the 2007 pattern, something a bit different did of course transpire: a three month bounce period between the March 2007 "Bear Stearns Day" low and a bear market rally top into late May 2007. A severe bear market then resumed.

I also must mention here the possibility of a George Lindsay "Three Peaks & a Domed House" formation in-the-making. There is a new book out by Ed Carlson entitled *George Lindsay and the Art of Technical Analysis* which I would recommend as clear and concise for anyone interested to really understand the work of George Lindsay and how to continue applying this work to current markets. Lindsay wrote about a period of three peaks forming over a period of approximately six to eight months. The 2011 topping formation was almost exactly such at seven months, and was a clear three peaks in structure. Lindsay then looks for a swift "separating decline" that takes about a month to transpire (think Aug 2011) followed by another 1-2 months of base building (think Sep-Oct 2011). After multiple retests of the low in the base building process, Lindsay then offers a very specific day-count tool: from the last retracement test of a bottom (point 14 in the chart below), count forward 221-224 calendar days and one will locate in advance the exact date of a "Domed House" top (point 23) or "an easily recognized and defined point near the bull market top" still well in our future (i.e. points 25 or 27).



It is debatable still of course whether last week's rally marked a successful end of a basing period, but assuming October 4, 2011 was a low that will survive, Lindsay might suggest to us to expect a high into May 12-15, 2012. This would obviously be something more than just a bear market rally a la the 1946 or 2007 analogs.

Let me mention that I have a minor pi cycle date forthcoming October 22-23, 2011. Should this latter period be a final retest of recent lows then May 30-June 2, 2012 would be the Lindsay 221-224 day window for a high. Highs left anywhere in this period would then still be expected to reverse into a major mid-November 2012 low.

Can we stretch our Fibonacci bands to allow for such? This is <u>not</u> our preferred view, but anything is of course possible. 1436.42 is one double fractal vibration that would be possible (see chart below). But to get to that target, multiple things would have to occur first: the market would need to stop going down fairly immediately (to rule out the 1930 or 1937 analogs); then one will have to overcome a food-fight of resistance at 1277 (to rule out 1946 or 2007 analogs) before we would be forced to accept Lindsay's "Domed House"-in-the-making vision in the current instance.

I have laid out so many potential paths for the major equity indices above that I feel pretty wishy-washy – but that is exactly the way I feel. I await more technical evidence to choose between these paths. However, it is time to turn to other chart patterns where I do have a stronger opinion: BONDS.

Within these pages, I have previously suggested that the key to "investment success" in the current environment is to *rotationally learn to short different assets*. Very few investment managers are any good at this. Almost everyone considers being invested as choosing the right asset to buy. But with global debt

levels where they currently are, there are no easy fixes to unwind the last thirty years of debt build-up. This situation is simply not going away. If readers really want to become scared about this topic, I would suggest reading the attached article from the Boston Consulting Group entitled *Back to Mesopotamia? The Looming Threat of Debt Restructuring*. In it the authors nicely outline total indebtedness globally, and suggest that with bank capital levels too low to absorb debt write-offs, authorities may eventually be forced to migrate to a one-time 25% wealth tax to cover the hole! Obama already has taken one step in this direction in his plea to increase taxes on the rich to pay for his proposed stimulus bill.

But don't hold your breath for the *Back to Mesopotamia* 25% wealth tax outcome, as it is not going to happen tomorrow. But who knows with time what desperate governmental authorities may eventually resort to. Here is my general point: *the fulcrum point of real excess and more critical funding issues resides in the fixed income arena.* Equities in general are not the current source of any major problems. Equities are a side-show. Corporations are generally being conservative with their cash balances and expansion plans. Equities simply get the focus of attention when economic slowdown fears hit. Equities make the headlines, but it is the fixed income market that has turned almost terminally sick – albeit in almost imperceptible fashion (ex-Europe) to date.

Returning to the concept of rotational short-selling, in 2007-2008, the assets of choice to short were clearly sub-prime bonds, sub-prime lenders (let that read banks), and sub-prime guarantors. Then, after a brief period of reprieve for most assets in 2009 through early 2010, all things European (excepting German Bunds that benefitted to a perceived flight to quality) have basically been candidates to be successfully shorted across 2011: European bonds of peripheral countries and European equities.

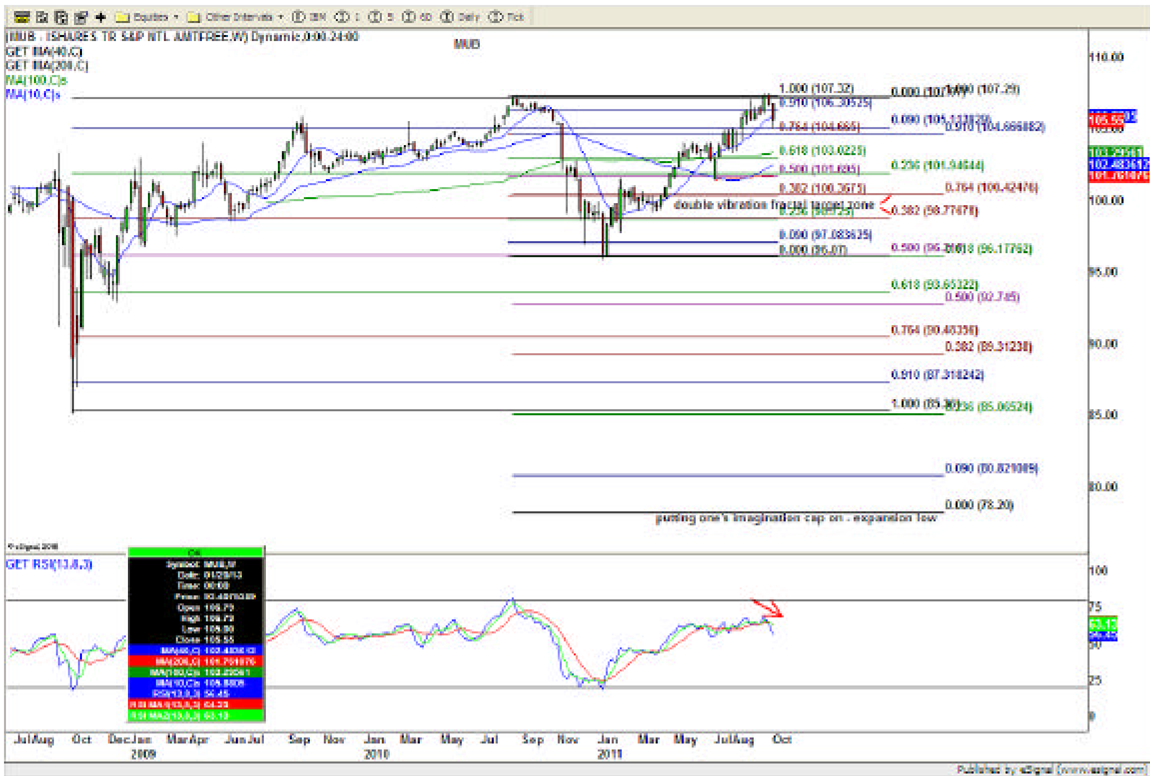
So what is the next great short?

Not to sound too much like analyst Meredith Whitney, I would not be surprised if it was the U.S. municipal bond market.

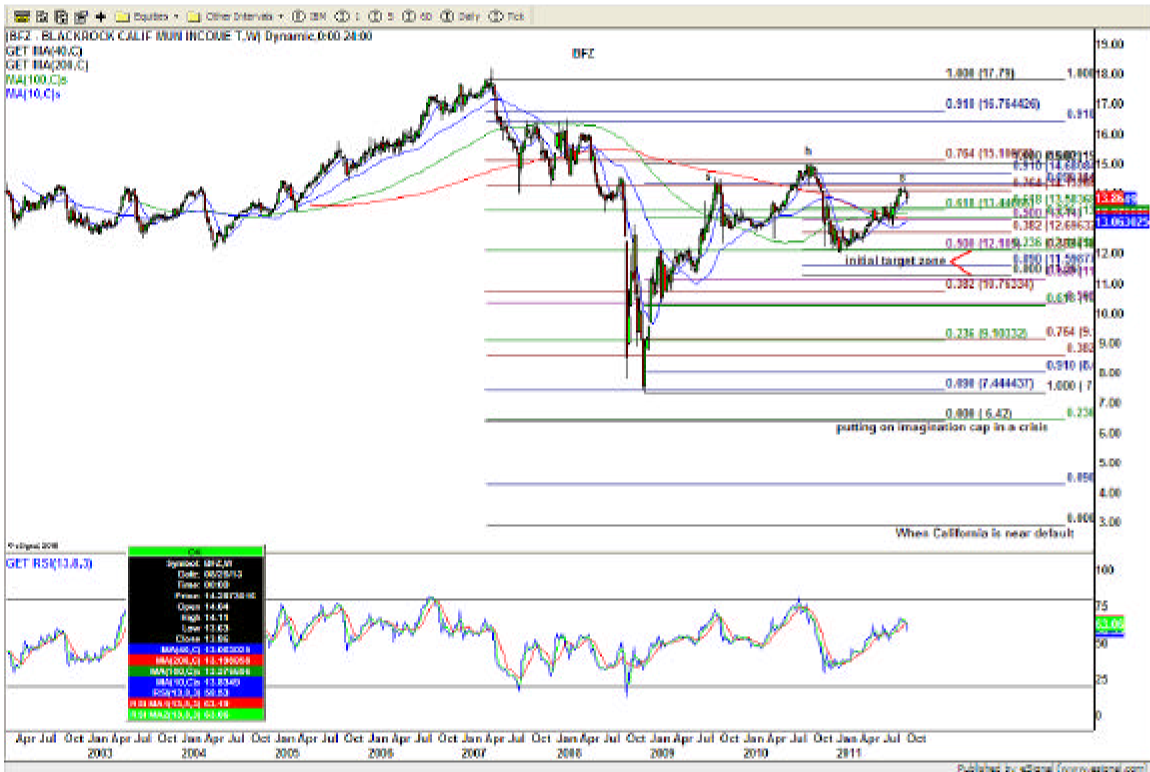
For some time now, even as the media focuses on long-term U.S. Treasuries going to new modern era highs (lows in yield), municipal bond prices have been in more of a step-and-stumble funk. While the ultimate short with time will of course be U.S. Treasury bonds themselves, the muni-market has a much better chance to be the next "low hanging fruit" for shorting. The European financial institution DEXIA used to be a major player in the U.S. muni market. Last week, DEXIA got carried out on a stretcher by Belgium and French regulatory authorities – destined for some sort of good bank/bad bank restructuring. Would it not be reasonable to assume that such problems may only trickle downhill to the muni market itself? While Dexia only still owns approximately $9.8 billion in munis (down from $58 billion back in 2008), they are still levered overall at approximately 74-1 with only $10 billion of capital supporting $566 billion of total positions. And fundamentally, all the rumblings in muni-land are there: swelling deficits as the fixed costs of services, debt interest, and pension funds all remain while municipal tax revenues decline. *2011 in munis feels about the way 2006 felt in sub-prime land. It just takes a while for the housing implosion of 2007-2008 to create its obvious knock-on effects – but those effects are there and should be increasingly apparent soon.*

Shorting a muni-bond is of course not nearly as easy as shorting a stock. Indeed, it is next to impossible. There is no active securities lending market for muni-bonds, no active futures market, and dealer pricing of munis is not particularly transparent. Individual munis and corporate bonds remain the last "Wild Wild West" of our capital markets -- generally opaque and thin in their available pricing and liquidity.

But there are a few etfs built around munis where security borrows are available. MUB is the principal one that I watch and trade, but if my view is right, California and Illinois should likely lead the way in problem credits. I am thus personally short both the MUB as well as the Blackstone California Municipal Income Trust (BFZ).



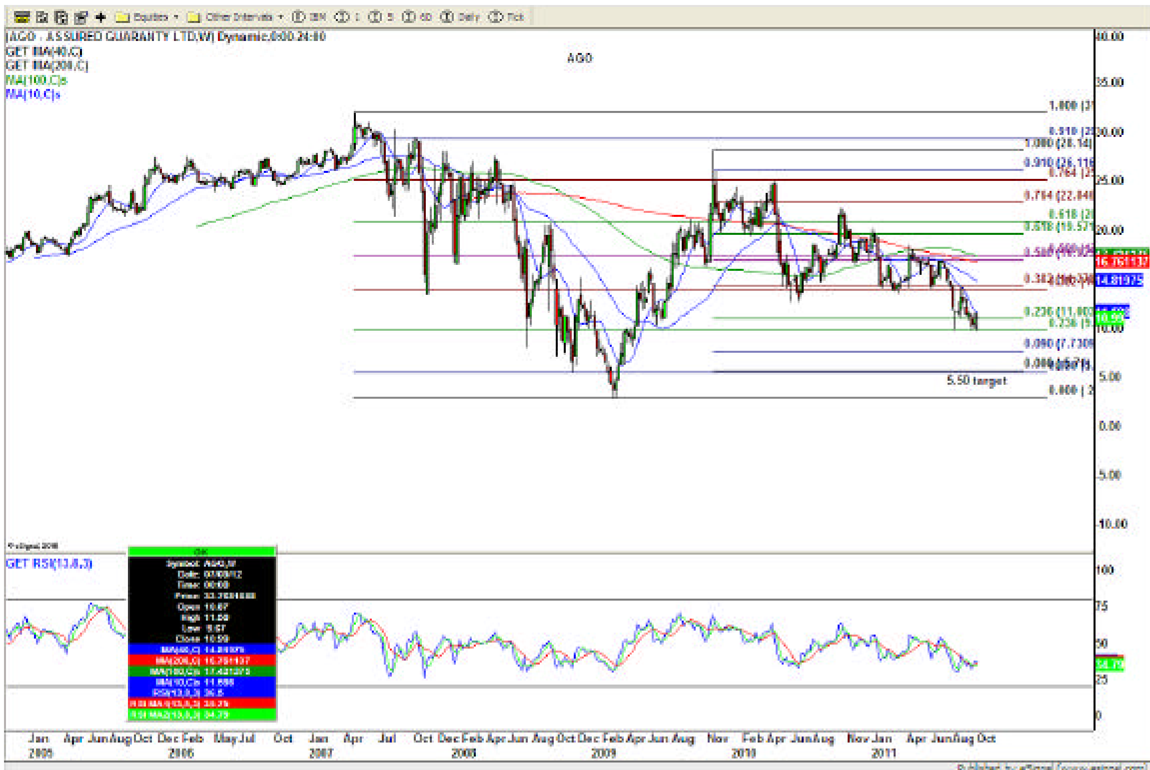
In terms of the MUB trade, 98.77-100.42 is the initial fractal target range to the downside. But if the sh*t really hits the fan someday, an expansion fractal target would be all the way down at 78.20.



BFZ, trading at 13.86 presently, sports a pretty clear Head & Shoulders topping formation which should be good for at least a 11.20-12.10 downside target range. Putting on our imagination caps for a period of funding crisis, 6.42 and 3.00 also pop out as potential longer-term Armageddon fractal expansion targets.

One municipal ETF with less trading history but a potentially more aggressive (let that read toxic) portfolio mix is HYD – The Market Vectors High-Yield Muni ETF. It invests in bonds below investment grade ratings which might be the most obvious outbreak for problems. 25.06 would be a first target here.

Muni insurance guarantor Assured Guaranty (AGO) is also a stock I keep my eye on, but am not currently short. It trades at a very low P/E, and also currently pays a dividend. These make it a tough short, but if the muni market behaves as I expect it to, AGO could easily see its 5.50 fractal.



How ironic and sad it may be that municipal securities -- historically deemed to be the safest and most boring forms of investments – could turn so horrific for those blithely sitting long these securities. This includes many simple brokerage accounts where idle funds are swept into a "tax-free short-term muni fund" each day (because that is the box that the investors ticked when they initially opened their account), and investors sit back and consider themselves to be safe. It could be the muni-money-market funds that turns into the problem, more so than the common stock portions of these portfolios.

Let's ask yet another question. If Chairman Bernanke and Treasury Secretary Geitner have any modicum of success in saving the economy and the equity market in the short-term, what becomes their end-game? Might all of the Federal bond issuance accidentally crowd out the muni-market in the process? Isn't it possible that bond vigilantes get a whiff of recovery; bond yields everywhere start to tick higher, and the weakest hands – municipals – start to have to fund themselves at higher and higher rates that only exacerbates their current problems?

Muni taxing authority has always been viewed as an ultimate back-stop, but how high can taxes be raised without already stressed Americans increasingly protesting in the streets a la the recent "Occupy Wall Street" movement? In an age where so much can be done remotely via Internet, will people remain in neighborhoods where taxes eventually become egregious, or will they simply move – thus causing municipalities to effectively eviscerate their own tax base?

Some may argue that there has been scant municipal defaults over the entire history of the U.S., so why worry? But a close examination of history reveals this not to be entirely true. According to the 1964 University of Michigan dissertation by George Hempel, there were over 3,200 municipal bonds in default at the peak of the depression in 1935 which represented approximately 15% of total net outstandings at that time. While there was ultimately a high recovery rate on this debt, some was never repaid. In some instances, these full defaults came after subsequent electoral referendums specifically voted not to pay down past indebtedness. Later on, just ask anyone who happened to own Washington Public Power Supply System (WPPSS) bonds in the late 1970s how they felt when that entity defaulted on $2.2 billion of debt, and only settled in 1988 for between 10 to 40 cents on the dollar. Economist Nouriel Roubini recently referred to anyone who downplays the potential muni market default risk as being "Pollyannaish." I obviously concur.

The world is presently still focused on Greece and Europe. There may or may not be some reprieve to that tension in the short-term. But regardless, I have moved on to the next trade: short munis. At times, I have been known to be early in my views. But if the world somehow recovers in a Lindsay Three Peaks & a Domed House-manner, rates should go higher on all bonds with time, and I win. If the world continues to struggle, munis may easily represent the next flash point of overt financial funding tension. I think I can win either way.

Stay tuned, as always, for more updates by e-mail.

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