Sand Spring Advisors LLC

A Smart Guy amidst the Pabulum of Economic Analysis

by,

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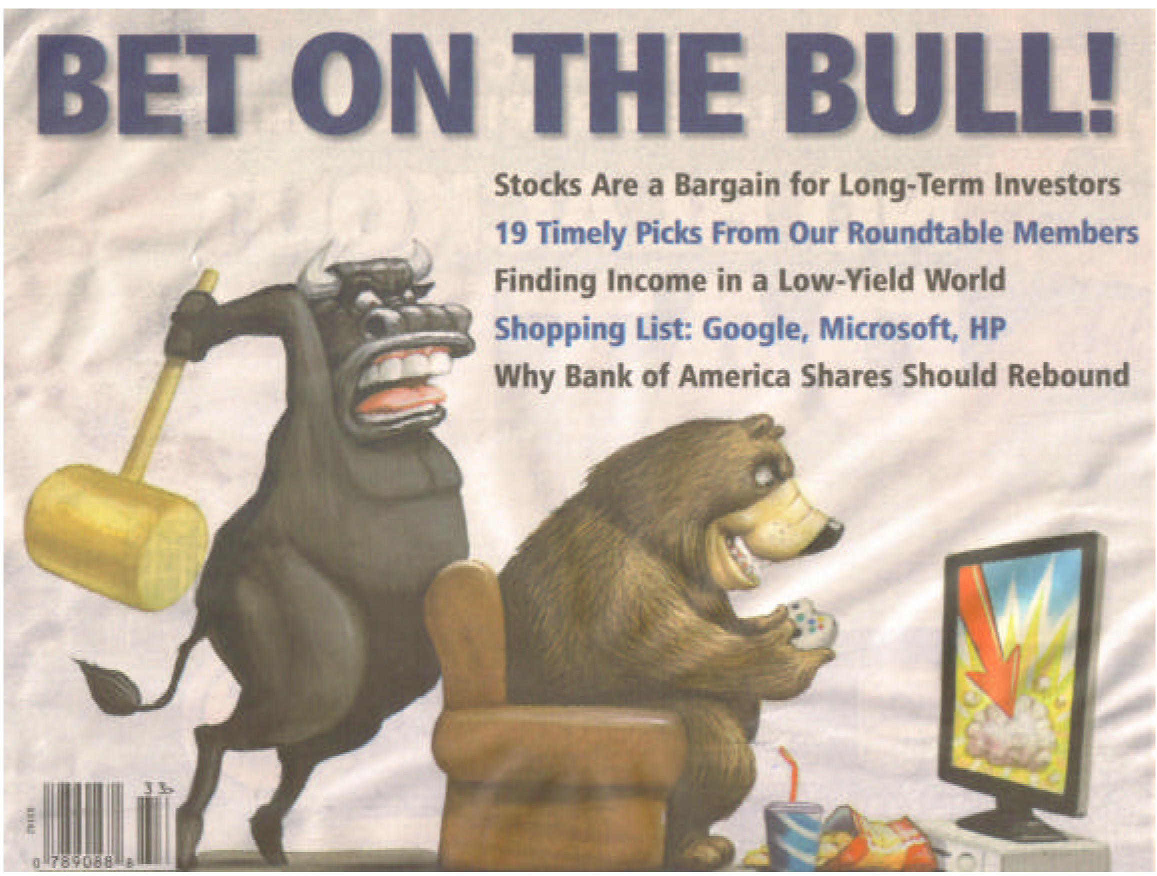
We have been writing on these pages for almost 12 years now. At various points during that period we have pointed out covers of *Barron's* that are poorly enough timed to be a good contrarian indicator. This weekend's cover certainly fits that bill:



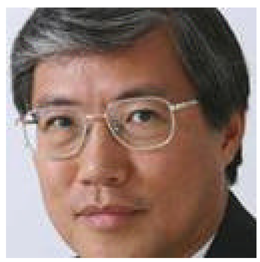
Barron's, August 15, 2011 edition cover

With a massive number of equity index trendlines recently broken, a Dow Theory sell signal in place (where the DJTA made new July highs while the DJIA did not, and then both broke their prior lows); and three different regions of the world – Europe, China, and the U.S. – all suffering from governments trying to perpetuate faux economic conditions, it is highly unlikely that August 2011 represents an adroit moment to "Bet on the Bull!"

Thank you *Barron's* for reinforcing in my mind that we have just entered a real bear market. The current period reminds me a bit of when interest rates started to move higher post a surprise Fed rate hike in February 1994, and everyone tried to play down the potential extent of the move, and buy the initial Eurodollar futures dip. All the daily notes from the investment banks were of the "don't panic"-variety, and yet Eurodollar futures (as well as European fixed income markets) just went down and down and down for the balance of the year.

We clearly live in the "Age of Media Hype." There is such a constant flow of pabulum from the media and from analysts on Wall Street (some smart, some not so smart) that it is often hard to differentiate what is important and useful to listen to.

Enter Richard Koo of the Nomura Economic Institute in Japan. He is one of the few big bank economists who, in my humble estimation, really "gets it."



Koo, who is Taiwanese by birth, previously worked for the U.S. Federal Reserve and also advised the Hashimoto administration in Japan, has a basic thesis that the U.S. has entered a "Balance Sheet Recession" that is very different from normal recessions. In Koo's opinion, after you start with a bursting of a bubble of asset prices financed with debt, no matter how low interest rates get pushed, the average consumer and business continues to look at its assets and liabilities and fret about being upside down/under-water in balance sheet terms, and thus are more focused on balance sheet repair to pay down debt than they are responsive to any Fed efforts to stimulate spending and investment on leverage.

"For seventy years, U.S. real estate prices basically advanced," says Koo. "In Japan, real estate had been advancing for forty-five years into our 1989 peak. It was a very similar picture. But then people become faced with something that they have never experienced before: falling real estate prices. Suddenly, there is far less equity to borrow against. And yet all the debt is still there. Balance sheets need to be repaired. Paying down debt is of course the right thing to do on the micro-level, but when everyone does it on a combined basis at the same time, the cycle turns ugly, and it is in no way a normal recession."

"If you are upside down on your balance sheet with no income, then it is of course 'game over,'" says Ku, "but if you have income and enough time, balance sheets can be repaired. But it is a long drawn out process, and if you start to hit government fiscal frugality along the way, this is the exact wrong antidote to the wrong disease. This is like Europe today. What they need right now is more fiscal expansionism. What the ECB is pushing instead is fiscal conservatism. This is like treating the wrong disease at the wrong time with the wrong medicine. But Trichet and colleagues just don't seem to see this."

Koo gives Bernanke and a few other top Obama economic advisors credit for understanding the problem better. "Bernanke knows the risks of a balance sheet recession," says Koo. "I have personally discussed it with him. But the problem is that no one further up in the Obama administration wants to explain this to the American people. No one wants to admit how long this is going to take to repair. And then the Tea Party people come along with all their good intentions of fiscal conservatism, and by cutting back on the size of government they accidentally create even more damage and extend the period that it will take for balance sheet normalization. We went through ***all of these same steps*** in Japan between 1995 and about 2005, and when I look at the U.S. today it is like watching a movie that I have seen before – that I have lived before."

Koo has written a 2001 book "The Holy Grail of Macroeconomics - Lessons from Japan's Great Recession" that I have not read, but intend to add to my bookshelf soon. This guy is a piece of fresh air to the normal economic type who doesn't understand anything beyond the norms of the past few decades. He is trying to respect and apply history while most other economists cannot fathom the system working any differently than it did in the 1980's or 1990's.

For those who want to listen to Koo talk, here are a few recent links:

http://ineteconomics.org/video/conference-kings/balance-sheet-recession-richard-koo

http://ineteconomics.org/video/bretton-woods/macroeconomic-management-after-crisis-2-7

If I were to fault Mr. Koo for anything it would be that he always stops short of the end-game: Even if governments keep their fiscal expansion strong until individual and corporate balance sheets are repaired, can the government ever really safely retrench its own balance sheet once it becomes so central and important to the economy? Maybe there are safer times to try to do so than others, but I personally don't see the ultimate way out. If the famous Austrian economist Ludwig von Mises were still alive, I would love to set up a hypothetical debate between Koo and von Mises and hear the two of them go at it.

On an overall basis, I think Koo understands the current economic problem better than most, but whether he also understands the solution is another question. Koo may argue that Japan today has largely repaired its corporate and individual balance sheets, and that Japan would have experienced a much more severe depression had the government not spent what it did with fiscal expansionism across the last two decades. But Japan's equity market is not exactly acting like a spring chicken yet, and the Japanese government has now of course created mountains of JGB debt left behind. The fact that they owe most of this debt to Japan's own population is often viewed as a good thing, but in my mind, it may actually be a worse situation than when the debt is owed externally. When the debt is owed externally (a la the U.S.), currencies can be devalued, rules changed, losses pushed offshore. When debt is owed internally and ultimately goes down in value, wealth is still simply destroyed.

Rotational wealth destruction has of course been a topic of these pages for sometime. The sovereign debt crisis in Europe has clearly destroyed much wealth already; the global equity swan dive of the last two weeks has just destroyed more. Elsewhere, money seeking a safe haven recently migrated to hide in Switzerland. Its value just went down precipitously in value as the Swiss National Bank mumbled about potentially pegging the Swiss franc to the euro at a 1.15 peg. Even gold finally started stumbling last week after the CME raised margin requirement on gold futures.

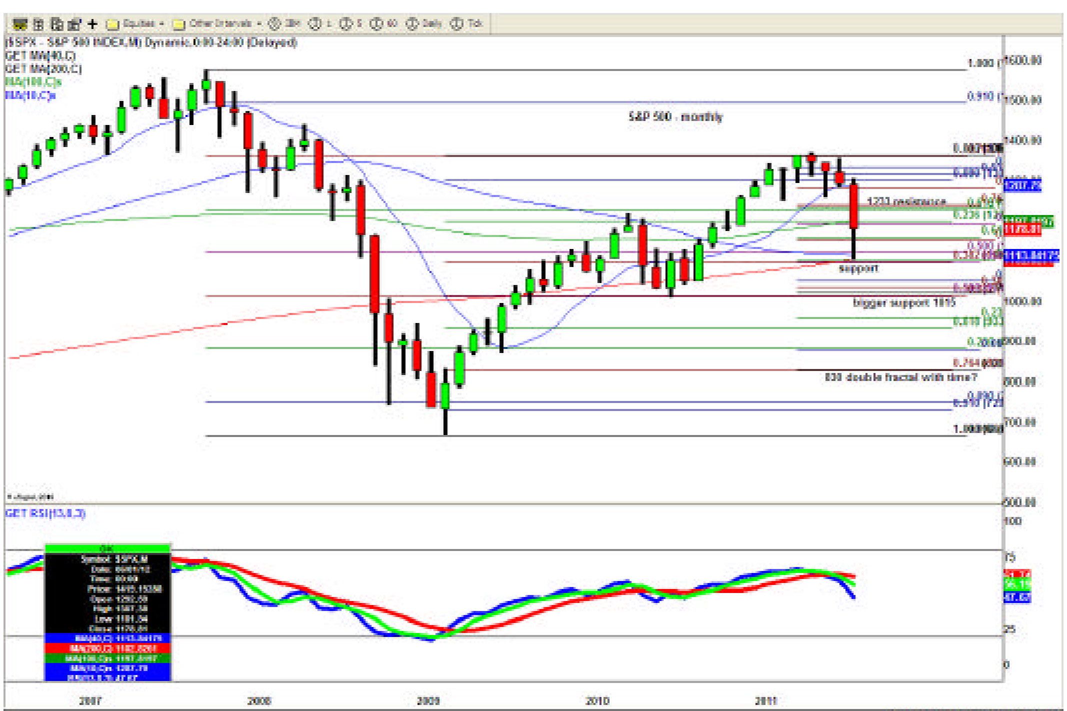
There really is no place to hide. U.S. Treasuries might appear to be such a place in the very short-term, but they are of course at the very epicenter of the imbalances. They offer little value on a post-inflation real-return basis.

For the past few weeks, I have regularly been short all three of these assets – equities, bonds, and gold – and while on any given day, I may have gotten clipped by one or two of these markets, I have net made money (the equity decline overwhelming gold and bond losses to date), and in the long-term, I think that I will end up being profitable on all three exposures.

So how about a few charts to finish this meandering letter…

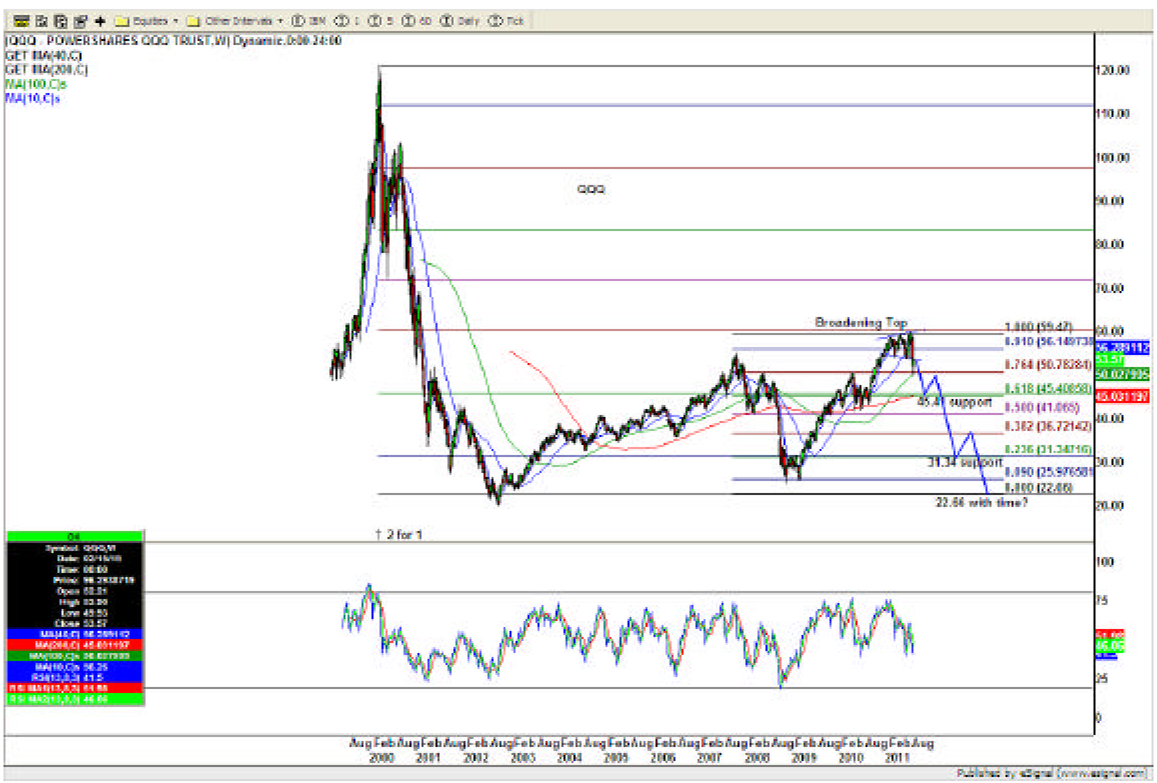
On the S&P 500, there are just a few levels that interest us.

- Let's start by pointing towards huge fractal resistance at 1233, with further resistance residing at 1288 where all the moving averages are also currently rolling downward.
- Some support currently resides at the recent overnight low near 1077 in futures that may need to be revisited in NYC trading hours.
- intermediate term support comes in at 1015 both fractally and from the old summer-time 2010 lows.
- a double dip target with time is down near 830.



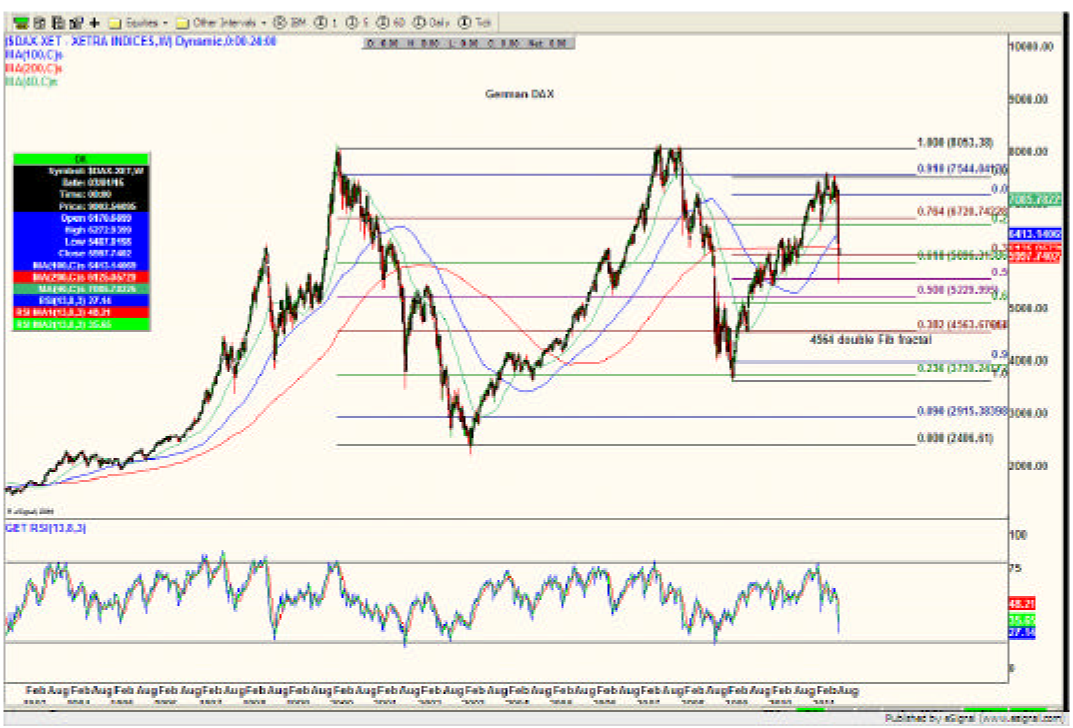
What’s the potential path getting to 830? This is harder to tell, and there is way too much volatility in the market to espouse any single path with much conviction. The majority of our analogs shown previously (1930, 1937, and 1946 markets being most worthy of attention) suggest a “trap door” type of market where bounces are shallow and longs are not given the opportunity to get themselves onsides. But the 2007 topping pattern also seems to have fractal similarities to the current topping process, and this latter pattern would certainly allow for a bounce period to 1233 or maybe even 1288 into Labor Day. Earlier this past week as the S&P approached 1100, we temporarily covered all of our equity shorts in order to have ammo should such levels be offered. But feeling somewhat naked should the “trap door” pattern continue, we also started to resell some of them this past Friday with the S&P back to 1170.

Other clues may perhaps be found in terms of the tech market. The QQQ ETF currently sports a “broadening top” formation that is most bearish longer term. Following along with Richard Koo’s focus on the similar behavior between Japan in past years and the U.S. today, does the QQQ chart look a bit like the Japanese Topix did circa 2007? Should we eye the Topix as a good potential analog for the NASDAQ?

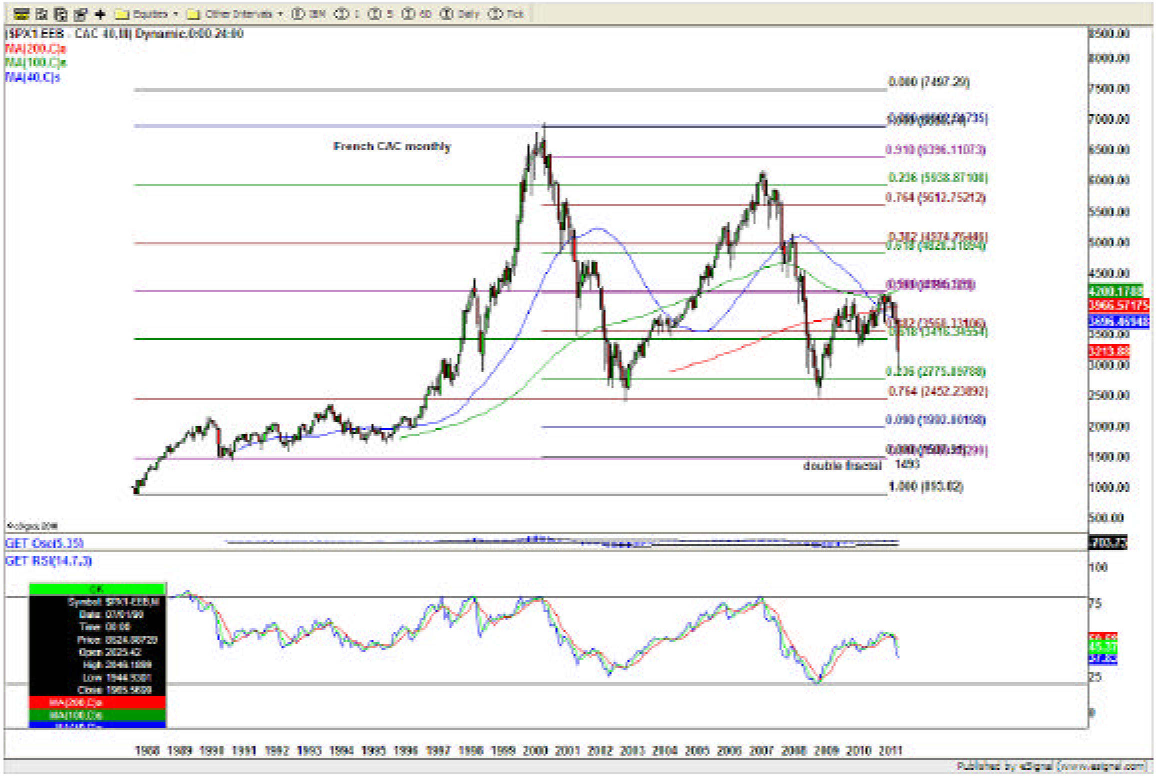


By the way, we continue to see new lows in the Topix coming as well, albeit this new low may be a huge buying opportunity in Japan. Patience is required first until a washout level near 549 on the Topix is seen.

Meanwhile, we expect Europe to remain a mess. The German DAX specifically has a double fractal Fib level at 4564 that should be seen again with time. The overall monthly pattern between 1999-2011 looks a lot like the 1929-1937 pattern in the DJIA that we have shown previously.



The French CAC looks even worse, with a double fractal target down near 1493. Germany goes down, but France goes down further and harder. God help Italy, Portugal, and Spain.



Yes, these are Armageddon-like calls, but they are simply where our technical work leads us. By mid-November 2012 we hope that equity price levels will be low enough so we can be outright bullish into September 2015. But first we have to get there.

AN IMPORTANT DISCLOSURE