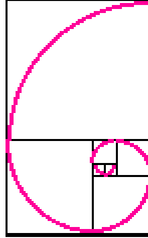

# Sand Spring Advisors LLC

## "Rats & A Sugar High that Can't Last"

**by,**

**Barclay T. Leib**

**September 20, 2009**

We apologize for our quiet absence for some weeks. After briefly covering all of our shorts around 980 on the S&P, and then putting them out again all-too-quickly between 1000-1020, the subsequent grindy up-move to the 1060-1080 region on the S&P has simply not been our "cup of tea."

Our timing has been poor, and the market's appetite to go on steady (albeit not particularly volume-laden or dynamic) advances day after day has been somewhat mind-numbing.

If Sand Spring has an Achilles' Heal type of market that we quite dislike it is indeed a grindy up-market without clearly defined momentum characteristics. Because the market is grinding on low volume, every sharp break initially feels like a potentially important turn, but alas within 24-48 hours, these potentially important breaks have to date dissolved back into nothingness. The grind higher instead reasserts itself.

To a certain extent, we do understand that equities and commodity markets are kind of winning by default. The Fed has manipulated short-term money market returns so low that people feel like patsies leaving their money idle earning just a few basis points in money market funds. And yields further out the Treasury curve are not much better. In the end, there will be "no joy in Mudville" investing in 30-year Treasury paper with yields around current levels. At some point over their 30-year life you can sure of only one thing: these bonds will be available at a marked-down 50-60 cents on the dollar. *When* this markdown exactly occurs is simply a function of how fast the Chinese bawk at buying more of our paper, as well as how fast the Federal Reserve admits that its current balance shoot ballooning exercise is a temporary hallucinogenic drug that must be withdrawn at some point -- lest the drug itself kill the patient.

Anyone who is blithely committing capital to either the equity or bond market at the current time is effectively playing a "Greater Fools"- game of investing. Stocks and higher

yielding assets (corporate bonds, junk bonds, etc) may have been going up in the short-term – but it is all based on a faux "sugar-high" induced by our own government.

I like to think of yet another analogy: the general populous is equivalent to a bunch of rats in a controlled cage – a maze of sorts – where the rats are generally happy to go about their business and reproduce as long as they get their daily dose of cheese. Cheese gets thrown into the cage daily, but over time, the number of rats multiplies, and the cheese ration provided soon seems skimpy in comparison to the number of rats. The rats revolt and gnaw through the wire mesh of their cage. Soon, rats are everywhere, and an emergency hunk of cheese is borrowed from another laboratory and thrown back in the original cage to lure the rats back into complacency. This works for awhile before the rats get antsy again. It is a naturally unstable situation.

The natural way out of this situation is that some of the weaker rats – unable to get to a limited food supply – should be allowed to die. But the laboratory professionals controlling the experiment have strict orders from their team leader not to let this happen. Preventing the death of too many rats is a high priority.

At times, the laboratory professionals can't obtain or borrow enough real cheese to feed all their rats, so they allow some synthetic cheese to be introduced into the daily feeding. The rats generally don't notice the difference, and in limited quantities, the synthetic cheese doesn't upset their digestive system. But if they eat too much synthetic cheese, they explode.

Now the technicians have yet another problem to deal with. If a given rat has over-indulged himself on synthetic cheese, that rat needs to be nursed back to health instead of simply being allowed to explode from obesity.

Over time, the rats only learn one lesson: make enough of a ruckus and the cheese always seems to appear. When it does, they can calm down again and blithely go back to enjoying their maze.

Well, the rats of Wall Street certainly made a ruckus last fall, and the lab technicians at the Fed have done their damndest to restore calm. The problem is that the methods that the Fed used (the cheese so to speak) is not going to be self-sustainingly available. Just as there are physical limitations on the amount of cheese in the world, there is simply not enough ongoing demand for all the financing the U.S. government is going to need to support its balance sheet. Like a guy at the poker table who goes "all-in," and proffers a huge bluff of further resources behind him (but without any real borrowing lines actually in place), the government wants you to believe that they are all-powerful – "it never pays to fight the Fed." They want the rats to believe that the cheese will just keep coming.

By shifting as much debt as they did last fall from the private sector onto the public sector, the government effectively bought itself some time, but solved no actual long-term problems. And they have no real end-game. If the economy does recover, the eventual withdrawing of the medicine will still kill the patient – just later than would otherwise have been the case. And if the medicine is simply left in place, eventually the government won't be able to finance itself anymore. The doctor administering to the patient, so to speak, will become infected.

It is with the above thoughts in mind that we noticed this past Thursday, September 17th that USA Today sported an entire special section "Investing for the Recovery." Can any popular media bell of a top be clearer?

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# Investing for the recovery: Where to place your bets

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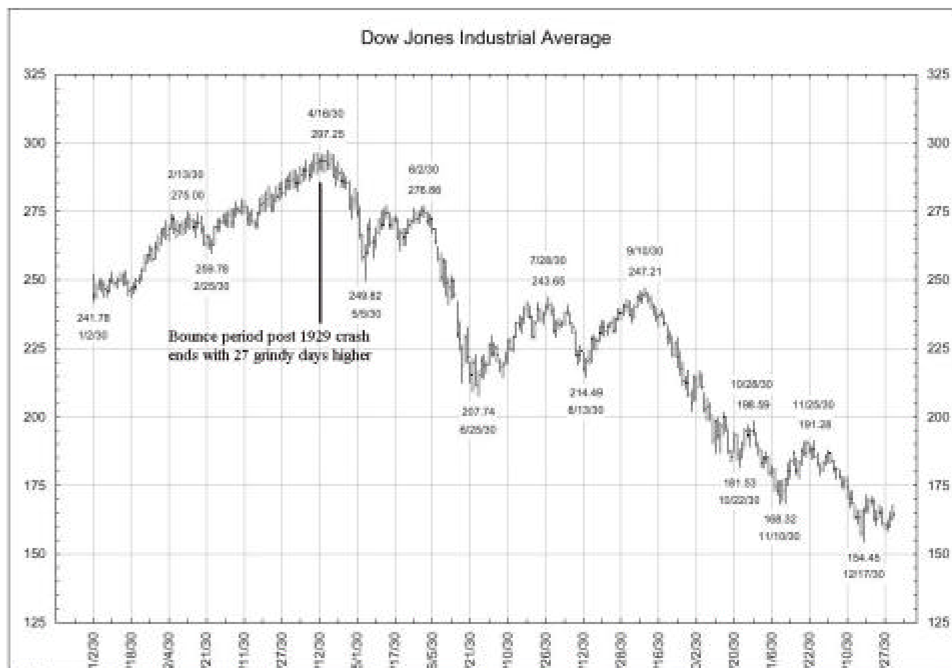
By John Waggoner, USA TODAY

This special section appeared just a day or two before a September 19-23 window marking .382 x the day count between the October 7, 2007 all-time high and the March 6-9, 2009 low, which when added on to the March 6-9,2009 date yields a possible important turning point RIGHT NOW.

I know that I am at risk here of sounding like a perma-bear, but I honestly have a feeling that NO ONE – absolutely NO ONE (excepting perhaps Bob Prechter of Elliott Wave International) – expects another market crash in the near term. Go to any investment conference on Wall Street at present and analysts all sound uniformly bullish.

And yet as I stare at CNBC over recent days and try to fathom recent equity strength, all that wells up inside of me is a memory of August 1987. This was a period when I was mostly traveling with my wife on vacation in Maine. But from our hotel rooms along various stops, stocks were rolling higher day after day – even with bearish currency and fixed income markets at the time. Of course, this period ended in tears about eight weeks later when the Crash of 1987 took equity markets down over -35% in a swan dive.

The recent grinding higher market action also reminds me of an earlier period where the post-1929 bounce was ending into an April 16, 1930 high. Prior to this high, stocks experienced a steady advance of some 25 days from January 18, 1930, a small 5-day correction, and then another 27 days of grinding higher price action.



In the current instance, since the July 10, 2009 small-range-day low, stocks have been grinding higher for some 49 subsequent days, with just two minor 3-day pullbacks along the way. The advance has been so relentless that almost all technicians have had to throw in the towel on the bear case somewhere along the way. But does it in actuality look and feel a bit like April 1930? Certainly the overall 50%+ magnitude of the overall advance from March 2009 fits the October 1929-April 1930 52% advance reasonably closely.

The above picture is one of the constant daily "battle" to correctly analyze markets. Sand Spring has had its moments in 2009 – particularly around the March 6, 2009 low and across the choppy July period – but for the past two months we have been struggling. Some might say that we need to get back onsides and admit our recent mistakes, and turn bullish. However, there is nothing in our analysis and general psyche that allows us to do so.

The most bullish statement that we currently can make is that the SPY ETF has yet to fully fill its "gap" from last fall that resides between 107 and 109.80.

But NOTE BIEN: If you look at the Russell 2000 IWM ETF, it has already filled its late 2008 gap – doing so last week.

In addition, the top edge of the SPY gap is so close by at 109.80, do we really even care if the market pokes a bit higher in the short term to fill it? Not really. Not in the big picture.

The bottom line is that we refuse to play the Greater Fools' game of investing. It could possibly still be too early to be short equities (as it certainly has been for the past two months of agony for us), but it is certainly too late to remain long.

Strong markets in July have also historically been followed by nasty fall declines. Just look at the table below prepared by analyst Eliot Glazer of DuPasquier & Co. There is a 100% record of success to expect some modicum of market weakness by mid- to late-October.

## Fall Collapse After Unusually Strong July/Aug

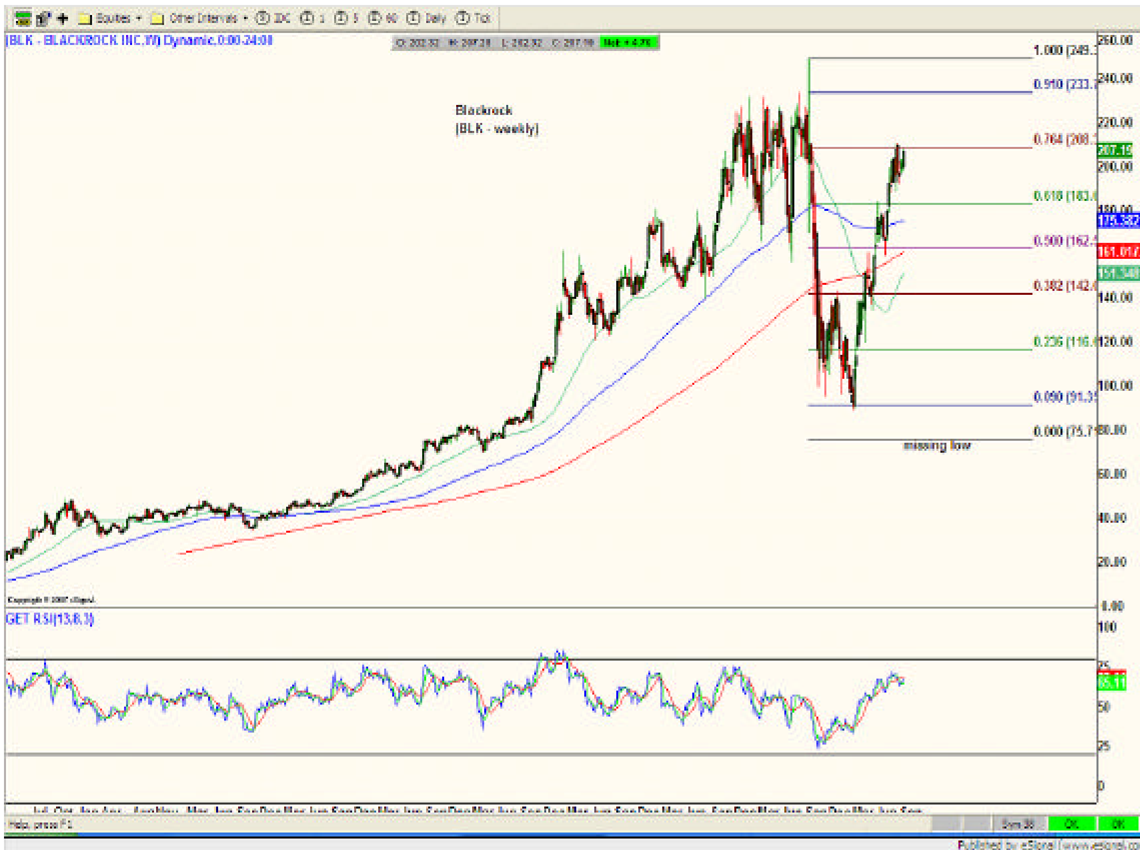
| | | | | | |
|---|---|---|---|---|---|
| 1974 | 7/12 | 7/28 | Change | 10/4 | Change |
| DJIA | 770 | 808 | 5% | 573 | -29% |
| 1975 | 6/13 | 7/16 | Change | 10/2 | Change |
| DJIA | 811 | 889 | 10% | 782 | -12% |
| 1976 | 6/7 | 9/22 | Change | 11/11 | Change |
| DJIA | 952 | 1026 | 8% | 917 | -11% |
| 1978 | 7/6 | 9/11 | Change | 10/30 | Change |
| DJIA | 801 | 917 | 14% | 782 | -15% |
| 1979 | 7/18 | 10/5 | Change | 10/23 | Change |
| DJIA | 818 | 905 | 11% | 801 | -11% |
| 1987 | 6/2 | 8/26 | Change | 10/20 | Change |
| DJIA | 2266 | 2728 | 20% | 1616 | -40% |
| 1989 | 7/5 | 10/10 | Change | 10/16 | Change |
| DJIA | 2436 | 2795 | 15% | 2505 | -10% |
| 1990 | 6/27 | 7/23 | Change | 10/12 | Change |
| DJIA | 2832 | 2961 | 5% | 2360 | -20% |
| 1992 | 6/22 | 8/3 | Change | 10/5 | Change |
| DJIA | 3254 | 3400 | 5% | 3096 | -9% |
| 1997 | 6/5 | 7/31 | Change | 10/28 | Change |
| DJIA | 7268 | 8283 | 14% | 6971 | -16% |
| 1998 | 6/16 | 7/20 | Change | 9/1 | Change |
| DJIA | 8570 | 9368 | 9% | 7400 | -21% |
| 1999 | 6/1 | 8/25 | Change | 10/18 | Change |
| DJIA | 10409 | 11335 | 9% | 9976 | -10% |
| 2000 | 7/6 | 9/7 | Change | 10/19 | Change |
| DJIA | 10393 | 11329 | 9% | 10015 | -12% |
| 2001 | 7/11 | 7/19 | Change | 9/21 | Change |
| DJIA | 10121 | 10678 | 6% | 8062 | -24% |
| 2005 | 7/7 | 8/10 | Change | 10/13 | Change |
| DJIA | 10175 | 10719 | 5% | 10156 | -5% |
| 2009 | 7/8 | 9/18 | Change | ? | Change |
| DJIA | 8087 | 9854 | 22% | ? | ? |

The right way to approach this market may be to focus on fixed income. When the fixed income markets independently start to misbehave (either because of ongoing equity market strength, or because of an increasing outside financing malaise/revolt by foreign bond holders, or because of an overt change of course by the Fed) – with Treasuries, High Yield, and Muni-Bonds all falling together – that will be the signal that the jig is up in the Fed's current manufactured faux prosperity.

Along these lines, we see the longer-term Fibonacci fractal rhythm emerging in the TLT ETF (20-year Treasuries) as follows:

We also believe that there will be a muni-bond financing crisis of some magnitude in this country in 2010-2011 as tax revenues skid lower and municipalities scramble to remain current on their burgeoning debt burdens. Along these lines, we are personally currently short the Nuveen Value Muni-Bond closed-end fund:

Fixed-income and muni-bond centric companies like Blackrock (BLK) may also still offer an attractive short over the coming year -- albeit the weakness we previously expected here has certainly been slow to start (to date):



As discussed in previous newsletters, we also still have a close eye on China. While U.S. markets have to date effectively shrugged off the steep decline in Chinese markets that began in late July, another leg down in China could easily be more unnerving to Western capital markets. There are many possible Fib rhythms here, but the one below for the Shanghai A shares is certainly possible.

So what to be long? If anything? Gold perhaps?

Sadly enough, we also feel that the same faux central bank policies propping up global equities in the short-term are also artificially propping up commodity markets. Inject too much artificial liquidity and this liquidity will manifest itself in odd and unexpected ways. There has already been much written about Chinese pig farmers speculating in copper that they don't really need. Here is a short *Bloomberg* article that appeared last week:

> "Private investors in China, the world's largest metals user, have stockpiled "substantial" quantities of copper as the government ramps up stimulus spending to spur the economy, according to Sucden Financial Ltd. Pig farmers and other speculators may have amassed more than 50,000 metric tons, Jeremy Goldwyn, who oversees business development in Asia for London-based Sucden, wrote in an e-mailed report after a visit to China. That's about half the level of inventories tallied by the Shanghai Futures Exchange, which stood last week at a two-year high of 97,396 tons. Sucden's estimate

> underscores the difficulty analysts face in gauging metals demand in China amid increased speculation by retail investors, whose holdings remain outside the reporting framework undertaken by exchanges. Private investors in China also had as much as 20,000 tons of nickel, Goldwyn wrote. "Private stockpiles, built by many including the much-vaunted, pig-farming speculators, have clearly absorbed substantial quantities of metal," Goldwyn wrote. "Much of this metal will remain out of the normal market place."

Throw in the Baltic Dry Freight market collapsing for multiple days in a row last week, and the following recent comments from brokerage/research firm Miller Tabak & Co. about forward shipping rates (passed on to us by a friend):

> A worrisome trend is forming in the forward rate market where prices are collapsing. Forward rates on cape size ships, the largest which are used to ship about 170K metric tons of cargos, fell 7.45% today to $23,500, down 21.13% for the week, and are now at the lowest since early May. Many had speculated that part of the decline in the Baltic Dry Index (nearly 45% off near term high) reflected expectations regarding the pace of Chinese imports in the second half of the year. Indeed, it appears these concerns have been somewhat validated as Chinese imports of various commodities slowed in August; crude oil down 6%, iron ore down 14.46% (largest month/month drop since October 2008) and copper down 20%.
>
> With respect to forward rates, the trend is worrisome in the sense that declines in forward rates by this measure have appeared to be a leading indicator with respect to the Baltic Index. If the index itself were to follow forward rates lower, it would be an incredibly negative sign for the pace of global trade and the price of commodities generally. There has tended to be a strong correlation between the Baltic Index and industrial commodity indexes including the JCI and CRB, although neither of those indexes has reflected the recent weakening in the Baltic."

Does this sound like a real commodity bull market in the making, or just a house of cards ready to come tumbling down? While gold in a "currency sense" may represent a nice store of value longer-term (particularly in a paper-money world of competitive FX devaluation attempts), we fear that too many speculative interests are currently involved in gold – including one of the largest hedge fund managers in the world -- John Paulson. Paulson is a brilliant man who adroitly caught the 2008 credit meltdown. But now he is exhibiting extreme *hubris* by accepting more and more investor money and trying to also play the credit "melt-up" with large positions in stocks like Bank of America, as well as mining stocks Anglogold and Kinross Gold. We think Paulson will eventually get himself into trouble on one of his investments (NB: the Wyeth merger deal with Pfizer is Paulson's largest single holding – as it is at many hedge fund shops – and would be an ugly moment for the capital markets in general should this deal not go through for some reason). Given just one misstep -- a la Tiger Management in 1998 with large trading losses in dollar/yen after which redemptions started to pour in – Paulson could easily become food for the investment banks to feed upon (let that actually read: Goldman Sachs to front-run). Given his size, he will simply be too big not to matter, and the dialogue could easily become: "Paulson is in trouble. What else is he long? Sell in front of him."

Gold is such a small market that a speculative rush for the exits could easily knock it down a few hundred dollars.

Technically, when we look at the recent upside "breakout" in gold, we are also reminded of gold back in February 1996. Yes in 1996, gold shot higher for a few last weeks after resolving out of a similar "coiling pattern" as 2009, but it eventually was a horrible time to invest in gold stocks. With patience we expect gold to be available as an investment down the road at significantly lower levels.

To our eye a copper-centric metals stock like Freeport-McMoran (FCX) are also now topping – FCX specifically having just reached its 50% retracement level of the 2008-2009 decline, as well as a cluster of longer-term moving average resistance.

And what will be under the Christmas tree in 2009? Not a ton of Mattel (MAT) toys in our mind. Just look at the two fractal patterns depicted below, and decide which looks better to an artistic eye. You are choosing between the first chart where Fibonacci bands are drawn between the 2007 high and the existing 2009 low, and the second chart where bands are drawn to an extrapolated low still to come down near $8.68. Doesn't the second chart just look so much more pleasing on a Fibonacci fractal basis? <u>We think that this comparison alone speaks volumes for the market as a whole.</u> There will be no lasting V-bottom, but instead a renewed decline that will likely dribble on into our next major pi cycle low expected in June 2011.

So in our mind the only real chance to make much money in these markets over the next two years is effectively to be short everything! Be short bonds (particularly munis); be short stocks; and selectively on a trading basis at least, consider even being short commodities.

If these views put us in the camp of being a "deflationist" – so be it in the short-term. However, being negative on fixed income (concomitant with a bearish view on equities) would not regularly be associated with such a title. We are honestly not sure what to call ourselves. Realists, perhaps? We know only one thing: We are not rats in a maze happily nibbling at our cheese.

Maybe we worry and ponder too much. Maybe we should lighten up and join the party. But historically, keeping honest to our true thoughts and not cutting corners to accept consensus conclusions, has served us well.

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