Sand Spring Advisors LLC

Long-Term Equity, Gold, and K-Wave Cycle Thoughts

by,

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In recent days we have had two subscribers both write in to us asking where we believe the global economy currently stands with regard to the longer term Kondratieff Wave. Kondratieff, for those not familiar with his work, was a Russian economist who was eventually banned to Siberia for his belief that a self-correcting long-wave cycle of price behavior existed in capitalist markets. Under Kondratieff theory, a peak in price inflation typically occurs every 52-62 years.

In one instance the subscriber wrote:

"Some people discuss the possibility of a Kondratieff winter coming. It seems to have started in 1997 or 2000 and will last until 2012-2014." The subscriber then went on to correctly note the importance of November 2002 under the Princeton Economic confidence interval theories since that date is 4.3 years (or one-half of a full 8.6-year cycle) from the July 20, 1998 high. But the reader was unsure of whether this date would necessarily represent a high or a low. He also noted that late 2004/early 2005 could be yet another period for a stock market panic basis the Kondratieff cycle (1987 equity panic +17.2 years = December 30, 2004).

Overall, the subscriber had many cogent thoughts floating through his head, but was clearly having a difficult time putting them together in a logical flow. We may not have all the answers, but on the pages that follow, we have tried to synthesize what we see longer term -- *notably working backwards from the short term.* We have also tried to tie in our cyclical views with longer-term Kondratieff theory.

One word of some importance before we start: We have are going to lay out our roadmap starting from July 20, 1998 -- a date of much significance to the Princeton Economic Institute as an equity turning point, but certainly a date that was well short of marking *the ultimate* equity high. Final highs in the major equity indices did not of course take place until the January-March 2000 period, and did so on three different dates within that window depending upon which equity index one uses.

Some may wonder why we have used July 20, 1998 instead of using our own cycle analysis as espoused in "Measuring Financial Time with Pi." The answer is that while over long periods of time we like our 17.2 year cycle in a broad brush manner more than that of PEI cycle, for some strange reason, the PEI 17.2 year cycle has had more success in calling actual "turn days" and periods of panic reversal. It picked the 1989 top of the Nikkei to the week and the July 1998 equity high to the day. One of its 8.6-month sub-cycles fell just before the 1985 Plaza Accord and right on the February 1994 Fed rate hike. Another came just after the 1987 equity crash to mark a turn back higher. Allowing that there may actually be several different 17.2-year cycles hop-scotching each other, the PEI one often seems to catch exact turns. For that reason we choose to use it here.

With that in mind, June 2, 2001 was due an intermediate 8.6-month turning date within the longer-term PEI cycle -- and the market left a high just in front of this date. Ideally, we believe that this high should lead into a short term low 4.3 months hence on or about October 11, 2001. As previously prognosticated, we also expect a significant gold low in August, but perhaps with solid upside acceleration in the gold price lingering until October -- the pace here depending in part upon the overall tempo of reflationary policies in Japan. It is also possible in our estimation that while October could represent a spike equity low, full basing in equities might extend all the way to early February 2002. This latter date would increase in probability as a significant low the longer that we dawdle in attempted rallies now.

In short, we have a vision of gold starting to act better in the very near future and a few months ahead of an October-February window of time when we will be looking for a significant equity low as well. If this short-term part of our prognostication comes to pass, we then could actually envision quite a hellacious and strong equity market rally for 8.3 months from the October-February basing period into June 30, 2002-November 7, 2002 topping period. For equities this would be akin to the bear market rally experienced by gold for 8.3 months back between June 1982 and February 1983 when the price of gold vaulted from under $300 to over $500. Gold did so at the time due to a perception of a return to inflationary ways when Volker let go of his stranglehold on U.S. interest rates.

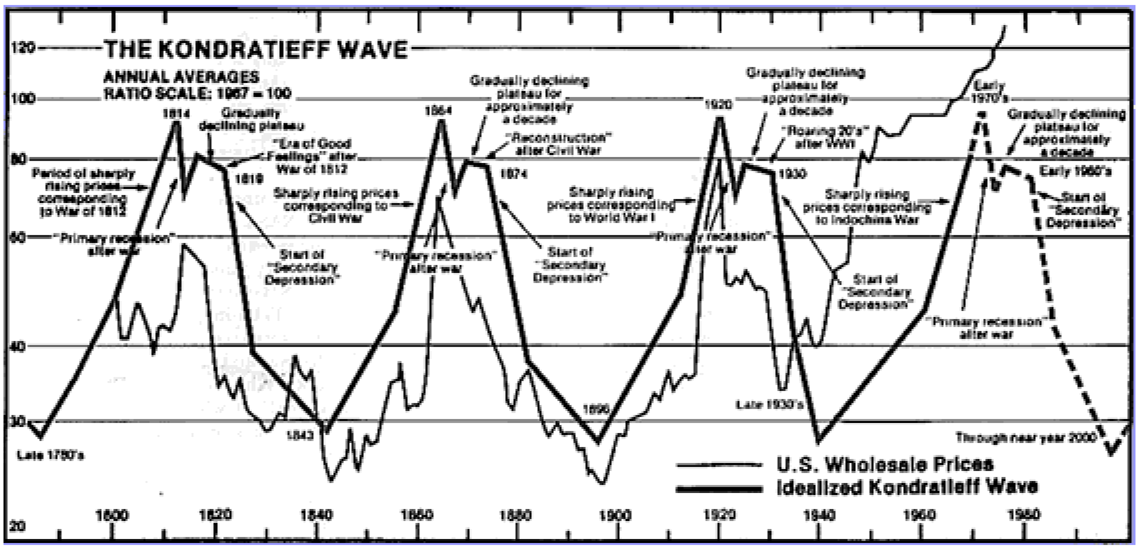
This time around in late 2001-early 2002, we would expect the bullish influence impacting both gold and equities will emanate from Japan where overt monetization will drive that country's currency down (168.35 remains a strong USD/JPY target in our mind), but its equity market (representative of real assets as opposed to paper ones) up. Gold should also benefit as a dollar-denominated hedge to the declining yen during this period.

But then, November 7, 2002 should mark the end of this frothy bounce period. In our estimation, this date should begin a renewed bear-market equity decline that will last for at least for 2.15 years (or a quarter cycle) into the very tail end of December 30-31, 2004. How interesting it is that this PEI date lines up with our subscriber's call for a panic equity move at the same time using the 1987 crash plus 17.2 years. Another overlapping 17.2 year cycle no doubt.

Then, from that December 30-31, 2004 low, a final push upward in equities should ensue into early 2007 – a full 8.6 years from the July 20, 1998 high and 17.2 years from the 1989 Nikkei high. Carrying on even further, 2011 would then be a likely low, 2013 a likely minor high, and September 2015 a final major low falling 17.2 years after the July 20, 1998 high.

Within these moves, we see 2001-2002 as an inflationary spurt, 2002-2005 most likely to be marked by strong debt deflationary forces, whereas the latter part of the cycle and certainly the very tail end of this period, 2013-2015, will likely see inflationary forces mounting once again. Overall, there will be pockets of deflation, but we don't exactly see a "Kondratieff winter." Instead we'd expect overall stagflation punctuated by a few nasty periods of debt write-offs when the Fed will be completely ineffective in its effort to assuage the economy's pain with interest rate cuts.

Here are a few nitty-gritty Kondratieff price change observations that we think are of some interest. Few doubt that with 30% price inflation, 1864 was a significant Kondratieff price high that led to an 1878 price trough – some 14 years later. Subsequently, deflationary forces remained strong until 1897, before the War of 1898 spurred inflation's return. Prices then peaked again in 1918-19 (approximately 54 years after the prior 1864 Kondratieff price peak), troughing in 1932 – again 14 years later. Deflationary pressures again remained a strong force until 1939 when, with the onset of World War II, inflation started to head upwards once again. In the current instance, the 1980 peak in inflation (62 years after the 1918 Kondratieff peak) led to a price trough once again 14 years later in 1994 (first Fed recognition in February of 1994 of growing inflationary pressures), and we have been zigging sideways in a push-pull of inflationary-deflationary forces ever since. If history is any example, the next part of the equation should now be another major war to reignite inflationary pressures. The idealized and now very dated Kondratieff picture below shows 2000-2001 as a potential period for inflation to start turning higher, and while that may end up being somewhat true, we think a real acceleration in these inflationary forces (concomitant maybe with war) is best expected in 2005 or beyond.



We thus do not expect a "Kondratieff winter." We expect instead a 1-year spurt of inflation, a strong last bought of deflation, and then inflation reemerging out of increasingly stagflationary conditions. The peak in prices that occurred in 1864, 1918-19, and 1979-80 probably will not be seen again until somewhere beyond 2033. As previously espoused in "Measuring Financial Time with Pi," July 2034 would be the most likely period for a large price spike higher, falling 314 years after the 1720 South Sea Bubble, 942 years (3 * pi) from the Monetary Crisis of 1092 and 1570 years (5 * pi) from the period in which the Roman Empire was falling from power. This does not mean however that deflation will exclusively rule in the years before this. That would be like saying no inflationary pressures existed in the 1950's, 1960's and 1970's just because the final peak in price pressures did not occur until 1979-80. Instead we are likely already turning the corner from outright deflationary times into more stagflationary ones. Certainly beyond 2005, inflationary pressures should seriously start to mount once again, with war at some point a likely trigger in its acceleration.

Whatever the case in terms of inflation, overall in terms of the equity market, we believe that our NASDAQ price path may look something along the following lines. Amazingly enough we can draw it superimposed upon our old analog 1980 boom-bust gold chart as follows:

While this is not a happy picture for those that believe that a well-diversified portfolio always compounds at an average 10% (a complete fallacy of course over long stretches of history), the key point here is that we should have tradable periods of equity market strength. It's just that these periods won't grow to the moon as they did in the 1980s and 1990's but instead will peter out after 8-month to 2-year runs within a more protracted overall bear environment.

Our answer to Kondratieff fans is that after an initial spurt in inflationary expectations between October 2001and November 2002, the markets should indeed eventually experience a period of debt deflation where the word "leverage" will slowly grow to be greatly disdained. All the convertible bond telecom debt issued over the past few years, all the excess credit card debt, all the growing corporate debt used to finance stock buy-backs will need to be worked off or written off. Even with the utmost help from an accommodative Fed, this is likely to be a long difficult period of retrenchment akin in many ways to 1931-1938. It is also likely to be a period where yesterday's financial heroes will fall dramatically from grace.

Let's pause for a moment to take this little quiz as we revert back to the boom year of 1923.

1) Do you know who was the president of the largest steel company in that year and what subsequently happened to him?

2) How about the president of the largest gas company?

3) Or how about the president of the New York Stock Exchange?

4) What happened to the greatest wheat speculator of that era?

5) Or how about the President of the Bank of International Settlements back in 1923?

The answer to our short quiz:

1) The president of the largest steel company, Charles Schwab, died a pauper.

2) The president of the largest gas company, Edward Hopson, went insane.

3) The president of the NYSE, Richard Whitney, went to jail.

4) The greatest wheat speculator of the era, Arthur Cooger, died abroad, penniless.

5) The president of the Bank of International Settlements shot himself.

Our quiz is of course stacked. Many prominent people doing well in their career in 1923 survived the 1931-1938 period to go on to great success. The point is that some current industry titans like our current Carly Fiorna of HP or Lew Gerstner of IBM could easily end up looking far more villainous than they do today.

Back in the 1930's my grandfather happened to be one of the surviving good guys, but it wasn't without tremendous stress, effort, and fight. He launched San Francisco-based Blyth Dean Witter & Co. in 1914 with a few bond-salesmen friends who together chipped in a total of $600 in original seed money. By 1929, that initial investment had vaulted into a firm of several hundred employees with $12 million in partner capital. Even after the Crash of 1929, the firm was the lead underwriter of bonds to finance the 1933 construction of the Golden Gate Bridge – a prestigious accomplishment. But by the end of that same year, and courtesy of unsold inventory of various stocks and bonds that had substantially declined in value since 1929, partner capital had fallen below $2 million, and for a year or two it got even worse from there. In the fall of that year, it fell upon my grandfather's shoulders to move to New York in order to cut Blyth's New York office from 139 employees to just 7 people. Even with just 7 employees, the firm barely made its payroll on several occasions in the mid-1934-35.

Of course, the situation at many of New York's money center banks and investment firms is not nearly as dour today, but the analogies between that period and this are most definitely there. And to some extent they are worse. In the modern era, Chase and J.P. Morgan didn't just get left with unsold inventories of wilted telecom and Internet paper, but in 1999 they actually jumped into the fray at the worst possible moment to actively accumulate investment positions in "new era" securities. So too did Microsoft and Intel and other major corporations. Today, all of that paper is slowly being written down as "extraordinary losses" beyond the normal earnings statement. Many try to ignore these write-offs, but this is real money being lost, costing Microsoft $4 billion alone in write-offs in the latest quarter. And where real money is lost, it is our experience that heads usually follow.

Nothing of course happens instantaneously. Post the 1929 crash, it took Blyth several years to even start cutting its staff. Yet when it finally did so, that staff eventually declined by 95%. We think Wall Street is currently being set up for a similar (albeit perhaps not quite as dramatic) period of layoffs and tough times. If Lucent can shed over 50% of its workforce, so too can Charles Schwab or JP Morgan Chase. And yet money management groups like Janus still find some reason to keep Charles Schwab in their top 10 holdings. The entire thought-pattern from the bull market has yet to be broken.

Other Themes – more currency related

We mentioned before our view that U.S. dollar-yen would eventually touch 168.35 on increasingly reflationary policies in Japan. Cyclically, these policy moves should start to definitively emerge in October and are likely to initially be greatly applauded. That said, USD/JPY has recently been on the move higher already. The Fibonacci bands depicted below should represent minor stopping point in a steady and at some point accelerating advance. Once the current 127.35 resistance is cleared, the next target of any importance is 134.73.

In addition, and as we saw demonstrated in 1997 courtesy of Thailand, the Philippines, and Indonesia, currency moves often presage equity problems. At some point in the not-too-distant future be prepared for Argentina to truly abandon its currency peg (supportive of gold as well), triggering perhaps this last short-term leg lower in equities that we envision in the coming months. If you look at the forward curve of the Argentine peso, the market is already discounting over a 50% probability that this will occur within a year.

And ironically Argentina's devaluation could actually be more bearish for Europe than the U.S. given Europe's greater relative banking exposure to Latin America than U.S financial institutions. This could thus be an excuse for a final plunge of the euro to our major .7750 price target that shows up so clearly on longer-term charts with stretched Fibonacci bands.

Moving even further along in the currency world, with time one should eventually look for pressures to reemerge on the Hong Kong dollar and Chinese yuan. Right now, Hong Kong and China have been among the best performing equity markets globally in 2001, but if the yen devalues, we wonder how far behind Hong Kong and China would be. Certainly at some point in a weakening yen environment, these major export-oriented economies could easily decide to abandon their dollar peg policies in order to maintain export competitiveness. China B shares were recently trading at an average price-earnings ratio above 80-1, and of note, only started dropping precipitously (8% in a few days) just after our June 1-2, 2001 cycle window. This market has been languishing lower ever since.

As one interesting rhythm in the currency space, 2.15 years post the Dec. 20, 1994 Mexican peso devaluation, we saw the first cracks starting to develop in Southeast Asia in February 1997. Another 2.15 years later brought us to April 8, 1999 – a PEI cycle date that came just a few weeks after the Brazilian real devalued and represented a momentum high in many Internet stocks. 2.15 years further on from April 8, 1999 was June 1, 2001– another PEI turn window after which we have started to see increasing pressure on Argentina, and a notable weakening in China's share market. Is there yet another 17.2-year rhythm at work behind the scenes here? If so, we'd be looking for pressure to build for a devaluation of the yuan and /or Hong Kong dollar near July 26, 2003 – another 2.15 years beyond June 1-2, 2001.

Perhaps after laying down all of these longer dated prognostications, we will at some point find compelling short-term price action to change some of our interpretations and visions. If so, we will not be shy to change our mind and bring our mistaken projections directly to our subscribers' attention.

For the moment however, we think our long-term cycle work fits nicely with our long term gold/NASDAQ analog chart as well as more major Kondratieff deflation/inflation implications.
At a minimum we hope to have answered a few of our subscribers K-wave questions.

Send us your comments at information@Sandspring.com.

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