Sand Spring Advisors LLC

Depressed in the Short and Long-Term

But Market Hubris To End Soon

by,

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Sand Spring has been quiet lately. Not only has our fund of funds business kept us increasingly occupied (and profitable), but we honestly feel befuddled by an equity market rally that to date just will not stop. Since the early summer, we keep spying expected target areas of resistance; then see these targets reached; soon start to become excited when a topping formation initially develops; only to then become somewhat depressed when the potential top gives way to an incessant bull.

We know that bullish sentiment is high.

We know that VIX volatility is relatively low and complacent.

We know that mutual fund cash levels are back toward their all-time low of 4%.

We know that NASDAQ margin debt is back at all time highs, and that much Fed-induced and mortgage refi-induced liquidity will not be repeatable in the future.

And we know that upward sloping wedge chart formations that resemble George Lindsay's "Three Peaks and a Domed House" tend to end badly.

But in the short-term, Greenspan just keeps winning. Despite the fact that for every dollar of GDP growth created in the U.S. over the past year, $6 of new debt has also been created, no one seems to care about this – particularly given that the sponsor of such Ponzi-like economic behavior is the U.S. Government.

While we understand that when presented with a relatively "free lunch" (let that read ultra-low borrowing costs to lever up with) most Americans will gladly step up to drink from the punch bowl, the chart below of total NASDAQ margin debt (courtesy of www.elliottwave.com) is still of great concern. It continues to make us feel that current market strength is somewhat akin to January-March 2000 when the last 70-point advance of the NASDAQ also irritated us on an equal basis.

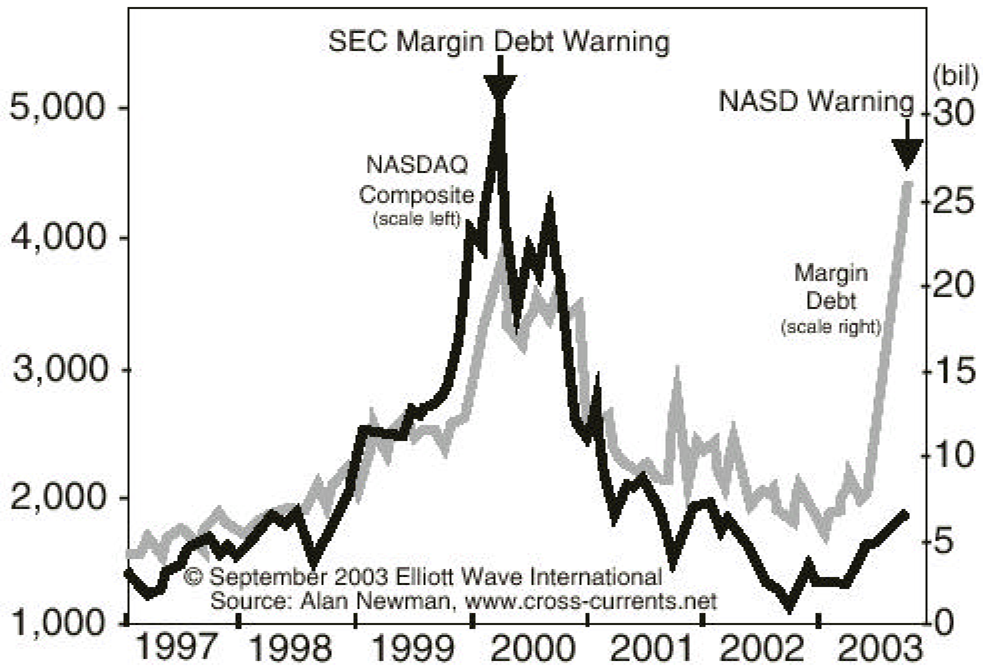


Chart Courtesy of Elliottwave.com

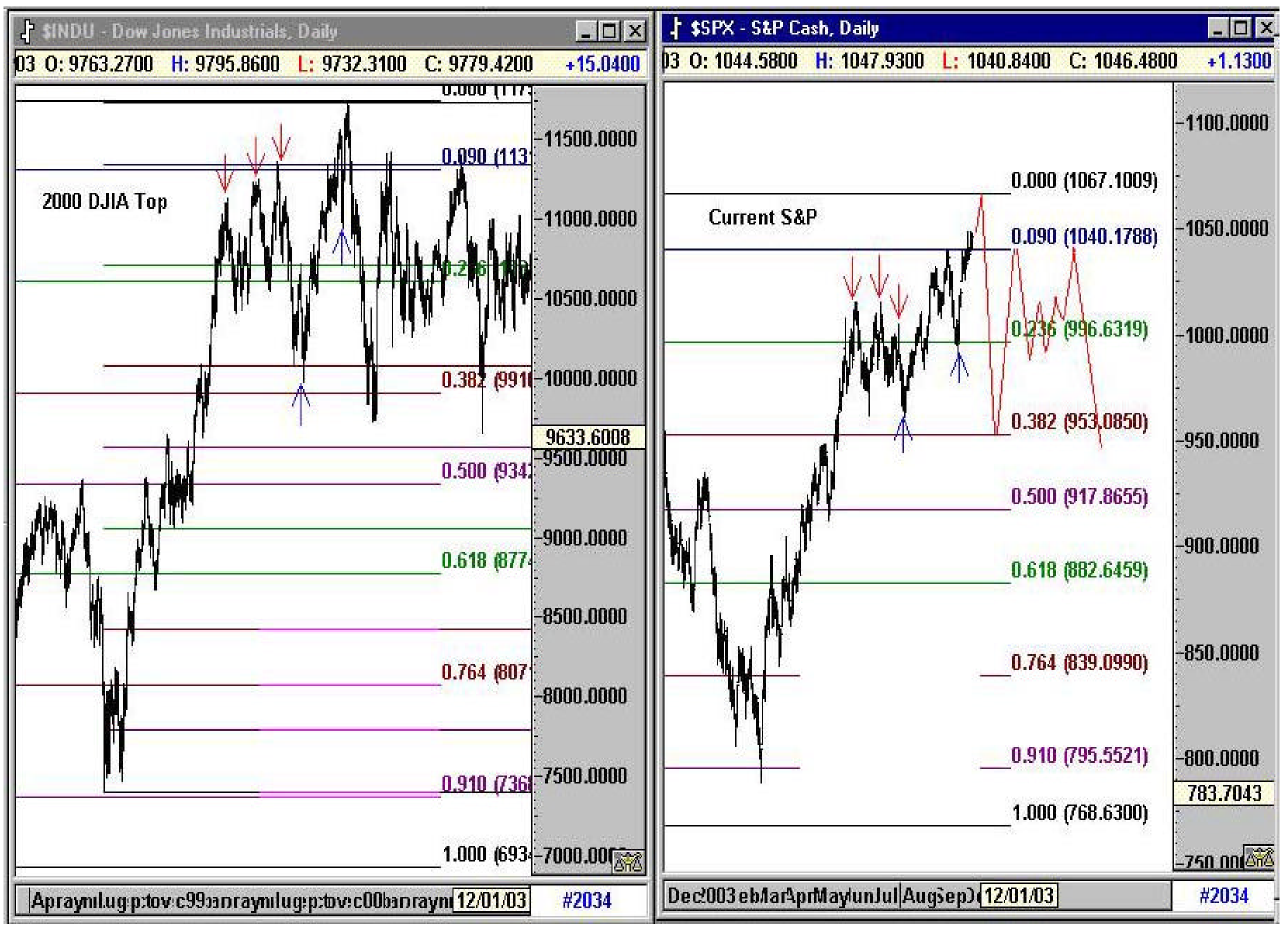
Overall, this also makes us sad, and leaves us in an awkward position. We in no way want to join the bullish parade of debt-induced equity buyers, but we also grow sick of our own ongoing call for something "bad" to come along that will suddenly upset the debt-induced apple-cart. Post the recent break above the 1040.29 S&P high, it gives us little satisfaction to now point to 1062-1068 as the next likely stopping point. We feel that this roughly 25-point potential final advance is just large enough to be irritating and also time consuming, but hardly worth adjusting our overall longer-term bearish view.

While the value of a hard stop-loss is not lost upon us, one of the better articles that we have read lately on how good traders behave, states:

> "We live in a busy world with a lot of noise and a lot of volatility. Great trading often results from a combination of patience, consistent non-intuitive behavior, and 'peripheral vision'… You don't have to perform many actions to become wealthy. -- Just a few good ones. Most people get very nervous if they are not doing something. Sometimes the best thing [and hardest thing] is to do nothing."

In other words, it may feel "good" to cut one's losses – to do something – and look to reestablish these shorts higher up. And maybe that is an acceptable tactic for some short-term traders paying close attention to day-to-day price behavior. But for our money, the temptation to cover, or worse yet, flip to long, for a last 25-point spurt is just not worth agonizing over. The longer-term fundamentals are just too stretched for us to feel any real fear of this bull. Instead, we are determined not to miss the "bear move" when it starts, and are also cognizant that from current stretched fundamental conditions, such a move could start in swift "trap door" fashion at any time. It is the dollars in our wallet longer-term that we really care about, and if this means short-term pain, so be it.

Overall, the current topping pattern may still take some time and end up resembling that of the DJIA back in early 2000. Note the three red arrows marking the three-peak formation on both charts, and the two upward blue arrows marking pullbacks within the progression to an ultimate high.



"Asta La Vista, Baby"

While equity market ebullience has certainly been irritating in the near-term, the recent election of Arnold Shwarzenegger as Governor of California carries a more serious and perhaps depressing longer-term message.

Don't read us wrong: If anything, we consider ourselves more Republican than Democrat, and even to our ear, Shwarzenegger's call to "Give government back to the people" has an appealing ring.

But then we slap ourselves and think: Here we have a Hollywood actor who runs on a campaign of no facts, no hard agenda, and no platform except "Trust me. I will perform an audit once elected, and see what governmental fat needs to be cut." He is also an individual with a womanizing and drug-use reputation that in some ways may make Bill Clinton look tame. How can such a person possibly have gotten himself elected?

Perhaps we are reading too much into this recent election, but we think that this could easily be the first sign of America getting desperate enough to "try anything" rather than admit that it's "Golden Age" of unfettered growth and prosperity is in trouble – or perhaps ending. It is the first sign that the populace might actually be willing to embrace the promises of a dictator-like candidate over real common sense.

Consider one socio-political perspective recently sent to me by a reader. In 1770, not that long before our original 13 states adopted their new Constitution, a Scottish history professor by the name of Alexander Tyler wrote a book entitled *Cycle of Democracy*. In it, he wrote of the Athenian Republic's fall some 2000 years earlier by stating (the *italics* are ours):

> "A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largesse (generous gifts) from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits from the public treasury, with the result that *a democracy always collapses over loose fiscal policy, which is always followed by a dictatorship.*
>
> "The average age of the world's greatest democratic civilizations has been two hundred years. These nations have progressed through this sequence: From bondage to spiritual faith; from spiritual faith to great courage; from courage to liberty; from liberty to abundance; from abundance to complacency; from complacency to apathy; from apathy to dependence; from dependence back into bondage."

Another more modern professor, Joseph Olson of Hamline University School of Law, in St. Paul, Minnesota, points out that in terms of the 2000 Presidential election, measured in terms of our nation's total geographic expanse, Bush carried 2,427,000 square miles and Gore carried only 580,000. Yet in terms of the electoral and popular votes, the result was obviously far tighter. He then sites one scary statistic: "Murder per 100,000 residents in counties won by Gore was 13.2 per annum, while for Bush it was only 2.1 per annum."

This leads Olson to conclude: "The map of the territory Bush won was mostly the land owned by the people of this great country. Gore obviously carried far more cities where greater populations reside dependent upon the government." The tightness of this election indicates to Olson that "the U.S. is now between the complacency and apathy phase of democracy, with 40% of the nation's population having already reached the dependency phase."

Will dependence now lead back to bondage? This question might have seemed silly just a few months ago, but now -- almost in a 'retro'-move to the onset of general apathy, and as if to vent the public frustration of democracy running aground -- California has served up Arnold -- the Terminator -- as its potential right-wing savior.

No matter how well intentioned Shwarzenegger may really be, and no matter how well connected and supported he is by smart men such as Warren Buffett, Shwarzenegger's election is a bad sign overall for America. It is a sign of desperation, and when people become desperate, financial market volatility is likely not far away.

We obviously do not know how the recent Californian political events might potentially impact the more important presidential election of 2004. But there is little doubt that America is becoming increasingly polarized between two very different groups of people: those fed up and drained by government, and those dependent upon government – with both sides searching for representatives that will share (or rebate) a portion of the government's treasury. Just as Shwarzenegger has gained popularility on the right in California, so too does Howard Dean gained popularity on the left in most American cities. Being a middle of the road candidate suddenly seems less attractive and less electable than before. America is anxious for change, and the risk of elections swinging to one extreme or the other has increased.

Dates of Concern

But before we end up pontificating for too long on the socio-political changes currently going on within America, and getting labeled a perma-bear or even anti-American, let's get back to something more specific.

Within the ongoing equity topping process, a few date windows continue to pop out of some importance. It is particularly around these date windows that investors should be attentive for market reversals:

October 22nd – October 24th: a minor Bradley cycle date with additional negative hamonics for President Bush's astro chart,

but more likely at this point…

The period between the November 23rd Bradley cycle date & December 5th PEI cycle date.

We think this latter window may be particularly important because November 29th is also 262 days after the March 12, 2003 S&P low (261.8 being a Fibonacci ratio that can be found two ways – (a) dividing two adjacent Fibonacci numbers 55/34, or 89/55, etc., or (b) by dividing 3141 [pi * 1000] by the 12 signs of Zodiac).

If an unexpected "Crash" were to begin on or about October 22nd to 24th, then we would expect this Crash to consummate itself on or about November 29th. However, at this juncture, having "cried wolf" about this market a few times too often, it will not exactly surprise us if equity strength lasts all the way into the latter late November window. Only onward-and-upward strength beyond this window would be truly surprising.

The prospect even of this scant 2-6 more weeks of "froth" once again leaves us depressed. CNBC is already whooping and screaming about the new bull market. Daily talk of Dow 10,000 has reappeared. The naïve public is getting sucked in -- yet again. In California, dreams of Shwarzenegger saving the state's economy (equivalent to the 7th largest economy in the world) abound.

This will likely all end in tears, but for now, it is our turn to sit down and shut up. The last several months have severely tested the old adage by Keynes: "Markets can stay irrational longer than one can stay solvent." Although we nicely caught the bond decline of late June and July, as well as recent U.S. dollar weakness that has been led by the yen, our hand on the equity market has been stone cold.

So please forgive our briefer-than-usual notes this month with the following image in mind: an analyst scratching his head in frustration and disbelief, but still far from willing to wave the "all clear." The market's current hubris should abate soon, but a few more weeks of patience may be needed first.

Send us your comments at information@Sandspring.com.

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