Sand Spring Advisors LLC

Harmonic Reverberations Between 1968-1972 and Present Times

by,

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Early September is here, and to date – no equity market smash-up; no California earthquake; and no impending demise of George W. Bush's second term prospects.

Yes, Hurricane Frances did arrive this past weekend, and Hurricane Ivan may once again threaten Florida's residents in coming days. A tough hurricane season is not entirely surprising within a "Saturn in Cancer" period which is often marked by "trouble from water." The wealth destruction here is obviously non-trivial, but no one appears to really care.

In addition, if 1960's market prognosticator George Lindsay were still alive, he also would certainly have noticed the interesting "harmonic" between the 2004 Republican National Convention with anti-Bush peace protesters filling New York streets and parks, compared to the far more violent 1968 Democratic Convention in Chicago – some 36 years ago.

Per Lindsay's now out-of-print book *The Other History*, societal themes tend to reemerge every 36-40 years – sometimes doing so with more intensity than the earlier period, but more often with greater acceptance of what previously evoked huge emotions in the first cyclical period.

August 2004 in New York was of course a far less "emotional" echo of 1968 Chicago. While no one likes what is happening at present in Iraq, protestors were less willing than they were in 1968 to resort to physical violence to vent their distaste. Instead, they were far more cautious. Ditto the police.

The result is that while protestors won the media battle in 1968 and served to truly impact American history, they did not do so in 2004. Instead, we saw a NYC local government that required permits to hold protest marches, and held arrested protestors in lock-up pens until the Convention was effectively over. Although street violence is never to be desired or applauded, the manner in which events were so controlled and orchestrated in 2004 strikes us as somewhat sad. It is another sign of big government winning out over individual liberties in current times.

With the current presidential race involving an incumbent Republican running during wartime, 2004 also has the feel of 1972 when Republican Nixon ran for reelection amidst the Vietnam War. In 1972, as in 2004, federal budget deficits were out of control, the U.S. current account balance was plunging, and the U.S dollar was weak as demand for U.S. gold reserves by foreigners mounted. In 1971, trying to support an incipient economic recovery out of the 1970 recession, the Fed was loathe to raise rates too quickly in defense of U.S. gold reserve depletion -- keeping the real funds rate below zero through the first half of 1971. Then in August 1971, Nixon simply changed the rules and closed the gold window to foreign central banks. Commodity prices globally started to soar in reaction, and would continue to be strong into 1974. Foreign central banks, now shut out from taking delivery of more U.S. gold, had to be satisfied to hold more U.S. Treasury securities, thus providing a momentary bid to U.S. fixed income markets. But by 1973, the U.S Treasury market eventually unraveled in somewhat dramatic fashion. 1973-1974 were of course also horrific years for U.S. equity and property markets.

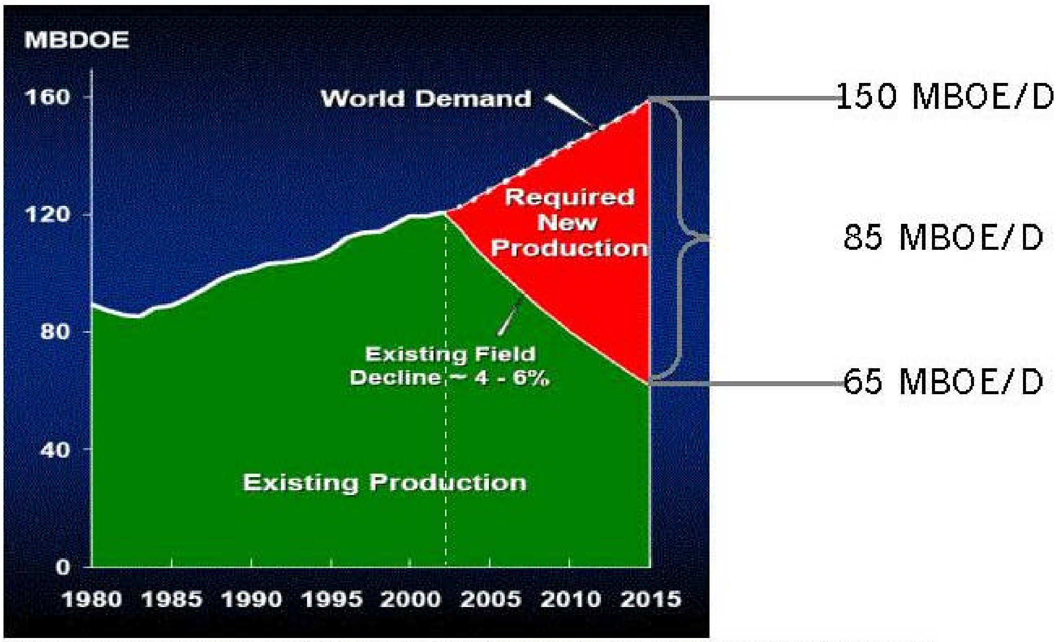
There are of course some differences between the current period and this earlier one. Specifically, in 1971-1972, almost everyone recognized that inflation was a problem. In 2004, our government is trying to hide this fact, and a large swathe of investors somehow believes the pabulum of economic statistics that they are being fed.

In a similar fashion as NYC police kept protestors at bay during the 2004 Republican Convention, the BLS has kept most investors temporarily assuaged of the incipient inflationary risks to the U.S. economy that are emerging.

We have previously bemoaned all of the hedonic adjustments to the CPI releases, and will not repeat our discussion of them here. Suffice it to say that the price of televisions and computers may indeed be in constant decline while the quality of these products simultaneously improves, but the price of most important services including healthcare, education, and housing (all grossly underestimated by BLS measurement techniques) all continue to rise. And today, there is certainly no denying the reality of gasoline prices above $2.00 a gallon in the U.S.

Meanwhile, one look at the charts below (provided to us courtesy of Round Rock Capital) of expected supply versus demand for crude oil over the coming several decades, as well as stagnant rig count activity in North America, and it is easy to see why T. Boone Pickens expects oil prices in the $60-80 range within the next few years.

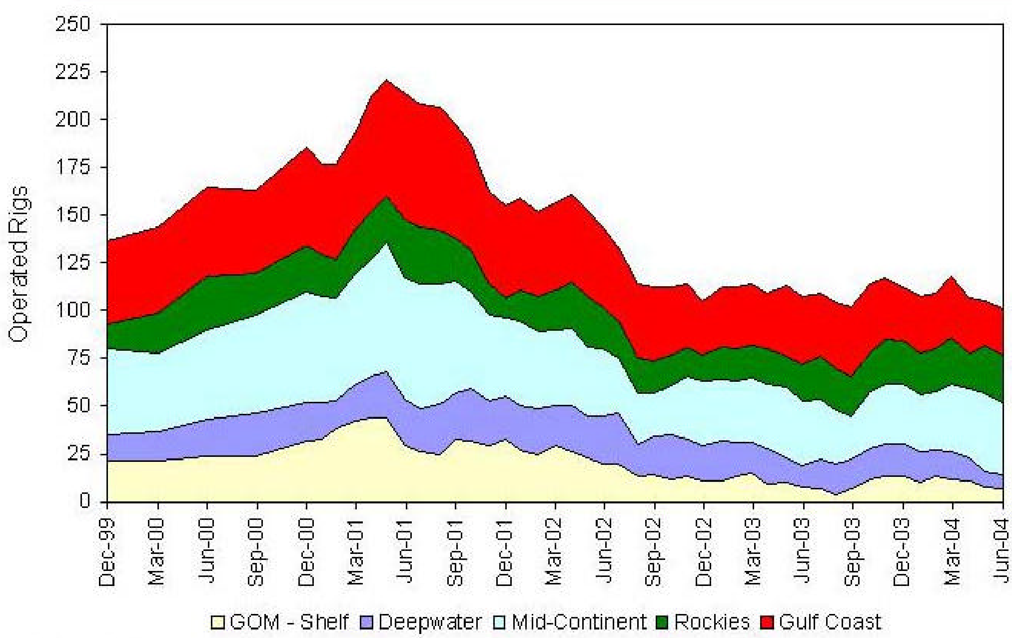
Global Energy Outlook



The wedge, represented by a 2% increase in demand and a 6% depletion rate equates to +/- 85 MBOED that has to be found and developed in 11 years. This is equal to approximately 3.5 OPECs or 9.5 Saudi Arabias. It can't happen! Price Will Allocate Supply.

Source: ExxonMobil presentation; November 2003

By Region: Operated Rig Count (Majors)



Source: Simmons Intl

If 2003 can be analogized to 1971 (low real rates, surging commodity markets, weak dollar), then the election year of 2004 could easily be seen as analogous to 1972 (a faux recovery period just in front of an economic storm).

The underlying robustness of the U.S. economic recovery already appears very tenuous. While in April-May, the BLS put out non-farm payroll numbers that made it look as if the U.S. job growth was on a massive upswing, subsequent lackluster summertime retail sales now put those BLS numbers into serious question.

Overall, perhaps the very best article that we have read over the past two months on this topic was one penned by economist Kurt Richebacher on August 20, 2004 entitled "*The Plug Factor*." This article is so powerful and to the point, that we have decided to reproduce it in its entirety below:

The Plug Factor
by, Kurt Richebacher
August 20, 2004

At first look, the May consumer income and outlays numbers - which we were eagerly awaiting last month - appear excellent: Incomes are up 0.6%, and spending is up even a full percentage point. At second look, after adjustment for inflation, the reality is pretty ugly.

The increase in disposable income melts to less than 0.1% in real terms, and that of spending to 0.4%, of which well over half came from the burst in motor vehicle promotion. Spending on nondurable goods has been flat for two months. The whole of the extra increase accrued from a blip in spending on services.

Amazingly, this sharp slowdown in consumer spending, though lasting for half a year, has been met with flat denial all around. During the five months to May, it was up in real terms by $78 billion, or $186 billion annualized. This is less than half of the consumer spending growth in the second half of last year - $376 billion annualized. Meanwhile, we know that June was another horrible month for consumer spending.

One important reason for the general indifference to this drastic reversal in consumer spending was apparently the fabulous job figures for the three months March-May that the Bureau of Labor Statistics (BLS) miraculously pulled out of the hat, reporting almost 1 million new jobs during these three months.

It shocked us to see how readily and uncritically research institutions, economists and media around the world accepted these numbers at face value, even though they came like a bolt from the blue in the face of otherwise rather mixed economic data. For the few who wanted to see, these numbers were bluntly suspect.

It turned out that virtually two-thirds of the new jobs had come not from the survey, but from a new computer model. For decades, the BLS has aimed at small businesses when measuring job creation in times of recovery, especially those not captured by its established monthly survey. Until 2000, this statistical adjustment was fixed at 35,000 each month, called the "plug factor."

The recent sudden jump in these figures towards 300,000 each month results from a computer model based on a calculated "net birth/death adjustment," which is supposed to measure how many jobs small firms have created and shuttered. In this way, the former monthly 35,000 figure exploded into numbers that are almost 10 times greater.

For us, the sudden statistical spike in job creation during March-May was massively out of whack with prior numbers and other concurrent economic data to be credible. Then came June: 112,000 new jobs created, less than half the expected number. We never saw it mentioned that the net birth/death adjustment contributed 182,000 to this disappointing increase. Without it, employment would have fallen 70,000.

What all this means for the U.S. economy's prospects should be clear: The suddenly strong support from job and income growth looks very much like a mirage. To the contrary, sharply slower consumer spending is essentially exerting the opposite effect of depressing income growth.

What, then, induced the American consumer to his sudden retrenchment in spending in the first quarter? Partly due to lower taxes, his nominal disposable income grew during the quarter by $171.7 billion. Yet he raised his spending by only $119 billion, putting fully $52.7 billion of his higher earnings into savings. That was definitely a drastic break with his past spending mania.

The salient point here is that the retrenchment was plainly not forced by tight money or credit. Oddly, consumer borrowing set a new record at the same time with an increase by $1,008.2 billion at annual rate, after "only" $659.9 billion in the prior fourth quarter of 2003. We have a hard time making sense of this mixture of income growth, savings growth and record borrowing.

The answer probably lies largely in the fact that the "average" private household is a statistical fiction. The other day we read that nearly a quarter of households have to spend 40% of their current income on debt service, as against 14% on average. On the other hand, there are, of course, many households with net income from assets after debt service. Higher bond yields and loan rates speak, in any case, for sharply lower borrowing in the future.

In April, an increase in nominal disposable household income by $52.3 billion compared with an increase in their spending by a mere $16.3 billion. In real terms, spending even declined slightly. No less than $36 billion went into savings. Due to the huge promotions and rebates by the automakers, spending in May was drastically distorted. Purchases of durable goods were up $17.8 billion, accounting for 54% of the total increase. News about auto sales since then has been disastrous.

Glancing over the figures for real personal consumption expenditures, it strikes the eye that the sudden spending weakness has gripped all sectors of consumption, services and non-durable goods, as well as durable goods.

As mentioned earlier, lesser consumer spending essentially means lesser income growth. If allowed to develop, it implicitly turns into a vicious circle where lower and lower spending leads to lower and lower incomes. One has to wonder what Mr. Greenspan can come up with next. In 2001, he had more than 500 basis points of interest rate cuts at his disposal to fight the economy's downturn, led by plunging business investment.

Our view has always been clear and unambiguous. Ultra-cheap and loose money together with fiscal priming of unprecedented scale have provided a tremendous stimulus to consumer spending in the United States. For the bullish consensus, this policy stance has been most successful, as measured by recent real GDP growth of 4% and higher at annual rates.

For us, this is a much too simplistic and superficial a view. Lost in the celebrations are the long-term costs of this recovery as manifested in the form of ever-mounting structural imbalances - namely record trade gaps, record levels of financial leveraging, record levels of personal indebtedness, a record-high budget deficit and rock-bottom national savings.

For any reasonable person, it ought to be clear that this cannot be the road to healthy economic growth.

Here at Sand Spring, and in a similar fashion to Mr. Richebacher, we have been warning of an impending moment of entropy in consumer spending as the extraordinary stimulus of 2002-2003 moves into the past.

That moment of entropy may have finally arrived when restaurant chain Applebee's recently reported weaker than expected results in August, and then tried to blame these results on people staying home to watch the Olympics.

But if the Olympics really were to blame for suddenly poor nighttime foot traffic in restaurants (something we hardly believe), what happened to consumer spending habits during the daytime? All of the sales and earnings warnings by firms such as Walmart, Hewlett Packard, and Intel certainly point towards a consumer increasingly keeping the wallet and purse strings closed. Missed sales projections by other companies from the GAP, Pier 1 Imports, May Department Stores, Federated Department stores, Abercrombie & Fitch, and The Limited all tell a similar story.

Going back to our discussion of the 2004 presidential election, if Bush is reelected as Nixon was in 1972, our only thought is that the faux economic nirvana of 2003-2004 will come undone in 2005-2006, and that Bush will be so disliked, that like Nixon in 1973-1974, he somehow may not finish his entire term. Whether this comes from some sort of scandal or an assassin's bullet (let's hope not), or some other cause, is impossible to forecast, but the potential divisiveness to America that he would cause over another four year term is already clear.

Meanwhile if Kerry is elected, rightfully or wrongfully he will generally be viewed as an anti-business anti-affluence president.

Either outcome seems dangerous – almost in fatalistic fashion -- for our financial markets. But at present, complacency reigns, and markets stay stuck within a holding pattern marked by diminished trading volume and low overall volatility.

Do we fully understand this complacency? No. Does the recent market lethargy irritate us? Yes, most certainly. When August came and went without a significant market plunge, we were forced to shift our view that such a decline might transpire into our December 30-31, 2004 PEI cycle window. As long as the S&P stays under 1125, this easily may still occur. But more market meandering could also transpire, with our anticipated volatile market plunge only coming as 2004 wanes into 2005.

Here at Sand Spring Advisors, we certainly do not hold all the answers. We can only recognize the fundamental imbalances that currently exist in our global economy, and point to the inevitability that these problems will soon cause much more dramatic problems than the average American currently realizes.

But just to prove that we can look at the world objectively, and not just as a perma-bear, there are of course, certain stocks that we continue to favor – even while our list of negative looking chart patterns remains quite a bit bigger. Below is a brief update.

<u>Eclectic Longs</u>:

Delta Pine & Land….Nice looking price action; This stock has a first upside Fibonacci target at 32.32, then 33.74, and finally 37.94 .

SunCorp and Canadian Oil Sands Trust…Both long-term winners as crude oil heads ever higher.

Agco…a nice looking coiling chart pattern that appears set to advance toward 39.58 Fib target.

Waste Management…Confluence of upside Fib targets between 36.40 and 38.60.

Centerpoint Energy…Utility turn-around story likely headed into the high teens.

Particularly Vulnerable to Tumble:

Wal-Mart….This chart looks like USD-CAD did back at 1.60, ready for a 20% plunge.

Bank of America…Last week saw an "outside week" down reversal. This should be the kiss of death, although we have been waiting for downside satisfaction for awhile.

CDW…Corrective A-B-C retracement rally period since late 2000 now ending.

Tiffany…a volatile struggle, but even high-end spending should soon be crimped.

Novellus…a favorite short of ours now finally slipping toward 15.63 Fib downside target.

Walgreen…A Janus top 10 holding that appears headed down toward a downside $25 Fib target.

General Motors …When monthly incentives stop, so too do monthly sales – a poor business model. $24.20 downside target here.

Citigroup and Wells Fargo…Two behemoths starting to stumble.

KLA-Tencor…Still a sick looking chip stock headed toward eventual target at 18.63 or below.

Send us your comments at information@Sandspring.com.

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