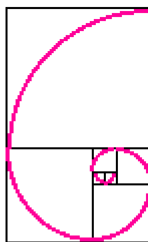


Sand Spring Advisors LLC

2011 View

by,

Barclay T. Leib

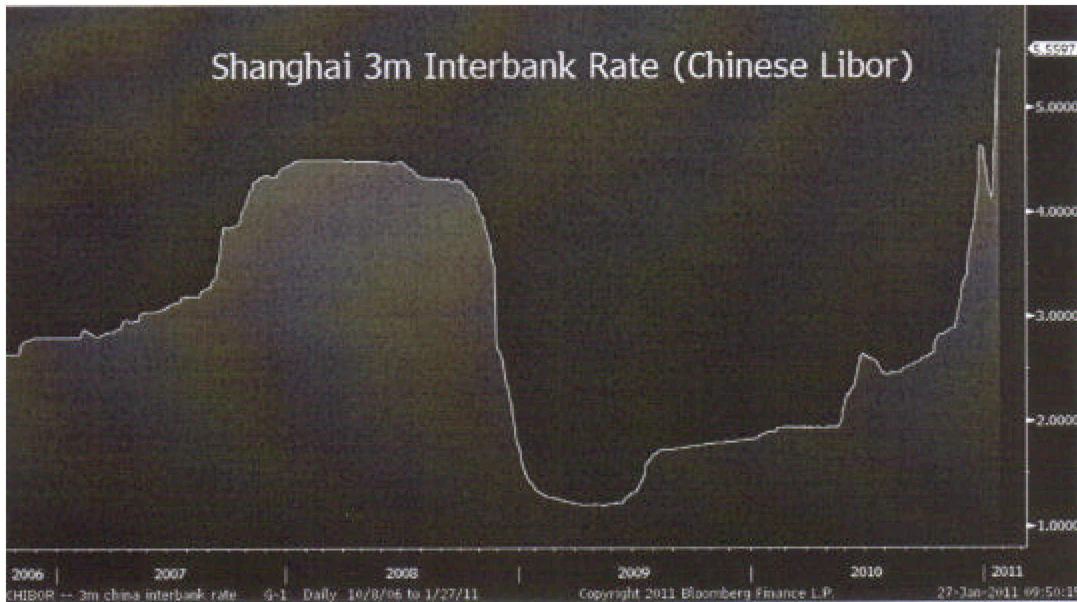
January 30, 2011

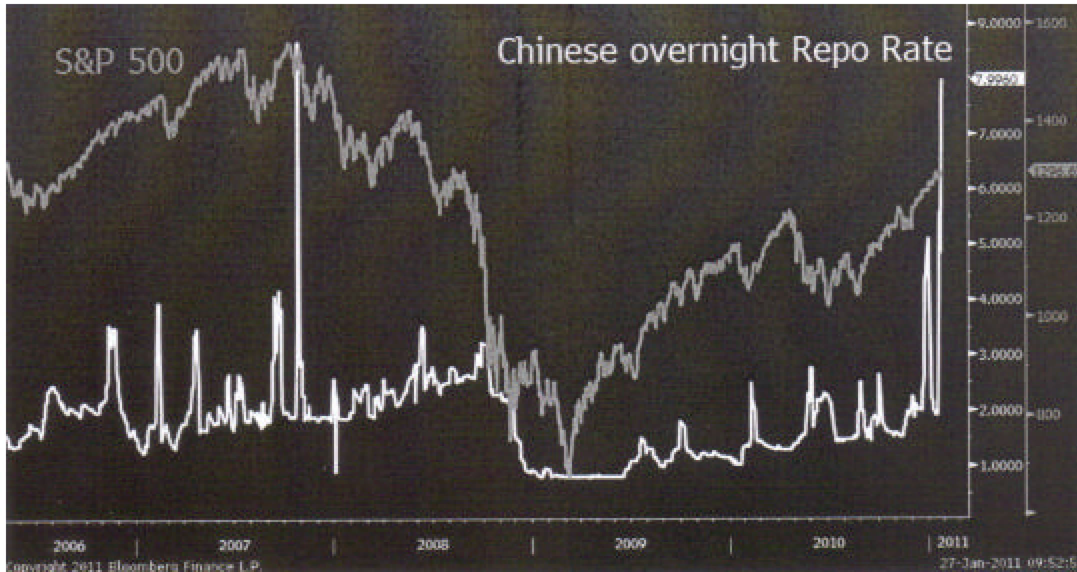
17 years ago America experienced the heavy markets of 1994 where both bonds and equities both fell. Much like the early winter of 2011, January and February 1994 was also a season of heavy weather -- weekly snow storms rolling in to paralyze New York City.

At the time, I was working at Barclays Bank running their New York currency derivatives desk. I remember sludging into work each day, and I remember the general denial that confronted the initial declines in both bonds and stocks that winter. No one really believed the first tick higher in interest rates in early February 1994. Everyone wanted it to be a passing storm. Few understood how to possibly make any money when both bonds and stocks were going down together. But by Q4 1994 -- when the Mexican debt crisis unfolded -- that initial February tick higher in interest rates looked paltry in comparison to 1994's overall devastation. While it is true that equities bottomed in April 1994, and staggered back to close the year basically unchanged, Eurodollar rates were over 275 basis points higher by Q4 1994 than they were in early February 1994.

2011 is not of course 1994. In 2011, the Fed has yet to even make a passing noise that they want to raise interest rates. But as of this past week, we do now have a generally more hawkish group of Fed governors than has previously been the case; we do have Ron Paul set to oversee the Fed; we already have European sovereign debt markets generally misbehaving; and more recently, we have started to see the U.S. municipal bond market doing the same.

More importantly perhaps, and as shown in the two charts below, we have significant rate hikes currently transpiring in China.





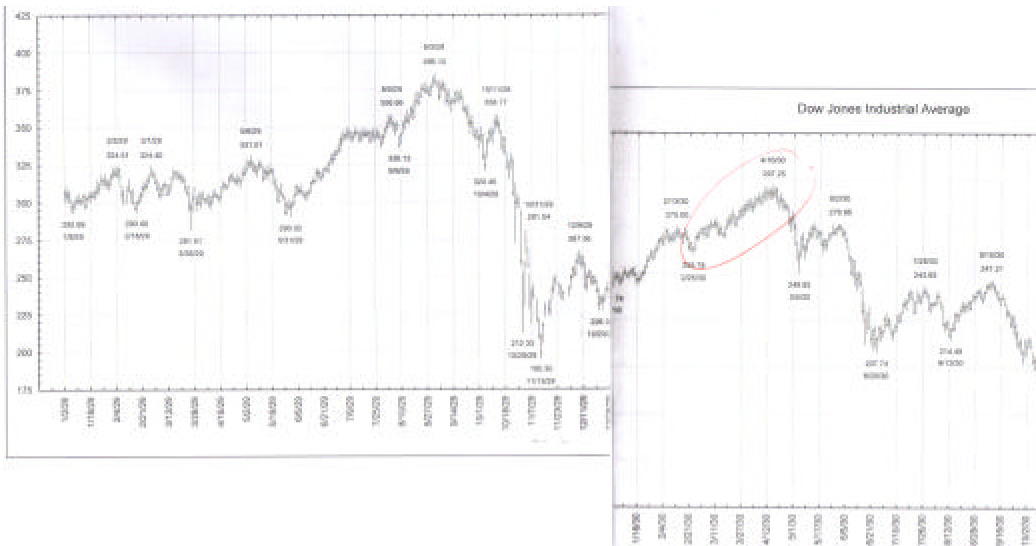
Source: Cowen & Co.

In a more interconnected global economy than ever existed before, does it really matter that the Fed is sitting on its hands, if the global driver of growth – China – is pulling back on the reigns? Investors risking their dollars in the U.S. equity market focused on a still accommodative Federal Reserve are likely being myopic. I think what happens in China this year could easily trump anything that the Fed tries to do here – at least in terms of larger market trends.

And then there is our previously espoused possibility that 2011 – a la 1940 -- may usher in a period of war. As Sandspring.com readers may remember, back in 2008-2009, we were closely following the following broad analog:

1929 – market peak….	70-years later…	1999 – market peak
1932 – market low….	70-years later…	2002 – market low
1937 – market high…	70-years later…	2007 – market high
1938 – dramatic low…	70-years later…	2008 – dramatic low
1939 – rally period	70-years later…	2009-2010 – rally period
1940-42 – WAR	70-years later…	2011–2012 - WAR?

Then, as yet another possible analog, let us take the liberty to compare the overall topping/rebound pattern 1929-1930 to the topping/rebound period of 2006-2011. Blurring one's eyes, the nature of the original topping patterns are reasonably close, as have been the cascade declines and the steady retracement in both chart patterns to fill in the holes left in the cascade.



Currently, in 2011, are we about at the equivalent point that we were when prices peaked on April 16, 1930?

One interesting tidbit – perhaps in support of this analog -- offered to me by one broker recently is that through this past week, the S&P 500 has stayed above its 10-day moving average for the longest unbroken string of days in over 80-years – yes, from exactly the circled period in the first chart above back in March-April 1930. A bit akin to President Obama's recent State of the Union speech, this was exactly when President Hoover said that the worst effects of the Depression will be over within 90 days: "Prosperity is just around the corner."

What happened in early1930 that helped change the steady grind higher that had been transpiring that spring?

Interestingly -- and in similar fashion to Egypt and Tunisia today -- an increasing rash of food and rent riots started to transpire in early 1930 America:

> In New York, bands of thirty or forty men regularly descended upon markets, but the chain stores refused to call the police, in order to keep the events out of the papers. In March eleven hundred men waiting on a Salvation Army bread line in New York City mobbed two trucks delivering baked goods to a nearby hotel. In Henryetta, Oklahoma, 300 jobless marched on storekeepers to demand food, insisting they were not begging and threatening to use force if necessary….In Cleveland, marching columns of unemployed became a familiar sight. Public Square saw demonstrations running into tens of thousands. The crowds did not always stay in their own neighborhoods, and the authorities were not always judicious. On February 11, 1930, for example, some 2,000 unemployed workers stormed the Cleveland City Hall, dispersing only when the police threatened to turn fire hoses on them. A few days later the unemployed demonstrated at City Hall in Philadelphia, and had to be driven off by the police. A week later mounted police with nightsticks dispersed a crowd of 1,200 jobless men and women in Chicago. On February 26 a crowd of 3,000 was broken up by tear gas before the Los Angeles City Hall.
>
> In March the demonstrations became a national event. The Communists declared March 6, 1930, International Unemployment Day, and rallies and marches took place in most major cities. Many of the demonstrations were orderly, as in San Francisco where the chief of police joined the 2,000 marchers and the mayor addressed them, or in Chicago where some 4,000 people marched down Halsted and Lake Streets, and then dispatched a committee to petition the mayor But in other places, including Washington, D.C., and Seattle, local officials grew alarmed and ordered the police to disperse the crowds with tear gas. In Detroit, Cleveland, Milwaukee, and Boston, the crowds resisted, and fierce battles broke out between the demonstrators and the police.
>
> The worst clash occurred in New York City, an event which was reported by the New York Times:
>
> The unemployment demonstration staged by the Communist Party in Union Square broke up in the worst riot New York has seen in recent years when 35,000 people attending the demonstration were transformed in a few moments from an orderly, and at times a bored, crowd into a fighting mob. The outbreak came after communist leaders, defying warnings and orders of the police, exhorted their followers to march on City Hall and demand a hearing from Mayor Walker. Hundreds of policemen and detectives, swinging night sticks, blackjacks and bare fists, rushed into the crowd, hitting out at all with whom they came into contact, chasing many across the street and into adjacent thoroughfares and rushing hundreds off their feet. . . . From all parts of the scene of battle came the screams of women and cries of men, with bloody heads and faces. A score of men were sprawled over the square with policemen pummeling them. The pounding continued as the men, and some women, sought refuge in flight.

Union Square Riot of March 1930

> The rising anger among the unemployed took other forms than street marches and riots. Jobless men and women began to defy the local authorities and the rules upheld by these authorities associated with specific hardships. One such kind of defiance was mass resistance to evictions. As unemployment rose, large numbers of families in many places could not pay their rents, and the number of evictions increased daily. In 1930 and 1931 small bands of people, often led by Communists, began to use strong-arm tactics to prevent marshals from putting furniture on the street. Sometimes they were successful. Even when they were not, physical resistance was the only resort for people forced from their homes. The rent riots began on the Lower East Side and in Harlem, but quickly spread to other parts of the city.
>
> *Source: Libcom.org*

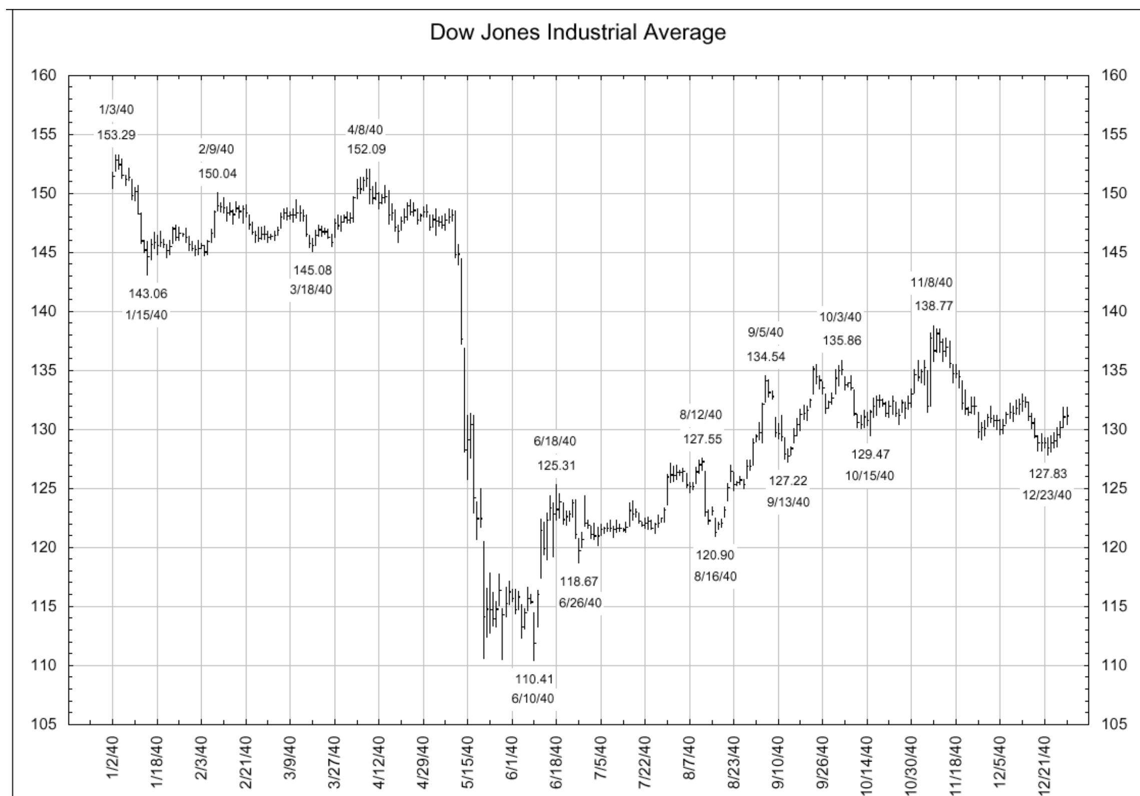
Internationally, in the spring of 1930 the Chinese Civil War began; it was accompanied by internal strife brewing in Russia. Persians launched a major offensive in early 1930 against the Kurds, and by the fall of 1930 the Nazis had become the second-largest party in Germany, with Hitler gaining popularity as he espoused scrapping the Versailles Treaty. By October 1930 Benito Mussolini in Italy was also demanding that the Versailles Treaty be drastically altered.

In other words, early 1930 was already setting the tone for the eventual onset of World War II – even if it would take until 1939-1940 for all the pressures towards war to fully foment.

Thus we end up with at least three possible analogs for 2011:

1) Based on the 10-day moving average not being broken for an extended period of time while social unrest builds, do we stand at the equivalent point as **April 1930**? Almost on a larger fractal basis, the 2006-2011 chart pattern certainly resembles that of 1929 through early1930.

2) Or, based on the general progression of markets since 1999 that have been so similar to the basic progression of events from 1929, do we stand at an analog position of being at the equivalent position as perhaps **January 1940**? If so, a major war in 2011 could be imminent, and 2011 might mimic the mid-year 1940 lurch lower that transpired when Germany invaded Norway and Denmark on April 9, 1940. After the steady advances of 1939, here is what 1940 equity markets did:



3) Or, going back to our December article where we discussed certain similarities between the 1862-1878 period and today, perhaps we stand somewhere near the equivalent of the 1869 peak in gold leading to the 1873 deflationary bust in the Northern Pacific railroad. Or perhaps this is broadly where China effectively resides today since the craziness of China today so resembles the craziness and rampant corruption of the 1862-1873 period in America.

The master technician George Lindsay wrote about 40-year cycles in his 1969 book *The Other History*. 40-years ago in 1970-1971 America was mucking with the value of its currency as President Nixon moved America off of the gold standard, America was expanding its war in Vietnam, and ironically, Wall Street was inventing a new market index called NASDAQ. With regard to the Middle East, the United Arab League finally dissolved in 1971. 40-years before that in 1930-1931 we saw the food riots and increasing global frictions discussed above even while markets were grinding higher in very similar fashion as they have most recently from late 2010. Again, with regard to the Middle East, Dec 7, 1931 also marked the World Islamic Congress in Jerusalem. In both prior instances – as well as the current situation -- our President espoused that things were about to get better. Instead, in both 1930-31 and 1970-71, things got worse.

Much to the contrary of most market analysts at the current time, I expect 2011 to be an absolute mess.

Feb 2-3, 2011 is a minor pi cycle window that could easily bring an acceleration to the downside of the equity decline that began this past Friday. What begins in this window of time should then stretch to a panic low in mid-June 2011. One may note that the possible 1940 analog chart pattern discussed above bottomed in mid-June 1940 – exactly in the same window of time that the Princeton Economic Confidence Interval pi cycle suggests a 2011 low.

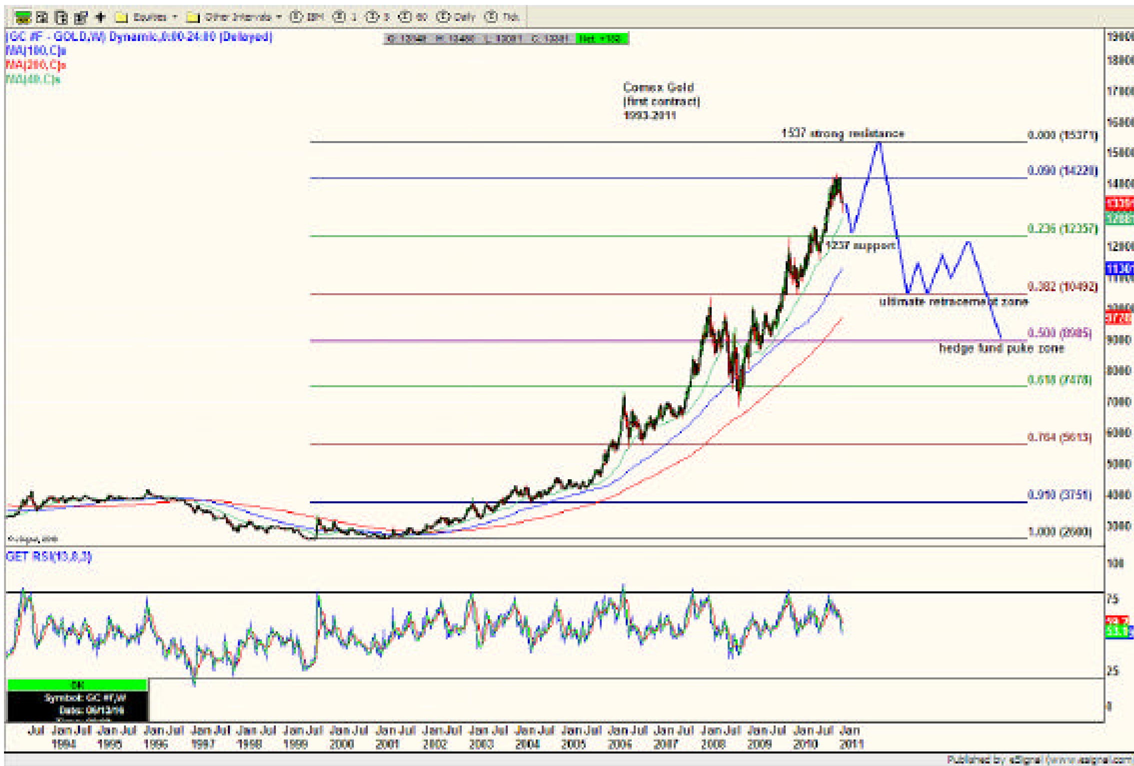
Quite often, when I write my initial Sandspring.com letter each year, I have a firm roadmap about a variety of asset classes and sectors. Last year I wrote about four themes for 2010. My specific predictions were that agricultural commodities (and associated ag-oriented stocks) would go on a tear to the upside; that the meat sector was also a buy; that uranium and uranium-oriented stocks were attractive; and consumer-oriented retail stocks were great short

sale candidates. While I got the first three sector views very much correct, I was completely wrong on the latter view. In my own Sand Spring Fund LP, my negativity to consumer stocks cost me dearly as stocks such as Royal Caribbean Cruise Lines, Dillard's, Dine Equity, and Lululemon vaulted toward the heavens. Losses on stocks such as these actually overwhelmed other gains. 2010 overall was a very frustrating year for me.

For 2011, I have fewer strong sector views – particularly on the long side. In terms of commodity markets going forward, I have lost interest in the agricultural sector now that this area has become oh-so hot. I have no edge there any longer. I still like uranium-oriented stocks in the longer term, but have no immediate visions for them. I look at the energy markets and can make different stretched fractal band interpretations of the price action that leave me with little confidence to make a formal prognostication for oil or energy-related stocks.

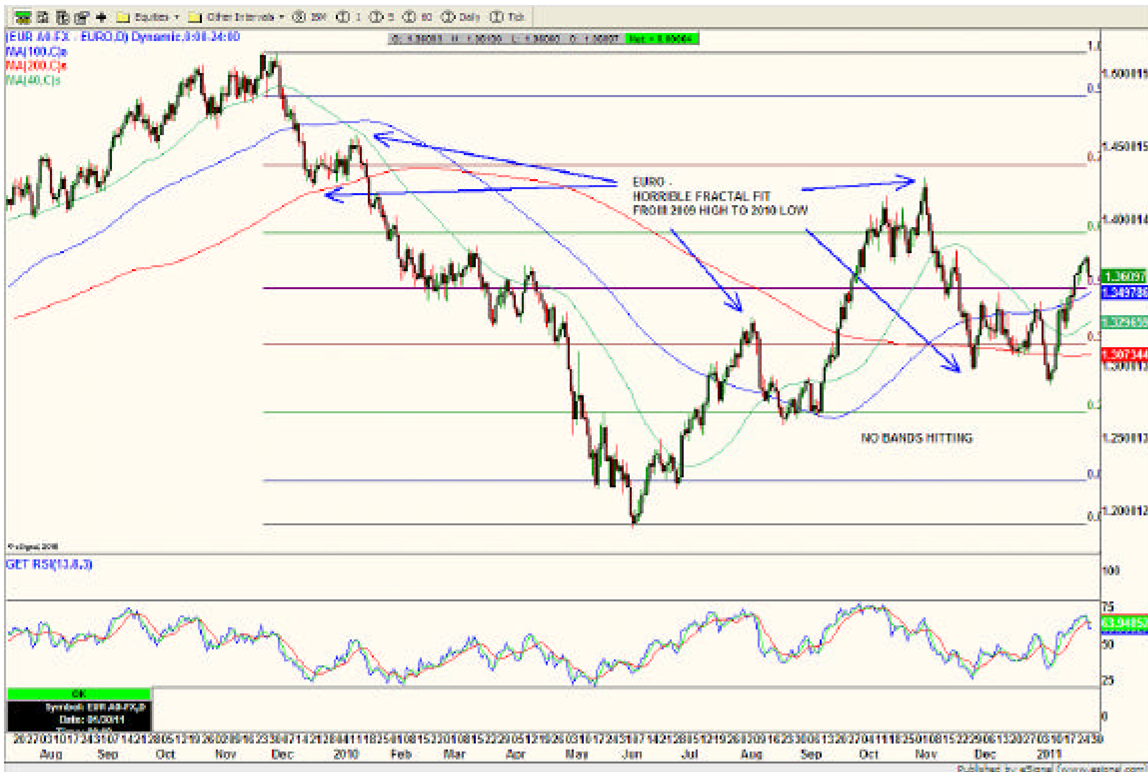
I have recently been short gold and copper, but it is a trickier call from here to stay actively involved in those trades. The clearest chart pattern that I can find related to gold is the chart of its price denominated in euros where the Fibonacci fractals actually suggest that after the current period of retracement, **gold in euro terms has one more missing high left in it near 1165 euro**. But could that missing high come from gold going sideways for a bit, while the euro falls? Or will gold itself go up, while the euro treads water? Or will there be a bit of both gold strength and euro weakness in a continuation of 2010's general behavior?

Looking at gold itself, all that I can really say is that $1,237 should be initial support, and $1,537 a possible ultimate top, but the timing of touching those extremes is not clear. The blue lines below are <u>firmer in general concept as to important levels than they are as to exact nature of gold's path.</u> And since current prices reside towards the middle of this range, I feel no great compulsion to be involved in this arguably crowded trade. In the end, gold's current popularity is unlikely to end well for aggressive speculators late to the party. Hedge fund manager John Paulson will likely overstay his welcome in the metal, and ultimately be hurt by it. But will this happen in a straight line like the 2008 natural gas market implosion? This is unlikely.



In the meantime, what about the euro itself?

The chart below shows the current fractal fit between the 2009 high in the euro and the 2010 low. Nothing in terms of Fibonacci fractals fits! However, when I stretch the Fibonacci bands to around 1.1560, bingo – a much tighter Fibonacci fractal fit appears. This fit to 1.1560 also works reasonably well back to the 2008 euro highs.

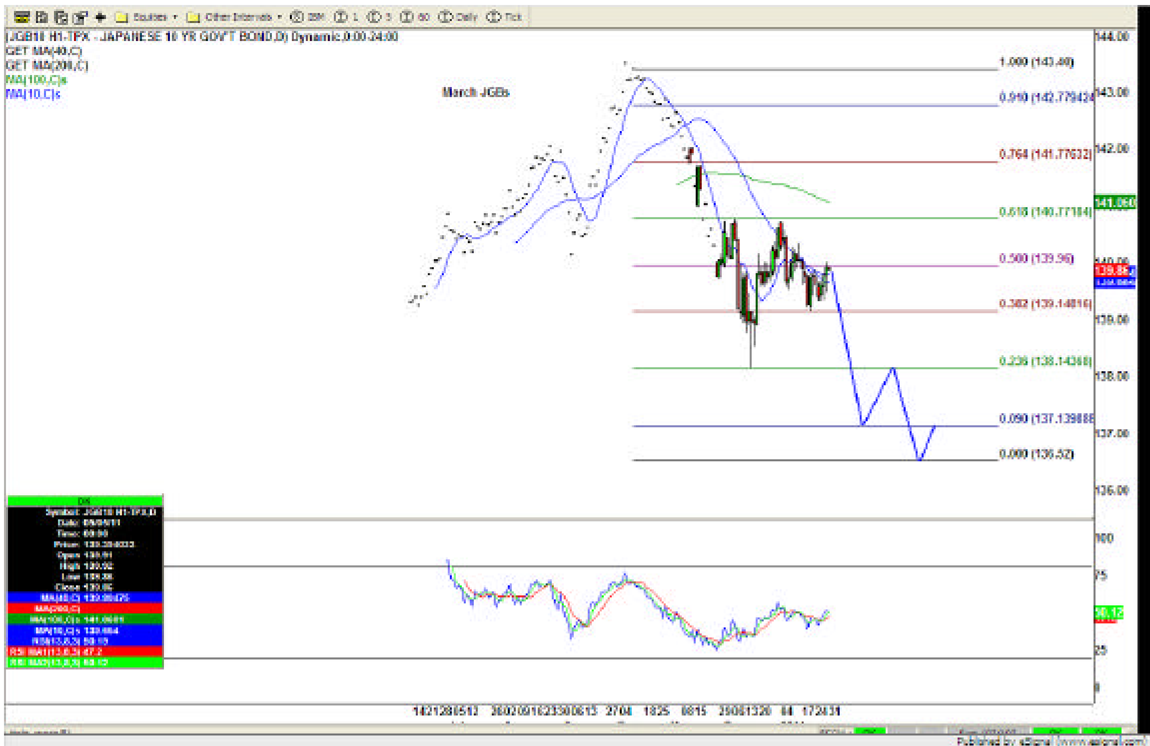


Triangulating the above few charts, if gold just traded roughly sideways, and the euro fell to 1.156, then bingo, my 1165 gold/euro price pops out. Alternatively, if gold reaches the above espoused possible dollar target of 1537, then for gold to get to 1165 in euro terms, the euro would be around 1.3193, just modestly below current levels. For my money I'd rather just be short the euro to catch this final gold/euro advance than be playing heavily in gold itself, but either route is of course possible to reach the 1165 gold/euro level.

Another view that I have which is very non-consensus involves Japan. Stocks are arguably very cheap in Japan, but the country has been a fiscal malaise for over two decades, and Japanese management style never seems particularly attentive to unlocking shareholder value. Many people think that Japan may be getting ready to make a move to the upside. Every time the yen weakens a bit, people rush to buy Japanese exporters. But if this market really was ready to lift off, shouldn't it have already participated a bit better than it has in global equity ebullience across 2009-2010? And alas, my Fibonacci fractals on the small-cap TOPIX Index suggest otherwise. **There is a clear missing low still lurking at some point in the TOPIX market.**

It is always possible that prices could first rally to the fractal line at 1156 on the TOPIX and then decline to the missing low near 598.40, but this path does not line up with any of my other global equity analysis. Japan will be a great investment with time, but the last -30% to the downside could be a gut-wrenching puke. It is important to have your powder dry and be onsides for when this last descent occurs. Because of the value argument, I would not advise shorting the Japanese equity market, but I wouldn't buy it yet either.

What could go wrong to unnerve Japan? I have long been fearful that so much of its wealth is tied up in JGB and postal system assets (which in turn are invested in JGBs) that a sudden fall from grace in that market could destroy perceived wealth and capital. On a monthly basis, the JGB market left a “gravestone doji” formation last October on its highs. The market has since fallen away in dramatic fashion. Is the current daily chart formation (shown below) nothing more than a continuation flag formation within an ongoing decline?



Hedge fund manager Kyle Bass of Hayman Capital Partners has written extensively about a coming debt crisis in Japan. Readers may find his interesting letters sprinkled across the web. Just because Bass has not been correct in this view to date that Japan will ultimately face severe default risks does not mean that he won't be right in the end. We like being short JGBs as an asymmetric bet that central banks are starting to lose control of their own financial destiny. Of course, shorting JGBs could also prove fruitful if our view of Japanese equities above proves wrong. It is a win-win type situation on the short side. Most people view the recent JGB decline as the flip side of recent equity strength. Maybe it has been. But I view it as an ominous portent that an important chunk of global savings may have taken the first step towards wealth destruction.

The above meanderings of different chart patterns may be interesting, but what are the actionable ideas that I believe in the most to trade?

In addition to a core short in the euro (could the mid-June pi cycle date bring a nasty culmination to the debt crisis to Spain?) and a core short in JGBs, here are the two other chart patterns that seem particularly compelling to my eye:

The Russell 2000 Index (as tracked by the IWM ETF) is ripe for a significant fall. There are a number of different Fibonacci fractals on the monthly 1987-2011 chart of the Russell below that allow for eventual new highs, but not before at least a significant retracement occurs. Zooming into the daily chart of the Russell and the weekly chart of the IWM ETF, the retracement levels are clear. I am personally short the IWM looking first for a move to around 73.66, then a bounce, and then a second decline down to around the 66.20 level.

($RUT - RUSSELL 2000,M) Dynamic,0:00-24:00 (Delayed)

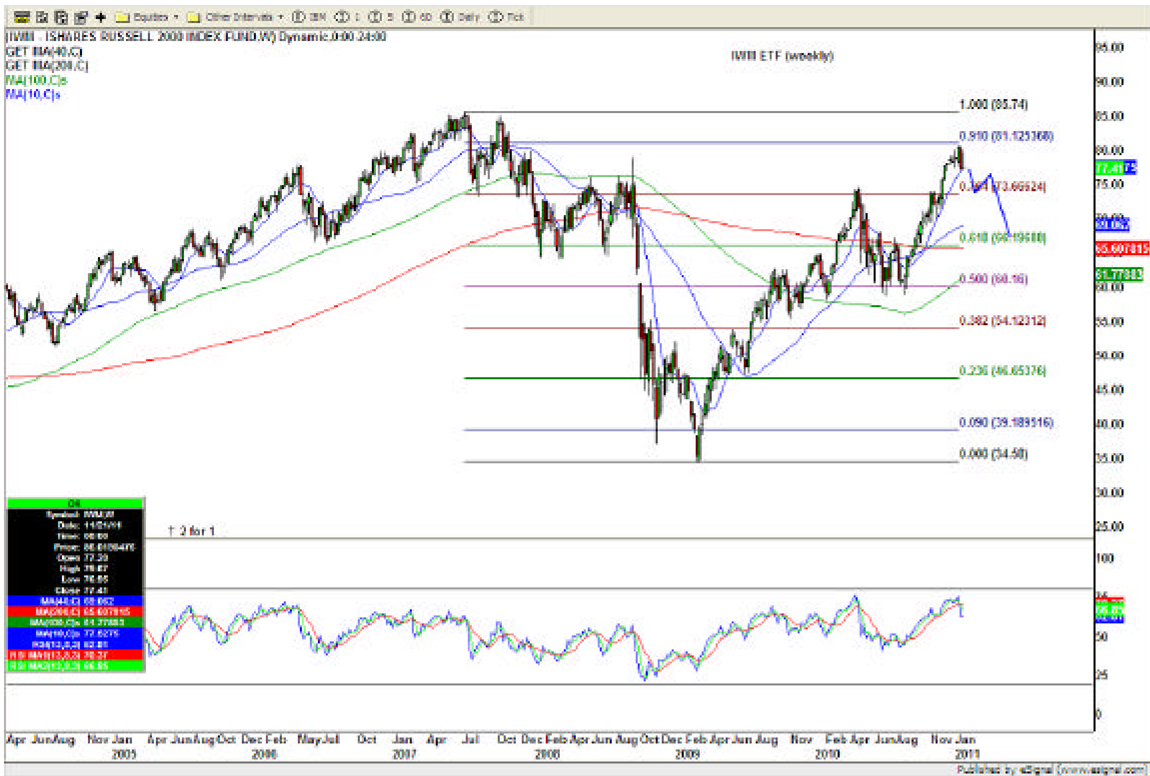
Russell 2000 Monthly 1987-2011

Published by eSignal (www.esignal.com)

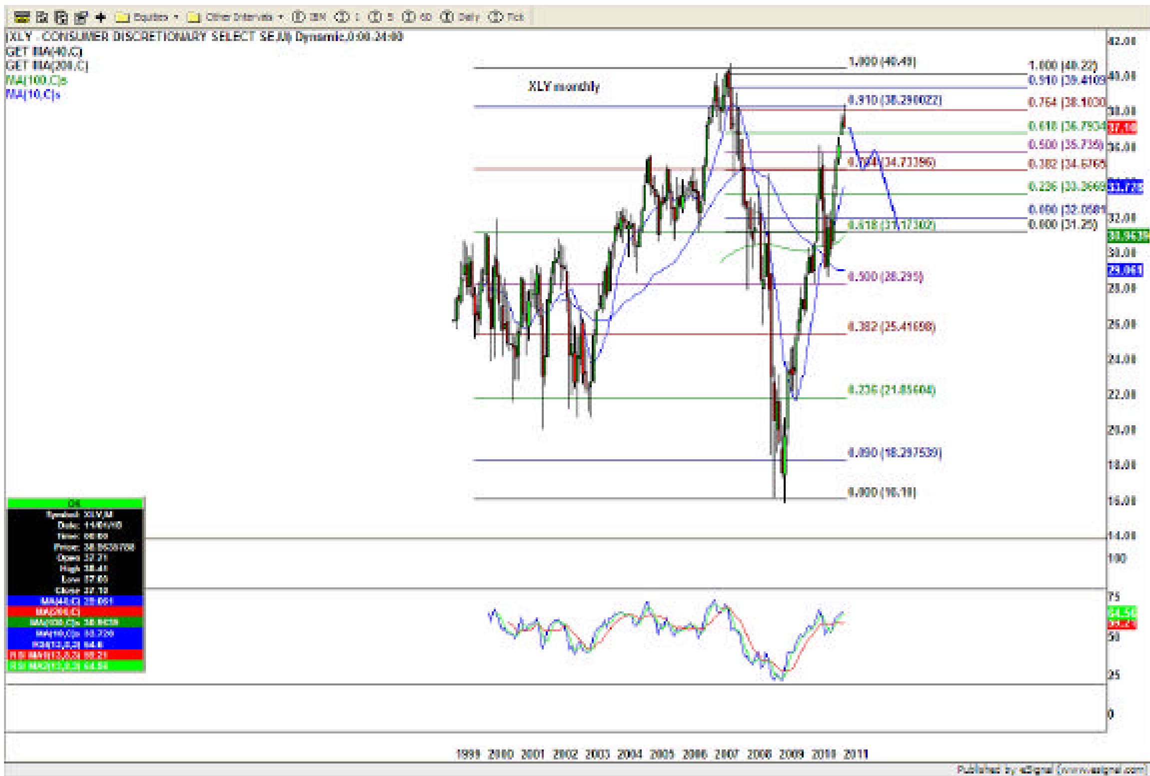
($RUT - RUSSELL 2000,D) Dynamic,0:00-24:00 (Delayed)

Russell 2000 (daily)

Published by eSignal (www.esignal.com)



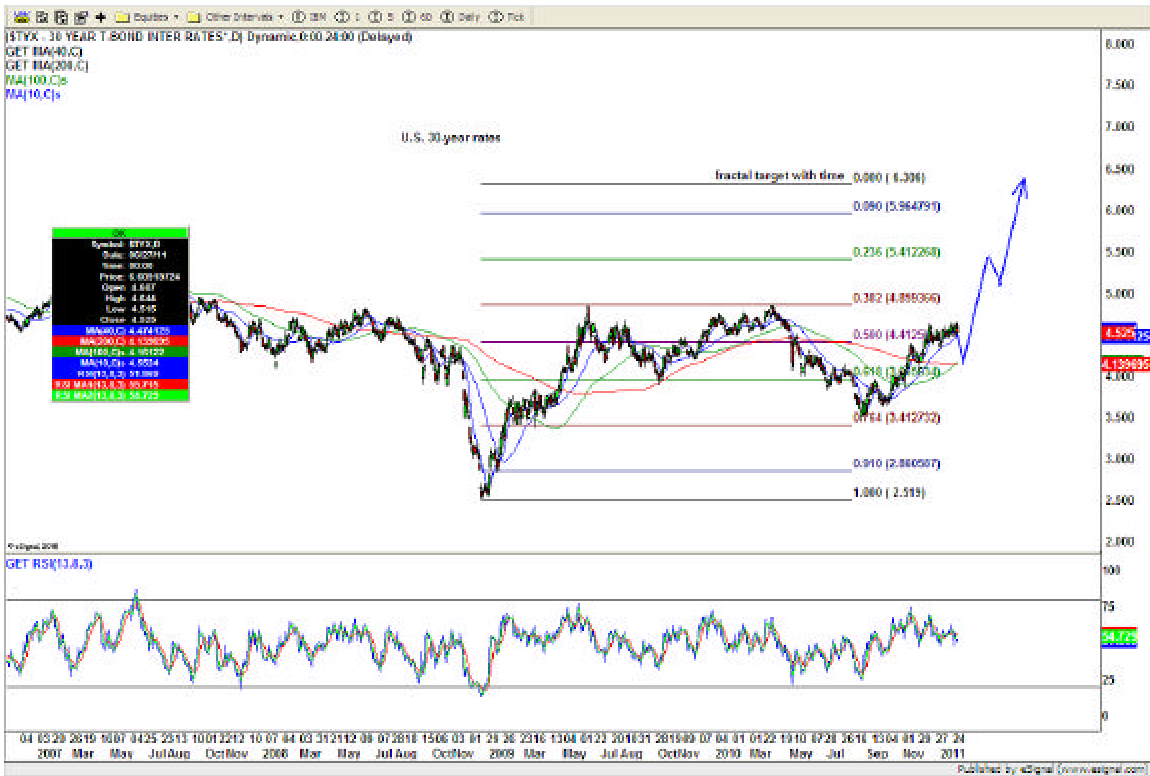
Consumer stocks did not melt in 2010. They should in 2011. The XLY ETF has a complete looking Fibonacci fractal appearance. I was recently amazed that one could buy January 2013 36 puts on the XLY for a premium of just around $4.30. What a great way to play the consumer eventually getting into deep trouble. The blue lines below represent my minimum expected move for this ETF. The destruction could be much bigger.



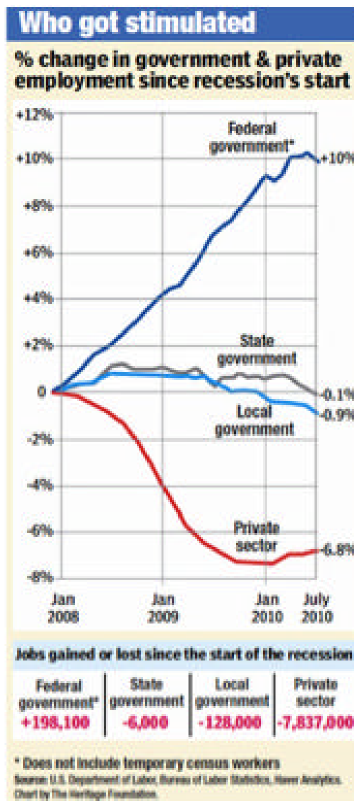
The above view is confirmed on a fractal basis if one looks at the Morgan Stanley Retail Index – **currently in the process of completing an outside month down** after earlier touching upside Fibonacci fractal targets.

The above negative views of equities may leave one asking: well what should one possibly buy? Bonds perhaps – yet again?

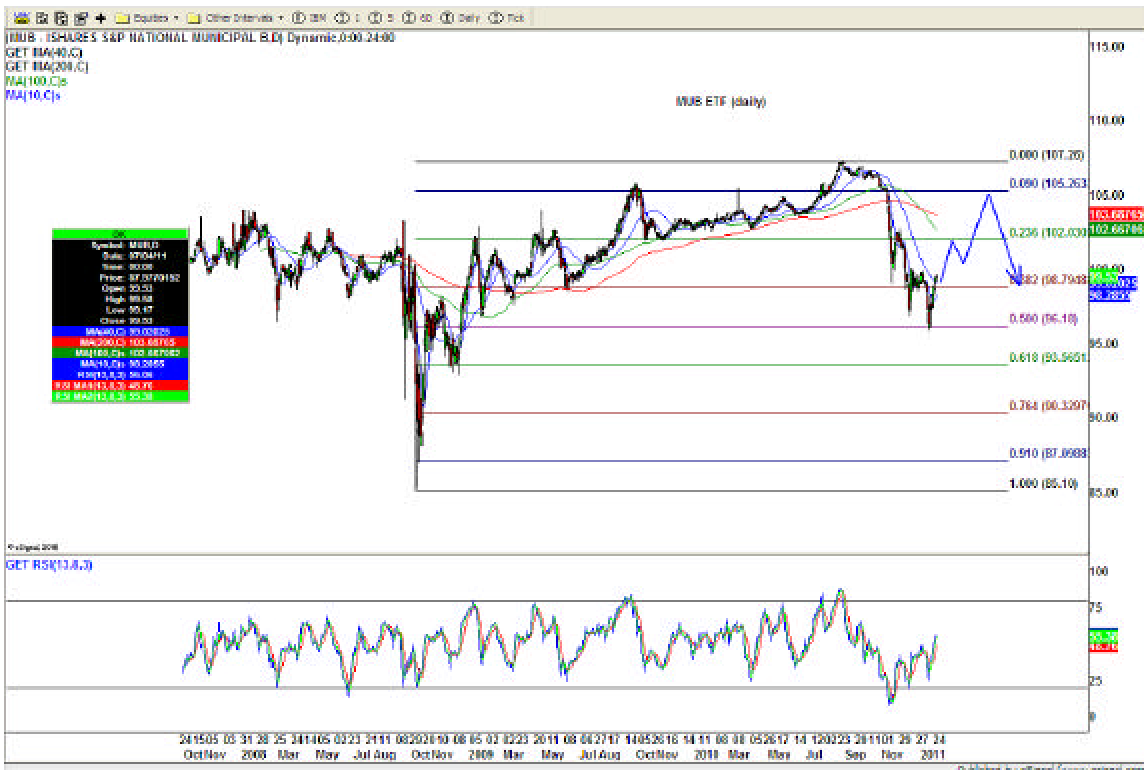
In answer to this, U.S. 30-year bond rates should indeed trend down a bit – at least in the short-term -- to around 4.13%. The TLT ETF could rally to around 101.37. But beyond this, hiding in bonds would be a mistake. There is a bear market brewing in fixed income too. Excessive debt is the core of the problem, not the place to run and hide.



Accidents in the muni-bond market are also increasingly likely with time. The next two years is when the unsustainable growth of government spending will be tested and revealed. It is when network television will finally wake up and tell us (as if it was a brilliant revelation) that the growth in government spending has been only a short-term fix and that the true organic growth of the U.S. economy is actually quite fragile without it. It's when charts like the one below will be more fully appreciated and understood.



Should the iShares municipal bond MUB ETF fill in some of the holes it left across its recent slide, sell it short too. A level up around 105 for this would be most ideal – if offered at some point in the future. But there is nothing to do here right now.

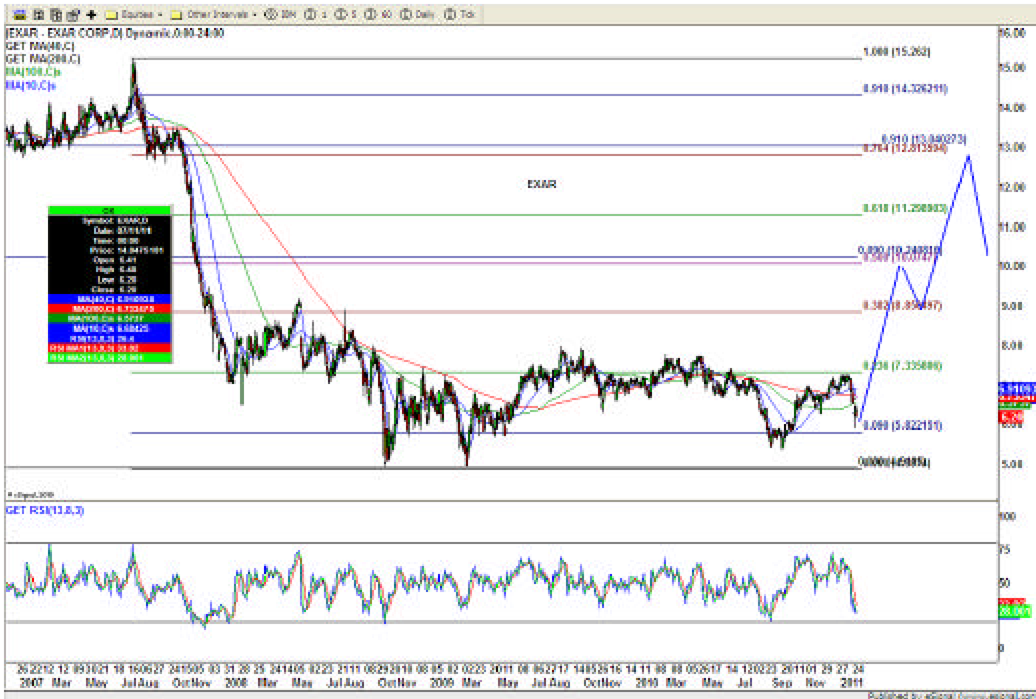


This leaves me excited about very few things on the long side. If some of my views above work out, various volatility indices should likely do well, and I am personally long the VXZ

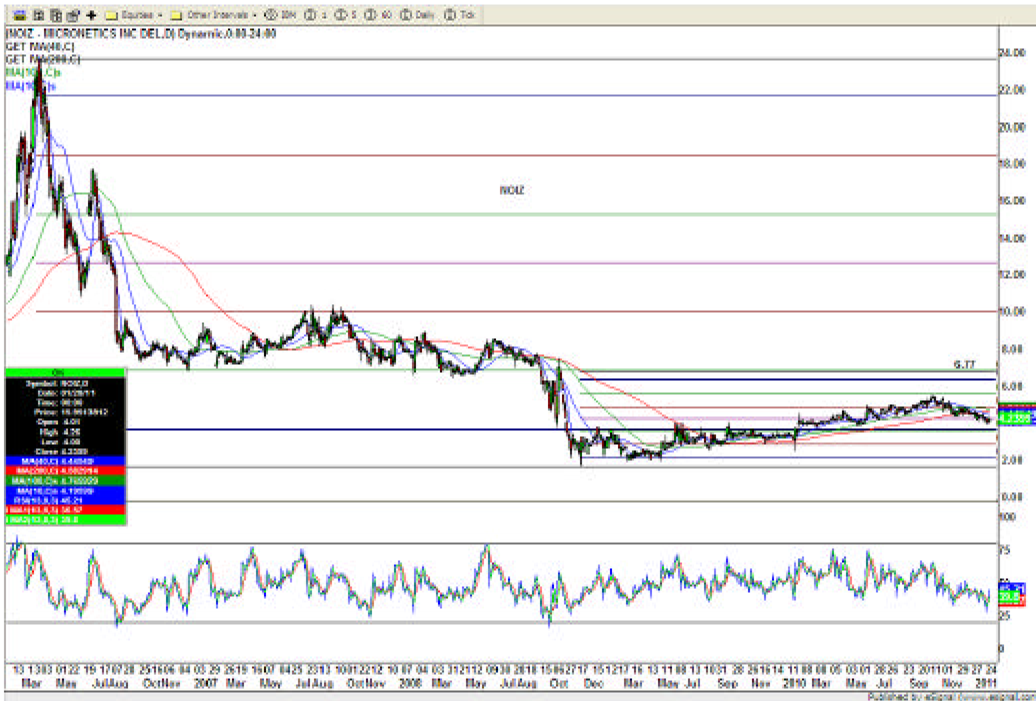
ETF right now for a trade. I will likely flip it out however on any significant strength as there is a possible missing low on this one down the road.

I am also long a few special situations.

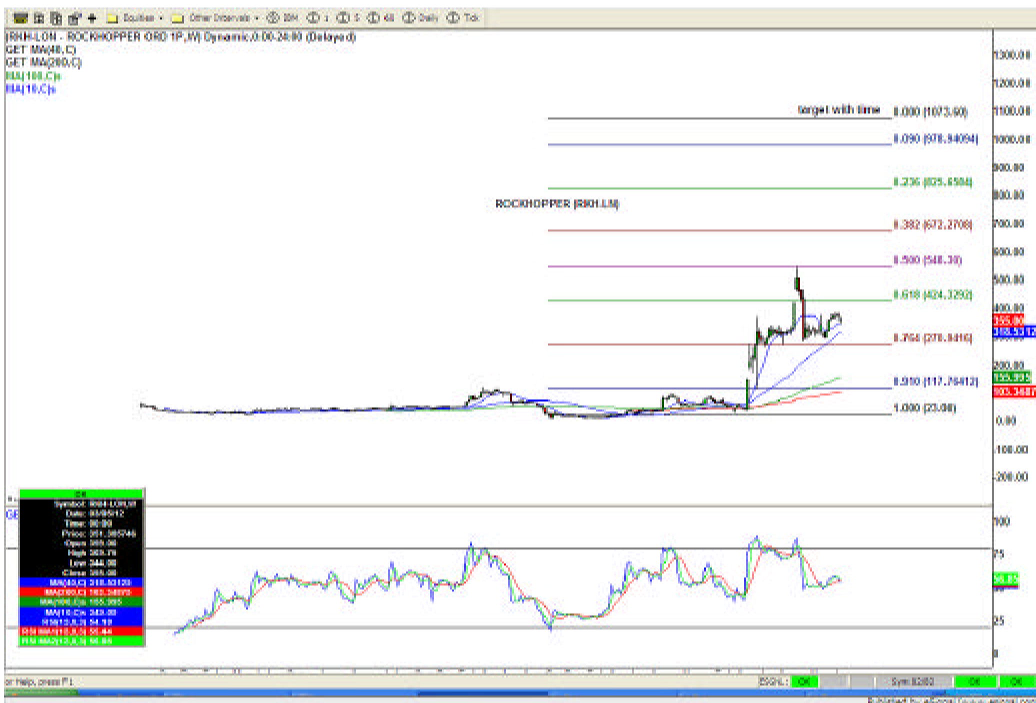
EXAR is a tech company that recently missed earnings, but has a bunch of nifty data compression and other tech products. George Soros owns a bunch of shares. It is a thinly traded stock, but I believe in its story longer-term. It also has some nice looking fractal attributes suggestive of at least a bounce from current levels. $10 or $13 are two targets if it ever escapes its current funk.



Another similar small tech company that I own is Micronetics (NOIZ). It is involved in radio wave testing software. In an increasingly mobile world, shouldn't this be a business area in demand? NOIZ had a hand in the development of Wi-Fi for airplanes for example, although they lost out on a big Boeing contract a few years ago. They are an honorable small New England-based company that should creep up to around a 6.70 fractal target with time. It is not an exciting investment, but one that I feel comfortable with.



Another eclectic and somewhat more speculative investment of mine is Rockhopper Exploration listed in London. Rockhopper made a huge oil discovery off the Falkland Islands in 2010 which when monetized should eventually make them worth about 9-11 pounds a share.



Another Falkland exploration company Falkland Oil and Gas came up with a dry hole in 2010 – pushing it back down from a 170 pence high to around 95 pence today. But FOGL still have other encouraging prospects. The Falkland oil reserve is real, and I think the stock could double at some point in the future, if not perhaps turn into the next Ultra Petroleum (UPL) type investment. As a matter of record, I originally bought UPL at under 20 cents in 1994, and thought I was pretty smart when the trader in me sold it at $3 a few years later. UPL stands at $47 today, having touched $100 in 2008. Tant pis! My attack-and-retreat approach to markets is filled with those types of stories.

Lastly, if you want a restructuring story also involved in the Falkland space, another possibility would be to buy the RAB Special Situations Fund (RSS-LN) which hit a flurry of redemptions in 2008, and has been in restructuring mode to meet these redemptions ever since. RSS-LN holds a basket of different Falkland oil plays as well as other interesting global natural resource properties and could come back from the dead to at least double from its current 30 pence price. Warning though: patience may be required.

Enough for now. Hopefully I have provided some thought-provoking ideas within this letter – both short and long – for investors to ponder and further explore. As always, let me remind readers that they should always consult their own Registered Investment Advisor before following any of the personal opinions offered here.

I am a bear at heart as we start 2011, but do own a few special situation stocks, and sleep well at night with my IWM and XLY shorts more than offsetting my few eclectic longs.

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