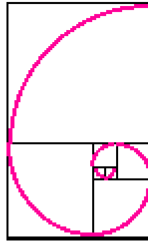

Sand Spring Advisors LLC

America on Sale, or Road to Revulsion?

by,

Barclay T. Leib

July 10, 2006

I spent a portion of June in England touring colleges with my 17-year old son who – in a slightly contrarian fashion reminiscent of my own instincts -- wanted to explore the potential of applying to colleges abroad in addition to more standard U.S choices.

I have previously lived and worked in England during 1990-1991, and remember well from that period (when the pound was within the 1.75-2.03 region, as it is today) that the cost of living in England always seemed irritatingly high. I remember particularly that the cost of London taxis, dry cleaning, and food always seemed a bit out of whack with equivalent dollar costs of such services in the U.S. But other things like theatre tickets, underground tube tickets, or museum admission costs seemed more in line.

But after this most recent trip, I came back even more shocked at the cost of *everything* in England, and really pondering: "In terms of purchasing power parity, what is reality and what is not? Is everything in Britain now exorbitantly expensive, or is the U.S. really the country which is cheap in comparison to the real cost of goods and services elsewhere in the developed world?"

My pondering over the exchange rate and apparent cost differentials of goods and services between the U.S. and Britain did not have an immediate conclusion. It was simply a heightened observation that something must be very screwed up such that the average British guy simply doesn't realize that paying 3 pounds for a tube ticket, 6 pounds for a sandwich, 5 pounds for a pint of ale, or 60 pounds for a tank full of gas is anything out of the ordinary. The Brit sees it as normal; while we see it as local pricing where costs in pounds generally equal costs that we are used to seeing in dollars -- except that pounds cost almost twice as much to buy with our dollars.

Under the Economist magazine's "Big Mac" Index of comparative pricing around the globe of a McDonalds Big Mac hamburger, the British pound comes in supposedly only about 18% overvalued in 2006, but to my wallet most items felt more like 100%. I'm glad my son didn't seek out Denmark or Switzerland where the Big Mac Index suggests local currencies that are respectively 58% and 68% overvalued. But in China, a Big Mac can apparently be purchased for a price 58% *cheaper than in the U.S.* Take a look through the table below.

The hamburger standard

	Big Mac prices		Implied PPP* of the dollar	Actual dollar exchange rate May 22nd	Under (–)/ over (+) valuation against the dollar, %
	in local currency	in dollars			
United States†	$3.10	3.10	–	–	–
Argentina	Peso 7.00	2.29	2.26	3.06	-26
Australia	A$3.25	2.44	1.05	1.33	-21
Brazil	Real 6.40	2.78	2.06	2.30	-10
Britain	£1.94	3.65	1.60‡	1.88‡	+18
Canada	C$3.52	3.14	1.14	1.12	+1
Chile	Peso 1,560	2.94	503	530	-5
China	Yuan 10.5	1.31	3.39	8.03	-58
Czech Republic	Koruna 59.05	2.67	19.0	22.1	-14
Denmark	DKr27.75	4.77	8.95	5.82	+54
Egypt	Pound 9.50	1.65	3.06	5.77	-47
Euro area§	€2.94	3.77	1.05**	1.28**	+22
Hong Kong	HK$12	1.55	3.87	7.75	-50
Hungary	Forint 560	2.71	181	206	-12
Indonesia	Rupiah 14,600	1.57	4,710	9,325	-49
Japan	¥250	2.23	80.6	112	-28
Malaysia	Ringgit 5.50	1.52	1.77	3.63	-51
Mexico	Peso 29.00	2.57	9.35	11.3	-17
New Zealand	NZ$4.45	2.75	1.44	1.62	-11
Peru	New Sol 9.50	2.91	3.06	3.26	-6
Philippines	Peso 85.00	1.62	27.4	52.6	-48
Poland	Zloty 6.50	2.10	2.10	3.10	-32
Russia	Rouble 48.00	1.77	15.5	27.1	-43
Singapore	S$3.60	2.27	1.16	1.59	-27
South Africa	Rand 13.95	2.11	4.50	6.60	-32
South Korea	Won 2,500	2.62	806	952	-15
Sweden	SKr33.00	4.53	10.6	7.28	+46
Switzerland	SFr6.30	5.21	2.03	1.21	+68
Taiwan	NT$75.00	2.33	24.2	32.1	-25
Thailand	Baht 60.00	1.56	19.4	38.4	-50
Turkey	Lire 4.20	2.72	1.35	1.54	-12
Venezuela	Bolivar 5,701	2.17	1,839	2,630	-30
Aruba	Florin 4.95	2.77	1.60	1.79	-11
Bulgaria	Lev 2.99	1.94	0.96	1.54	-37
Colombia	Peso 6,500	2.60	2,097	2,504	-16
Costa Rica	Colon 1,130	2.22	365	510	-28
Croatia	Kuna 15.0	2.62	4.84	5.72	-15
Dominican Rep	Peso 60.0	1.84	19.4	32.6	-41
Estonia	Kroon 29.5	2.40	9.52	12.3	-23
Fiji	Fiji $4.65	2.69	1.50	1.73	-13
Georgia	Lari 4.15	2.31	1.34	1.80	-26
Guatemala	Quetzal 17.25	2.27	5.56	7.59	-27
Honduras	Lempira 35.95	1.90	11.6	18.9	-39
Iceland	Kronur 459	6.37	148	72.0	+106
Latvia	Lats 1.35	2.47	0.44	0.55	-20
Lithuania	Litas 6.50	2.41	2.10	2.69	-22
Macau	Pataca 11.1	1.39	3.59	7.99	-55
Moldova	Leu 23.0	1.75	7.42	13.2	-44
Morocco	Dirham 24.5	2.82	7.92	8.71	-9
Norway	Kroner 43.0	7.05	13.9	6.10	+127
Pakistan	Rupee 130	2.16	41.9	60.1	-30
Paraguay	Guarani 9,000	1.63	2,903	5,505	-47
Saudi Arabia	Riyal 9.00	2.40	2.90	3.75	-23
Slovakia	Koruna 58.0	1.97	18.7	29.5	-37
Slovenia	Tolar 520	2.76	168	189	-11
Sri Lanka	Rupee 190	1.85	61.3	103	-40
Ukraine	Hryvna 8.50	1.68	2.74	5.05	-46
UAE	Dirham 9.00	2.45	2.90	3.67	-21
Uruguay	Peso 42.3	1.77	13.6	23.9	-43

*Purchasing-power parity: local price divided by price in United States

Sources: McDonald's; *The Economist*

†Average of New York, Chicago, Atlanta and San Francisco ‡Dollars per pound

§Weighted average of prices in euro area **Dollars per euro

Cogitating on this table a bit, there is something very screwed up with the current dollar standard that I believe is causing distorting effects on most global capital markets. Let me try to put this in simplistic terms.

At the moment, dollar wealth is clearly being accumulated in China/Asia, but instead of converting these surplus dollars into yuan at higher and higher yuan exchange rates, the Bank of China effectively takes on the exchange rate risk by pegging the yuan and cycling Chinese wealth back into U.S. assets. There are plenty of dollars around flowing compliantly and steadily back into our capital markets, so our bond and equity markets benefit.

But because everyone knows that there are plenty of dollars sloshing around the world, and most countries also need dollars to purchase oil, many corporate companies and countries also have a tendency to borrow in dollars. The dollar is, after all, perceived to be in a long-term secular decline, so why not borrow in a depreciating asset – and an asset that at some point you may likely need anyway to pay for oil or other transactional items. Borrowing in dollars also attracts institutional investors who would otherwise shun investing in Emerging Market debt that carries local currency risk.

But then some of these dollars (either borrowed or otherwise) end up in the hands of the Arabian world in payment for oil – and the Middle Easterners are of course pretty savvy. To the extent that they can, they want to diversify their wealth away from dollars, so they go out and buy euros, Swiss francs, and pounds – thereby making those currencies overvalued.

The whole flow works exceedingly well, and everyone is reasonably happy. The Chinese get to employ more people than they otherwise would if the yuan exchange rate was stronger; the U.S public gets to go deeper into debt with more excessive spending than it otherwise could achieve without the Chinese being willing to recycle their dollars so readily into our asset markets; global borrowers are happy borrowing money in a depreciating currency, namely the US dollar; and the Arab world is happy to buy overpriced assets in London, Geneva, and Paris maybe because they don't have much other choice and these places are deemed politically safe and enjoyable to visit when investment holdings need to be periodically reviewed.

The three paragraphs above are, of course, a bit over-simplified. Japan – holder of some 20% of the global world's savings – is specifically not included in our discussion, and Japan clearly is capable of throwing its own surprise "curve balls" at global monetary stability (as the BOJ clearly did this April-June with the swift removal of its Quantitative Easing Policy that continued until June 10th when BOJ tightening suddenly eased up a bit). But basically, leaving the Japanese aside, as long as the dollar goes down against Europe, and stands still against the yuan, almost everyone on all sides feels reasonably cool and happy. In our mind, this type of situation could continue into early 2007: Dollar down against Europe; stocks go up in the U.S. (but only after some continued short-term sloppiness over the latter part of the summer); the U.S. bond market falls less than it should; and China continues booming and saving their recycled wealth mostly in dollars.

But within the dollar flow cycle, there is also a clear "illusion of prosperity." America thinks that it is richer than it really is (with buoyant capital markets that may not really deserve such buoyancy); China thinks that it is richer than it really is (holding dollar assets like bonds that may be destined for devaluation); and the Arab world owns over-priced assets in Europe (with Europe itself not really even being cognizant that their markets are so well bid only as a diversification tactic).

In addition, as long as U.S. monetary aggregates keep growing at a brisk pace (something that is harder to check now that M3 figures are no longer released, but highly probable), every rate hike by the Fed relative to those of other G7 countries simply attracts more global savings to arrive in the U.S., which in turn funds more U.S. credit creation. Thus, perversely at least in international terms, further U.S. rate hikes that further separate U.S. yields from foreign rates actually represents *an easier – not tighter – U.S. monetary policy.* Higher U.S. rates helps perpetuate this oddly constructed global economic stability – even as acknowledgement of this notion is completely lost on the general public. And everyone has a vested interest in just two things: that the dollar generally stays weak against Europe, and nothing goes awry in China (or other parts of Asia/Japan).

But somewhere around February 24, 2007 – if our pi cycle date hits as anticipated -- something in this equation will start to come undone. But it is very hard to predict what exactly this "thing" will be.

Two main themes would be particularly scary: 1) If either the Chinese people were to decide to save less in general --thereby offering less natural dollar recycling demand; or (2) If for some reason, the Chinese decide that they no longer want to direct the bulk of their savings toward the U.S. A sudden destruction of wealth from a Chinese banking implosion or a natural disaster of some sort (maybe an earthquake in California, for example, or another tsunami or hurricane disaster) might also be enough at this point to upset the global economic balance. Or maybe Europe simply will be seen for what it is: an overpriced alternative asset with little intrinsic value. The dollar could "inexplicably" rise against Europe screwing all those with a vested longer-term interest to see the dollar fall.

Alternatively, maybe Mr. Bush will get his wish and the Chinese will grudgingly allow the yuan to revalue. But Mr. Bush is an idiot. While a yuan revaluation may be inevitable over time, when it first transpires, it will change an economic "game" that has worked exceedingly well for some period now. As such, it will at least be a dangerous moment. On the one hand, all of our assets will suddenly look that much cheaper to the Chinese – maybe attracting even more direct investment by the Chinese in the U.S. over time ("America on Sale" so to speak). But on the other hand, in domestic yuan terms, the Chinese will take mark-downs on the yuan value of their current U.S. investments (a "Road to Revulsion" so to speak). The U.S. has long followed a broad strategy to sell debt to domestic and foreign investors and then the effectively renege on a portion of this debt through inflation and dollar devaluation. But if the yuan revalues, we will be reimporting the inflation that we have so successfully exported to date to other Asian and European countries. A yuan revaluation that takes place in the wrong manner could shatter the current "illusion of prosperity" within the U.S.

Clearly, the recent April-June tightening of Bank of Japan monetary policy and its dramatic rippling effect through many global markets already shows that the U.S. is no longer in primary control of its own destiny or the principal driver of global economic well-being. What Ben Bernanke *wants* to do may still draw many headlines in the popular financial press, but what he actually *can* control in the global economy is clearly diminishing. Instead, our destiny now lies in the hands of the Bank of Japan, the Bank of China, and other foreign investors. But notably, the U.S. markets also fell less during the period of May-June stress than other Emerging Markets. That is because our asset markets are already on sale because our dollar is already being discounted by global markets relative to the real assets that these dollars will actually buy.

Yes, there is a bubble of macro-economic imbalances, but this bubble is more in relative currency valuations (between the Swiss franc and the Chinese yuan, for example), not necessarily in the dollar value of hard assets like U.S. equities or U.S. property markets. These latter assets are simply a "mirror image" reflection of the currency bubble problem. The more the dollar

slides, the more a U.S. company in dollar terms will tend to advance. But these currency imbalances cannot persist over the long run. Someday, the Big Mac Index needs to rectify itself such that the burger in Britain, Denmark, or Switzerland is not 100%+ more expensive than the same burger in Beijing. When this rectification process takes place, watch out – global markets will be deemed to be acting in a "perverse" and non-intuitive manner versus past history. What will really be happening though will be a realignment of historic imbalances.

But enough on big picture macro issues. Amidst all of the problems, there are of course a few "constant global themes" that one can reliably lean on when investing with a 10-20 year horizon. These themes are:

- Global energy supply is diminishing and alternative energy sources will need to be developed over time. More specifically – even if many alternative energy companies may currently sport valuations that are beyond reasonable investment value -- the demand for energy services like deep water drilling, fracking/cracking providers, underwater rig repair, offshore logistics provisioning, etc. should be a no-brainer for the next several years.

- The pollution of water supplies – particularly in China and India -- is a major issue that will need billions of dollars devoted to its resolution. Find companies that will benefit from this environmental infrastructure build-out need, and future wealth will be found at the same time. (We have discussed this theme in the past, so will not spend much time on it today.)

- Within a continued environment of global terrorism, security concerns should soon lock up with improved smart card and chip technology to better secure national borders. The world is going wireless faster than any of us quite realize. Find companies that are on the cutting edge of frequency modulation and smart card chip transmission technology, and wealth will once again be found.

In the short-term, we are of course still short-term bearish overall on the equity market into our next 4.3-month mini-PEI cycle date in mid-October. But we are bearish in a bifurcated type of way. We are mostly bearish names in the tech and consumer retail sectors where year-over-year sales growth expectations may not line up well with already excessive inventories and an increasingly tapped out U.S. consumer. You will not find us near stocks like Best Buy, CDW, Apple, Wal-Mart, Amazon, or any semiconductor names. In the past we have suggested possible shorts in some of these as well as stocks like Williams Sonoma and Ruby Tuesday's, as well as Wells Fargo and MBIA (see Feb'06 letter). Some have already worked nicely to the downside; others still await their fall from grace. Wells Fargo and MBIA have specifically been most irritating as shorts and may still represent interesting short opportunities. Others are already well on their way to initial downside targets. We specifically see Fibonacci rhythms at present suggestive that AMZN will eventually touch 24; CDWC will reach at least 47; WSM will fall to 31; and RI is still headed to 18.28.

However, on the potentially bullish side, we were recently tempted to get reinvolved in some energy and smart-card/frequency technology names after their recent six week smashing. We have previously suggested that after a short-term washout in energy and metals, there would likely be one "last hurrah" rally in these sectors into February 2007. Despite being wary of equity markets in the Aug-Oct period of this year, we are generally still bullish overall on the global economic system to continue to function into our pi cycle window of late February 2007. So let us devote the balance of this letter to presenting a few individual chart patterns in the energy and smart card/frequency transmission worlds that appeal to our technical eye. As a matter of disclosure, we are personally already long most of these companies, having established positions

in many of the energy names in early June after that sector's drubbing. Thus, in terms of short-term timing, we make no claim of any short-term rush to add to these exposures today. Crude oil is trading off as we speak, as are a few of these names. But we do like the longer-term pictures.

Energy-oriented patterns we like…

Longer-term we like offshore drillers like **Transocean (RIG)** and **Global Santafe (GSF)**, but hesitate at their chart patterns which resemble head and shoulders topping patterns in the short-term. Keep an eye on them should further weakness evolve.

Other names that look more constructive from a chart perspective include:

Danbury Resources (DNR)… Gulf Coast oil and natural gas exploration company and recent acquirer of 30-40 million barrels of reserves in Northern Louisiana via its Delhi-Holt acquisition, we see a nice E&P play continuing to develop in DNR. While there is some exposure here to further natural gas price declines, the Fibonacci rhythm suggests a long-term target of $49.66.

Peabody Energy (BTU)…The largest U.S. coal producer, Peabody more than doubled earnings in the first quarter of 2006 on the back of strong coal prices. The Fibonacci rhythm points towards $82.53 longer-term.

Imperial Oil (IMO)…a large Canadian production and refining company and pioneer in tar/oil sands extraction (with a 25% participating interest with Syncrude, and 100% interest in 16,500 hectares of tar sands in northern Alberta) IMO is 69% owned by Exxon. The company generates significant free cash flow and periodically buys in its stock. The technical rhythm here suggests a $42.40 upside price target over time.

Core Laboratories (CLB)…leading provider of energy reservoir production enhancement and optimization services – a service area that should stay in strong demand regardless of short-term energy market price swings. Does upside target of $74.26 beckon on a Fibonacci rhythm basis?

Tidewater (TDW)…provider of offshore supply vessels and marine support services to the offshore energy industry around the globe through the operation of a fleet of 560 marine service vehicles, TDW assists in the towing and anchoring of mobile drilling rigs, the transportation of people and equipment necessary to sustain offshore drilling, pipe laying and other specialized services. TDW has lower volatility and growth prospects than some of our other choices, but also has a lower P/E multiple associated with it. Despite TDW's generically lower volatility, the Fibonacci rhythm here suggests a bold upside target of $87.67.

Energy Transfer Equity (ETE)…Natural gas midstream transportation storage and pipeline company. There is some natural gas price sensitivity to this throughput company, but a nice 3.6% cushioning dividend, and a $29.25 upside Fibonacci rhythm target.

Cal Dive International (CDIS) & parent Helix (HELX)… energy services companies that provide innovative solutions to the oil and gas industry worldwide for marginal field development, alternative development plans, field life extension and abandonment, with service lines including diving services, shelf and deepwater construction, robotics, well operations, well engineering and subsurface consulting services, platform ownership and oil and gas production.

CDIS sports an upside price target of 49.33, while HELX is a volatile stock that we see someday reaching a price above $100.

CDIS - Cal Dive International I, Weekly
03/03/06
O: 36.55 H: 38.77 L: 34.64 C: 38.14
+1.39
Cal Dive Intl (CDIS) -- weekly
target 0.000 (49.33)
0.090 (45.59)
0.236 (39.54)
0.382 (33.48)
0.500 (28.58)
0.618 (23.68)
0.764 (17.62)
0.910 (11.57)
1.000 (7.83)
60.00
55.00
50.00
45.00
40.00
35.00
31.87
30.00
25.00
20.00
15.00
10.00
5.00
0.00
2003
2004
2005
2006
01/05/07
#497

HELX - Helix Technology Corp., Daily
07/07/06
O: 40.15 H: 40.50 L: 39.22 C: 39.39
-0.74
Helix Energy Solutions (HELX) -- weekly
target 0.000 (101.82)
0.090 (93.24)
0.236 (79.34)
0.382 (65.43)
0.500 (54.19)
0.618 (42.96)
0.764 (29.05)
0.910 (15.15)
1.000 (6.57)
10.00
20.00
30.00
40.00
50.00
60.00
70.00
80.00
90.00
05/31/07
#3005

Falkland Oil & Gas (FOGL on London AIM market; www.fogl.com)…all initial seismic work points to a last major global energy reserve that has yet to be tapped around the east and south basins of the Falkland Islands. If the oil is really there, this 1.1 pound speculative exploration company which carries a current market cap of just 100 mm pounds, hits a home run.

Rockhopper (RKH on the London AIM market; http://www.rockhopperexploration.co.uk) is another even smaller 12 mm pound energy exploration company trading at 37 pence in London that using advanced seismic technology already has encouraging results from the southern end of North Falkland basin. This region had several successful hydrocarbon finds on initial drilling back in 1998, but at the then current $12 oil price, these discoveries were not commercially viable enough to develop further at the time. They easily could be now at $73 oil. The geology of this latter region is quite different from the South and East Falkland basins, but generally with more work done on it.

If either FOGL or RKH stumbles across a 500 mm barrel oilfield, such would be worth about $4 bln. So consider both of these stocks a bit like going to the racetrack and betting on a first-time starter at 20-1 potential payoff in the case of FOGL and a 100-1 potential payoff in the case of RKH -- but both with encouraging prospects.

Or lastly – if you want a speculative company closer to actual energy production – it may be worth looking at **Asia Energy PLC (AEN on London AIM market; website www.asian-energy.com)** -- developer of the huge Phulbari Project coal reserve in Bangladesh that one day soon should be capable of producing 15 million tons of high grade metallurgical and thermal coal per year. Production only awaits governmental approval expected sometime soon in 2006. There will of course be some inevitable snafus along the way in this company's production development, as well as some significant additional share issuance (dilution) to help finance production, but this is a huge resource.

All of the above companies are obviously at more attractive prices than they were before the May-June energy sector dump, but let us reiterate again: these stocks should not necessarily be chased higher right away after their recent bounce. To be honest, in terms of timing, we would have liked to get this letter out 10 days ago, and at that point our timing could have been reasonably prescient. But alas, family logistics around the 4th of July weekend prevented such.

Frequency/Smart Card companies we like….

On-Track Innovation Ltd. (OTIV)…This small Israeli-based company is the winner already of multiple contracts from a major Asian country (China?) to embed smart chips in passport documents, as well as the Boston transportation system to provide an electronic subway pass capable to be read at a distance. For a company with only a current market capitalization of $92mm, this seems to be pretty impressive stuff to our eye. OTIV technology is under patent. The company is not profitable yet, but they may be soon – if they don't get taken over by someone bigger first. A target of $18.65 looks possible on a Fibonacci rhythm basis.

Micronetics (NOIZ)…This company has state of the art frequency modulation technology that may soon see things like Direct TV or DSL delivered to the chairback screen on commercial airliners. Defense electronics is another of their specialty areas. Ranked by Forbes as one of America's 100 best small growth companies, we like the story here with an $84mm market cap, and profits which recently almost doubled on a year-over-year basis. There is a strong Fibonacci rhythm in this chart pointing towards an upside price target of $25.40.

As always, do your own homework before investing. Sand Spring Advisors is not a Registered Investment Advisor, and we do not pretend to advise clients on what stocks may or may not be appropriate for their own portfolios. We only offer our own technical and fundamental views as a matter of free speech and academic interest.

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