Sand Spring Advisors LLC

Behavioral Finance – Equity Downswing Not Ready in July But Should be by September

by,

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Between the twin London bombings July 7th and July 21st and the Chinese yuan revaluation of the latter date, U.S. equity markets were given every opportunity to decline in July if they had wanted to do so. They did not – at least not yet -- showing in good "behavioral finance" fashion that the short-term value/impact of a given news event is very much a function of the preexisting technical position of the market.

We previously suggested that mid-July should mark the first of "three thrusts to a high formation" that should complete into late August to early September. Using daily, weekly, and monthly chart perspectives, our preferred Fibonacci upside target for completion of this topping pattern remains between 1259-1272 on the S&P. But on the hourly chart, 1245 also showed up as an important Fibonacci level (see last newsletter). Thus whether the 1259-1272 target on the S&P is eventually reached or not, we believe that the equity market will certainly be turning lower by our next PEI cycle date of September 19th, 2005.

All of this leaves us in a quandary as to ultra-short-term equity strategy. As we type this, the U.S. equity market is clearly too high to buy, and experiencing a very nasty daily reversal lower from a 1245.15 high made on July 28th. We find ourselves itching to sell (and actually starting to do some shorting – see below), yet the topping process still may have a bit more time to run before we will have a truly compelling low-risk shorting opportunity in the major indices.

It's all a bit like the consumer. Pockets of weakness are starting to emerge in discretionary spending, but no swan dive lower in spending has yet to occur – just the first cracks.

Of first note within consumer spending, summertime movie sales are down. No one is quite sure why. Some say this phenomenon may be due to the poor quality of the movies being released this season and the increasing availability of cheap DVDs. But perhaps there is an element here as well that an $8-$10 movie ticket is just the first easy thing for a stretched American wallet to cut out.

As another anecdotal observance, a major antique show recently took place in New Hampshire where 350 quality antique dealers converged to display their inventory. And yet less than a few hundred potential shoppers showed up at the event. "This is the worst antique market that I have seen in years," said one dealer. "There is still some demand at the very high end of the market, but nothing else is moving. This summer is a non-starter for antiques." Any of those long eBay in 2005 may already know this.

And these trends make sense to us. Things like movies and antiques are indeed easy things to be cut as consumer liquidity starts to wane. Eating out could easily be next – although we have suggested such previously, and we have been admittedly early in this prognostication. Yet we remain highly suspect about restaurant chains like Ruby Tuesday's – already starting to stumble lower. We are also eying Darden's and others as well for an eventual fall from grace.

Personally, while still not aggressively involved short the S&P, we *have* begun shorting the Spiders Consumer Select ETF (symbol: XLY) which includes several restaurants within it, as well as automobiles and components, consumer durables, apparel, hotels, leisure, media, and general retailing. With a flattening yield curve and U.S fixed income market now finally making an apparent swing move to the downside in price (see 30-year yield chart towards the end of this letter), the Spiders Financials ETF (symbol: XLF) also looks fully baked in terms of its 2002-2005 bounce, and we have recently gone short it as well.

Are we maximum short yet? No. We are scaling into our shorts in the consumer cyclical and financial sectors first, and leaving more firepower to add to these shorts on the broader equity market indices should further silliness occur into late August/early September. But we *do* find ourselves wanting a toehold on the short side at this time. As a side note, we have also temporarily harvested many of our long water industry stocks as Fibonacci resistance levels on stocks like SJW and CCC were reached. We hope to add them back maybe next January on a significant market downswing.

Elsewhere, on an overall macro basis, even while nothing overly dramatic happened to bonds, stocks, or the dollar immediately after the yuan (RMB) revaluation news, *this does not mean that fireworks aren't still coming down the line.* We suggested back in our April letter *Rabbit Out of the Hat* that a yuan revaluation was coming, and that its arrival would initially be viewed as an economic policy success for the Bush administration, even if longer term the Bush Administration might easily regret getting what they wished for. On this front, we recently read the following words by our friend Ray Dalio of Bridgewater Associates, and they match our own views so closely that we cannot resist reproducing below Dalio's thoughts on the RMB reval (with certain sections highlighted for emphasis by us):

> "The inevitable path is…that China will do what is in its best interest – and that is to a) develop an independent monetary policy that allows it to better balance inflation and growth, b) have the amount and mix of forex determined based on what is best for its balance of payments picture and c) slow the American (and European) move toward protectionism.
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> **"What the Chinese and the Americans are both having a tough time understanding is that, if faced with the choice between a) having the Chinese hold their currency down, lend the U.S. lots of money to buy Chinese goods, and have the Chinese increasingly stimulate their economy, and b) letting the RMB appreciate, have the Chinese lend the U.S. less money and allow the Chinese to tighten monetary policy, it is clearly in America's interest to choose a) and in China's interest to choose b).**
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> "Some people think the opposite is true – i.e., they think that it is in America's interest to have the RMB revalue, (i.e. to make American goods more competitive and to have the Chinese buy fewer U.S. bonds) because they put the emphasis on the "make the U.S. more competitive" part and less emphasis on the "buy fewer U.S. bonds" part. Spending on borrowed money is enjoyable – whenever any country (or person) can spend more than they earn (i.e., run a current account deficit) it holds living standards higher than they would otherwise be. So having them lend us the money to buy their goods now is clearly better for us than having them not lend us the money to buy their goods. Look at the history of this dynamic in all countries, especially emerging countries – when the lending is curtailed, the trade balances improve and the living standards fall. **So it is a bit funny that the Chinese are hesitant to revalue because they figure that, if the Americans want them to do it, that must mean that it is in their interest to do the opposite. Remember the Chinese curse – "may you get what you ask for." It could be a curse for Americans. The Chinese should give the Americans exactly what the Americans want – less intervention in the U.S. currency and the U.S. credit markets – and do so as quickly as they can while keeping the markets orderly. The Chinese are gradually and wisely coming around to this point of view.**

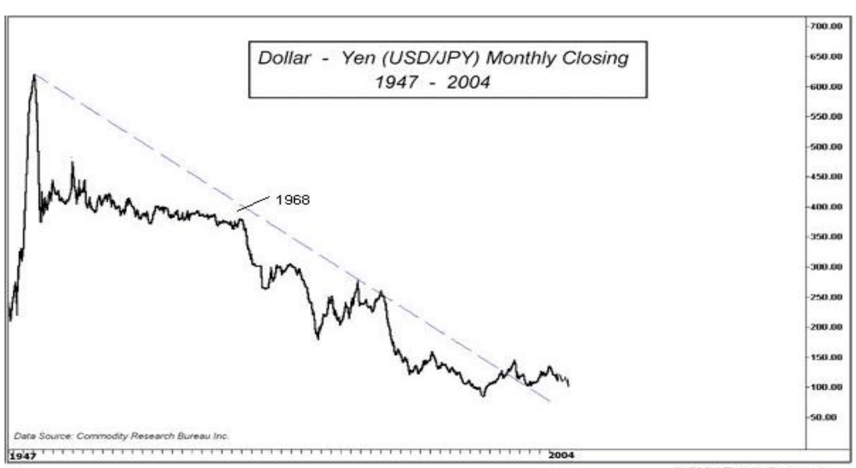
"…We think that it is inevitable that the RMB will be 25% to 30% higher in three years and about 60% higher in 10 years, because we believe that it is in China's interest to have this happen. The big picture is that it is inevitable that per capita income in China will rise relative to per capita income in the U.S., so China will have a bad inflation problem (and lots of foreign bonds) if they keep the exchange rate fixed. For example, over the last several years per capita GDP in China rose at an annualized rate of about 8% while in the U.S. it rose at 2%; this took the average Chinese worker's income from about 1.5% of the average American's to about 2.7%. Since we think that an average Chinese worker is worth more than about 1/35th of an average American worker (and apparently many multi-national businesses agree with us), we expect this income gap to narrow. Let's say that this continues at the past rate (i.e. Chinese income rises 6%/year faster than American income) and that Chinese inflation mirrors income growth (which isn't exactly true, but is enough true to convey the point); then China will certainly have lots of inflation. Because this inflation is going into investments (like real estate) – due to the propensity to save in China – it produces a bubble as well as classic inflation.

"A free Chinese central bank that seeks to balance inflation and growth will tighten monetary policy and have the currency appreciate so that Chinese nominal GDP growth is desirable. While real incomes in China will rise relative to those elsewhere, this needn't show up in undesirably higher inflation **<u>if the exchange rate rises commensurately</u>**. Since we think that it is inevitable that real incomes in China will continue to rise relative to those in the U.S. at a fast pace and that it is in China's interest to run monetary policy to balance growth and inflation, we believe that it is in China's interest to have its real exchange rate appreciate at a fast pace and to have an independent monetary policy. In our opinion, we are shifting from an era during which the foreign exchange rate policy drove monetary policy to one in which the monetary policy will drive the exchange rate. Said differently, domestic conditions will be more important than exchange rate stability in setting policies and driving markets (as it is about everywhere else in the world).

…We believe that the relevant analog [for China] is Japan in 1968-1978 when the circumstances were similar – i.e. a) real per capita incomes in Japan were very low relative to the U.S. (60%), b) the trade balance/current account, growth rate and investment/saving rate gaps were huge and c) the Japanese were trying to hold the exchange rate the same via huge bond purchases.

Dalio's vision of this situation seems compelling. Overall, while the initial 2.1% slip in the USD vs. the yuan peg was a trivial "political bone" thrown out by the Chinese to stave off U.S. protectionist measures, it likely represents the "tip of an iceberg" – the "crack in the dam" – that will lead to much bigger things to come. In our mind these "things" will on a net-net basis be more difficult for the United States than they are beneficial. The day that the "piper must be paid" is certainly now closer given the new yuan policies.

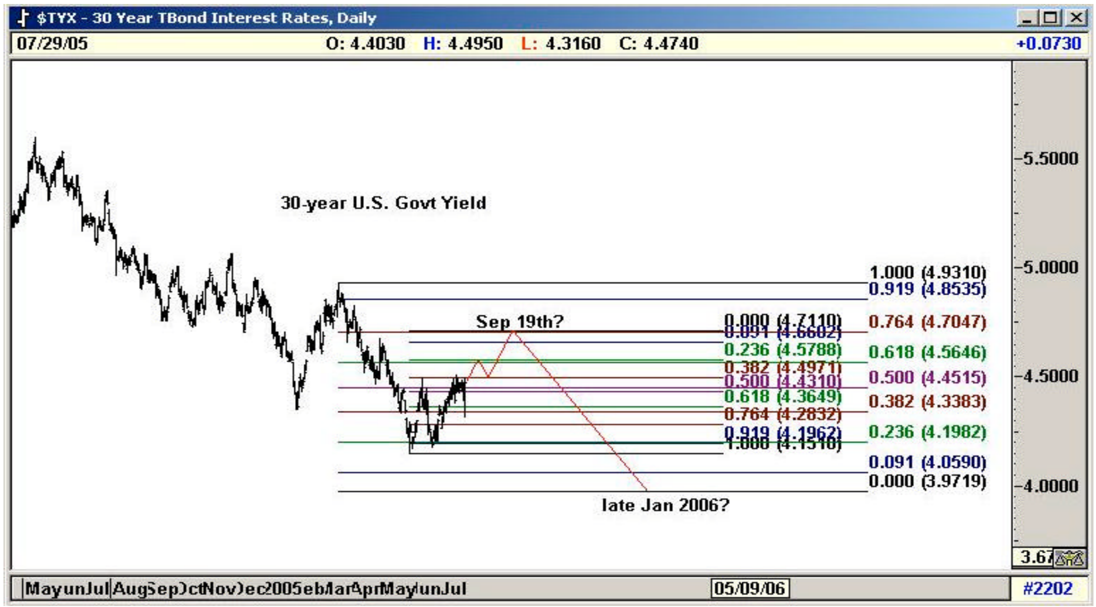
Using Bridgewater's analogy of Japan in 1968-1978 as comparable to China now, just take a look at the USD/JPY chart below and where USD/JPY was circa 1968.



So as a first thought here, maybe one should at least think about buying some exposure to Asian currencies at current levels. A China or Asian equity fund that does not hedge away it currency exposure might be one potential path longer term, albeit the equity component here could of course hurt during our anticipated Sep 2005-Jan 2006 period of severe equity weakness. An Asian emerging market bond fund might be a better choice, but we would suggest staying with funds with short underlying bond durations. For the retail investor, something like the Profunds Weakening Dollar Fund might be appropriate, albeit one gets a more diversified basket of currency exposure via this route than just Asia. But longer-term, we do spy at least one missing upside Fibonacci target on EUR-USD around 1.4112, so this risk here would likely be one of simply timing the near-term USD high.

For investors who trade futures or forward currency markets, we also still see at least one important downside Fibonacci target on USD/JPY near 96.62. Recent USD/JPY trading levels above 112 may easily represent an opportunity to establish an attractive long yen/short dollar bet.

While we argued in our last letter that playing bond market swings was a crowded and dangerous space these days, one other chart bears careful attention into the September 19th PEI cycle date: the daily chart of U.S. 30-year yields. In this chart rhythm, we do see a pattern that suggests a move higher in yields to approximately 4.66%-4.71% levels -- possibly by September 19th -- even if we would subsequently then forecast 30-year yields will make yet another run to the downside, possibly reaching 3.97% yield levels by late January 2006. Such a path would obviously be quite consistent with our call for extreme equity market weakness this coming autumn and early winter. Higher bond yields in the short-term could perhaps create the necessary causal "reflexivity" (in George Soros' lingo) to set-up for that equity downswing in the fall.



Lastly, let us mention gold and silver. Both have recently been teasingly quiet, yet firm. Silver appears singularly coiled within a multi-week pennant formation – having made two false breakouts, first up and then down, over the summer. This metal appears increasingly ready to do something more substantive and lasting. Technically, we still see gold reaching at least $475 sometime this year, and maybe even the next zone of Fibonacci resistance between $580-610 over time. AngloGold (symbol = AU) is a gold stock we now own once again on the long-side. Silver moving above its June 2005 highs would be a most welcome confirmation to our bullish gold view.

Send us your comments at information@Sandspring.com.

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