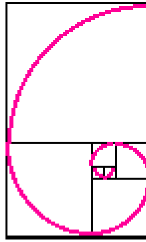


Sand Spring Advisors LLC

The Coming Jolt

by,

Barclay T. Leib

June 14, 2009

There have been numerous times across my thirty years of trading markets when I have seen a given market get stuck in a stultified range, and a quiet equilibrium price gradually achieved. Human nature is such that no wants to really believe in a boring range, and market strategists and participants keep looking for the "next big trade." But then week after week, month after month, a "grindy" range of false breakouts and continued chop is all that the market serves up.

In the current instance, there is certainly an element in my psyche to simply write-off expecting much more than a range in 2009 equities after the violently negative 2008 year recently experienced. I am reminded a bit of how the British pound traded so violently across the late 1992 ERM crisis, but then proceeded to effectively go to sleep in a choppy range that persisted not just for 1993, but a range that persisted on into the 1994, 1995, and 1996 calendar years.

If there is any element of analog between the 1992 British pound collapse and the current 2009 U.S. equity market – where a sudden jolt is followed by years of meandering nothingness – I would have just one current trade suggestion: sell brokerage stocks.

Indeed, speak to any executing broker already, and they will all tell you that the volume of their business is already down by almost a third from any given month across 2007-2008. People are already sitting on their hands – confused, stultified, and increasingly unwilling or uninterested to trade very much.

Will this eventually result in a stock like KBW (Keefe, Bruyette & Woods) to be a $11 stock somewhere down the line?

Given one set of stretched Fibonacci fractal bands, we think a KBW short may easily represent an attractive risk-reward situation. From a fundamental perspective, KBW's financial services focus might make the firm particularly vulnerable.

While there might be more short-squeeze risk in already beaten-up specialist firm Labranche & Co. (LAB), it too appears to have a fractal rhythm implying that it could halve yet again in value over time.

Or how about one of our old favorites: Blackrock Inc (BLK) -- a firm which just finished a $13.5-billion dollar hubris-laden buyout of Barclays Global Investors? Talk about buying a bureaucratic and somewhat dysfunctional asset management firm at the top! Blackrock's purchase of BGI will someday likely be viewed as about as astute a move as the AOL-Time Warner merger was back in 2000.

After all, BLK – while often considered a "chosen white knight" by the U.S. Treasury – is still a very fixed-income centric firm, and fixed income is just starting to fall from grace. Maybe Blackrock considers their foray into BGI as a portfolio-diversifying move into equities, but we doubt that this purchase will do them any favors longer-term.

Not to pick on financial firms too much, but on a fractal basis, we even see Goldman Sachs as having more problems. Yes, GS is rumored to post blow-out Q2 earnings tomorrow, so caution is warranted, but GS should eventually fall back from current levels to at least around 110.

We also believe that value-hunters who are currently scooping up Bank of American (BAC) at what they presume to be half of book value will only hit more potholes and disappointments. On a fractal basis, some of our stretched bands warn that BAC may yet be a 0.

But wait a second, weren't we speaking above of a potential stultified range a la 1993-1996 British pound?

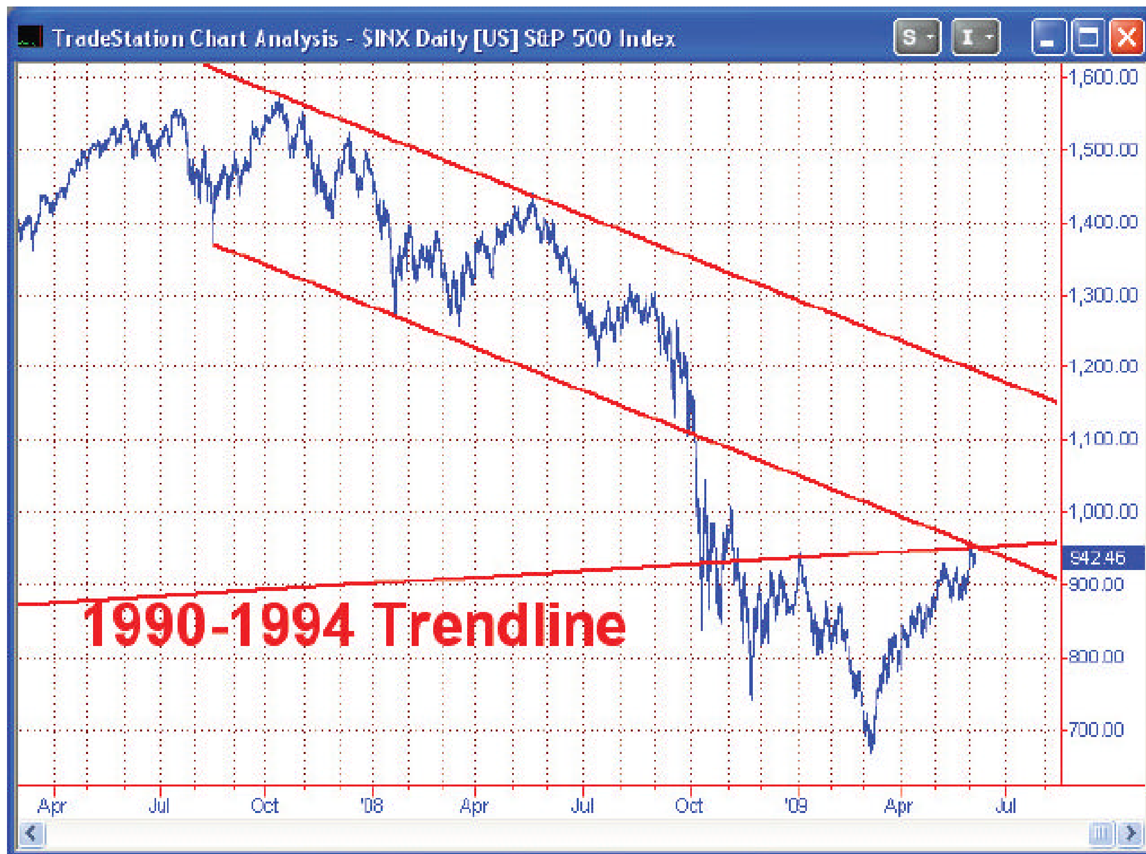
And on an even more potentially bullish basis, haven't we previously sent out an e-mail to subscribers warning of a potential "V" bottom analog to 1949 and/or 2003 – paths we at heart have not wanted to believe in -- but that we had to admit were possible?

Are any of the bearish financial charts presented above really consistent with such other possible analog "pattern matches?"

Anything is of course possible. Energy and metal stocks could conceivably trade firmly over time while consumer-oriented and financial stocks soften again – with the broader S&P indices ending up stuck in the middle in good "push-pull" fashion.

But whether we get stuck in a broader S&P range over time or not, a more immediately bearish view of the market (at least for a trade, if not a massive breakdown) seems appropriate. Here are three reasons why:

First, Peter Eliades recently pointed out the confluence of trendlines just above last week's highs. Not only is there a trendline stretched up from the 1994 lows (that was broken for the first time last fall and is now being retested), but there is a second trendline stretched down across the 2007-2008 lows providing further resistance. Eliades argues that we are at a critical juncture where bearish forces are likely to re-appear.



Source: SMC Letter, June 2009, Peter Eliades

Second, we must not just look at the current quiet market ranges, but we must anticipate what the heavens may hold for human psychology over the balance of the summer. More specifically, looking toward the July-August 2009 period, we note an extremely rare cluster of three eclipses – the first a Full Moon eclipse in Capricorn on July 7th; the second a New Moon solar eclipse on July 21st; and the last a Full Moon eclipse in Aquarius on August 5th. Arch Crawford has previously referred to this period as potentially explosive in its astro implications as any that he seen in the past – including patterns going into the first Gulf War of August 1990 as well as the period pre-9-11-01. Already I have the sense of something foreboding in the air as I commute to New York on many days and see a greater and greater number of police and bomb-sniffing dogs on PATH and subway platforms. If swine flu doesn't get New Yorkers in a bigger way next fall, could a terrorist attack serve to shift investor sentiment sometime over the next eight weeks?

Third, as previously mentioned, we are also entering a period where from a pi cycle perspective, increased earthquake activity might be expected. As we wrote back in our April letter:

> If a major earthquake were to hit the West Coast of the U.S. anytime soon, we believe that this will fall on or around June 28, 2009 as this latter date…will represent an exact 12 * pi * 1000 day interval from the San Francisco earthquake of April 18, 1906, and the same approximate window of time will also represent an almost perfect 2 * pi * 1000 day interval from the swarm of earthquakes that struck southern California (Joshua Tree and Cape Mendocino) in late April 1992.
>
> So is Sand Spring in the earthquake prediction business now? Not really, but we must point out that in November 2004 we did warn that something major would hit to hurt global equity markets on or about December 30-31, 2004. The December 26, 2004 Indian Ocean Tsunami certainly fit that forecast.

The July-August tightly grouped series of three eclipses would certainly also be suggestive of potential earthquake and volcanic activity. Certainly, when we see astro elements such as this period overlapping with a pi cycle forecast, we are particularly attentive to sudden geo-physical activity that might appear as a complete surprise to most others.

And if going back 12*pi*1000 to the Great San Francisco earthquake of 1906 and the 2*pi*1000 cluster of April 1992 earthquakes in California is not enough, one might want to consider that:

- 4*pi*1000 days prior to June 28, 2009 was one day off from the from the Feb 4, 1975 major 7.0 earthquake in Haicheng, China (which killed 2000 people);

- 5*pi*1000 days prior to June 28, 2009 saw a 6.1-magnitude earthquake in Parkfield, California;

- 6*pi*1000 days prior to June 28, 2009 was just a few days off from the 8.1-magnitude Gobi-Altai Mongolian earthquake of late 1957;

- 7*pi*1000 days prior to June 28, 2009 was just a few days off from 7.1-magnitude Puget Sound earthquake of April 1949.

Fundamentally, yes, there is a tremendous amount of cash on the sidelines; super-low savings deposit rates at banks and in the Treasury market as an investment

alternative, and a mild feeling of stupidity by those who have sat out (or fallen behind in their long investedness) across the recent 40% equity market rally. The wall of potential cash that could come into the market has created almost a self-fulfilling "Greater Fools" investment psyche. Most people realize that the average consumer is shaky and cutting back on spending; they know that the S&P is still richly priced vis a vis its expected earnings power; and they know that the U.S. Government is currently engaging in a huge and dangerous experiment with its massive quantitative monetization policy. But at least in dollar terms, people can rationalize their way to still invest. To quote one such investor, "There is so much money looking for a home that stocks may easily go up in nominal terms even as the dollar gets trashed. Higher equity prices in dollar terms simply represents the desired domestic illusion of prosperity – even if America in real global terms actually becomes poorer."

And so it is that we recently completed a month in May where the S&P rose by about 5%, but the dollar against the Euro declined by -7%. Are we really any richer or financially healthier in June given this result? Or have we simply fooled ourselves to think that we are better off?

Indeed, to buy into the view that one should "invest today because some Greater Fool will come along to get on board the market tomorrow" or the corollary view that "stocks will go up as an inflation-resistant store of value as the dollar goes lower" is somewhat presumptive that the government is still in control, and will – by hook or by crook -- win its battle against debt deflation. But things like terrorist attacks and/or earthquakes – either of which could easily further dampen investor enthusiasm --- are simply not factors that governments can control.

I remember back to the time in 1987 when I was running the proprietary trading desk at PaineWebber, and everyone around me was always focused on "What will the Fed do next?" It was as if they thought by answering that single question, they could somehow unlock the key to making money in everything. By comparison, I always thought of the world a bit differently with the query "What will the markets do anyway that the Fed may feel compelled to somehow react to?" I never saw the Fed to be in the lead, but instead, more as an entity belatedly reacting to events forced upon them. Over twenty years later, little has changed.

Indeed, one can argue that the entire Bush/Obama combined reaction to the recent financial crisis has done nothing to solve the core problems of excessive debt. All that has been done is to transfer the ownership of some of that debt to the government, and introduce the <u>next new problem</u> of how the government will possibly fund itself when Chinese demand for our Treasury securities will never be able to keep pace with our government's increased funding needs (Read or listen to Jim Bianco of Bianco Research for more on this). Our government has simply swapped an immediate economic meltdown for a very different potential issue: a "crowding out" effect of government financing needs squeezing out the availability and cost of capital to others. The May meltdown in the U.S. Treasury market has already shown early elements of this. Short of imposing a massive tax hike, and simply to clear the system – to fund itself -- the government is going to have to offer far more attractive interest rates on their debt than are currently in the market. And as interest rates back up, the consumer gets more underwater and squeezed.

But why can't the government just pull out the printing press to fund itself? After all, "Helicopter Ben" is in the driver's seat. However, in such an event, then the fixed income market will get wind of such and will simply fall even faster.

In our humble opinion, the Fed and U.S Treasury have now largely lost control of our own economic destiny. With ever more upside-down mortgages soon to reset from initial teaser rates over the next 12 months, and the unemployment rate ticking higher -- the pie is baked; the clock is ticking – and the inevitable outcome is not an easy "v"-shaped bottom.

So should one rush out instead and buy gold? Nope – or at least think long and hard about picking the right price level before you do so. Gold is already an arguably "crowded trade" (with hedgies like John Paulson and David Einhorn potentially over-exposed to this space), and if interest rates start backing up in earnest, and the consumer stops spending, there could be a rush for the exits by many weak-handed gold speculators. Compared to the equity and fixed income markets, the gold market is tiny in size and filled with many nasty brokers who just love to front-run trapped investors. So while it might sound counter-intuitive given a government engaged in quantitative easing, I honestly could imagine gold tumbling $300 in a matter of days simply on a rush for the exits by a few weak hands. It is only after such a decline that I would likely be buying gold here at Sand Spring, and if I never get such an opportunity, I will simply need to re-evaluate this stance later on.

Part of my thought process here is also related (surprise, surprise) to a pi cycle. Go back and find the low of the XAU Gold/Silver Index, and you will find it to have been at 41.61 on October 25, 2000. Add 3,141 (pi * 1000) days to this date, and you come to June 1, 2009. The XAU recently peaked exactly on that date at 163.34, and has since fallen by over -10%. Given such a technical set-up we are in no rush to be involved on the long side of the gold or gold share market. And yet we acknowledge the danger longer-term to be short this market. Sometimes a market is simply bet left alone.

And so it is that, consistent with our April and May letters that we remain with a few core consumer-sensitive ETF shorts: XLY, XRT, PEJ, and PEZ. We dislike restaurant and restaurant-oriented stocks like PZZA, DIN, MCD, YUM, and MIDD. We remain suspect of the housing sector as represented by the XHB ETF. And now we will throw in a dislike once again for broker and asset-manager-oriented stocks like KBW, LAB, and BLK.

All contents are Copyright © 2009 by Sand Spring Advisors, LLC, Morristown, NJ

Send us your comments at information@Sandspring.com.

AN IMPORTANT DISCLOSURE

Sand Spring Advisors provides information and analysis from sources and using methods it believes reliable, but cannot accept responsibility for any trading losses that may be incurred as a result of our analysis. Our advice should be deemed our personal opinion and not a recommendation to invest. Individuals should consult with their broker and personal financial advisors before engaging in any trading activities, and should always trade at a position size level well within their financial condition. Principals of Sand Spring Advisors may carry positions in securities or futures discussed, but as a matter of policy we will always so disclose this fact if it is indeed the case. Sand Spring's principals currently hold modest positions in the ETF positions discussed in this letter. Sand Spring also offers technical consulting services to an outside hedge fund manager who may at their own behest be involved trading some of the securities mentioned.