# Sand Spring Advisors LLC

## Debt Bubble & Islamic Threats

**by,**

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For over three years now, Doug Noland, sitting at his desk within the Texas offices of PrudentBear.com (a division of David Tice & Associates), has written almost daily about the growing debt bubble in the United States. He has maligned the ever-burgeoning balance sheet of Fannie Mae and the aggressive credit card marketing promotions of companies such as Capital One and Providian. He has criticized excessive government spending and deficits, and in true doom-and-gloom fashion, has sung the praises of gold – an asset that does not involve someone else's liability.

Even while in the long run we have always held Noland's analysis in high regard, Noland's message was so dour and his style of writing so dense and long-winded, that we honestly grew weary of even trying to negotiate his bi-weekly postings. We are well aware that a debt bubble has been building, but rather than constantly harken its arrival in boy-who-cried-wolf fashion, the question always remained in our mind: "What exactly would come along to pop the debt bubble that Noland kept warning about?" Answering this latter question always seemed more important to us rather than constantly reiterating the existence of a growing problem.

This past Friday, the passage of President Bush's new tax bill may be one step toward the debt bubble popping. We say this because by making dividend paying stocks that much more attractive to hold for their dividend vis a vis government bonds, municipal bonds, and other fixed income instruments, the government just changed the rules of investing. They did so hoping to give a favorable kick to the stock market and the economy, but without focusing on what might be very negative for the marginal dollar going into fixed income investments. And if money going into fixed income suddenly slows down, even temporarily, surely the accumulated debt bubble will start to pop.

Greenspan-speak being what it is, it is reasonable to assume that short-term rates will not be heading higher anytime soon. In addition, with a touch of hubris, Greenspan recently announced that the Fed is also considering buying longer-maturity notes – breaking the historic tradition of allowing the back end of the yield curve to be determined solely by market forces. The combination of these two events has led hedge fund managers to believe that they face a free lunch in yield curve carry plays. In many respects, it is simply 1993 all over again with carry trades abounding. How tough is it to borrow at the front end of the curve at 1.75%, lend to the back-end mortgage market at 5.35%, lever that up 3-4 times on top of one's actual principal, and voila, produce steady 15% annual returns net of a 20% hedge fund incentive fee. It seemingly doesn't take a rocket scientist to get rich – and at what risk?

A similar type of carry trade has been occurring of late in the world of foreign exchange. Everyone has been borrowing in cheap dollars and yen on a leveraged basis to buy the euro and European fixed income assets and play the relative carry game. This trade is of course somewhat defensible in terms of the U.S trade deficit, and it is also being aided by the Bank of Japan's constant intervention to buy dollars against the yen – thereby preventing a currency cross rates such as euro-yen from having much probability of ever falling, at least in the minds of most market participants.

But when trades get overly popular and "crowded," they also become dangerous. It is at such a juncture that we believe we currently stand – at least on a short-term basis -- in both the fixed income carry trade and the long euro-yen trade.

Back in August of 2002, we suggested in the chart below that a solid longer-term Fibonacci target for 10-year note yields was in the 2.9%-3.0% yield region, or a price target in terms of CBOT Note futures of approximately 125. We depicted such on the following chart:


While 10-year note futures have not yet come anywhere close to the espoused 125 long-term target, we *are* at the first band of significant resistance – just above 119 -- on the path toward potentially getting to this latter objective with time. In candlestick terms, this past week also left something of a "doji-star" reversal formation on the weekly T-Note chart at a time when Market Vane sentiment numbers are sporting an 85% bullish reading for T-Notes.

Perhaps courtesy of the new tax-bill, it may be time for a surprise shakeout of leveraged buyers of longer-dated fixed income securities. We could easily imagine a surprise reversal in fixed income trends at this point that then puts pressure on the entire debt bubble situation (as mortgage rates also back up as well and refinancing opportunities peter out), that in turn sinks the U.S. economy's ability to perpetuate its already shaky pace of growth. 10-year notes, after a nasty multi-point reversal that starts now, could then eventually still zoom to 125 when “all the shit hits the fan” so to speak (please excuse our language, but this is the most apt description of what could truly happen).   As well-intentioned as the current tax bill’s enactment is, by changing the rules of the game to make fixed income investing less attractive on the margin, Mr. Bush could easily be providing the initial “prick” to the entire debt bubble coming undone. At last some of Doug Noland’s dire prophecies may start to play out.

As one side note on this topic, famed and astute hedge fund manager Bruce Kovner was recently quoted as saying that he believes a “debt bubble” certainly exists – and this comes from a man who actually played a significant role in the 1993 carry game trade.  Financial journalist Jim Grant also recently penned the following potentially astute words: “We remain bearish on bonds, contending that, at prevailing levels, Treasurys provide not risk-free return but “return-free risk.”

Although the reversal in fixed income that Sand Spring Advisors currently anticipates may look reasonably small on the overall chart depiction below, this anticipated chart pattern is obviously just our best guess at one potential long-term path for T-Notes – not something etched in stone.  It also does not address at all what mortgage or muni-bond markets could do in terms of potential underperformance vis a vis T-Notes going forward.

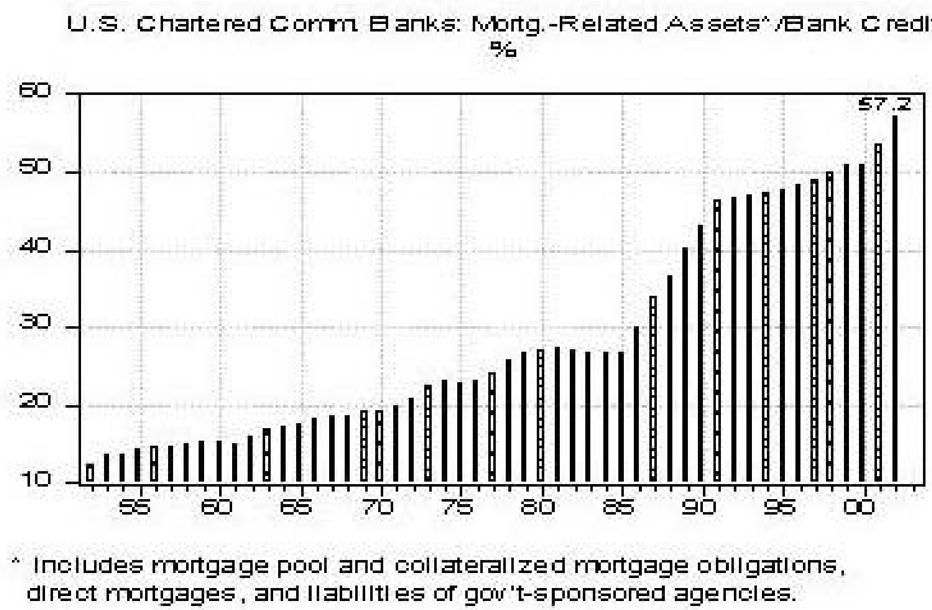

2003 does in many ways feel like 1993 – with the Fed pushing on a string to keep the financial system solvent and awash with liquidity.  1993 came, of course, just after the 1990-1991 Gulf War downdraft in a reasonably similar fashion as 2003 has come after the 2000-2002 economic downdraft related (at least in part) to the events of 9-11, the Afghanistan War, and the latest Iraqi War.  But 1993’s steep yield curve did not solve all of the economy’s many problems at the time (just some of them – such as the banking system’s health and profitability), and only set the stage for yet more trouble in 1994 when fixed income markets imploded, equities plunged (at least intra-year), and the Mexican peso suddenly devalued.  On a preliminary basis, we think 2004 could easily be as ugly as 1994.

One key difference between the current period and 1990-1993 is, of course, that real estate has yet to come undone in the current period whereas a decline in commercial real estate values was a key part of the earlier period’s malaise.  Instead, in the current instance, the U.S. consumer has continued to draw down further indebtedness to buy new houses and refinance old ones. Banks, hurt by commercial real estate loans in the 1990-1991 period, learned some valuable lessons from that experience: they no longer are as willing today to lend on new office construction as once was the case. But within modern financial times, banks have yet to experience significant losses from residential mortgage investing.

Banks also appear to have little fear of residential mortgage lending at present.

As Paul Kasriel recently discussed in a May 15th article entitled "Why Does Fed Chairman Greenspan *Have* To Keep Interest Rates Low?," (see link: http://www.northerntrust.com/library/econ_research/weekly/index.html) banks are more exposed to the residential mortgage market than at any point in history. A full 57.2% of total bank credit is today mortgage-related. Fannie Mae sits as the single biggest client of most major money-center financial institution in this country – with an imbedded presumption by most that "Fannie is just too big for the government to ever let them get into trouble."

Chart 3




What most forget though is even if Fannie Mae is not allowed to fail in the end, the mere threat along the way that Fannie could experience a major loss or become involved in some sort of trouble would be enough to cascade our banking system into temporary chaos. In many ways, we can analogize this banking "blind spot" to the blind spot suffered by most hedge fund managers involved in distressed securities investing. Even if distressed-specialist managers are truly astute and can pick their credit exposures adroitly and avoid becoming directly involved in bad situations that get worse, the mere announcement that a major company such as Enron, Worldcom, or perhaps someday Ford, is going bankrupt can cause all distressed securities to be marked down and cause large losses on a portfolio of securities completely unrelated to the company actually experiencing bankruptcy problems. In other words, it doesn't matter so much if in the end Fannie Mae gets bailed out of any problems that their burgeoning balance sheet may create. The mere path of exposing such problems could be destructive enough to the U.S. economy.

In addition, the banks appear to be increasing their exposure to the mortgage market at exactly the wrong time. The charts below are once again courtesy of Northern Trust's Paul Kasriel. They show mortgage foreclosures hitting record highs together with non-financial personal bankruptcies.

Chart 1

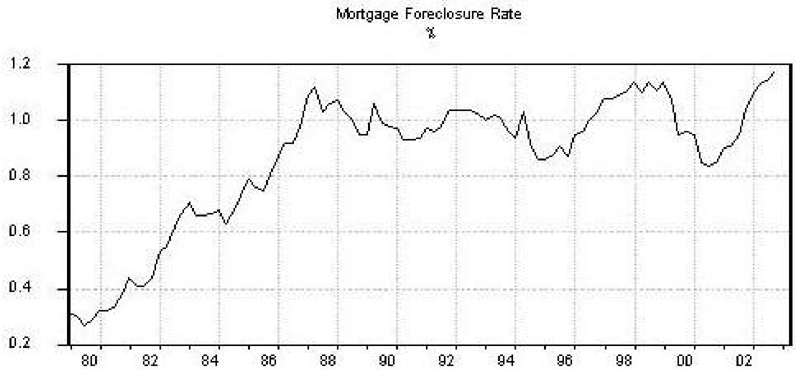
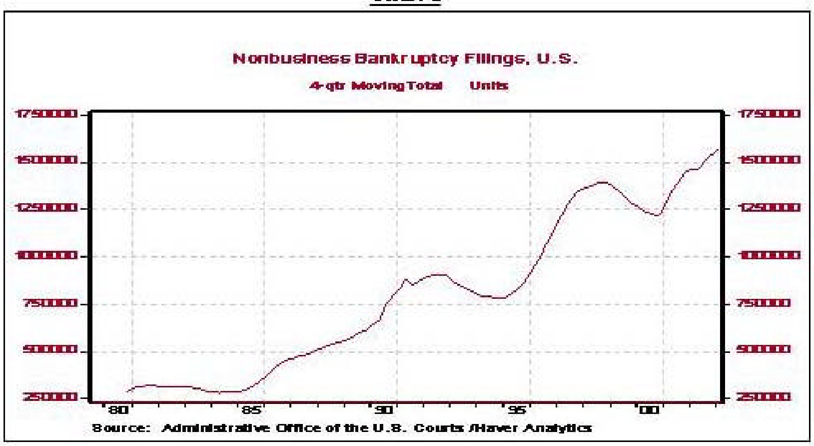



Chart 2




It's funny (and at the same time a bit sad) how a venerable institution such as JP Morgan, where I once worked for seven years, can hit every major pot-hole in the road over 2000-2002. Both JP Morgan and Chase jumped into the dot.com mania at the very worst moment in late 1999; the bank was subsequently hurt by the Argentine peso devaluation; and the bank also succeeded in having significant exposure to both Enron and Worldcom. At present, people talk about JP Morgan getting hurt at some point from gold derivatives trading. While this could of course occur, the size of the bullion business for JP Morgan is like a fly on an elephant. I scoff that it could ever cause JP Morgan anything other than mild irritation.

But a problem with Fannie Mae and the American residential mortgage market – now, that would be more serious. Greenspan is currently trying desperately to avoid such an occurrence at any cost, but the weapons at his disposal (namely keeping rates super low) only seem to be creating a bigger problem in the long term. If investors abandon mortgage investing even on the margin in order to buy utility stocks paying steady and now more tax-efficient dividends, problem days could soon be upon us – Mr. Greenspan's best efforts notwithstanding.

**A Second "Crowded" Trade**

Of course, we mentioned above another "crowded" trade – that of euro-yen. This chart appears as below, and for longer-term perspective, we still like to look at the chart of mark-yen to glean the best unfudged technical picture. We see both short-term divergence on the RSI of the first chart below as well as a complete looking 5-wave ascent. On the second longer-term dem-yen chart, we see a complete looking Fibonacci rhythm and a 61.8% retracement of the 1998-2000 dem-yen decline just slightly surpassed.


FXEUJYMUL [20] - Euro CONTRIB: TRD LAST: 138.41 CHANGE: ▲ 0.11 HIGH: 138.51 LOW: 138.31 5/23/2003
1
2
3
4
5
135.00
130.00
125.00
120.00
115.00
RSI (FXEUJY,14) = 72.14
76.00
62.00
48.00
34.00
Jun Jul Aug Sep Oct Nov Dec '03 Feb Mar Apr May Daily


DEMJPY A0-FX - D-Mark/Japanese Yen Cash, Daily
05/23/03 O: 70.0700 H: 70.8100 L: 70.0000 C: 70.7500 +0.6700
DEM-JPY
slightly past 61.8%
retracement
of 1998-2000 downmove
0.000 (70.7446)
0.090 (68.4807)
0.236 (64.8189)
0.382 (61.1570)
0.500 (58.1954)
0.618 (55.2338)
0.764 (51.5719)
0.910 (47.9101)
1.000 (45.6462)
80.0000
75.0000
70.0000
65.0000
60.0000
55.0000
50.0000
45.0000
11/30/05
#3047

We do not know the potential catalyst here to reverse this upswing, but we do know that the Market Vane sentiment indicator on the euro is currently at a lofty 85% bullish (yes, coincidentally, the same level as T-Notes) while sentiment on the yen is only a middling 45% bullish. At some point soon this chart portends a nasty rush for the exits by trend-followers late to the party.

**Implication for Equities & Muni-Bonds**

So overall, we have a strong immediate vision that the U.S. Treasury market trades lower and euro strength soon reverses -- at least for a bit.

Under normal circumstances, given those two views, one might expect that these two events could go hand in hand with a better performing equity market. Certainly the neophyte perspective would be that the added Bush stimulus tax package adds yet another dose of liquidity sloshing around the markets, and that some of this liquidity finds its way into equity investing (particularly in high-dividend paying names); then higher equity prices eventually increases consumer confidence, leading people to sell safe-haven bond and currency hedges.

Could it happen like that? Anything is of course possible, but in the current instance, we still doubt it. Some money will of course be attracted to dividend paying equities, but at the end of the day, equity valuations are still driven by real earnings – and current equity valuations vis a vis current earnings and realistic future earnings expectations remain very high. In addition, whether one looks at the current dividend yield, Tobin's Q, or price-to-book levels, all point to an equity market of little long-term value.

The government -- via its current steep yield curve and dividend tax-break changes -- is really just trying to fool the public into believing that the equity market does represent good *relative* value. They are trying to perpetuate a "greater fool's theory" in investing, and in the process have created yet a bigger debt bubble destined to pop.

All of this is, of course, made worse by the pension fund accounting situation that we have previously discussed at some length. The Pension Benefits Guarantee Corporation's chairman recently acknowledged that the U.S. private pension system is underwater by over $300 billion, with the public sector pension situation in even worse shape. This is going to divert much future cash flow away from hiring new employees or building new productive plant and equipment. Corporate America, like the over-indebted consumer, has instead started to feel compelled to at least try to save. Debt needs to be paid down and pension plans continuously topped up. Let that read that leveraged America has already started to be forced into paying back the piper that led us through at least three decades (starting with the Vietnam War) of excessive spending. On this topic, Bill Gross of PIMCO recently offered the following analogy:

> "Attention K-Mart shoppers and the private sector everywhere! You have morphed into a wet log. Uncle Sam, Uncle Alan, and assorted global kin are trying to light your fire again, but so far there's been mainly smoke and very little heat. Wet logs don't burn very well….Sure, policy makers could keep on applying the kindling – low interest rates, increasing fiscal deficits, and perhaps even a Bernanke blowtorch if need be – but that's not a self-sustaining fire. If anything it leads to more bubbles and new instabilities."

We recommend Mr. Gross's entire piece entitled "Is That All There Is – To a Fire?" (available at http://www.pimco.com/index.htm) to any reader who has yet to read it. Please note however that we disagree with Mr. Gross's suggested investment path at the end of the article. Instead of concluding as we do that both equity and bond markets are fraught with danger at the present time, Mr. Gross ends a great article in a wimpy fashion by suggesting that investors "purchase municipal closed-end bond funds that take advantage of mild leverage and borrowing costs near 1% to offer yields in excess of 6%." In other words, after defining the existence of a debt bubble, Gross then blithely recommends that investors join the party – get on board – by investing in levered municipal bond funds. Mr. Gross also ignores the potential dent that Mr. Bush's dividend tax cut could put on muni-bond demand.

Municipal bond issuance – with tax receipts down and local deficits blossoming across the country -- has of course been on a real rip in 2003, currently up over 23% from 2002's pace. But another thing Mr. Gross does not ask in his article is: "How far off are we from a municipal bond problem of some sort?" Mr. Gross fails to mention how Fidelity Investments research division Vestigo Associates recommended earlier this year that customers sell municipal bonds insured by MBIA Inc., citing the insurer's risk of losses on derivative transactions. In our humble opinion, anyone thinking of following Mr. Gross's general advice should look for pre-refunded municipal bonds. These yield a tad less than normal municipal bonds, and may still be subject to market volatility, but their pre-refunded status ensures that credit risk is largely eliminated from the investment equation. Held to maturity on a levered basis, one should indeed do just fine.

Of course, savvy hedge fund managers (at least those uninvolved in fixed income carry games) combined together in a fund of funds type of format will still likely beat muni-bond returns in coming years. But *note bien*: here we are blatantly talking our own book since we run such a product and maintain the majority of our own liquid net worth within it. Our fund of funds is currently up 4% year-to-date and approximately +21% net of fees and expenses since its July 2000 inception. While some of these gains are taxable, and past performance cannot be any indication of future performance, we still like this "safe haven" investment over levered muni-bond investing. After all, if one doesn't have to take any implicit exposure to a chart such as the one below – MBIA – why do so?


As an aside, Golden West Financial, a popular West-coast variable rate mortgage lender is one stock in particular that we continue to watch as a clue that messier times are finally at hand in the mortgage arena. Its upward-sloping wedge formation (shown below on both a weekly and daily basis) certainly looks ripe to break lower – in spite of Alan Greenspan's loosey-goosey rhetoric and ongoing pump priming.



**Islamic Wrath**

If we have not already been too dour this month, we must of course reiterate our cyclical concerns for the months of June and July 2003. June 1st is specifically 628 days (2*pi*100) post September 11, 2001, and we received from one subscriber the other day the following astrological snippet regarding June 3, 2003:

JUN 03, 2003 | 03:36 AM | 180 | 13LE06 | 13AQ06R
There's one more chart of particular interest at this time in history; namely the chart for Islam itself (set for Mohammed's arrival in Medina). In that horoscope, the Mars super perigee falls right across a Jupiter-Neptune opposition - the latter aspect appearing again in 2003 as it did at the foundation of Islam in 622. It's unprecedented, so who could know what all this means? I suspect it points to some kind of attack at least as big as the January-February clash. And this time around, the attack seems to focus on technical and economic infrastructure (e.g. computer and network assaults) - or uses highly advanced military weaponry. It seems highly likely that one focus of this is the war between Islamists and Western civilization: a major terror attack, a significant reprisal, something of that sort.

Combined with the fact that July 8, 2003 will represent 6,282 days (2*pi*1000) post the Chernobyl explosion of April 26, 1986, and Christopher Carolyn points to yet another lunar cycle date on July 29$^{th}$ (just after our PEI cycle date on July 27, 2003) that he can relate back to the Crash of 1987, the Crash of 1929, *and the nuclear explosion at Hiroshima*, we are extremely nervous about the early summer from a geo-political perspective.

Net-net, while certain high dividend paying stocks have already experienced a market rotation in their favor, we continue to see the risk of surprise equity weakness – perhaps of some significance -- developing this June and July. To our eye, the NYA Index is the easiest chart pattern to interpret in this regard, and is depicted below. Late July lows toward 415 (potential end of v of 3) could be followed by an 8.6-month 4$^{th}$-wave bounce into the spring of 2003, and then be followed by an ugly 5$^{th}$ wave decline (to finish a larger I-Wave down) into the late December 2004 PEI cycle date.


For our own part, therefore, New York City will not be on our agenda for June 1-3, July 4-8, or July 27-29. Neither will be levered fixed income investing either directly or for our fund of funds (although some of our multi-arb managers may regrettably still have a bit of exposure here). Nor will be chasing the recent equity market upswing.

Instead, we plan to look for growing "cracks" in the façade of the fixed income world, and while maintaining a short S&P exposure for part of our portfolio, may also selectively short some companies with the greatest exposure to a mortgage market malaise should such start to develop. We have already mentioned above Golden West Financial as a potential short candidate, but many others certainly exist. To our eye, companies such as Wells Fargo, Citigroup, and MGIC sport particularly bearish looking chart patterns at present that deserve close attention. In addition, past home building short recommendations such as Toll Brothers that have recently rallied back significantly (in the case of TOL, making a 76.4% retracement of its May 2002-March 2003 downmove at $28.11 this past week) may also hold new opportunities to resell. At some point we will get excited about shorting Fannie Mae itself. While its chart pattern is still not quite as compelling as some of these others, it could easily become so. All we need at this point is a clean break of Fannie's $58.40 low to open up a downside objective toward $39.26.


In addition, in the consumer cyclical sector, we also still dislike the chart patterns of Walmart, 3M, and Deere (with P&G still suspect as well, albeit to date, frustratingly well bid). Within tech, KLA-Tencor, Novellus, and CDW Computers remain chart patterns that also appear singularly vulnerable.

From a personal perspective, we obviously hope that June and July end up passing without a major geo-political or nuclear incident. We honestly hope that we can look back in a few months and say our warnings about a nasty summer were wrong. For the moment, however, it is our job here at Sand Spring Advisors to point out the various cycles at hand and the risks implied by these cycles as we see them. We sincerely hope that some of the opinions expressed here may simply help Sand Spring subscribers continue to preserve their wealth and invest conservatively through extraordinary times.



Send us your comments at information@Sandspring.com.

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