Sand Spring Advisors LLC

Falling Off the Edge Early

by,

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In prior communications, and at least for the immediate period between late 2008 and March 2009, we basically expected 800 to mark the lower end of the S&P 500 Index range and 1060-1100 to mark the upper end of the range. We then expected a scary plunge lower into our April 16, 2009 mini-pi cycle date, followed by more buoyant markets later in the year. This expected pattern was based in part on an analog to the manner that markets behaved in 1938 after their 1937 swan dive lower.

In our mind, history was rhyming a bit with a 69-71-year lag: the 1929 top lined up nicely on an analog basis with the 1998-1999 top; the 1932-33 low lined up with the 2002-2003 low, and the 1937 high lined up with the 2006-2007 high. Master technician George Lindsay in his 1969 book *The Other History* (now out of print) wrote about history resonating at certain points approximately 69-years apart. From his grave, he might be most proud of our current analog assertions.

On a broad brush basis we continue to like this overall analog, and it would be suggestive of continued choppy markets across 2009-2010. Our pi cycle work is then suggestive of an ultimate June 2011 low that on an analog basis could be seen to line up with either the mid-1940 low or the mid-1942 low. If the analog were to work perfectly, the increased whiff of another major war (Iran vs. Israel?) might soon start to permeate the news pages.

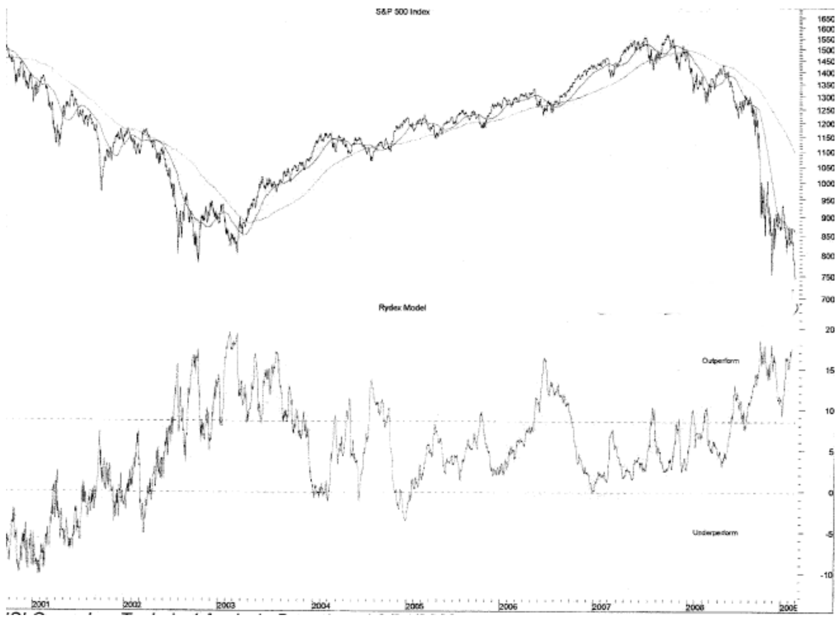
However, when prices started to slide below 800 on February 17, 2009 after the Presidents' Day long weekend (in front of which one presumes many traders got square), we started to become concerned that the "final rally into early March"-leg of our expected choppy path was not working.

We initially thought that our range might be just slightly off.

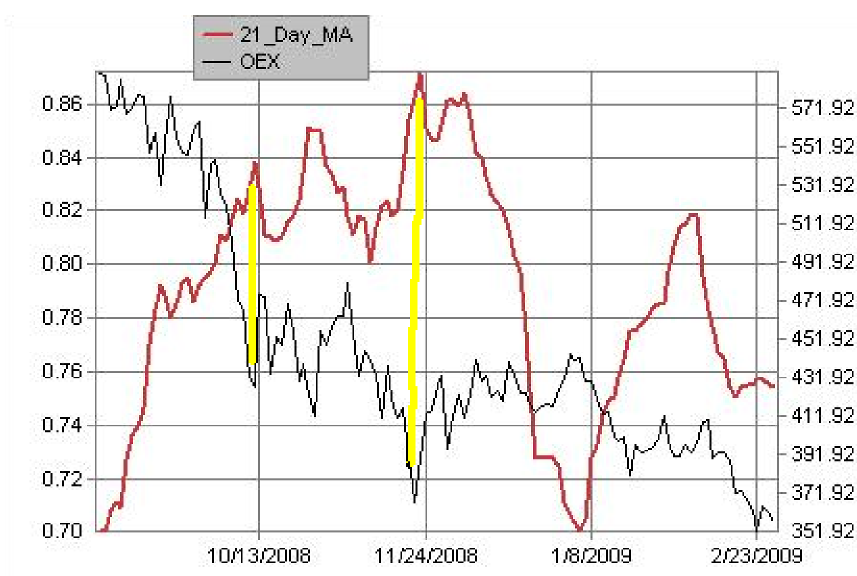
Bearish sentiment statistics reinforced our unwillingness to definitively change our opinion for about the past eight trading days. As reported by the American

Association of Individual Investors on February 19th, there were only 21.6% bulls versus 56.7% bears according to their surveys. Such a level was fast approaching the 57.1% bear reading on November 21st, 2008 and the 60.8% bear reading seen last October 10, 2008.

The chart below provided separately by a friend shows a similar type sentiment picture built around the relative popularity of various Rydex Mutual Funds designed for directional market timing by retail investors. It would imply being closer to a buying opportunity than a new major leg lower in the market.



But throughout the past eight days, while sentiment statistics have suggested an eventual rally, other market internal measurements of fear and loathing have not appeared. More specifically, the CBOE put-call ratio has not gotten anywhere near as extreme as it became last fall during the twin lows of October and November. To see a real low, the 21-day moving average of the CBOE put-call ratio (red line below) should be quite a bit higher than it currently is.



Instead, equities just grind lower day after day in quiet complacency. There has been no panic. Market volumes have actually been reasonably anemic. No selling crescendo appears, but instead just a steady drip. Many executing brokers we talk to say that the past two weeks have actually been among their quietest in terms of volume for the past two years. Per one of these brokers:

> "Most people think stocks are reasonably cheap, and have money on the sidelines available for investment, but they see no need to pick a bottom until they first witness better market price action. And the better price action just never comes. We've had a number of violent rallies – days where we end up 3-4% -- often driven by short-covering, but no matter how sharp and violent these days initially appear, the market just peters out by the following morning. Meanwhile, those who are bearish see no reason to press their bets into the hole. So they just sit there too. The market drifts lower day after day on relatively light volume, and without signs of a final panic or capitulation."

Meanwhile another quarterly redemption cycle looms for hedge funds on March 31, 2009, and if many hedge funds imposed gates at year-end 2008, awaiting "better market conditions in which to raise cash," the clock is ticking on these managers to do so, and the ultimate investors are generally fuming and hardly rescinding their redemption requests.

<u>It is with the above backdrop in mind that we must now admit that the choppy range that we expected to hold until early March 2009 has apparently broken down earlier than we expected.</u>

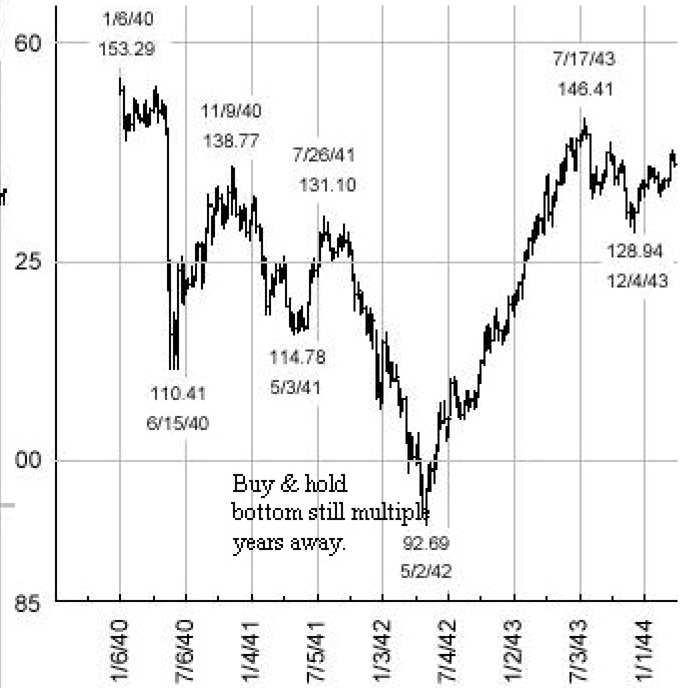
Referring back to our 1938 analog, stocks left a low 11/23/1937, and then rallied for ninety calendar days until 2/21/1938. From there, they stumbled lower for 38 days until a March 31, 1938 low. In 2008, we left a low 11/21/2008, and then rallied anemically until 2/13/2008, and now face a pi cycle date April 16, 2009. Counting from 2/13/2008 38 days forward, a low might be expected as soon as the third week in March, perhaps with the April 16, 2009 pi cycle representing a turn back to the upside, or perhaps being a date of more importance to some other market.

Let us repeat here two warnings about mini-pi cycle dates:

1) We have found that low pi cycles often come early by a week to 10 days, with the pi cycle date itself often representing a period when markets are already vaulting higher. (The Nov 2002 and March 2003 pi cycle lows both witnessed this phenomenon.)

2) It must be remembered that this forthcoming pi cycle date could have more to do with something other than equity markets. Maybe it will represent for example, a turn in the gold market, energy market, or bond market for example.

As a third caveat, one must remember that even if late March to early April yields a tradable equity market low, it will do so within the confines of an overall bear market pattern that is due to continue at least into June 2011. On an analog basis to the 1938 period, stocks were not really cheap enough to "buy and hold" until May 1942. Indeed, the world was only just marching into a major world war in 1938. Things on an overall basis got worse not better – even if late 1938 to early 1939 did yield a large rally first.



The policies of President Obama also seem to be a cross between FDR government-centric entitlement spending and Hoover-like tax increases on the rich that are unlikely to be blithely accepted without much anger and angst. *On an overall basis, the entire force of the government is trying to keep interest rates artificially low and asset prices artificially high.* What follows is perhaps the best e-mail on this topic that I have read of late:

> I wish I could ask Ben B the following question:
>
> If you were a prospective homebuyer, picture your average home for sale in Southern California, say it's currently valued around $400,000 ($600,000 at the peak)....would you rather pay $400,000 for it with a loan at 4%? Or would you rather pay say $200,000 at significantly higher rates...say 11%? Assuming your monthly payment is roughly the same ($2000).
>
> Answer if he was honest: would be he'd rather pay higher rates on a cheaper house. This would mean that as rates dropped from high levels, his house would increase in value,

and he could refinance lower. In addition a larger portion of his payment is tax friendly.

So next question: If you were a lender, would your rather lend someone money at 4% to buy a $400,000 home, or at 11% to buy the same house for $200,000.

Answer is obvious.

Is private capital to lend to homeowners more likely to appear when the govt is guaranteeing rates on high priced assets, or when returns are much higher for people buyer lower priced (and less likely to drop more) assets?

Answer: Private capital can't compete with the govt who is willing to lose money on every loan. Private capital will sit on the sidelines.

So...we know the solution going forward for future buyers and lenders....let rates rise to natural levels that will collapse asset prices and attract private capital.

Why not choose this solution?

It's obvious...the normal, market driven solution kills current asset holders and perhaps the whole economy.

Those in power are current asset holders and would suffer the most from letting the market work. There is no way they will sacrifice themselves for the health of future buyers and sellers.

Bernanke, admitting he is trying to save "franchise" value..i.e. specific brand name, i.e. we don't want any healthy banks...we want THESE banks (i.e. current employees, stockholders, and management).

Conclusion: We are sacrificing long-term health for the sake of those who have the most to lose, at the cost of those who have most to gain: those who stayed on the sidelines, raised cash, and waited for prices to collapse so that strong hands can remove them from the weak. In this case the weak hands have the reigns of government and won't let go.

So to a very large extent everything Bernanke and Obama are trying to do are unlikely to solve America's core problems. Instead, they are likely to just smooth out or otherwise disguise the pain, use the crisis as an excuse to redistribute wealth, and sweep the actual tough answers and solutions to America's problems under the rug. Obama espouses wanting to avoid Japan's "Lost Decade" but this is exactly where he appears to be headed. Despite his admitted eloquence in front of a microphone, we continue to see Obama as exactly the wrong type of President at the wrong point in time.

There is also a certain myopicness to President Obama's economic thoughts that scares us. Asked in his first press briefing how it was that the issuance of more debt by the U.S. government was somehow going to solve the American consumer's excessive debt build-up for the past two decades, Obama responded: "Now hold on a second. Let's get one thing straight: The American consumer did not create the current economic crisis; *the banks did*. The banks are the ones to blame for their greedy lending policies and excessive use of leverage." Nowhere in his response was there any admission that banks had in turn been led like mice by Pied Piper Alan Greenspan. Nowhere did he admit that it was Congress who put pressure on Fannie Mae and Freddie Mac to relax their lending practices so that more people could qualify for home loans. Obama simply does not see government as having had a hand in the current crisis except perhaps through benign regulatory neglect.

So where to invest? The answer over the longer-term may easily be gold, but over the very short-term, it is <u>not.</u> The gold market is as speculatively lopsided at present as almost anytime that I have ever seen it. Market Vane Bullish Consensus numbers have been running in the 90%+ bullish region for sometime; CFTC Commitment of Trader reports show speculative longs dominating commercial longs to an unhealthy degree; and yet fundamentally, scrap gold is being delivered out of Asia to an unusual extent. Consider the following Dow Jones news blurb:

> European gold refiners are being overwhelmed by scrap sales from Asian and Middle Eastern jewellery owners, who are cashing in on the surge in gold prices. Scrap gold sales of jewellery and old gold bars now outweigh demand for coins, new gold bars, and gold exchange-traded funds, which has fallen into a brief lull in the past week after a huge burst of growth in recent months, the refiners said. "The selling has been constant in the past three to four weeks," said Afshin Nabavi, head of trading and physical sales at MKS Finance, a bullion house that owns Swiss refiner PAMP SA, one of Europe's largest. "We're seeing here in Germany but mainly in Asia tremendous amounts of scrap gold," said Wolfgang Wrzesniok-Rossbach, head of marketing and sales at Heraeus Holding GmbH, one of the world's biggest gold refiners. "There's more scrap coming in now than physical gold and ETF demand." Refiners now have a backlog of supply that may take a few weeks to process, he added. A large Swiss refiner with plants in Europe and Asia said on average they are receiving about three to six tons of gold on a daily basis from customers in the Far East and the Middle East. Michael Kempinski, a trader at Commerzbank, which has a 35% stake in Argor Heraeus SA, another large European gold refiner, said the amount of scrap the refiner is taking in is "huge." Medium-sized gold dealers and fabricators who normally buy 10,000 to 20,000 ounces a week are now delivering one to two tons of scrap gold to Argor Heraeus, Kempinski said. Even in Europe there are some signs that investment demand for gold bars and coins has slowed, Heraeus said in a report this week. Once gold rose above $980/oz, demand in Germany slowed down. Precious metals dealers in Germany are reporting investors are selling old Krugerrand gold coins, a reversal of last year's scramble for the South African coins. While the scrap gold sales have worried some analysts that it may overwhelm investment demand, the tap could quickly shut off. Scrap sellers are extremely price sensitive, and with prices falling away from the $1,000/oz level scrap sales may dry up in days, said Wrzesniok-Rossbach. And as the financial outlook remains extremely uncertain, the rush fever for bars and coins among European investors in January and early February is likely to resume, he added. "With prices lower, that kind of demand is going to intensify." (Dow Jones)

If the equity market continues to fall for the coming three- to four weeks into late March, we could easily see a capitulation of sorts by people invested in the energy and precious metals areas. This could set up for a much stronger second half of the year –

particularly in energy -- but the first trade could easily be lower. It is also the wrong seasonal time of year to be heavily long of gold. Jewellery demand out of India traditionally drops off this time of year, and fabrication demand for the Christmas season does not start until late June. Gold could drop to $848 or lower in a heartbeat.

In the meantime, within the energy complex, we have previously espoused holding the DIG ETF on the long side, and with time, we still like DIG as an *investment*, but it has been a frustrating *trade* to date that has not been working, and DIG may be vulnerable for this coming 6-week expected "flush" period of time. Ominously, the chart of the XLE energy ETF shows a clear missing low down near 35:

So imagine if you will a period of hedge fund "forced liquidation" (to meet March 31st redemptions) and true general capitulation over the coming several weeks. In many ways, this move is likely too late to play aggressively, but the general key to larger investment success will be to be onsides enough to be a buyer when a late March or early to mid-April "ping" of a bottom finally comes.

We have one other timing tool to help us predict that April will bring a reversal month higher. Readers may remember us writing in the past that complete moves in markets often take 7, 11, or 18 months to complete (a timing technique taught to us by Marty Armstrong). When we saw for example crude oil having advanced for only 16 months back in May 2008, we immediately started thinking of July 2008 – 18 months – as the reversal month to watch. At present, equities topped in October 2007. Not counting that month since it was still a net advance, equities have been falling for 16 months between November 2007 and today. April 2009 will be the 18-month window to expect a reversal.

Lastly, let us discuss a few individual stocks and sector thematics.

How would you like to be running a massive utility with high fixed costs, the prospect of eventual Obama-imposed added emission permit costs, increasingly empty apartment buildings and office complexes, and yet a limited ability to push any rate increases past regulators during a recession/depression. Despite a 5% dividend payout, we are bearish on Con Edison (ED).

Similarly, many investors appear to be hiding in stocks like Burger King (BKC) and Papa John's Pizza (PZZA), but we feel that the consumer has only just started to cut back on discretionary dining, and even these low-end restaurant chains will be hurt. The fractal rhythms on both companies point downwards.

These last few stocks are among those where we remain particularly bearish. As for individual names on the bull side of the equation, our letter of late March 2009 will hopefully hold many.

Send us your comments at information@Sandspring.com.

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