Sand Spring Advisors LLC

The Potential Feel of 1907, or Not?

By,

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First in 2007 there was a crisis with one Bear Stearns hedge fund. Then in 2008, it was Bear Stearns itself. Concomitantly, firms like Countrywide, Washington Mutual, Wachovia, Key Bank, and even AIG all have plunged into an abyss. Rumors of problems at Lehman Brothers abound. Former darling mortgage insurers like MBIA, Ambak, and PMI hover in single digits – albeit their formal credit ratings still remain higher than one would expect. Next throw in an earthquake in China, and voila: a scramble for capital intensifies.

Flash backward to the years 1906-1907 (courtesy of the recent book: *The Panic of 1907* by Bruner & Carr):

The crisis in this earlier era actually *started* with an earthquake – the big April 1906 one in San Francisco which put immediate strain on the insurance industry. In 1906 there was already a strong demand for money particularly by railway and industrial companies. The San Francisco earthquake just hastened a strain on the world's capital supply and credit facilities.

While post the earthquake, U.S. equities initially rallied on into September 1906 [let that compare to equities continuing to rally into Oct 2007 even while credit spreads started widening in late February 2007], a slow steady decline in equities then started. By mid-March 1907, a cascade of declining days for equities finally hit of some magnitude until investors took courage from an announcement by the U.S Treasury that it would deposit $12 million with national banks to ease the money situation [a la March 2008 and the Fed liquidity injection and arranged buy-out by J.P. Morgan of Bear Stearns].

Immediately following that liquidity injection in 1907, there was a swift rally and strong opinion that the worst of the crisis had past. But then volume on the exchanges petered out. During April and May 1907, stocks started to slide yet again. [Let that compare to stocks vaulting higher in April 2008, but then starting to slide south again in May and June 2008.]

In the summer of 1907, a new rule by the Bank of England designed to protect its own gold reserves made it harder for U.S. firms to re-finance themselves [let this period compare to the Bank of England protecting its own interests across the Northern Rock crisis, and Congress now encouraging the CFTC to impose new regulations with regard to oil speculation limits – attempting to change rules in mid-stream]. In 1907, courtesy of the Bank of England regulatory changes, liquidity conditions in the U.S. capital markets only worsened as the flow of gold to the U.S. reversed.

Then New York City suddenly faced an inability to finance itself as its bond offering met paltry bids [a bit akin to the muni-bond auction rate security crisis of spring 2008].

From June through September 1907, amid a general atmosphere of capital stringency, U.S. equities dropped another 8.1%, accumulating to a decline of 24.4 % for the first three quarters of the year. By October 1907, commodity markets had come under severe duress as well, with copper prices falling daily. Foreign firms started to face financial stress, and increased their sale of U.S. securities to raise liquidity. The sale of these securities simply increased the stress on the value of collateral within the U.S. financial system in a "perfect storm" type of way.

And then came a doubling down bet by Otto C. Heinze & Co in the fall of 1907 whereby that firm tried to create a short squeeze in the shares of United Copper Company – which they already owned substantial portions of – but alas, the squeeze failed, and sent Heinze & Co. (as well as several trust banks and brokers that had backed Heinze) into a mad scramble to survive. Bank runs started; the NYSE was soon near bankrupt; and broker Moore & Schley was teetering on insolvency, owning too much collateral in one Tennessee Coal & Iron company which was falling daily in value. If Moore & Schley failed, several other brokers seemed destined to fall.

All that stood in the way of a real disaster was one man: J.P. Morgan – who in a variety of late night and weekend sessions patched together various ways to save Moore & Schley, the NYSE, the City of New York, and numerous banking institutions.

Now back to the present day by way of comparison….

Will June through October 2008 hold a similar path as June through October 1907? Could the double down bet of Otto C. Heinze & Co. end up being akin to some double down bet yet to be made by Kirk Kerkorian or Cerberus Capital on the U.S. auto industry?

More importantly, if the analog year to 1907 continues, do we have a modern day J.P. Morgan to save us? Lloyd Blankfein at Goldman Sachs today is certainly no J.P. Morgan type of persona. Hell, Lloyd will have his boys running aggressively short well before he is likely to risk Goldman capital helping out other financial institutions. And is Jamie Dimon at J.P. Morgan Chase really up to the task to fill the elder JPM's shoes? Meanwhile Ben Bernanke is the whiney "accountant type" who it is hard to imagine being forceful and adroit on a repeated basis. The current team of financial leaders staggered through the Bear Stearns crisis, but could they do so again and again if more crises continue to arrive?

Our own view is mixed at present as to whether we have a crash now into our July 31, 2008 pi cycle date, or whether this crash type of behavior will be averted until 2009-2011.

Originally, we anticipated that late July would simply represent a "faux" break of the March 17th market lows, with the DJIA reaching 11,350 and the S&P reaching the 1230-1243 region, scaring the hell out of everyone, and then rallying for the balance of the year.

But as we type this letter on June 28th, the DJIA has already reached our 11,350 target, and the S&P 500 is no more than a few bad trading days away from our 1230-1243 target as well.

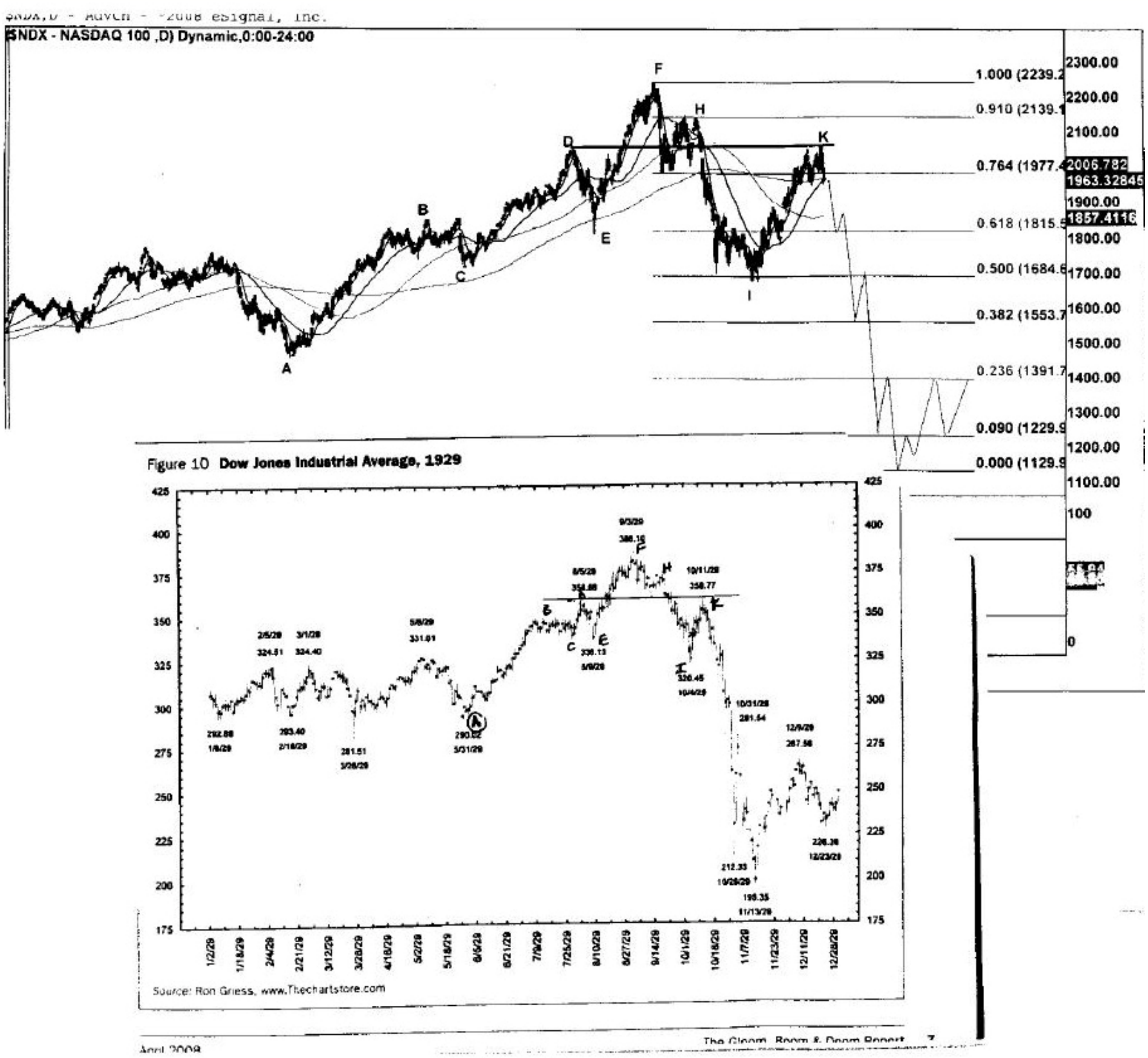
The problem we face: all of this is happening a bit early, with too many trading days still available into the July 31 pi cycle window. If the DJIA doesn't hold right here at 11,350, our stretched band Fibonacci fractal techniques will begin to point to a real crisis in July with far more serious damage.

During May and June we e-mailed out to readers various analog pattern matches that looked very scary. We found the 1937 DJIA chart (mislabeled to be an S&P chart) very similar in structure to the current 2008 S&P 500 chart. We also found the structure of the current NASDAQ 100 not dissimilar to the pattern of the DJIA right before the Crash of 1929.

We reproduce these possible analogs below. Added to the 1907 analog of events described above that compare quite closely to 2008, we must admit to being somewhat scared about the brewing progression of events here.

Sent by e-mail May 19th: 1937 DJIA vs 2008 S&P

Sent by e-mail June 10th: 1929 DJIA vs 2008 Nasdaq



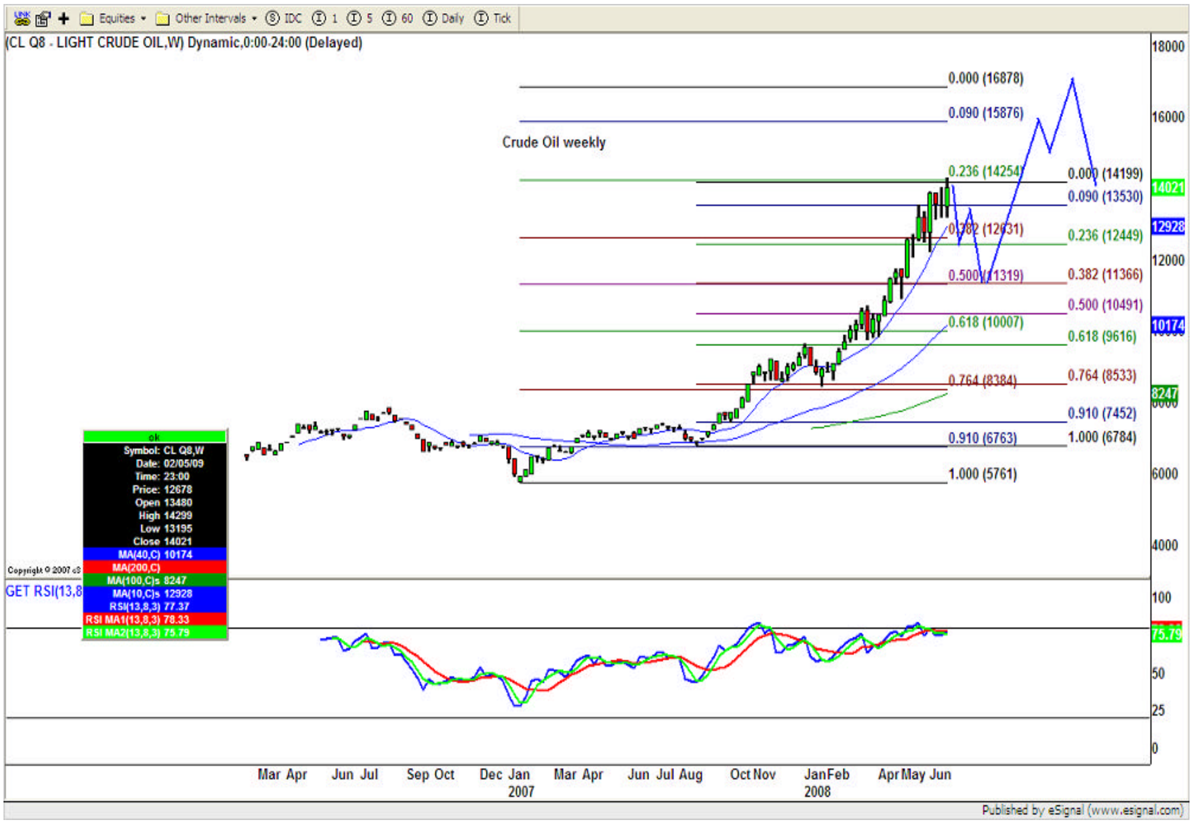
For these analogs to continue to play out, the key to watch out for would be crash-like behavior in any or all of the "four horsemen" of AAPL, GOOG, RIMM, and AMZN. If the public starts to really dump these stocks, stay out of the way. The markets could be a "trap door" scramble to the downside.

Oil Reversal to Potentially Save the Day

But even if this trap door opens, we would also not be surprised to see at least one sharp equity rally in the very near term off of this past week's oversold conditions.

Indeed, an easy "knee-jerk" excuse for a rally might be a reversal lower in the oil market.

We previously espoused an extrapolated "natural attractor" high for oil around the $141.00-142.70 region. This target was hit this past week. Even if oil eventually trades higher towards another fractal target up near $169, we are reasonably confident that a downswing to the $113 area will occur first. Equity markets could initially be quite happy about this.



We can certainly imagine a collapse in oil "saving the day" for the equity market – at least in the short-term. Oil trades down; equities pop; weak shorts get squeezed; and then maybe afterwards, equities trade down again. An oil correction would certainly be perceived as good, but in the end its impact might be more mixed. After all, one of the few sectors that have been holding up the S&P 500 has been the energy sector. Across early 2008, financials going down and energy stocks going up have largely canceled each other out in equity index price terms. If we now move towards an environment where financial stocks are going sideways, while energy stocks start to fall, it will be hard for the major equity indices to really rally that much.

But a pop higher in equities across the first week of July on the back of a sudden reversal in oil could be just enough to gain some time for our July 31st cycle window to represent a secondary retest of current market lows – without a real further crash from here.

While we are loathe to make a specific equity prediction amidst current market volatility (and at least the potential for a crash into July 31), overall, our rational mind now leads us to expect the following more muted equity path as most probable:

Please note that the late March 2008 pi cycle "buy signal" that we issued was in our mind a relatively "easy trade." So too in general terms was the early May 2008 "sell short" advice. **The current equity market is trickier and more complex.** One side of our psyche believes the worst is over, and the equity market is about to come up for air. This is largely based on individual chart patterns such as GM, C, WM, and WB that appear very washed out and overdue for a bounce. This view is solidified by the DJIA having already reached our 11,350 fractal target; and oil also reaching our fractal target at 141-142.70. Something good should happen – at least in the very short term.

But a week from now – after a bounce – will this market have sufficient "sea legs" to carry on higher? Or might it do a swan dive back down? None of this is clear. A crash into late July certainly remains possible.

Earlier this year, we wrote about 2008 as being a teasing year of false panics and shaky unsure bottoms. We specifically wrote in January:

> "As a matter of background, 2008 in the Chinese calendar is the Year of the Rat – a water sign that tends to cool off the overly ebullient typical fire of the markets. There at times may be a quiet calm, but also a very poor "sloshy" foundation underneath this calm. It will feel like a trap door could open at any time, but often it will not."

When we recently read the following possible Elliott Wave path from Robert Prechter (not his preferred count mind you, but one he deems possible), we found it holding some appeal to us with the Year of the Rat in mind. After all, April 2009 is a much more logical pi cycle time in our mind for all hell to break loose in earnest, rather than mid-2008. Prechter wrote in early June:

> "The Dow could fall to or a bit below its March low over the summer and then rally to slightly above the May high later in the year, all to complete a large upward flat correction for wave (2). Then the 3.3-year cycle's upward potential would be spent, and the market would collapse in waves (3) through (5) down, coinciding with the two down years of the four year cycle."

Markets have a way to tease and coerce before they reward. It seems almost too easy to be massively short right now. We are generally looking for more complexity in this market's path – weak longs being shaken out right now; weak shorts getting squeezed later on; and then after a faux down and a faux up, the real trend to the downside should finally arrive in earnest – next year.

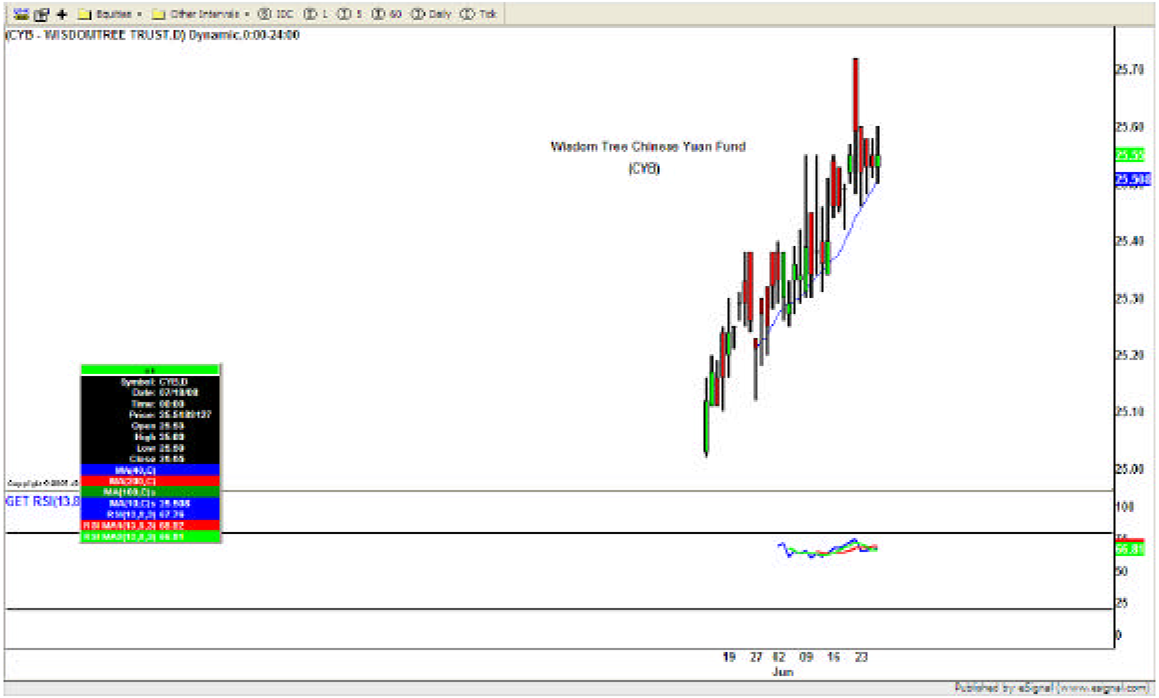
Big Picture Thoughts

But some out there may consider us too dour in general. Does a crash really have to occur sooner or later? What happened after all to the old adage: "Never sell America short"?

For anyone who does not believe that America is just starting to face a period of extended crisis, we are taking the liberty to attach to this report an opinion research piece received from hedge fund Clarium Capital, and would encourage all Sandspring.com readers to carefully review it. The writing of this piece -- entitled *The Bull Market in Politics – Part Two* -- is somewhat dense, and requires careful thought as you read along, but the vision expressed is well thought out and believable. The future of America depicted in this letter is one that we can easily fathom transpiring over coming years.

Central to the discussion in this letter is a prediction about an acceleration in the appreciation of the Chinese yuan (renmimbi). This has also been a topic written about by our friend Ray Dalio at Bridgewater Associates over time. It would appear that a first easy and perhaps inevitable step to rebalancing global economic imbalances is to allow the yuan to float upwards at a faster and faster pace than has been allowed to date.

But how can a retail investor play this move? The Chinese yuan remains a closed currency, and non-deliverable forward contracts to trade it are only in the domain of the institutional interbank market. However, we are pleased to be able to suggest here that the new Wisdom Tree Chinese Yuan ETF (symbol: CYB) may hold the answer for smaller investors. Indexed to return the appreciation on non-deliverable forward contracts long the yuan, these shares should chug slightly higher in the short term in somewhat boring fashion, but could someday accelerate higher as the yuan moves towards free float and convertibility. We believe that these shares deserve a place in everyone's portfolio – even if they are likely to be quiet in the short term.



Academically as well, the economic situation in Brazil (with its ethanol energy independence and yet improving commodity-centric balance of trade and high interest rates) may also make the Wisdom Tree Brazilian Real ETF (symbol: BZF) of some interest to investors.

This is more a carry game than a revaluation game, but it is also worth a thought. Some of the smarter macro and quant funds that we know have been making a lot of money lately being long the Brazilian real. Of course, the day that iron ore demand falls from grace (perhaps forthcoming soon!) could hold some rocky moments for the Brazilian currency, but earning 12%

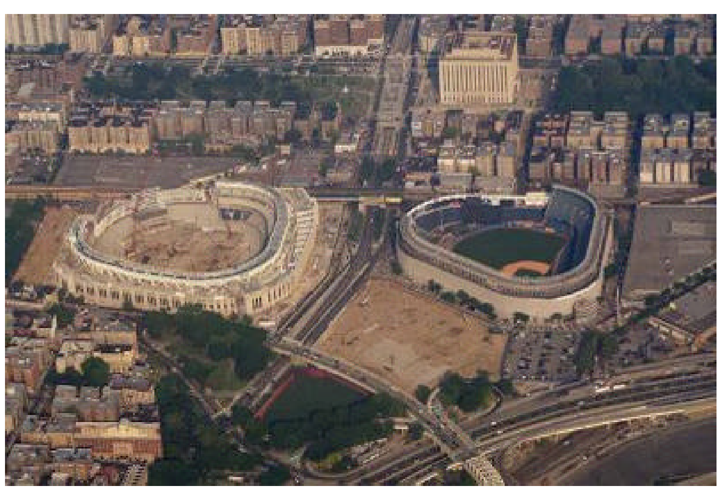
interest rates for accepting this risk is likely worth it. The risk of Brazilian commodities falling from grace can also be hedged by shorting a company such as RIO (Companhia Vale do Rio) that exports iron ore to China, but we would suggest waiting to do so until RIO touches $48.

Longer-term Thoughts from Construction

We had occasion to visit both Yankee Stadium and Shea Stadium lately and were struck by the oddity that newly minted stadiums are now being built next to both. Completion of both stadiums by the spring of 2009 would seem perfect timing for our negative pi cycles to hit, and baseball attendance to fall off the cliff in NYC as people need to cope with far more serious economic and societal issues. The time, money, and interest to go to baseball games in New York City will likely hit a pothole ironically just as these stadiums are completed.

The fact that the new stadium for the Mets is called "Citi Field" is also somewhat reminiscent of Enron Field down in Texas a few years ago. Enron Field opened in April 2000, only to be renamed Minute Maid Park in June 2002 -- after Enron went up in smoke. Will Citi Field face a similar fate by our anticipated market low in 2011?

The two Yankee Stadiums – old (on right) and new (on left) under construction

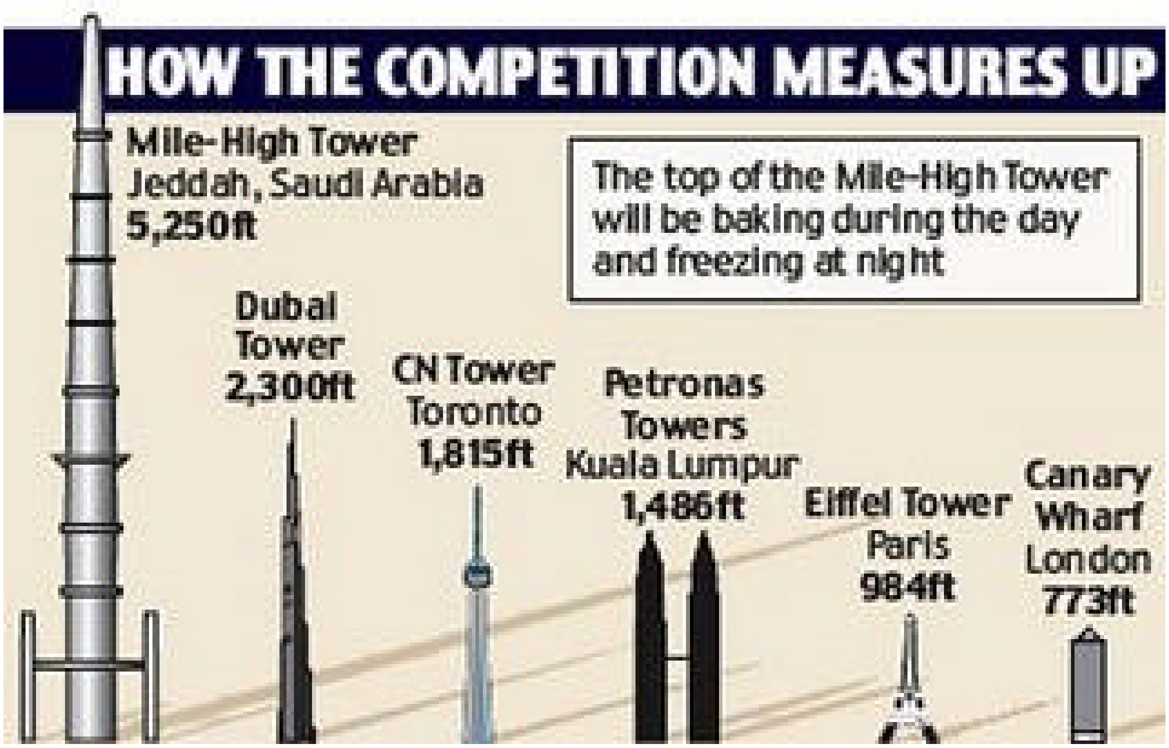


The New Replacement for Shea Stadium – Citi Field

And then of course we have the competitive construction of "tallest buildings" in the Middle East. The Durj Dubai should reach completion in 2009, but right behind it is the Mile High Tower now planned for Jeddah.

Durj Dubai under construction & final anticipated look

Schematic of the Mile High Tower in Jeddah



Look for oil to be peaking – maybe up near $169 – about the time that the Durj Dubai Tower completes. In the meantime, we cannot help but wonder whether the Mile High Tower will ever really get built.

Send us your comments at information@Sandspring.com.

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