Sand Spring Advisors LLC

The New Era of Government, Debt Deflation, & Weakening Consumerism

by,

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There have been two striking developments in the recent popular media. The first is the sudden governmental witch-hunt to draw up and punish greedy and potentially corrupt corporate executives, as well as generally impose new rules and standards on big business. The second is the sudden fixation of the media on the U.S. property market – and whether that market too represents a bubble.

On the first point, I am reminded of a point made to me a few years ago by the now defamed Martin Armstrong. He said: “The 8.6 year Princeton Economic Confidence Cycle not only has to do with the way markets behave, but it also has to do with the way people perceive free enterprise versus big government.” Armstrong went on the explain that “There is an alternating current every two PEI cycles – 17.2 years -- of first, depending upon business to lead us toward the nirvana of prosperity and then turning to government to save us from big business.” At the time Armstrong was arguing that we were likely already beginning a turn back to reliance on big government. But still focused on the downsizing of government generally being espoused by Ronald Reagan, then by both George Bush senior, and later by Bill Clinton (the latter at least in economic budget terms), I hardly believed Armstrong’s view that big government was ever going to experience a huge upswing in support.

But suddenly his words seem to have more meaning. For the 17.2 years between August 1982 and March 2000 – it was all a reliance on big business and entrepreneurism. Excessive governmental interference was deemed bad. This of course occurred as a backlash to the run-away power of government during the prior 17.2 year cycle of 1965-1982…a period that saw Nixon take the U.S. off the gold standard, several Presidents perpetuate and expand a war in Vietnam, and stagflation bring U.S. capital markets into a true quagmire. 1948-1965 was of course a big business era, and 1931-1948 a big government era with Roosevelt’s New Deal policies and World War II. Before that, 1916-1931 was of course an all-business era.

We thus find ourselves enmeshed in a period when once again – and for better of for worse -- business is losing its dominant position to government. It feels like 1931-1948 or 1965-1982 all over again in so many ways. We have a stagnant economy with all eyes turned toward the Fed as a savior; we have a dependence on government-induced super-low interest rates that are not solving the prior over-indebtedness of our economy, but instead only creating further distortions in the property market; and we have George W. Bush now hell-bent to go after Saddam Hussein in a new war.

And as the reliance on government increases, there is little doubt that America's past love affair with stocks will fade. Indeed, the entire notion that "equities always go up in the long run" will likely sound like poppycock by 2017. And of course, excepting the payout of dividends (of which there are scarcely any in this modern age), and adjusting away inflation, the entire equity advance over the past two-centuries has largely been an illusion.

How so? In a recent paper by First Quadrant's Rob Arnott (a fellow who we have quoted previously with regard to America's growing pension problems), he points out that $100 invested in 1802 does indeed grow to $700 million in the 199 years to 2001 – assuming dividends are reinvested along the way. But some of this growth is due to inflation, and adjusting this inflation out of the equation, the $100 only grows to $33 million – still a healthy gain. But the really interesting part comes here: Assume that instead of dividends being reinvested, the dividend payouts were spent over time (as common men are often prone to do). In this latter instance, the $100 in 1802 only grows to $1,884 net of inflation, with the large majority of that gain coming from the post-1982 equity market rally. Now adjust out the fact that taxes would be due on this gain somewhere along the way. A portfolio worth $100 in 1802, with dividends spent over the years, might in constant dollar terms only be worth around $1,300 today – or an average appreciation of about 6% a year.

Has the equity market really been that wonderful a thing? Yes, equity prices inclusive of dividends have tended to advance by the same pace as GDP over the long-term, but few modern day market pundits pause to admit that multiple decades can pass when equity markets have been just plain sour. The magic of compounding together with the inflationary environment are the factors that have really made equity returns appear stellar, and this perception can mathematically be picked apart just as easily as the compounding can seem so wonderful.

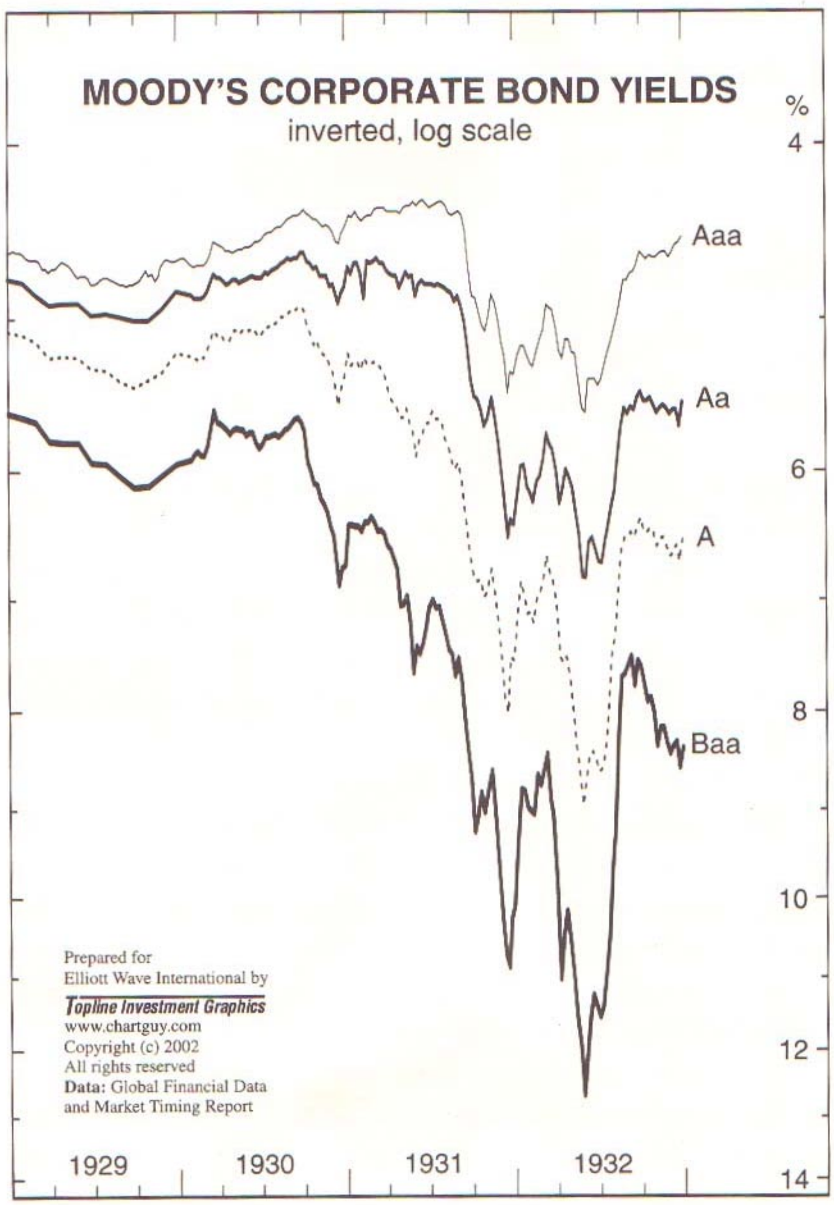
Meanwhile, coming back to the current property market and its potential to be a bubble, the CBS Evening News ran a story August 15th stating that the New Jersey residential real estate market has been so hot that many realtors aren't taking any vacation this year. To that I already say: "poppycock." I live in an upscale residential neighborhood of New Jersey. My wife is a realtor, as is my sister. Both tell me that "The only housing moving are the cookie-cutter variety being sold to first-time home-buyers who can ill-afford them. Low mortgage rates and lax credit standards rule the roost here. But few middle- or upper-end houses are selling. Almost all these listings are sitting on the market for more than 90-days. The market is dead. Sellers are offering their houses at prices that are generally too high, and buyers aren't showing up with any bids." In other words, the bubble has already started to burst DESPITE low mortgage rates. The popular media is, as usual, largely reporting a distorted and up-beat version of past news instead of new current trends.

And how far down could real estate prices tumble? Thankfully, people must live somewhere and land/housing (unlike equity issuance) is an asset in finite supply. Anecdotally when I started looking at houses in New Jersey in 1986, a perfectly good house in a quiet area could be bought for $230,000. By 1989, that same house was being bought for $450,000. By 1993 it was trading at $665,000. Today that house sells at $1.4 million. Do the math and you will find a 11.95% compound annual rate of return – perhaps reasonable given general population growth, finite supply of desirable property, and the low level of interest rates. But could we get a 61.8% retracement back to $677,000? – Sure we could – particularly in a period where people are unable to service their debt.

It is a fact that equity crashes generally only result in recessions. But for every dollar invested in equity markets, $20 is invested in fixed income markets. When fixed income markets implode, depressions, not just recessions, can result. Thus, more concerning than the 75+% fall in the major NASDAQ equity indices is the fact that at least $76 billion in corporate debt has moved into default this year, and on an ongoing basis, the debt/revenue ratio of U.S. corporations remains at historic highs. Of note, net corporate bond issuance actually fell in July – indicative of the possible onset of a nasty credit crunch.

The first part of this "credit crunch" process typically involves corporate bond yields simply widening as the U.S. Treasury market continues higher in price and lower in yield. This is what has been happening within our fixed income markets recently, with BAA corporate bond yields having recently touched post-depression highs. Corporate bond spreads have indeed been widening in this fashion since 1997. There is nothing exactly new going on here. And to the extent that government debt issuance was (until recently) contracting while corporate and consumer borrowing continued to expand in recent years, such price action by the markets can hardly be deemed surprising. A shift in the relative supply of debt between the private and public sector has simply demanded it.

But as shown in the chart below from Robert Prechter's recent book *Conquer the Crash*, if one looks back in the 1929-1941 period, the nasty part of the debt deflation cycle didn't really occur until high-grade AAA-rated bonds started falling in price <u>on an absolute basis.</u> The start of such a fall might come from a false perception by the market of inflationary pressures building, a small tightening by the Fed in defense of an excessively weak U.S. dollar, a major corporate failure, or some other minor shift of investor sentiment that causes a general disinclination to buy fixed income securities. Back in mid-1931 an extremely mild tightening by the Fed in defense of a weakening dollar was the specific culprit.

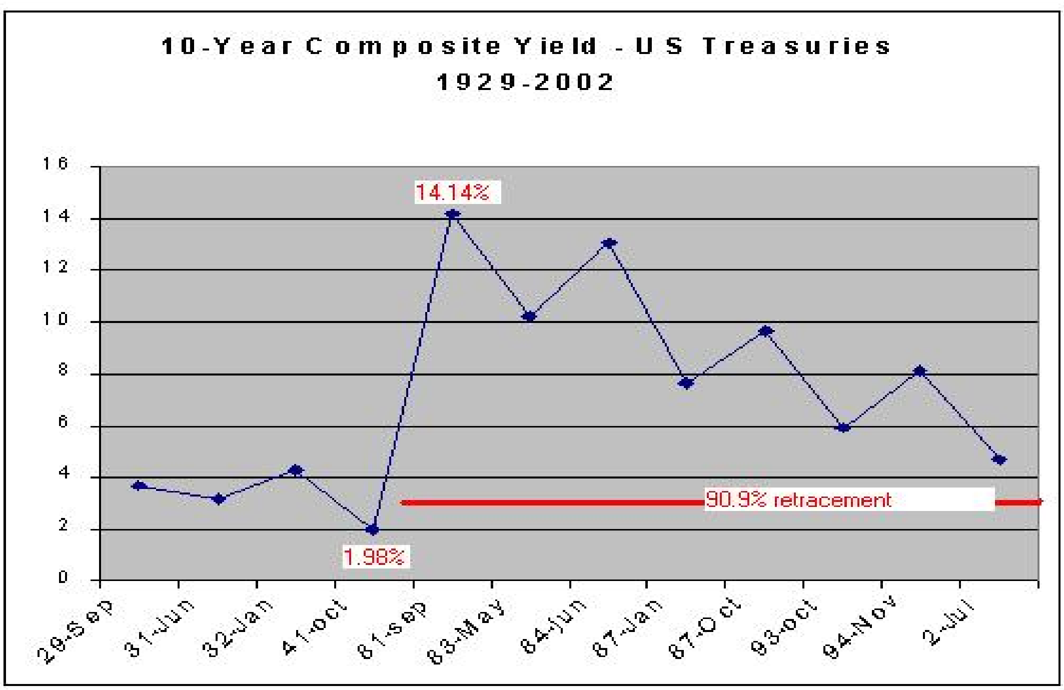


In the current instance, we do not know when U.S. Treasury prices will stop nudging higher and higher in price and lower and lower in yield. But we do know that the Fed is ever so aware of both the 1929-1932 debt deflation period as well as the failed fight by Japanese monetary authorities to combat debt deflation in Japan since 1989. Senior Fed analysts have even written a working paper entitled "Preventing Deflation: Lessons from Japan's Experience in the 1990s" -- a paper that makes it clear that the Fed will continue to err on being overly accommodative in an effort to avoid either a 1932 or Japanese 1990's outcome.

Thus, we may have very many elements of these prior periods, and Bob Prechter is undoubtedly correct when he states that "The Fed has become a slave to trends that it has already fostered for seventy years, to events that have already transpired" -- thus making a fixed income buyer's strike something of an inevitability at some point. And yet in somewhat desperate fashion, the Fed is likely to continue its "push on a string" policies either until the economy offers them some satisfaction or the market simply rebels.

But if it is hard to tell when this will all happen, might it be easier to anticipate the yield level from which a reversal in Treasury prices would be likely? – the point where investor sentiment toward AAA debt will potentially turn into cynicism and fear?

We spent some time looking at the average yields of securities with maturities of 10-years or longer (the longest data series that we could immediately access from the Fed, extending back to 1925) and have constructed the very basic chart below showing the major peaks and troughs in these yields. It is our opinion that the long-term bond market is currently in the process of making a Fibonacci 90.9% retracement of the 1941-1981 yield advance that began in 1941 at 1.98% and peaked in 1981 at 14.14%. 90.9% of this 1216 basis point distance is 1105 basis points, which subtracted from the 14.14% high yield, produces a 10-year yield target of 3.09%. This yield region would also fall reasonably close to an absolute 38.2% of the January 1987 10-year yield low at 7.6% (38.2% = 2.95%); and 50% of the October 1993 10-year yield low at 5.90% (50% = 2.9%).



To reach a 2.95%-3.09% yield-to-maturity region, it is relatively easy using a standard bond calculator to determine that the 10-year Treasury note futures would have to reach approximately a price of 125 – a level that of some note, would offer a nice Fibonacci rhythm "fit" to the price action of the 1984 continuous futures T-Note chart shown below.

Thus as a longer-term thought, we'd like to offer the following: If and when 10-year yields ever reach the 2.95-3.09% region, all Treasury securities should be sold. The risk of a substantial reversal in all fixed income markets from such a level would be very strong. But until this level is reached, we would also not be surprised to see softening commodity markets, with even precious metals continuing to languish. The demand during this period will be for liquidity and security, and not necessarily a demand for inflation-hedges.

On this very long-term basis, would we rush out to buy 10-year notes today? Certainly not. The timing of this analysis should in no way be construed as such a recommendation. Even though a move from 112.5 to 125 would represent an 11.1% capital gain on top of the 10-year coupon – perhaps an attractive total return in today's environment -- we are far less sure how fast such a move will transpire, let alone exactly when. Indeed, in the very short-term we could see 10-year notes fall toward support near 105.75, although the chart below is just one potential and very tentative path that we could imagine. On the way to 125, we also see 117-118 as a logical zone of resistance at some point.

What we do know from such a view is pretty simple:

1) While the property market has likely peaked in many locales already, it will not truly go "pop" until 10-year U.S. Treasury yields finally reverse. FNMA is already slowing its balance sheet growth of new mortgages, but "blood in the streets" to the residential property market will take more time to develop. A house is the last thing people generally try to sell when times get tough, with most making other spending cutbacks first before resorting to this more severe step.

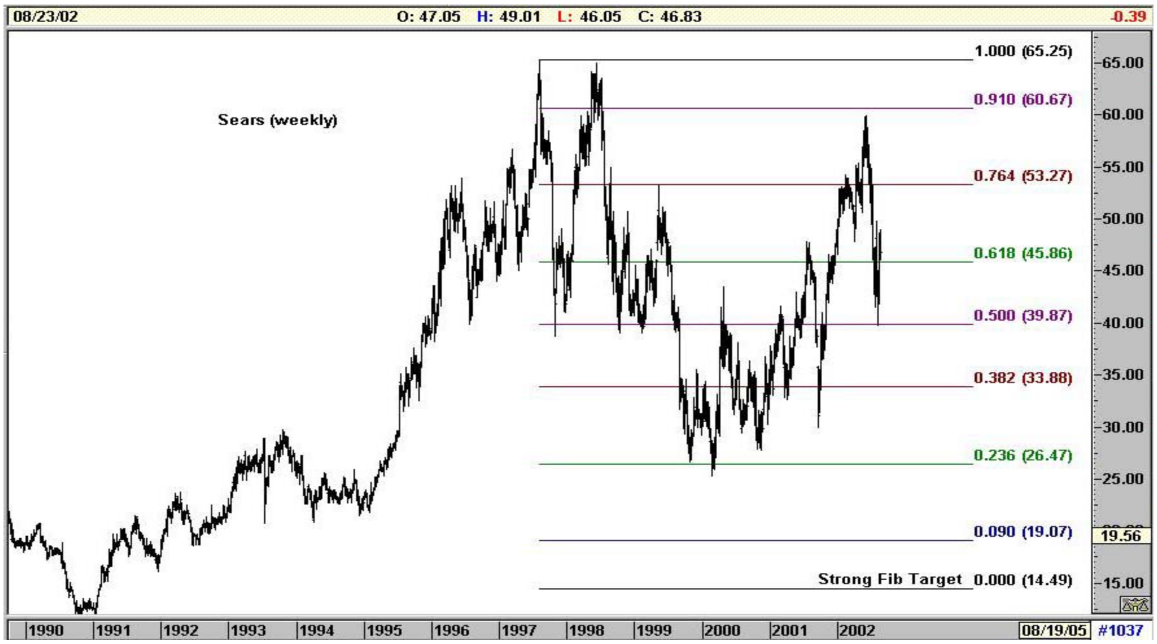
2) The apparent distance still to be traveled by 10-year notes suggests a Fed desperately trying to ease the corporate borrowing crunch as well as working to combat an increasingly weak consumer. If this is the case, overly indebted and consumer-dependent companies like Sears, Procter & Gamble, General Motors, and others are going to face a true struggle in the years to come. So too will the non-essential restaurant sector. One of the easiest luxuries for people to cut out will be the extra trip to the mall and lunch at Ruby Tuesday's or Applebee's.

Procter & Gamble in particular appears as a flawed stock trading at a huge multiple. Imbedded in this company's 29x P/E, there appears to be an assumption that P&G can maintain a growth rate of 12-14% annually. The company did reach an 11.2% growth in its core net earnings in 2001 and a 13.2% margin in fiscal 2002. But a close examination of how these results were achieved shows that in recent years, top line revenue for P&G has only grown by an average 2.35% a year. The advance in core earnings was largely achieved not by increased demand for P&G products, but by cost cutting – specifically in advertising expenses (particularly in 2001) and the number of personnel working for the company. There was also a bit of funny pension accounting. Although the actual value of P&G pension assets declined by -15.23% in 2001, the company somehow deemed this an appropriate time to actually increase its expected rate of return on pension fund assets from 8.1% to 8.3% -- thereby yielding a completely fake bottom-line earnings accounting gain. None of the increase in P&G's core net profit came from true organic growth in recent years. And if the consumer is going to start reigning in spending, one can be sure that Wal-Mart (the outlet through which P&G garners some 17% of its revenues) will be demanding more and more pricing concessions from P&G.

P&G also has a balance sheet that shows $15.8 billion in debt ($9.8 billion of which is long-term) compared to $13.4 billion in shareholders equity. Long-term debt as a percentage of equity has risen steadily from a 9% level as recently as 1971 to 81.5% in 2001. This largely began in 1985 when compressed operating margins led the company to use added leverage to enhance shareholder returns. Even if such a tact has worked in the past, it is not a sustainable trend in the future since significant added debt issuance at this point would put P&G's investment grade debt rating at risk of downgrade.

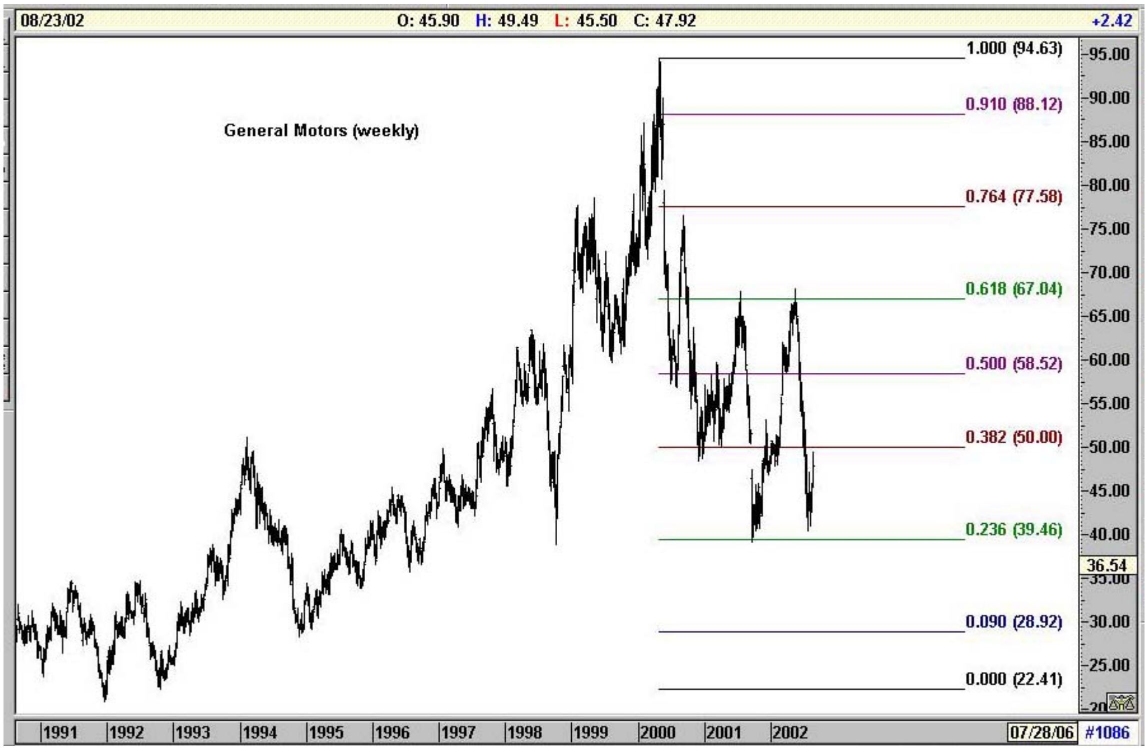
This company does not deserve a 29x P/E multiple, and is ripe for disappointment. Fibonacci rhythm techniques suggest a target of $32.56 is entirely reasonable to expect here with time.

We also think Sears' recent acquisition of catalog clothier Land's End at near 25x earnings will be deemed a silly and costly strategic move with time (in similar fashion as the AOL-Time Warner merger now is viewed). Sears itself trades at a far more modest 10x P/E, but if the consumer is slowly forced to put away the credit cards, Sears could also be ripe for a fall. Why buy a catalog clothier at this time? Sears' Fibonacci rhythm suggests $14.50 could be seen with time.



Even that icon of American success Wal-Mart looks vulnerable to our long-term technical eyes. It currently trades at 32x earnings and almost 7x its $7.88 book value. We think technicians Edwards & Magee as well as value investing icon Ben Graham would both blanche and be bearish here.

GM is also a company that we have previously spent some time discussing with pension-fund accrual problems galore, and an increasingly saturated car market. This stock appears to be on a slow slide toward $22.40.



At about this moment, we'd expect readers to say: "But wait a second, wasn't Sandspring.com pretty bullish in its July letter? Has all that gone out the window?"

No it hasn't. While in the very short-term the August 22nd equity market high (into the Full Moon) and August 23rd price reversal likely marked the end of an A-wave up, and could lead us down in a "B" wave for a few days or even weeks, over the next three months at least, we continue to see the possibility (if not the high probability) that a continuing C-wave relief rally of sorts can transpire. The NASDAQ chart suggests that this could still be of some magnitude after its 29-month down formation so reminiscent of the 1980-1982 bursting of the gold price bubble (See our "Returning To Our Roadmap," August 7th Chart du Jour on the web). But the S&P chart suggests that this ongoing rally will not be of significant magnitude from current levels – so in terms of degree, we find ourselves scratching our head a bit. Should the NASDAQ chart complexion end up dominating, it is even now our expectation that such a shift in sentiment could spill over into early February given the typical proclivity of money to be "put to work" in the January period. In order to remain psychologically on-sides for the ongoing bear market thereafter, it is of some importance not to get hurt as a bear in this short-term period of potential "relief rally" froth.

In terms of "why" the market would rally in the short-term, we continue to sense that current geo-political concerns are overblown. While the Middle East -- and Iraq, Israel, and Saudi Arabia in particular -- will undoubtedly continue to be powder kegs in the years to come, a perusal of various energy charts continues to suggest that short-term concerns are for the moment fully discounted. As best seen in the chart of Heating Oil below, these markets are likely continuing to set themselves up for a serious near-term fall in crude product prices.

While it is possible that this crude decline could be kicked off from equity weakness, we think it more likely over the next few months that the real driving force will be improving geo-politics that will reinforce the crude complex lower, equities higher (after any initial ultra-short-term weakness). Perhaps the headlines will read of a surprise sudden concession by Saddam, or even a successful and swift surgical strike to locate and capture Osama bin Laden or Saddam, or perhaps something else. Somehow, America needs to feel good about itself for a bit as a "set-up" for the still very tough economic times to follow.

In the end though, and somewhat ironically, it will likely be those companies and those individuals who default (declare bankruptcy) early in the current cycle that will fare better than those who struggle at all costs to avoid such a path. This former group of early defaulters will see assets liquidated when the market still has some bid to it, and before assets have been depleted by years of servicing untenable debt burdens. It may be possible for some of these companies and individuals to re-emerge from court protection in reasonably good shape. In other words, this is no time to bury long-term debt problems and hope to just weather the storm. It is instead better to call a spade a spade, and cut and run. Few realize this. It goes against our general American upbringing that teaches us to stay upbeat and optimistic – no matter how dour things may look.

But then again, America's psychology is still that of the last 17.2-year boom cycle. Anecdotally, NBC has offered another round of "Fear Factor" on the tube this summer – a show we deemed so very appropriate for a bear market when it first appeared last summer. After it on Monday evenings, "Dog Eat Dog" has been a new equally dour offering. But as if to indicate "We're not fully finished partying yet," the sex-laced show "Meet My Parents" follows both shows. This latter show still stresses America's pursuit of "the good life" with easy morals and few cares. Only with further time will psychology become more serious and closer to that of 1931-1948 and 1965-1982. And as sentiment slowly changes, people will increasingly look toward government as their savior/defender, and spending on credit will slowly diminish or be curtailed.

The current retailing giants featured above will -- with time -- surely fall from grace. But we will more aggressively be looking for such come November and beyond.

Send us your comments at information@Sandspring.com.

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