Sand Spring Advisors LLC

The Importance of December 30-31, 2004: Monetary Inflation vs. Economic Deflation Bush and China: The Two Keys

by,

Barclay T. Leib

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As the chart on the following page of the S&P details, December 30-31, 2004 is an important cycle window in our analysis of current market behavior.

December 30-31, 2004 is a period that will fall an exact 17.2-year (2* pi*1000) distance from the Crash of 1987 low; 61.8% of a 17.2-year cycle from the 1994 equity market low, and 38.2% of a 17.2-year cycle from the July 20, 1998 market high.

This date window also falls approximately 38.2% of a 8.6-year pi cycle from the tragic events of 9/11/01, 1.382 times a 17.2-year cycle from the spring 1981equity market high, and a double 2*pi*1000 34.4-years from the late July 1970 low.

Whatever is transpiring into this period should be of great significance and potential violence.

So what will this date bring?

Readers of these pages will know that over the past two years we have at times pointed toward this date as a potential equity market high – driven by Fed liquidity pumping and general asset price inflation -- and at other times, and generally more often, worried that it might represent a crash low – perhaps after a period of dollar or bond-market crisis.

In our opinion, which it will be is likely not etched in stone without the ability of human self-determination to somehow help shape the final outcome. Instead, the fate of Dec 30-31, 2004 may largely sit in the hands of two men: President George Bush and the Chairman and President of the Bank of China, Xiao Gang.

We will shortly explain why, but notably we do not include Fed Governor Greenspan in this list. While the market may currently deem Greenspan to be the most important single figure to the future of U.S. financial market health – hanging on his ever word of testimony on interest rate policy -- we believe that within an election year, Greenspan will be wimpish in his policy actions regardless of the path that markets take. He is in the position to wish and hope what the economic outcome may be, but will likely be less influential in actually determining the outcome than he has been in the past.

But first, let us restate the current macro situation as previously outlined in our January 2004 article *Imbalances that Persist*. We do so because the imbalances are substantial.

The U.S. consumer is spending too much relative to available liquid resources, and has built up too much of a debt servicing burden over the past two decades. At the same time, the U.S. worker currently faces slow U.S. employment growth and declining (or at best flat) real wages due to structurally unavoidable competition from abundant and cheap foreign labor sources. These foreign labor pools have become more accessible than in past decades due to improved global communication systems and Internet connectivity (virtual private networks, etc.). The U.S. education system has also been left in the dust relative to countries such as Korea and India. Left to natural forces, the U.S. consumer would realistically need to reign in spending at some point by suffering through a recession, and increase his or her savings rate to help heal a deteriorating balance sheet both at the household level and at the national trade deficit level.

But the Fed is fighting this tendency, and the U.S. government is engaging to deficit fiscal spending not seen since the early 1970's in its global fight against terrorism. Both the Fed monetary policy of 1% Libor yields (negative real yields) and fiscal over-spending by the Bush Administration is creating monetary inflation in asset prices (equities, real estate, gold, oil, foreign currencies), while giving the consumer sufficient access to borrowed money to avoid facing a day of reckoning. In the meantime, the cheaper cost of foreign goods production continues to give the consumer something attractive to buy.

The problem is that dollars – at the margin – end up flowing to Asia, where central bankers have been stockpiling them, issuing domestic currency to local merchants, and then re-circulating the accumulated dollar reserves back into U.S. Treasury investments. Most of the Fed's inflationary tactics actually ends up popping out in Asian money supply growth – not immediately in the U.S. CPI. As recently argued by the astute folks at Bridgewater Associates, the global economy ends up with "inflation in assets prices globally, disinflation in labor prices domestically, and deflation in the cost of simple goods."

It thus matters a great deal what exact "type of asset" one looks at when coming to understand inflation and the impact of foreign competition on America. As recently pointed out by John Hathaway, manager of the Tocqueville Gold Fund: "Thanks to Asian outsourcing, the Bureau of Labor Statistics was able to report [price] declines of 83% in computers, 56% in televisions, 18% in women's dresses, 7.8% in sports equipment, and 1.7-5.1% in other apparel categories for the period 1990-2003." Yet over the same period, the all-item CPI price average rose 46% -- with "college tuition fees… [rising] 171%, cable television fees up 114.7%, bank services up 104.5%, motor vehicle insurance up 85.2%, and movie, theater, and sporting event tickets plus 81.8%."

Get it? Certain goods prices are going down, but the cost of most services have gone up, and continue to do so.

Within the CPI mix, housing is of course an important component weighted at approximately 41% of the total CPI. Yet because of the housing construction boom of recent years, the vacancy rates on rental housing are up, and since the government largely measures the cost of housing as the "imputed rent" paid by a home-owner rather than the capital cost of buying or constructing a new home, we get events such as the January CPI release. This statistical release included a cost of housing estimate that rose by only 2.2% year-over-year even while other government statistics show that the median home price rose 6.7% over roughly the same period.

As recently discussed by Jim Grant of *Grants Interest Rate Observer*, the government's "imputed rent" calculations and actual home costs have now been diverging for over 7 years, and the BLS "imputed rent" methodology likely understates CPI within the U.S. by some 100 basis points a year. This literally means that even while the government spurs on the boom in housing via easy Fannie and Freddie credit policies, buyers of inflation-protected TIPS issued by the government get consistently ripped off by the way housing price increases within the CPI are calculated. The U.S. government gets to have its cake and eat it too.

But as previously discussed in our November 2003 article, *What Growth? & New Thoughts from the Warren Buffett of the Dark Side,* the CPI calculation situation only gets worse when one considers the other hedonistic price adjustments made by the government concerning the quality of goods sold in the U.S. In addition to the fudging of GDP growth upwards by grossing up the value of "better" computers sold at lower prices, the U.S. government is currently discussing even further hedonistic price adjustments to reflect the supposed improved quality of healthcare services provided. This is a hot topic since healthcare costs in nominal terms keep rising, but statistically the government wants to revise these cost increases downwards.

Overall, there is little doubt that inflation is certainly far higher than advertised. The myth of price stability is largely a function of public gullibility, and the role of the government in camouflaging this fact makes us think back to Mel Brooks' great line in the 1981 movie *History of the World: Part 1*: "It's good to be the King." Please excuse the cartoon of George Bush below in a similar vein, but we couldn't resist.

The above line of reasoning leads to the following conclusion: those holding U.S. Treasury securities and inflation protected TIPS -- on the premise that inflation is low or for other purposes such as the maintenance of Asian job growth – are the ultimate patsies. They are exchanging real goods for an asset that is likely to decline in value either through understated inflation (with upward inflationary pressures currently building) or dollar depreciation. In the words of one astute hedge fund manager: "It is essentially like taking goods from Asia for over 20-years, and then saying 'Thanks so much for all this good stuff. Now please accept a 50% haircut on the bonds that we are giving you in exchange.'"

And yet foreign central banks keep buying dollars and Treasuries. By definition, for the system to function, the central bankers almost have to accept such a proposition.

But there are warning signs that this is already becoming less sustainable.

● One warning sign per Hathaway is that, "the percentage of Chinese FX reserves recycled directly into Treasuries declined to 24% in the second half of 2003 from 54% for all of 2002."

● Another warning sign is the burgeoning talk by Japanese and other Asian finance ministers of increased holdings of gold and other baskets of currency reserves. Such comments have recently come from the lips of Japanese Finance Minister Sadakazu as well as Zhu Min, general manager and advisor to the Bank of China president.

● Yet another warning sign is that raw commodity price increases (copper, crude oil, etc.) are indeed starting to trickle into higher prices for end-product consumer goods. Just Friday, Continental Airlines said that it will be raising ticket prices given an oil price that stubbornly refuses to leave the mid-$30's.

● Other red flags can be seen in the recent record number of consumer bankruptcies despite low interest rates, and warnings from Wal-Mart about pending problems with an overextended Middle American consumer.

All in all, the Chinese–U.S. symbiotic effort at maintaining growth by the charade of recycling U.S. consumer spending into foreign Treasury purchases is starting to show some cracks. It would shatter in total if the U.S. dollar were allowed to reach its true equilibrium level whereby the price of imported goods would soar, U.S. interest rates would rise, and finally force a decline in consumer spending. This is what the Fed and the Chinese are both trying to avoid. Neither side wants to go there. But for now, in the words of the same astute hedge fund manager, "This can be viewed as the largest vendor-financing scheme in the history of world."

The question then becomes: who will lose their nerve at this scheme's perpetuation, and at what time, and for what cause? Will it be Greenspan that "blinks" first; the consumer who naturally retrenches; or some sort of financial market change forced upon the U.S. from the outside? Or might it be some combination of all three events at the same time?

To go back to our earlier assertion that President Bush and Bank of China officials likely hold the key to 2004's price action, let us now consider three possible paths for 2004, with our December 30-31, 2004 cycle date firmly in mind.

Path 1 (most optimistic, but least likely) : Within the next several weeks, money continues to flow into U.S. equities, spurred in part by pre-April 15th IRA contributions. Concomitantly, Europe cuts interest rates to spur their domestic growth, sending yet more money into U.S. asset markets. This supports the dollar in the short-term despite structural imbalances that require a weaker dollar longer term. At the same time, China grudgingly plays ball with the U.S. administration and agrees to implement an upward floating peg to the Chinese renminbi. The world breathes a sigh of relief that this is just enough of a concession that politically Bush will not have to resort to protectionist measures to stem Labor support at home as the U.S.

elections approach. The vendor-financing game is largely perpetuated; the world is happy. The S&P vaults per some rhythm close to the one depicted below to 1250-1270 on the S&P. December 30-31, 2004 ends up as a market high. Yet post the U.S. Presidential election, and after affording the markets a large amount of wealth creation as a cushion, Greenspan (or his successor) finally ends up having to raise short-term interest rates. With the U.S. economy still being highly leveraged, markets react poorly.

Path 2 (most pessimistic, yet possible) : Within the next several weeks, money continues to flow into U.S. equities, spurred by pre-April 15th IRA contributions. This supports mutual fund equity inflows in the short-term. But as spring moves into early summer, greater signs of end-user price inflation start to emerge in the U.S. The bond market starts to revolt, once again anticipating the eventual necessity of a Fed rate hike to combat the increasingly more apparent inflationary pressures. As rates start to increase, foreign holders of Treasuries start to get nervous about capital losses on their holdings. While for a moment the dollar is pulled higher in anticipation of higher relative rates in the U.S., it then turns significantly lower (particularly against Asian currencies) as foreign holders of Treasuries either try to sell some of their holdings or simply demand a greater currency concession before buying more. Fed Governor Greenspan feels increasingly in a box, but can actually do very little. He certainly does not have the nerve to actually raise rates pre-election. Meanwhile, U.S. job growth fails to improve. Bush's popularity starts to fall in the polls. The Chinese do nothing with their exchange-policy to help him, so he gets desperate, and reluctantly must support certain protectionist measures (that are already circulating through Congress at this time) in order to shore up his support among U.S. Labor. If, at the same time, something bad were to transpire geo-politically within Iraq or concerning global terrorism, consumer confidence is shattered, and markets plunge in a surprise late-year crash. Bush loses the reelection, and fear abounds at potentially unfavorable economic policies to come from Kerry, but this fear ends up being overblown. December 30-31, 2004 ends up representing a crash low. The path of prices ends up looking more as below.

Path 3: (realistic muddling path) : Everything outlined above in Path 2 starts to transpire, and equities weaken. The underbelly of the U.S. economy is exposed and Bush fails to get reelected. But it takes longer for a "crash like" event to develop. In addition, perhaps there is some spurt of American optimism after Kerry gains the Presidency that new leadership is at the helm.

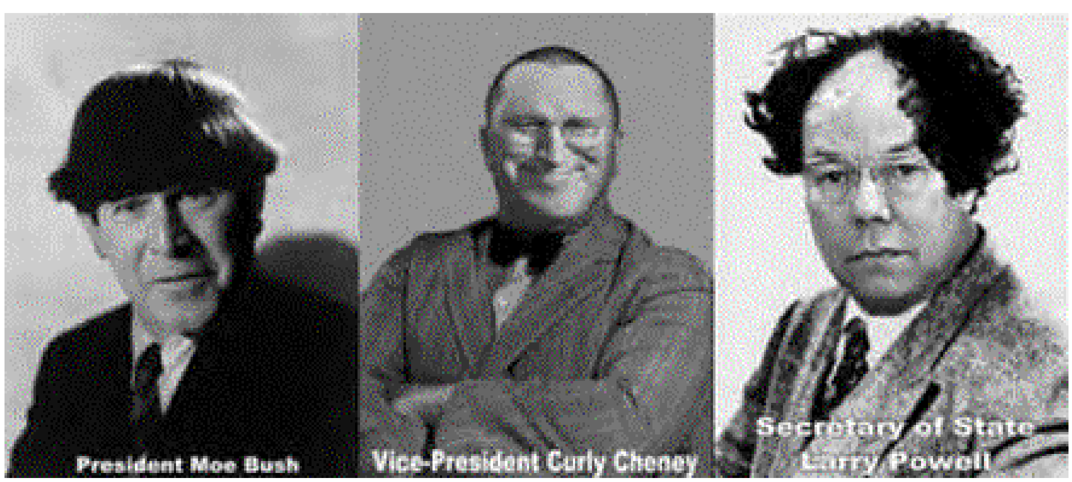
In this middle-of-the-road muddling scenario, a chart pattern as below could transpire, with a true "crash-like" event only coming on the other side of Dec 30-31, 2004. In Elliott terms, Dec. 30-31 could end up being a wave 2 of III high just before a 3 of III disastrous decline. This is perhaps the most believable case, but we will remain vigilant for the other two.

Now, while we recognize that we have presented three very different paths, and this may not seem of much initial value, we have also presented the "landmark" fundamental events to watch for in order to help distinguish between the three paths in real time. The landmarks are:

- We would suggest waiting until post the PEI cycle date of April 13th for any real clarity between these three paths to emerge. Mutual fund cash inflows have recently been very high and they will likely stay that way (or at least be supportive of the market) until the IRA investment season is behind us. Bush is unlikely to get desperate in his campaign before the early summer. China will drag its feet -- even if it eventually agrees to a floating currency peg. Iraq isn't likely to get really nasty until the summertime heat arrives when tempers on both sides could flare. Clarity as to 2004's true complexion really should only emerge after this early April window -- not before. If April 13th is minor new market high, additional concern is warranted.

- Watch Bush's mouth, more than Greenspan's. If Bush starts to resort to protectionist rhetoric and bravado, watch out for a second half of the year financial market accident. Most investors currently deem Greenspan as the key guy to watch, but within an election year, and given Greenspan's historically wimpish tendencies, it is more important to stay attentive for any crazy economic policies that Bush might latch onto at some advisor's coaxing.

Once again, please excuse the comic cartoons below, but Bush's proclivity to adopt quickie solutions that have sound byte appeal, and Cheney's complete disregard for the longer-term problems of current fiscal imprudence, certainly worry us.



- Lastly, if China plays ball on a potential renminbi currency revaluation, the vendor-financing game between the U.S. and China can be perpetuated for a bit longer. Bush wins the reelection, and then becomes one of the most unpopular Presidents in modern history as Greenspan (or Greenspan's successor if Al is savvy enough to retire) finally is forced to raise rates in 2005, and a 2005-2006 recession ensues.

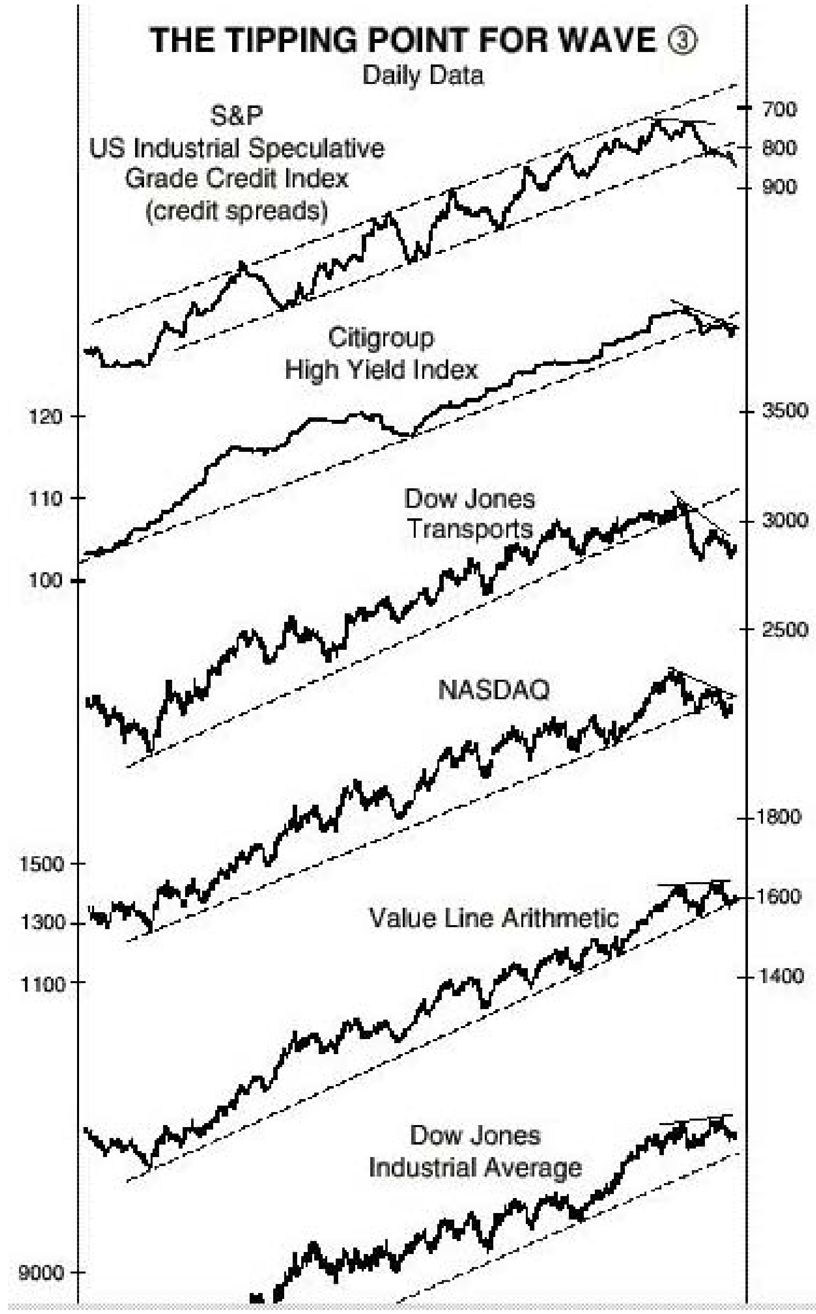
Why do we lean toward either the "muddling" scenario or the Dec. 2004 low "crash" scenario?

Partly we must admit that this is simply because absolutely no one – except notably Robert Prechter – currently expects a bad year in 2004. And people are tired of listening to Prechter. He has admittedly been crying wolf for some time. Yet, we know Bob personally and certainly respect his analysis. He should not be dismissed as some nutcase even if he incorrectly called for a 3 of III down in late July 2002 (a view we happened to disagree with at the time). Since revising that view, he has only really been guilty (as we have as well) of underestimating the power of Fed liquidity to create a protracted a-b-c corrective "2-wave" rally. The "c" wave of this move has been the real killer here because in Elliott terms, it could have ended anywhere from 970 on the S&P upwards, but has continued to simply stretch and stretch itself.

The current market complacency – and the general tightness of consensus opinion by most people that 2004 will deliver a "benign environment" -- just seems too "pat" a view for our contrarian instincts. In addition, and technically, all the signs of problems sooner rather than later already exist. Drawing in part from some of Mr. Prechter's views, these include:

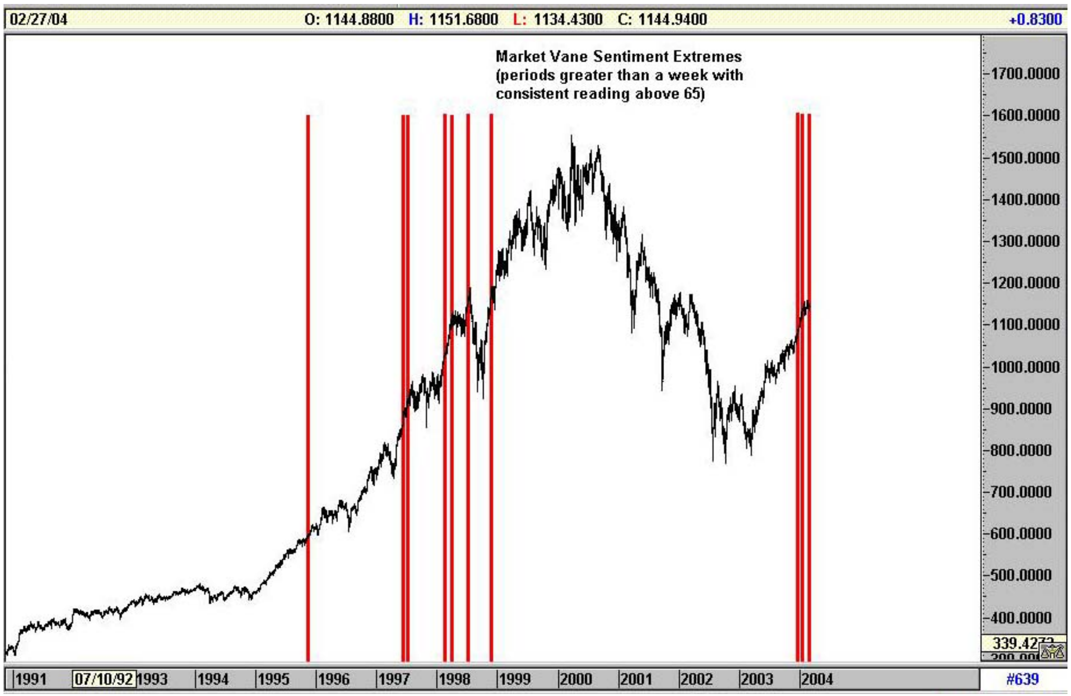
1) U.S. junk bond yields are already trading extremely tight to Treasuries, with 65% of junk bonds currently above their call price, and 85% above par. From a historical perspective, the compression in corporate credit spreads over the past 18-months was easily a three standard deviation event. At present, and if we correctly understood one expert speaker on the high yield market at a recent investment conference, more CCC-rated corporate paper was issued in January than in all of 2002, while higher quality companies have been prudently retiring debt. Worse yet, new-issue high-yield bonds show significant quality deterioration in the form of covenant protection. While every bond indenture is different, certain standards are generally observed, but recently there has been an erosion of protective covenants, especially in clawback provisions.

   In the past, such a pattern of low-grade bond issuance has usually resulted in a debt crisis within 18-24 months. At a minimum we should at least experience some reversion to more normalized high yield bond spread levels that are currently 20% below their long-term historical average. Per Prechter's technical work, the U.S. Industrial Speculative Grade Index also broke a significant uptrend line in late January. This technical break led breaks lower in various equity indices as few days later.



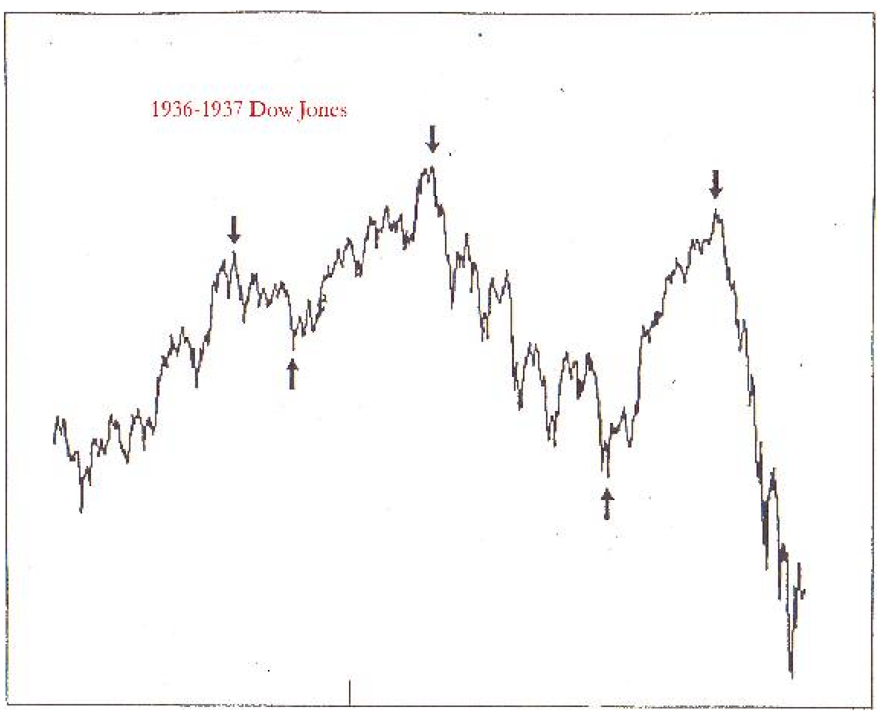
Source: Ellliott Wave International

2) The S&P has recently retraced an almost perfect 50% of the 2000-2002 decline. A Fibonacci "natural attractor" target of ours at 1155 was perfectly touched and then rejected. In Elliott wave terms, this appears as a classic "2-wave" of complacency. Sentiment levels are currently very high with Market Vane showing a 69% bullish reading on the S&P. Although such readings have now stayed in this region for sometime, historically, they have only done so on a few occasions in the past. These periods specifically were: late November 1995; mid-June through early August 1997; mid-February through early April 1998; mid-July 1998; and late November 1998. Although in some of these periods, the consensus bullishness proved correct in the intermediate-term, in few of these periods was it an astute time to chase stocks in the short-term. In addition, the overbought sentiment readings just in front of the July 20, 1998 S&P reversal date were certainly very prescient as a warning signal.

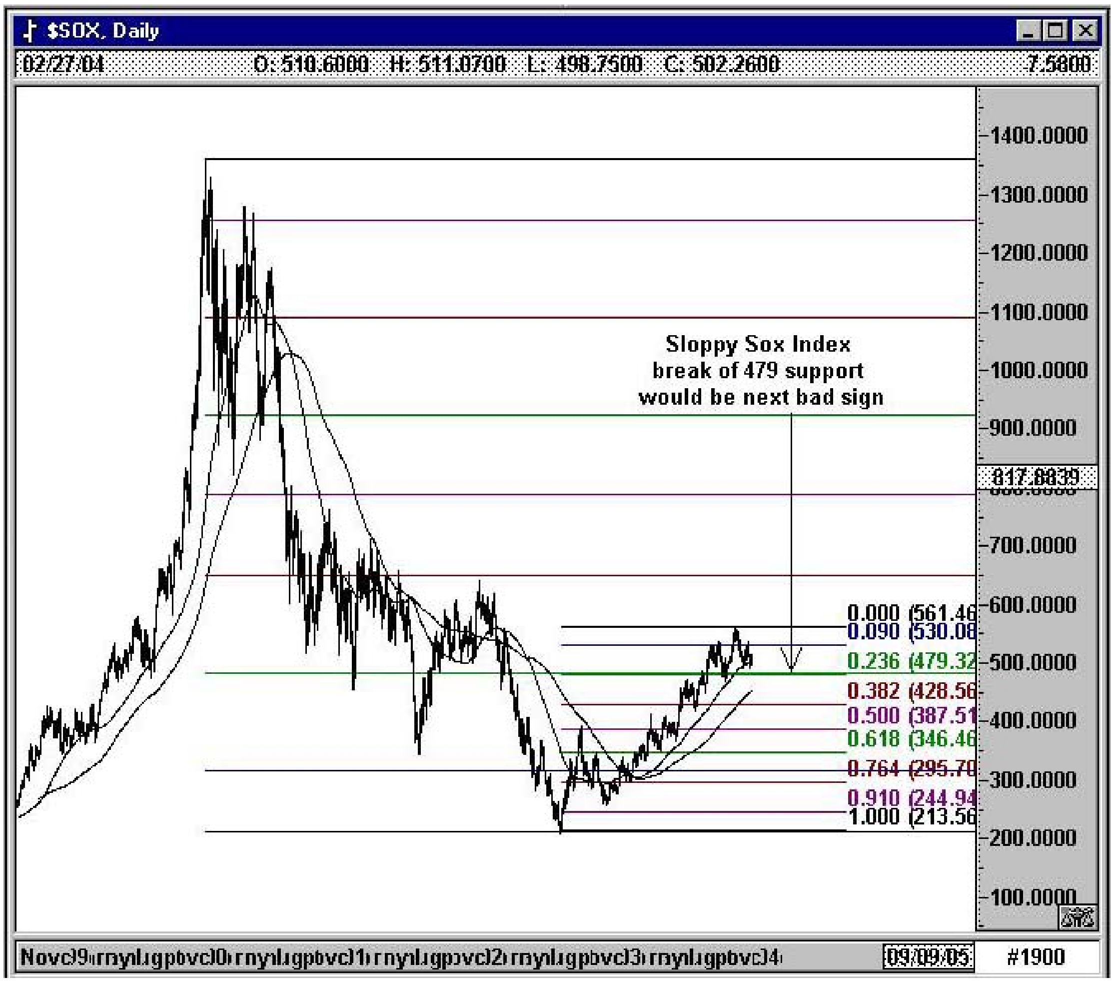


(As a side note, it is interesting that the Market Vane sentiment readings never reached overbought levels in 1999-2000. The market letter writers remained generally more skeptical during this period than the general public, and were wrong in the short-term, but actually correct to be skeptical in the intermediate term.)

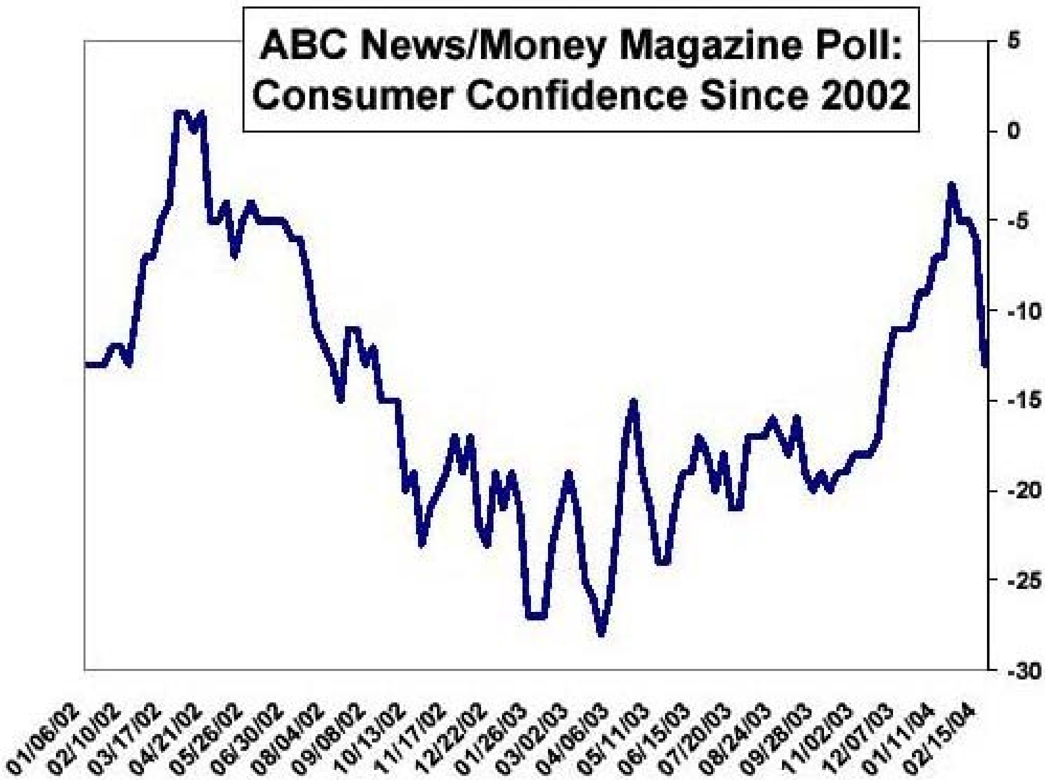
While an even greater 61.8% or 73.6% retracement of the 2000-2002 downmove could end up making the current S&P more closely match the 1936-1937 DJIA analog chart below (if a Path 1 transpires, for example) such is not absolutely necessary.



3) The fundamental quality of the companies that led the 2003 rally was poor. The general level of speculation and frothiness in 2003 was reminiscent of early 2000. Indeed, per data recently released by AMG Data, January equity mutual fund cash inflows of $47 billion were just under the $48.2 billion record of February 2000. Yet the net price advance in January was very small. One cannot be impressed by this combination of events. In addition, starting from September 2003 onwards, a gradual shift has started to transpire in market leadership back towards higher quality companies with stronger balance sheets. The speculatively-driven SOX Index has recently started to stumble. Housing and retail stocks were some of January's worst performing sectors. The only thing that has yet to wane is OTC Bulletin Board volume -- indicative perhaps that speculative juices may have just a bit further to go.



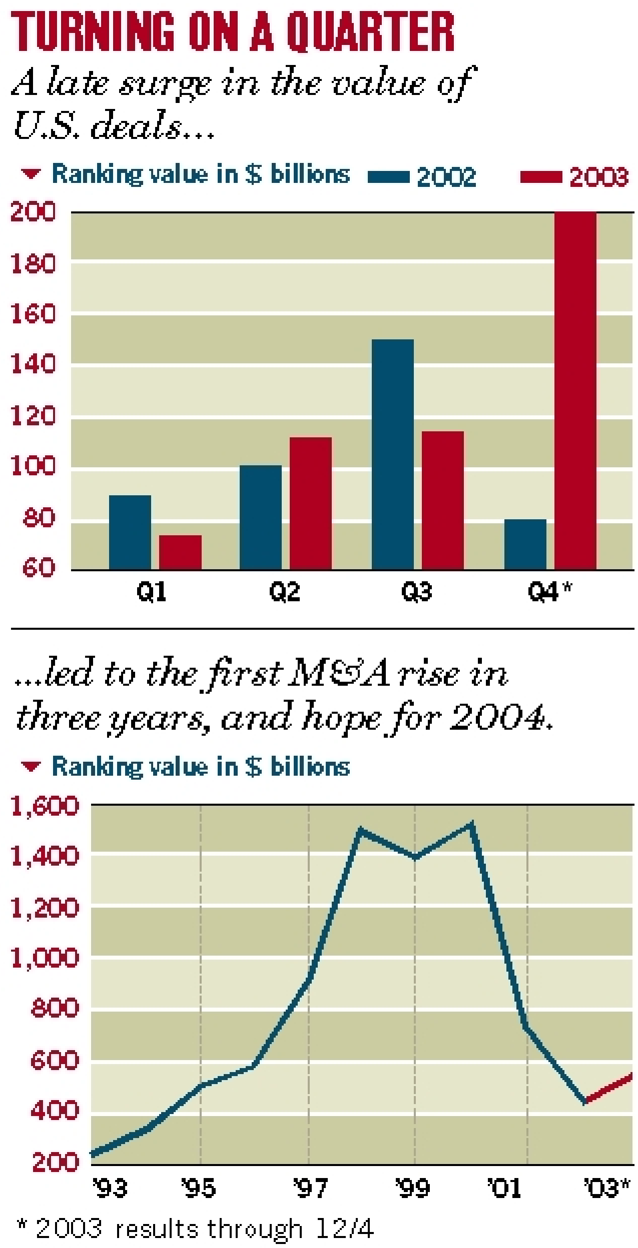
4) In the last few days we have gotten a sharp drop in consumer sentiment. As recently pointed out by Robert Prechter of *Elliott Wave International*, when the ABC/Money poll of consumer confidence has previously declined by more than 7 points in any one-month period, such an occurrence has historically always preceded a recession.



Source: ABC News

5) As also recently pointed out by Prechter, the mobile home and manufactured home markets remain under pressure from high loan default rates and bloated inventories of repossessed homes. Fannie Mae actually had to tighten its lending policies on manufactured homes in late 2003 because default rates were climbing so quickly. Mobile home loans actually declined 6% in 2003 (and as a sad statement about America in general, mobile and modular homes now represent 30% of new home sales – It only took us 200 years to ruin our naturally beautiful national landscape). Per Prechter, such weakness within the mobile home loan sector previously foreshadowed major real estate problems of the mid 1970's. Separately, the inventory of unsold single new homes is also now the highest level since June 1989. At December 2003's sales pace, that represented a 4.3-months worth of supply.

6) As further pointed out by Prechter, mega-merger activity is currently picking up for the first time since early 2000 when AOL and Time Warner got hitched – with horrific subsequent results of course. In the headlines today, we have instead Comcast/Walt Disney; BoA/Fleet; JP Morgan/Bank One; and Cingular/ATT Wireless. While this merger activity can certainly continue a bit longer given the less levered balance sheets of many large companies and the rebound in stock values that may be used to create stock-for-stock cashless transactions, such activity remains a potentially worrisome sign. Since JP Morgan has tended to hit every pothole in the road in recent years (stepping-up to Internet venture capital forays in 1999; Enron, Adelphia, and Worldcom exposures in 2002, etc.), their compulsion to get into increased consumer banking exposure with the Chase and BankOne mergers appears to us as particularly maladroit.



Source: Money Magazine

7) Lastly, from an anecdotal societal point of view, the reaction by the public and by Congress to the overly raunchy Super Bowl half-time show, and subsequent banishment of Howard Stern from late night cable television may indicate a society no longer interested to push the envelope of morality. Instead, we may be starting a throwback movement towards more conservative and protectionist values. Robert Prechter has previously written that a return to religious convictions typically escalates in a bear market.

   Is it thus just a coincidence that we now have a blockbuster and controversial new movie *The Passion of Christ* appearing? If this movie proves successful, it may be an early indication of America's psyche shifting from the 2003 French kiss between Brittany Spears and Madonna to more serious matters. Already, it was somewhat surprising to see *NBC Dateline* spend almost 40 minutes this past Friday with a story focused on the power of Christ in human lives. As much as we dislike the schlock that has now come to populate network prime time – generally filled with embarrassingly explicit sexual innuendoes -- it will be interesting to watch whether we are in the process of a backlash towards a more religious and serious American psyche. 9/11 brought a touch of this, but is there more?

2003:

2004:

But if either our Path 2 or Path 3 view of 2004 equities proves correct, most would expect the U.S. bond market to trade higher -- not lower. But in our opinion, such knee-jerk thinking is more likely to produce intermediate-term losses, not gains. Bonds are unlikely to be the safe haven people still perceive them to be since they stand at the middle of the various global imbalances and are over-owned by foreigners. While investing neophytes may chase bonds higher in the short-term as the economy shows signs of weakness, on an overall basis, such rallies are unlikely to have sustainable "sea-legs." Instead, bonds are more likely to either be stumbling lower to precipitate equity weakness, or stumbling lower because of continued equity strength (as in a Path 1 type world). In either case, trying to actively position oneself in the bond world is currently fraught with danger – with constant start-stop moves akin to a frustrating tug of war. It is a crowded space that is not compelling. The clearer long-term bets are to be short USD/JPY and long inflation hedges such as gold.

As one side note on bonds, it is possible that the panic date of Dec. 30-31, 2004 might somehow tie into the bond market in a significant fashion since the PEI cycle date in late July 2003 saw a "panic cycle" in the bond market instead of equities. The important thing to remember in this regard is that since global bond markets are twenty times as large as global equity markets, any significant weakness in bonds is generally harder to recover from than an equity market crash that occurs with bond strength. Bond weakness begets more wealth destruction. It is of course when equities and bonds go *down together* (a la 1994 and 1998) that the world becomes truly dangerous.

In the end, we believe that the bond market is likely to be something of a waste of time in nominal dollar terms, with the brunt of the foreign wealth destruction continuing to occur from a dollar slide. Certainly the U.S. Government and Fed are likely to err (as they have to date) on the side of dollar weakness instead of bond weakness if they can avoid the latter path since 80% of Americans have never been abroad, and most hardly notice when the dollar declines. The average American does of course notice any changes in interest rate levels.

It is easier to maintain an "illusion of prosperity" using the dollar as a policy vehicle even if American purchasing power creeps lower over time. A dollar decline also puts more of the direct cost of America's over-consumption on foreigners as opposed to directly on U.S. workers. Indeed, the Bush administration is basically begging for a weaker dollar against Asian currencies as a way to protect U.S. workers.

If we had to guess – and it is admittedly hazardous to do so -- the path in long-bond yields might go something like this in terms of 30-year yield levels: first 4.77% (sell bonds), then 5.76% (buy bonds), and finally 5.10% (back to middle value). Similarly, in 10-year T-Notes, any stretch in the short-term up toward a price target of 117-21 on the March contract would likely represent a great selling opportunity. Notes may not even get that far, but they are unlikely to go much further if they do.

In the meantime, recent dollar strength against the yen will not be sustainable. On both a traditional Edwards & Magee head and shoulders chart pattern basis, and a Fibonacci rhythm basis, 95.50-96.00 most definitely beckons over time!

As a final note, we are sometimes asked: “Well what exactly should the U.S. monetary authorities do to rebalance the world economically?” Here, we can only think back to one proposal by the independent presidential candidate of 1992 and 1996, Ross Perot. Although Perot was certainly over-the-top in many respects, he stated adroitly and correctly in his campaigns: “America has the cheapest gasoline in the world, and we need to encourage more environmental conservatism. If we placed a nice 10 cent tax on gasoline, one could make a good dent in our budget deficit problems, while helping the environment at the same time.” Perot made a lot of sense in this single regard, and got our vote because of it.

Such a consumption tax would of course also shock the U.S. economy and likely precipitate a nasty recession. It is politically unthinkable for any of today’s candidates to even propose such an action. This is one of the flaws of democracy: no one will get elected by promising the correct but unpopular path. But in the longer term, such is the medicine that the U.S. economy really needs, and after an initial shock and some economic pain, America’s economy would be healthier for it.

Yet, instead, and more realistically, increased taxes on imported luxury items will likely be a more viable political alternative to watch for over time – but alas, at that point, the nasty spectre of U.S. “protectionism” -- and potential foreign retribution in return -- would then be upon us.

Send us your comments at information@Sandspring.com.

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