Sand Spring Advisors LLC

Messed-up

by,

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Mid-April was a window of time where we expected a break lower in markets – a real sentiment shift, and initially it looked as if our views might be quite prescient in this regard. Global equities dropped like a stone on Monday, April 20th – really on no news – and then the following weekend, headlines related to the spread of Swine Flu initially sent markets down further.

But that is when any further thoughts of prescience came to an abrupt halt. Markets rallied back from their morning lows on Monday April 27th and then did so again on Tuesday April 28th, and ever since, we have been fumbling to understand what has been going on. Our calls espoused back in early April with retrospect now appear to have been horrific ones. Only one stock mentioned, BKC, fell from grace, and many of the other stocks and ETFs have marched in an ongoing romp to the upside. For this poor insight, we are profusely humbled and apologetic.

As a partial explanation of recent market behavior, let us chat for a moment about the tremendous amount of "quant money" chasing markets around. This money does not look at news headlines or use any modicum of macro common sense in its investing approach. Instead, it simply invests on the basis of various micro-security specific "stylistic" factor models such as quality of earnings, valuation, sentiment, and momentum. In the current instance, the quants were selling and selling stocks of questionable quality into early March – spurred on by all of their valuation, quality-of-earnings, sentiment, and momentum models. But they then got caught by a sudden "V-reversal" in momentum. Now all of a sudden, their momentum models sent signals to buy the same low-quality stocks that they had just been so hot to sell. Most of these low quality stocks were already highly shorted. Many were in consumer-cyclical industries such as restaurants and retailing. So bingo, a classic short-covering squeeze has proceeded to unfold mostly in these sectors.

Just read what Barclays Bank (one of the biggest and historically most savvy quant-oriented asset managers) recently penned about the recent environment:

> Over last eight weeks, top performing stocks rank as highly unattractive on a fundamental basis while the worst performers rank as highly attractive fundamentally. "This is usually not a winning recipe by which to generate quant outperformance. The Hardest to Borrow and Heavily Shorted stocks are up substantially more than the broad market average, giving some credence to the talk that the current rally is a short-squeeze at work. However, the Top Performers have substantially outperformed even these groups of stocks so we believe that there is yet an additional dynamic(s) at work. Indeed, the group of the Top Performers most resemble is those stocks that were less than $5 as of February 27th – the low price beaten down stocks.
>
> [Compounding problems], the average systematic correlation across stocks is at or near all time highs, exceeded only by the days following the October 1987 crash and a brief period in 1954. A high correlation means that there is very little dispersion among stocks and a low correlation means there is a high dispersion in performance. **Today there is very little dispersion when measured in stocks across the market as a whole. Systematic factors are driving stock returns across the market. Stock specific news is largely irrelevant and that this is the case in the middle of earnings season, when stock specific news should be at its height, is truly remarkable. Getting the individual names right in the portfolio has never been less important. Getting your systematic risk exposures (e.g. your style tilt, [as well as your net beta, net sector exposures -- if allowed in one's portfolio construction]) correct has never been more important.**

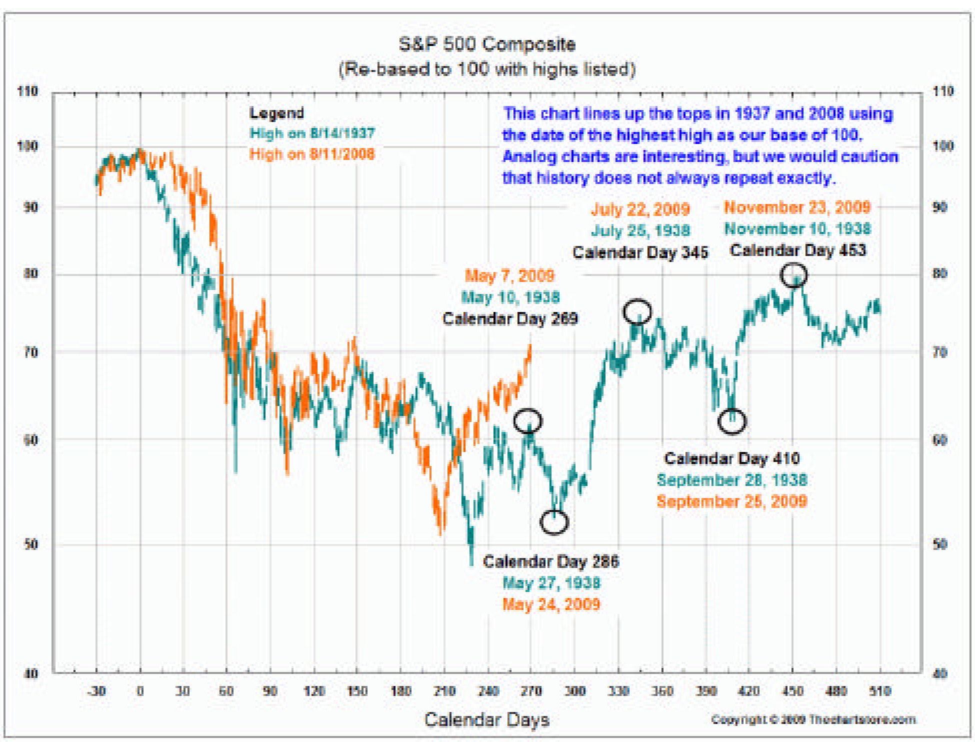
But does an eight week firestorm of quants tripping over themselves to flip momentum exposures lead to a sustainable market rally? Our answer: only if the fundamentals are there to support such a rally longer term. And in the current instance, we believe that it is <u>way too early</u> for the consumer to return to a spending binge at shopping malls and restaurants across the country. As rational human beings we know something that the quant models do not: the consumer is close to being tapped out, and even with the government pouring massive liquidity into the banking system, the wealth destruction of the past two years in housing and equities has left a gaping hole in America's balance sheet – a balance sheet which was already shaky at the start of this period.

So let's get this straight. Bernanke, Geitner, Obama and company have inherited an over-leveraged America now caught with its pants down playing the leverage game. But instead of letting market mechanisms work to resolve this over-leveraging problem in normal albeit somewhat painful fashion (defaults, higher interest rates, added restrictions on the extensions of credit), our policy makers are trying their damndest to prevent "Mother Nature of the Economy" from working the way it should in a cleansing fashion. They are trying to perpetuate the use of leverage through the application of more government funds and even more leverage – just with the holders and extenders of credit shifted around. In my mind, this is exactly the wrong policy response at the wrong time. It threatens the eventual complete de-stabilization of America's financial system when the issuance of Government debt becomes too big for the market to handle and interest rates start to naturally migrate higher in a natural supply-demand revolt. Some of this already appears to have started with the recent day-after-day grind higher in U.S. Treasury longer-dated yields.

Indeed, one might argue that mid-April really brought an entropic moment when inflationary-oriented assets (oil stocks, gold, etc) stopped languishing on their recent lows and started to perk up, while U.S. Treasuries started to break down. Higher oil prices and higher interest rates are not of course bullish for consumer stocks, so the fact that consumer stocks rallied during this period as well is not intuitively obvious corollary. Such would only make sense in a sustained recovery environment, and there is no economic foundation for such.

So we are back to concluding that recent market strength has been led by a bunch of quant models tripping over themselves. "Sell restaurants, sell banks, sell department stores" suddenly and irrationally flips to "buy restaurants, buy banks, buy department stores." The move should last only as long as the last quant money manager has money to adjust, the last mutual fund feels compelled to jump aboard and put money to work, and the last rational hedge fund feels grudgingly compelled to adjust its net beta exposure to be more exposed to the market due to FOMO pressures ("Fear of Missing Out" on a large market move). In other words, for awhile at least, this becomes a self-perpetuating pop higher very much in the vein of a "Greater Fools Theory." No one really believes the rally, but eventually – and for very little fundamental rational cause -- many feel compelled to adjust their portfolio so as not to be left behind.

In terms of past market analogs, the 1938 period remains possible – but would call for a substantive and fairly immediate multi-week period of consolidation in the market first back to 750-830 for the S&P before eventual further strength later in the year. The chart below by The Chart Store shows this ongoing possible analog the best:



One set of timing work supporting an immediate top over this weekend comes from Bill Erman of Ermanometry.com. Bill takes pi, phi, and other Pythagorean ratios across trading days (while our own cycle work focuses instead on calendar days), and comes up with a number of clustered possible turning points for markets each year. Not all of these end up proving useful, but some do. May 7-11th is one such possible period for a turn per Erman:

> Please recall the significance of the ratio 2.3416. This is the ratio of the perimeter of the One-Two Right Triangle over the hypotenuse.
> When the legs of a One Two Right Triangle equal 1/3 and 2/3 of Pi, the hypotenuse equals 2.3416. This is detailed in a PDF download from our web site and has been referred many times in previous Email Alerts. Also, 1.34164 x 2.34164 = Pi
>
> May 8 is 2341 days from the 2000 DJIA top. This top is 2340 days from the October, 1990 bottom. Thus there is excellent symmetry.
> In addition, there are 2341 days between the 1974 S&P bottom and the January, 1984 DJIA top.
>
> There have been two previous major moves of 6389 days: 1962 bottom to 1987 bottom, and 1974 S&P bottom to 2000 DJIA top.
> There are also 6389 days between the January, 1984 DJIA top and May 8. Thus 2341 and 6389 have shared common pivots in the past and both meet again on May 8.
>
> There are 1655 days between the 2002 bottom and May 8. 1655 x 1.4142 = 2341.
>
> There are 144 days between the October, 2008 low and May 8.
>
> There are 396 days between the October, 2007 top and May 8. 396 x .382 = 151, the number of days between the 2007 top and the May, 2008 top.
>
> There are 352 days between the 2007 top and the March 6, 2009 bottom. 352 divided by 8 = 44. There are 44 days between March 6 and May 8. This matches the 44 day move from the March, 2008 S&P bottom to the May, 2008 top.
>
> 2341.6 divided by 1.4472 = 1618. 2341.6 is directly related to all iterations of The Golden Mean and Pi

Dizzy yet? Erman's work is indeed tricky to follow, but suffice it to say that the small poke to new marginal highs by the S&P on Friday, even as the market's internal breadth feels as if it has been deteriorating over the last few days (consumer and restaurant stocks finally stopped going up earlier in the week) leaves me unwilling to get "on board" recent market strength and in any way change my previous own skeptical views of the recent rally.

But I could of course be wrong. Exploring back over a hundred years of market history, I have found very few equity "V-bottom" formations that did not have some sort of retracement re-test, but I must admit to finding a few. April 1942 (MacArthur's surrender in the Philippines), June 1949 (fear of post-war deflation/depression that simply never appeared), and March 2003 (beginning of Iraq War) were three such volatile 'V-bottoms" that went straight down and then straight back up without ever allowing for a normal period of retest after the initial V-bottom low. I suppose this is a risk to our generally bearish view. It doesn't happen often, but it is possible.

But then again, we also spy bear-market periods like 1973-1974 and 2000-2002 when sharp short-term rallies ended up as exactly that: short-term flashes in the pan, and in our gut, we feel much more oriented to this latter type view for the current 2009 period of market strength. We find ourselves agreeing with words by author Spencer Jacob in the *Financial Times* this past Friday:

> The granddaddy of all bear markets, 1929 –1932, had six false alarms with an average gain of 47 per cent. And Japan's ongoing bear saw the Nikkei rise by at least a third four times in its first four years with 10 more false dawns since then.
>
> Bear markets typically end with a whimper rather than a bang, casting doubt on the latest recovery according to Hussman Econometrics, which analyzed numerous US market bottoms and bear market rallies. With the exception of the 1987 crash, the month before the lowest point of a downturn saw a gradual descent. By contrast, bear market rallies were preceded by steeper declines and had sharper rebounds. Another characteristic of bear market rallies has been modest volume on the rebound compared to the decline. The current recovery fits the pattern of bear market rallies in terms of volume and the "V" shape of the trough. Analysts at Bespoke Investment Group noted that there have been only seven other periods in the past 110 years with rallies of similar magnitude for the Dow. Three preceded the Great Depression, three came during the Depression and one in 1982.

In terms of the August 1982 period, we do not find it to be a relevant comparison mostly because that period saw more of a slow dribble of multiple thrusts to new lows. While the recent market did exhibit three separate thrusts lower in October, November, and then January-March, the overall picture is a different one from the 1982 bottom. Momentum in the former period was clearly waning on each thrust lower, while momentum in the latter more recent period was almost increasing – until of course, the V-bottom hit. In 1982, then-Fed Chairman Paul Volcker had already put the economy through two-years of pain and cleansing via his tight interest rate policies. In the current instance, the Fed has only tried to <u>avoid</u> any pain for the market. There is quite a difference. Despite the massive printing of money by the U.S. Government, the recent rally has no real fundamental sea-legs. Moreover, what legs it does have are all artificially created. Bernanke is playing with dangerous fire in its quantitative easing stance, and yet so many of those around him (let that read namely Obama himself) hardly have any appreciation of the longer-term repercussions of this stance.

What Bernanke has begun in 2009 will likely end badly by mid-2011 or at the latest December 2012 (commensurate with the Mayan Calendar's end). Yes, Bernanke may easily still fit the description below by John Maynard Keynes of a "sound banker," pulling on all of the seemingly appropriate levers along the way, but he will not be particularly popular:

> "A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows, so that no one can really blame him." John Maynard Keynes, 1931

It will be during this latter period that people will be more openly questioning the Fed's very powers and mandate, and a new global monetary order will likely be in the works. The majority will finally wake up to the current cries of Congressman Ron Paul and view Paul (or some other Libertarian successor) as something more serious than his current image to many as a crack-pot.

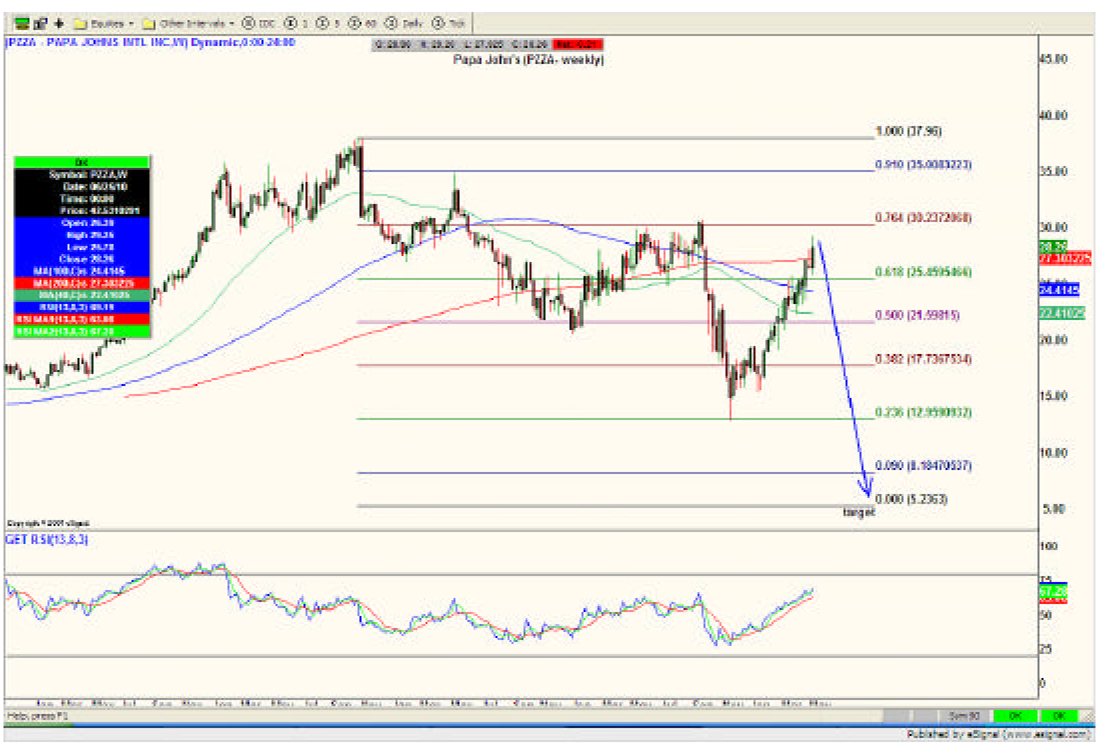
But to get there, first we must see Bernanke's and Obama's policies start to cause unfortunate side-effects and consequences.

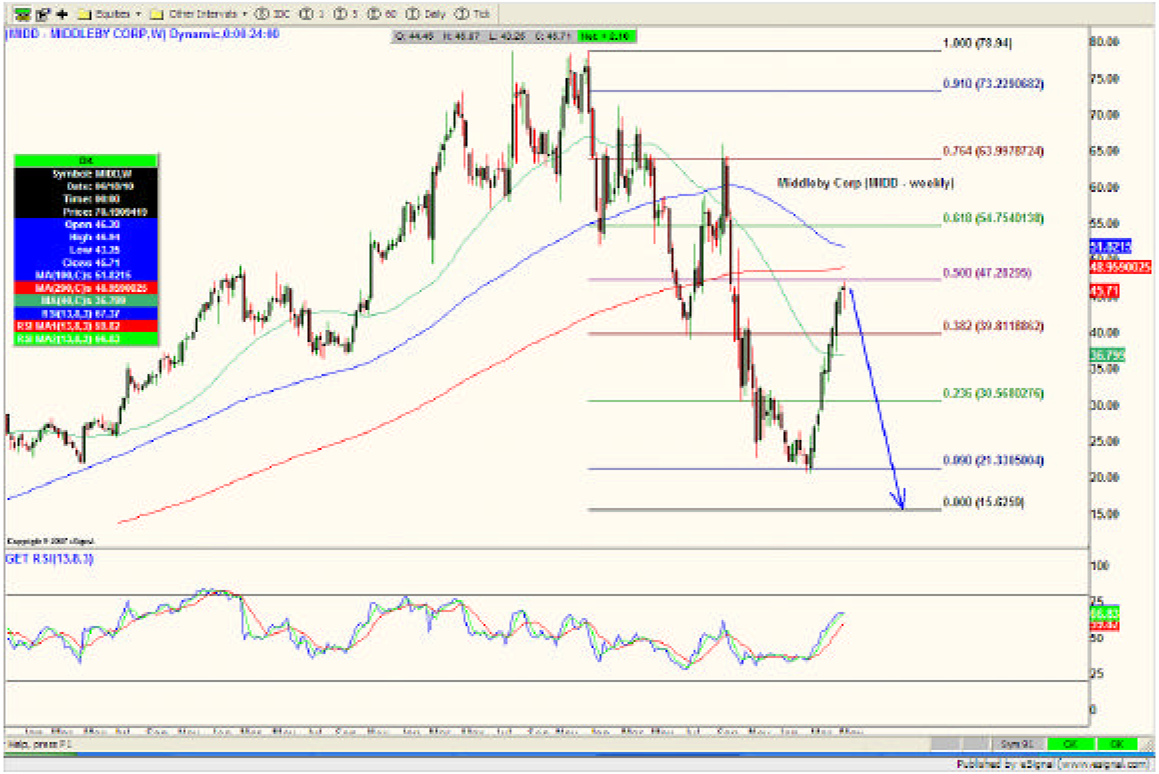
For the moment, the long-bond has run enough to higher yields that we cannot advise chasing it on the short side. We will simply be watching bonds and the dollar carefully for signs of further foreigner revolt against American economic policies. We have little doubt that over time such revolt will become more and more self-evident.

What we do see in the short-term is an the XLY Consumer Discretionary ETF that has simply run too far, and likely has a new low left in it (even if the broader market may only have a retest).

We see homebuilding still headed to at least one more new low as well.

Restaurant stock PZZA still looks like a great short to our eye, as does restaurant kitchen supply company Middleby. YUM Brands (not shown) also remains highly suspect.





Albeit double inverse ETFs have generally been proven a flawed investment vehicle (with excess rebalancing slippage and all), we also cannot help but be drawn to the chart pattern of the SKF (double inverse ETF on financials) and believe that after nine straight weeks down it should be able to muster some sort of a bounce. If the SKF were to start rallying, could we get back to \$100 in a heartbeat given this ETF's natural volatility? You betcha.

We are generally uninvolved in energies and somewhat upset about such, given that so. many companies in this sector arguably are cheap and still have good longer-term fundamental growth prospects. But a "missing low" in the XLE Fibonacci fractal pattern unfortunately leaves us with little edge as to immediate path. Any of the basic paths outlined below are possible – including a path straight back down.

Regarding REITs (as expressed by the IYR ETF discussed in the last letter), there has recently been a tremendous amount of broker hype about a turn-around in this sector based off of secondary offerings and more refinancing possibilities. Playing REITS from the short side has been frustrating and expensive. We still see new lows to come in this sector, but maybe there are easier fights to fight.

The only sectors that we do continue to be drawn back to on the long side are those involving agriculture (the DBA ETF tracking various soft agricultural markets holds some appeal to us) as well as water purification and infrastructure stocks. In this latter area, constructive longer term chart pictures may be found in such stocks as DNEX, DHR, TTEK – albeit all could easily retrace in the short-term.


DNEX - DIONEX CORP,W) Dynamic,0:00-24:00
DIONEX - DNEX weekly
longer term upside target 0.000 (96.3504)
0.090 (88.0239977)
0.236 (74.5409556)
0.382 (61.0486723)
0.500 (50.14395)
0.618 (39.2392278)
0.764 (25.7469444)
0.910 (12.2731436)
1.000 (3.9375)
GET RSI(13,8,3)
Published by eSignal (www.esignal.com)


DHR - DANAHER CORP DEL,W) Dynamic,0:00-24:00
Danaher - DHR weekly
missing high longer term 0.000 (97.52)
0.090 (88.827152)
0.236 (74.75072)
0.382 (60.66464)
0.500 (49.28)
0.618 (37.89536)
0.764 (23.80928)
0.910 (9.742496)
1.000 (1.04)
GET RSI(13,8,3)
Published by eSignal (www.esignal.com)

Lastly, for the market as a whole, and having been run-over of late, we will be satisfied to see a normal retracement in the S&P to around 836. If we get that much right at this point, we'll take next strokes one step at a time from there.

Send us your comments at information@Sandspring.com.

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