Sand Spring Advisors LLC

Messy May & Beyond

by,

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The concomitant turn lower in global equity markets together with commodity markets surprised most people in May. Thankfully, Sand Spring was not among them. We specifically spent considerable time in our May 6th article *Too Prudent To Be Rich* discussing how overbought copper and precious metals markets were likely to come undone at the same time as an equity market reversal – sudden equity weakness reinforcing the metals market rush for the exits by trend-following CTAs and others.

We wrote:

> The story of synchronized global growth – with the global equity, metals, and energy markets all advancing together – just seems too "pat" and overbought at this stage to really trust much longer. Indeed, by the mere fact that Copper recently touched 95% bullish on Market Vane sentiment indicators while Silver reached an unheard of 98% Bullish Consensus reading, these markets simply *must* experience a downside correction soon… But to get a meaningful immediate 4th wave correction in the metals sooner rather than later (and thereby satisfy the immediate Market Vane sentiment readings with a reversal), it might of course help to have a fundamental catalyst. The logical sign to look for would be some sort of sudden reversal of global economic confidence to break the mantra of the "insatiable commodity demand." And one of the few things that could cause global economic confidence to wane would indeed be a stock market downswing of some magnitude.

We also spoke of other cracks in the façade of bullish times that had already started to appear. Among other technical indicators, these included the already substantive year-to-date plunge in the Saudi equity markets and a chart pattern in the Turkish equity markets that as of May 6th sported negative price and momentum divergence when compared to other global markets. Well, suffice it to say that Turkey did not disappoint – with both its equity, currency, and bond markets simply being trashed over the subsequent two weeks after our mention of it.

The Turkish ISI National 100 Index

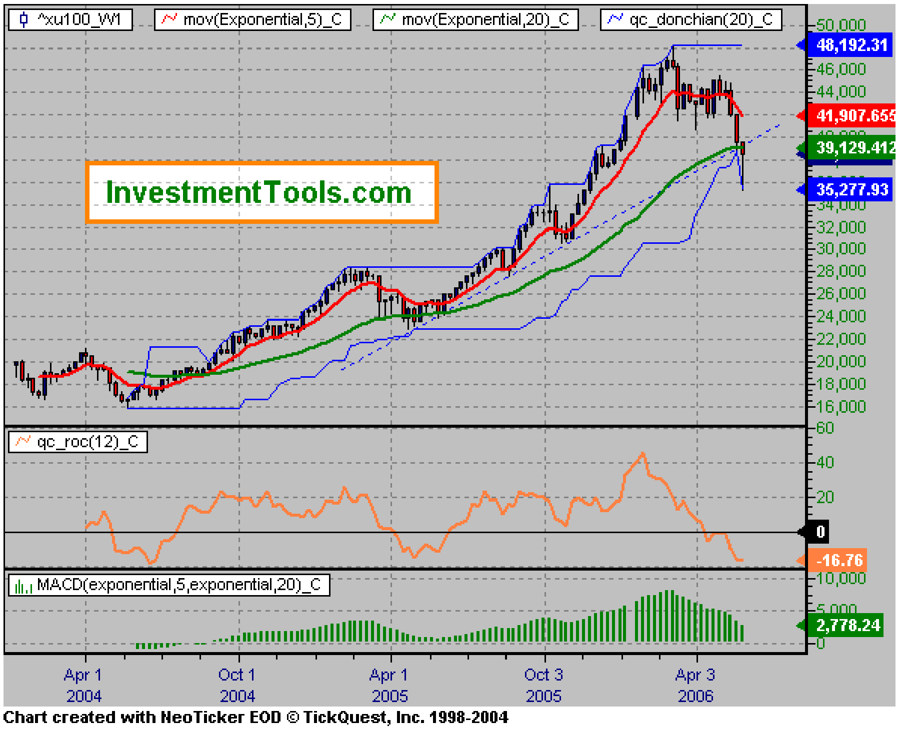


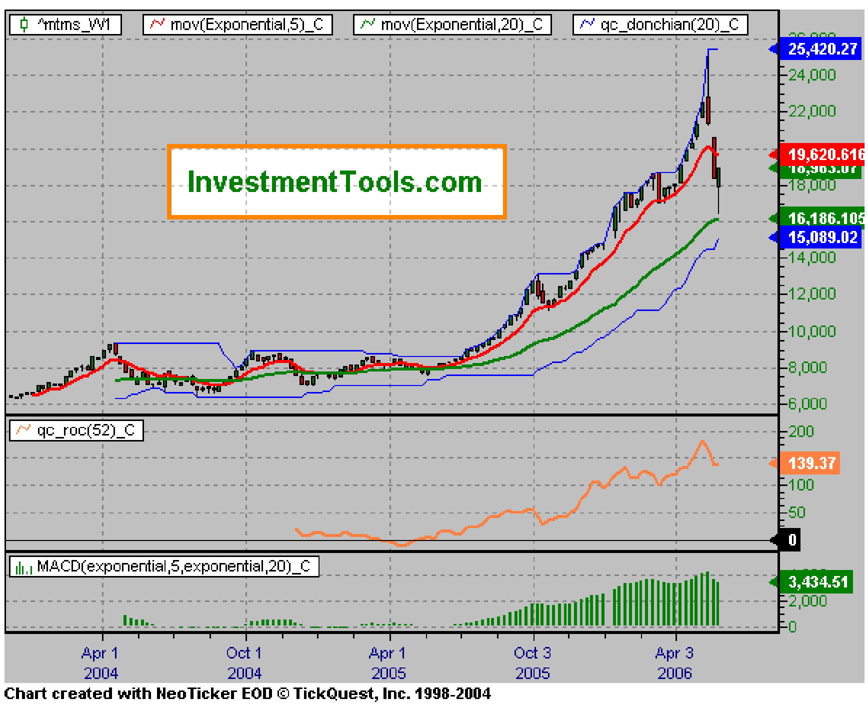
Chart created with NeoTicker EOD © TickQuest, Inc. 1998-2004

USD vs. Turkish Lira

Elsewhere, other markets such as those of Europe and Russia left prominent inverted "V" spike highs in early May that seem unlikely to be overcome anytime soon – no matter what U.S. equity markets may yet be able to deliver on the upside.

Dow Jones Europe Composite Index

Russia Moscow Times Index



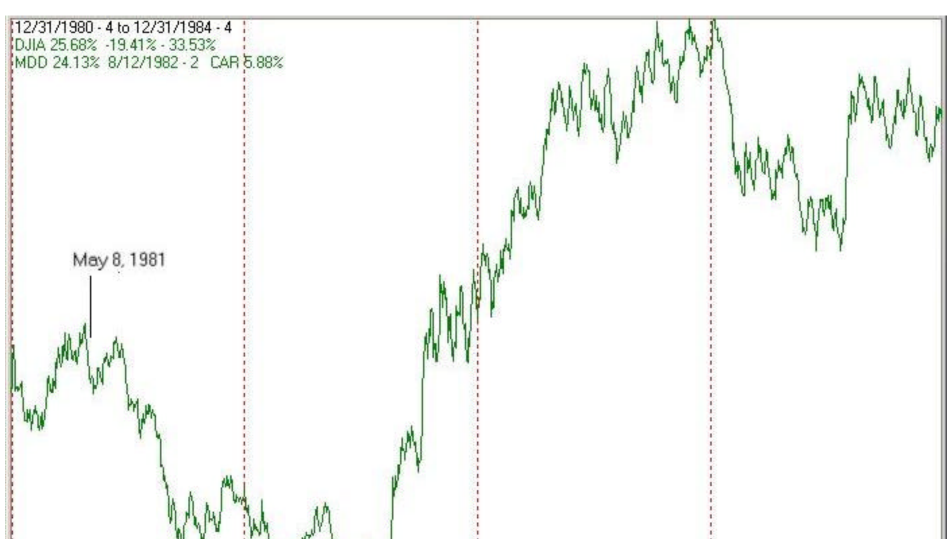
So where to from here? In our May 14th public posting entitled *Something Like This*, we wrote: "We would not be surprised to see a minor low into late May, with a bounce into the 06-06-06 PEI date. Thereafter, the true nastiness of the summer should begin." But if that sounds ominous, remember as well that we also expect general strength in the equity market to re-emerge in October 2006 and that the *major February 24, 2007 PEI date should be an equity market high, not a low.* So how nasty could the summer really be? To be completely honest, it is hard to tell. We need to play this summertime period one step at a time.

To take a step back, and for those who are unfamiliar with the 8.6-year PEI cycle and why it is so important to our analysis, this cycle was discovered and popularized by Martin Armstrong, formerly of the Princeton Economic Institute, and currently an incarcerated prisoner in the Downtown Correctional Facility in Lower Manhattan. Armstrong is a brilliant man who I knew personally, but who also had a shade of hubris and back office sloppiness that got him into trouble managing assets for the Japanese in 1999. Prior to this fall from grace, he had studied the cyclical rhythm of financial markets back over the past two centuries and determined that the equity market displayed a definite high-to-high "pi cycle" rhythm of 3,141 days – or 8.6-years – with each 8.6-year cycle turn marked by sudden mood changes and subsequent periods of financial panic.

Armstrong first garnered significant attention with this theory back in mid-1989 when he adroitly predicted to a packed audience of Japanese investors at Tokyo's Palace Hotel that the "Japanese Nikkei would top in the final two weeks of December 1989" – which is precisely what subsequently transpired. Then, exactly 8.6-years later, into July 20, 1998, he predicted a significant high for that date for European and U.S. markets. Go back and look at the daily charts of 1998 and you will find that Monday, July 20, 1998 was the exact and significant market high that was established just in front of the twin Russian ruble and LTCM crises. Yes, it is true that from October 1998 to March 2000 markets rebounded to even loftier levels through the Internet bubble-mania, but to a certain extent, the financial world was never quite the same after the August-September 1998 downdraft. Equity markets were instead increasingly imbalanced and out-of-control – moving into a "broadening formation" of the early 2000 peak and then the summer 2002 trough low. Despite the new market highs of 1999-2000, S&P 500 earnings also actually peaked over 1997-1998, and never recovered their 1998 high until late last year.

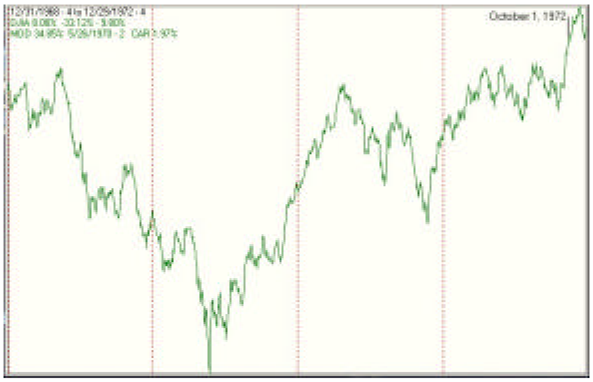
How far back does this 8.6-year cycle carry? 8.6 years prior to the 1989 Nikkei high was May 8, 1981 -- a scant few days after that year's closing high on April 27, 1981 at 1024.05 on the DJIA, and two days prior to the people of France voting out their conservative president Valerie Gicard d'Estaing in favor of Francois Mitterand's socialist party. This notable mood change in Europe and equity topping period in the U.S. preceded a gut-wrenching 15-month 24% plunge in the DJIA to 776.92 by August 12, 1982 -- a period during which Paul Volcker was raising interest rates to unheard of levels to squelch inflationary pressures.

DJIA 1981-1984

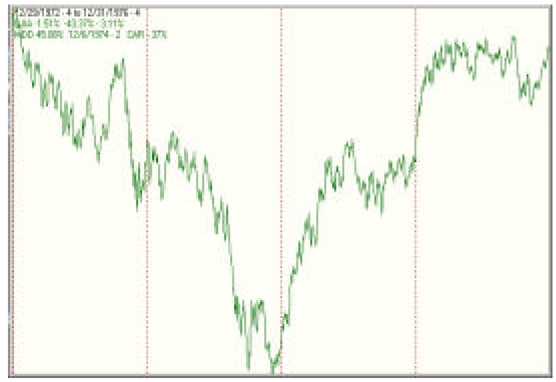


Another 8.6 years earlier, October 1, 1972 was not a perfect high (premature by a bit), but definitely preceded the nasty 1973-1974 bear market. That week was arguably also one of President Nixon's high points in office as he signed a significant arms control treaty with Russia's Foreign Minister Andrei Gromyko. Nixon would be reelected by a landslide the following month. But it was all downhill from there over 1973-1974 both for his own popularity and for the markets.

DJIA 1968-1972



DJIA 1973-1976



In our own work here at Sand Spring, as detailed in our February 2001 article *Measuring Financial Time: The Magic of Pi*, we have argued that there may easily be other overlapping 8.6-year cycles beyond just the PEI dates "high-to-high" turn dates. In that article, we specifically examined broader 8.6-year rhythms back to the birth of the U.S., and laid out the following rhythm:

1776-1785 - Type 4: high inflation, low growth, WAR
1785-1793 - Type 3: low inflation, low growth
1793-1802 - Type 1: high inflation, high growth
1802-1810 - Type 4: high inflation, low growth
1810-1819 - Type 3: low inflation, low growth, WAR
1819-1829 - Type 2: low inflation, high growth boom
1828-1836 - Type 2: low inflation, high growth boom
1836-1845 - Type 4: high inflation, low growth
1845-1853 - Type 1: high inflation, high growth
1853-1862 - Type 3: low inflation, low growth
1862- 1871- Type 1: high inflation, high growth, WAR
1871-1879 - Type 2: low inflation, high growth boom
1879-1888 - Type 2: low inflation, high growth boom
1888-1896 - Type 3: low inflation, low growth
1896-1905 - Type 1: high inflation, high growth, WAR
1905-1914 - Type 4: high inflation, low growth
1914-1922 - Type 1: high inflation, high growth , WAR
1922-1931 - Type 2: low inflation, high growth boom
1931-1939 - Type 3: low inflation, low growth
1939-1948 - Type 1: high inflation, high growth ,WAR
1948-1957 - Type 2: Low inflation, high growth boom
1957-1965 - Type 2: Low inflation, high growth boom
1965-1974 - Type 4: High inflation, low growth, WAR
1974-1982 - Type 1: High inflation, high growth
1982-1991 - Type 2: low inflation, high growth, WAR
1991-2000 - Type 2: low inflation, high growth

We then went on to state:

> Out of a 223.5-year period, the majority of the market's real inflation-adjusted gains have actually transpired in just 77.4 years, with the balance of the years representing no better than a struggle. This alone suggests that pundits who say equities are the place to be all of the time, just haven't examined actual price history very carefully. We have certainly experienced several long periods of time where equities have yielded little net return. If our analysis below is correct, the years 2000-2008 should be one of them…. After each previous double 8.6-year cycle of type 2 boom, we have either had a dangerous type 4 period (high inflation, low growth) or an equally scary type 3 period (low inflation, low growth). We have <u>never had three type 2 boom periods in a row</u>. Nor have we ever had the more benign type 1 situation of high growth with high inflation after two consecutive 8.6-year type 2 boom periods. With the 51-year cycle in commodity prices due to bottom in 2000-2001, a type 4 market of low earnings growth and high inflation would seem the most likely to us at this time. This will not make the next eight years easy ones.

In actuality, earnings growth *was* anemic for the first part of this period, but then turned reasonably strong since 2002. Measured from the July 20, 1998 PEI date, we actually experienced two mini 4.3-year cycles in S&P earnings --- first a cycle down between 1998-2002; and then another another one up between 2002 and present. That said, the total earnings of the S&P only recently surpassed its 1998 high. And inflation has indeed stepped up over the entire period since metals markets made their trough low in 2001. The DJIA as priced in gold terms has in effect trended lower for much of the time since Armstrong's July 20, 1998 PEI cycle turn.

So let's still call this indeed a "Type 4 -- high inflation low growth WAR" type of outcome.

So what then for the PEI turn of February 24, 2007 and the 8.6-years following that date out to 2015?

In the DJIA/Gold Ratio chart above, we have an extrapolated Fibonacci target near a 13.30 ratio that we believe will be seen before next February. This translates into ongoing overall flattish earnings (let that read: flattish to higher equity) and high inflation expectations (let that read: renewed metals strength) in the short term. Don't be surprised to see Bernanke viewed once again as a "spigot turner" with metals markets regaining their footing and some equity and metals markets perhaps reaching new highs. The world should generally hold together until next February with an overall return to the "higher metals – higher equities – lower dollar – lower bonds" type of alignment. The period that began in May 2006 (and may end sometime over the late summer or early fall of 2006) may easily end up being viewed by early next year in a similar fashion to the temporary setbacks of March-April 2004 or April-May 2005 that were quickly overcome.

However, thereafter, at least for the beginning portion of the next cycle shift, some market prognosticators such as Robert Prechter of Elliott Wave International are clearly anticipating a "Type 3 low inflation, low growth" debt deflation bust environment (last seen in 1931-1939). And to a certain extent, we would have to agree with Prechter that such is overdue to show up – at least initially. Within such a forecast, we also happen to believe that such a shock will be front-end loaded between February 2007 and the cyclical troughing period due for precious metals in late 2009 to early 2010 (previously discussed in our May 6th article). The path for markets beyond 2010 is probably best left for future discussion – particularly since the end of the Mayan Calendar will be reached in December 2012. With a sunspot maxima also due around that latter same time, God only knows that will be happening then. As of today, our only strong expectation is that the gold market will have bottomed by 2009-2010.

But leaving the distant future aside for now, we do want to lay out the following shorter-term roadmap:

- Global markets should initially continue to bounce into June 6, 2006 (a 4.3-month mini-PEI cycle).
- June 6, 2006 to Oct 15, 2006 should then represent another period of some stress – perhaps a slow C-wave dribble lower, or perhaps something faster and more severe.
- Oct 15, 2006 to February 24, 2007 should then be a last hurrah of the "buy equities and buy commodities" mantra.
- February 24, 2007 onward: being liquid should be king as global asset prices fall.

The overall rhythm in terms of the Nasdaq 100 could end up looking something like the following chart:

We believe that such a cyclically inspired vision also fits the expected fundamentals reasonably well. To explain why, first we must explain a bit more about what fundamentally happened in May 2006. In the minds of many, there was certainly no easy single news event to which the concomitant May reversal in so many global markets – the sudden loathing of so many risky assets – could be blamed. Or was there?

One interesting piece of research that recently came across our desk was from hedge fund manager FrontPoint Partners who adroitly was paying attention to Japanese monetary policies, and as early as last February 2006 wrote:

> "This month on the other side of the Pacific, BOJ officials signaled their intention to reverse the flow of the massive liquidity pipe known as the Quantitative Easing Policy (QEP). The end of QEP, which is likely to begin in the second quarter, will mark the end of the global war on deflation [in Japan] and more likely than not vigilance on a new front, that of inflation. QEP was a policy initiated in 2001 whereby bank bills carrying a zero nominal rate of interest were issued to Japanese banks by the BOJ…Over time the total outstanding bank bills have grown to Y44,000 billion [approx. $393 billion]. The end of QEP will involve the BOJ retrieving [some of] those excess reserves by ceasing to roll [all of] the short term bank bills….ABN Amro indicates that this process will take from 3 to 6 months and will begin around the April 28th meeting of the BOJ."
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> FrontPoint concluded their February commentary by saying that:
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> "The impact [of this] is more likely to be felt in financial markets and not so much in the real economy in Japan. [The reduction in] QEP is likely to have more impact on the risk premiums of financial assets purchased by the Japanese banks. Japanese banks [have long been] looking for ways to increase their ROI on the excess reserves by investing in assets with superior yields including U.S. Government bonds, mortgages, corporate debt,

CDOs, and emerging market debt. How much of this exists and when will those funds be repatriated is the real question at this point. The stronger the Japanese economy and higher the interest rate rise, the faster those funds will return home. Keep in mind that Asian central banks and Petrodollars are also integral to the global real rate and credit spread compression. The Japanese Bank excess reserves are just the first leg of the stool getting kicked out. How much load bearing responsibility it has had underpinning the carry trade will become clear by mid-summer."

What an awesome call this firm made because just look at what has recently happened to excess QEP reserves held by Japanese banks. As shown in the chart below, after multiple years of pump priming, the BOJ finally yanked all of the added liquidity back in a rush.

Source: Bloomberg as provided by FrontPoint Partners

In a mid-May follow-up note FrontPoint wrote:

"Folks, this is a lot of [risky asset] selling pressure. It is the equivalent of CALPERS, GM, and GE all deciding to liquidate their pensions plans in May and be 100% in cash for the Memorial Day weekend."

But in FrontPoint's minds-eye, most of this damage from the BOJ has largely run its course and will be tempered by the fact that non-bank lending by the Bank of China exploded higher earlier this year and now easily exceeds the $187 billion that the Bank of China has lent to Chinese banks under credit control caps. Given the fact that past growth in China has lagged Chinese credit growth by approximately 15 months, FrontPoint views Japan's recent monetary tightening as soon to be overwhelmed by another shot in the arm of global liquidity from the Chinese. They also see the political instability of various local petrodollar markets (Saudi, Bolivia, Venezuela, etc) as continuing to spur a rush of liquidity toward Western capital markets.

To complete the FrontPoint analogy, the stool of global liquidity may have lost one leg courtesy of the BOJ, but it still has 2-3 other legs to continue to stand on – at least for now.

Thus, the downdraft that began in May is unlikely to have significant sea-legs until something further goes "snap" either in China or the Petrodollar investment community.

But longer term, of course, maybe by February 2007 – but not now – something in China or the Petrodollar community should indeed go "snap." As recently explained within another piece of economic commentary – this one emanating from Bridgewater Associates in their May 25th Daily Observations article entitled *Where the Liquidity Is Coming From* – we find a cogent global economic overview that deserves careful reading:

> "One of the major drivers of market activity over the last several years has been the abundance of dollar denominated liquidity. In part, this liquidity was created directly by the Fed. However, the biggest contribution to this excess dollar liquidity has been the actions of foreign governments who have borrowed or created liquidity in their domestic currencies and bought dollar liquidity with it. While these purchases don't have the multiplier effect of a dollar of reserve creation by the Fed, the magnitude of these purchases swamps the Fed's activities. Normally, the increase in the supply of dollars would be bearish for the dollar as the supply would need to find demand, but the recent liquidity injection is short-term bullish for the dollar because the demand from foreign central banks creates the liquidity. Long-term, however, this liquidity is dollar bearish as we need to continue to attract the demand for the liquidity or it will disappear (with interest rates rising and the dollar falling). This liquidity creation by foreign monetary authorities is unprecedented.
>
> "To get US$ liquidity, foreign central banks first have to get their local currency to exchange for dollars. They have only two ways to come up with domestic currency: print it or borrow it. As the global economy came out of recession in 2002 and 2003, foreign central banks directly or indirectly printed the money that was then used to intervene in the currency markets. As growth has recovered, foreign central banks have become less willing to print domestic currency. Many have quit intervening, which would have caused a massive decline in the dollar if not for the fact that China has shouldered most of the load in order to keep their currency from appreciating. To avoid the inflationary pressures that would be caused by an increased supply of currency, the monetary authorities have increasingly resorted to borrowing these renminbi [i.e. issuing renminbi bonds]. As their balance sheet has expanded, they have developed a massive asset/liability imbalance. The liability side has been supplied by the massive increase in domestic household savings. As Chinese households have gotten relatively richer they have increased their savings rates, while US households have done the opposite."

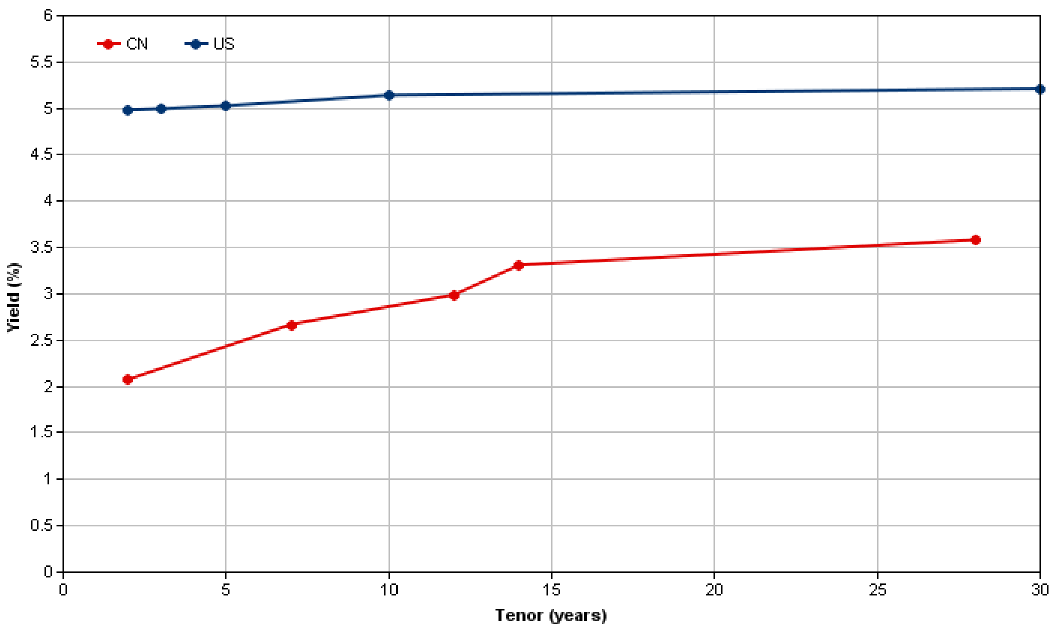
Bridgewater goes on to point out that the People's Bank of China (PBOC) today has a balance sheet that has swelled to 50% of their GDP. By comparison, the Fed balance sheet in the U.S. is about 7% of GDP. The PBOC is able to get away with issuing all the renminbi denominated bonds only because of the increased savings rate appetite from Chinese workers.

> "That is the circle. The Chinese worker saves a larger % of their growing incomes, and that is passed to US households who borrow a higher percentage against their declining (in a relative sense, at least) incomes. The PBOC and the US government broker the transaction and take the risk. These transactions only happen because the market prices are screwed up (the Chinese renminbi is too weak and this promotes domestic savings, and the dollar and US interest rate levels promote consumption). The PBOC takes the dollar and interest rate risk, while the U.S. Treasury takes on the household credit risk through its (assumed) implicit obligations to Fannie Mae. These massive imbalances

have not been corrected by market forces only because of the huge government interventions in three markets (currencies, bonds, and household lending)."

Such a situation cannot last forever. *To a very large extent, the fate of the U.S. economy is no longer in the hands of the U.S Treasury or an all-powerful Federal Reserve, but instead it is now in the hands of a huge Bank of China monetary experiment.* The PBOC issues domestic renminbi bonds to banks at interest rates between 2-3% and then invests the proceeds in U.S. bonds at 5%. By doing so they recirculate the dollars we send to them via our merchandise trade deficit. As long as they can prevent the renminbi from appreciating (the dollar falling), they have a locked in interest rate spread profit. They also keep Chinese employment opportunities growing. Multiple goals get accomplished in one fell swoop.

Approximate Chinese vs. U.S. Bond Yield Curves



The only problem is that the bet size keeps growing: they have to do this trade in ever greater size to keep it from falling apart. Someday, something will go wrong. Either the domestic Chinese populous/banking system will no longer care (or be able) to buy PBOC bonds, or the supply of U.S. government bonds needed to clear the system will simply overwhelm the debt issuance resources of the PBOC. The PBOC will have a problem. The U.S. will have a problem. President Bush may finally get his wish and see a renminbi revaluation, but all the excesses of the past that have been perpetuated for so long will suddenly be revealed. The U.S. dollar and U.S bond market will be in serious trouble. So too will America's lifestyle.

This is all out there still to happen someday – but for our betting money right now, nothing really horrible will happen before February 24, 2007. It is only after the PEI cycle date of February 24, 2007 that an entirely different mood and theme to the markets should appear. Indeed, by this latter window of time, the recent sloppiness of May 2006 may seem downright trite by comparison.

Send us your comments at information@Sandspring.com.

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