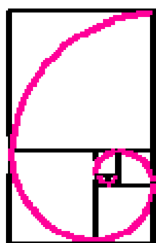


Sand Spring Advisors LLC

No Jolt Yet

by,

Barclay T. Leib

July 26, 2009

First we had the dot.com bubble. Then we hit the real estate bubble. Now there is at least one more bubble growing and it is spelled: CHINA.

The current consensus view on Wall Street/Main Street is that China's credit and fixed investment boom is a great thing for the world economy, and that BRIC countries and especially China will save the world. We would look at things a tad differently. No one quite knows just how far and how long China's current spending boom will build until popping, but what is basically known (to anyone at least who cares to pay attention) about China's economic situation at present is detailed below.

We know that China – in reaction to last fall's dramatic decline in export demand for its products – has rammed through a monetary stimulus injection unparalleled in modern financial history. Chinese money supply is growing at 26%+ per annum rate (dwarfing current U.S. M2 growth of around 9%). Chinese banks, using this liquidity, have lent $850 billion from January through May 2009 -- or approximately 19% of their annual GDP, with total loan growth surging some 34.4% year-over-year. According to some sources within the Chinese Government itself, about 20% of this money has found its way into the stock market. Much more of it has gone into apartment construction projects (with dubious true end-demand) and commodity inventory stockpiling.

More recently, headlines and stories of a Chinese retail investment feeding frenzy are now also starting to appear:

TIMESONLINE

CLOSE WINDOW

PRINT THIS PAGE

From Times Online

July 22, 2009

Novice Chinese traders dash to market

Nearly 500,000 novice Chinese investors open trading accounts in under a week, enticed by soaring Shanghai stocks

Leo Lewis, Asia Business Correspondent

Spectacular gains for Shanghai stocks and a blazing resumption of initial public offerings have enticed nearly half a million novice Chinese investors to open trading accounts in less than a week.

The arrival of what some analysts are describing as China's "post-crisis investor herd" is expected to add yet another layer of volatility to mainland stock markets where retail share-pickers account for about 70 per cent of turnover and ownership.

China's hearty economic growth has continued through the downturn with the help of huge government stimulus spending that has, according to official figures, raised the second quarter GDP growth rate to 7.9 per cent. Bank lending has also been conducted at a level that has defied the most bullish forecasts and flooded the corporate sector with more than $1 trillion in the first half of the year alone.

The combined effect has left many potential shareholders confident that the good times will soon be rolling again, the factories will hum once more and that hesitation to invest now will be a squandered jackpot.

With the leading Shanghai indexes nearly 90 per cent higher than they were in January, the appetite for risk has returned and the race to join the investment fray has intensified. Your-Mart, a retailer, which listed on Shenzhen exchange last week, soared by over 90 per cent in its first day of trading, while two other offerings – a drugs and a cable company – were more than 500 times oversubscribed.

Clearing house data published today showed that in five days last week, 484,799 individuals opened new stock trading accounts – a pace of increase not seen since China's roaring bull market that ended in early 2008.

Behind the rush to open trading accounts is a middle- class panic at being left out of what is expected to be a brief boom in Chinese initial public offerings (IPOs). The listing fever follows a long, government-imposed ban on new offerings put in place last year after the collapse of Lehman Brothers and the subsequent implosion of markets.

At least a dozen IPOs are immediately planned in what brokers in Hong Kong expect to be a release of pent-up demand. Companies expected to float include at least two securities groups, a road-building company, a brewery and several engineering groups.

However, the biggest test of the market's appetite for risk is likely to be the listing of China State Construction Engineering, which hopes to become the world's biggest IPO in the last 16 months by raising RMB 42 billion (£3.7 billion). The company's shares represent, for investors, a direct play on a recovery in property construction.

"The timing of the approval marks a shift, as our understanding was that the government wanted to delay large-cap IPOs," said Manop Sangiambut, CLSA's deputy head of China research. "The change either reflects government confidence in the market along with the surge in liquidity, or signals that the market is overheating."

So in essence the Chinese now own a lot of assets but potentially with no one to sell them to. And these owners are mostly middleman speculators, not real end-users. If the Chinese keep pumping money into their economy at the current rate, rapid inflation will eventually transpire, followed in all probability by an ultimate deflationary bust (as too much supply of everything swamps real demand). If they stop pumping money (i.e. tighten) sooner rather than later, then all the true warts of the global economy's weak demand will simply become more apparent that much sooner.

As pointed out to me within a publication "Global Macro Investor" this entire situation is very much analogous to the way the U.S. was positioned vis a vis Britain in the 1930's:

> "In the 1930's the U.S. had pretty much accumulated most of the world's gold because after WW1 American businesses helped rebuild Europe. They made a fortune and sold Europe everything it needed. Europeans spent all their gold buying U.S. goods on borrowed money. Global trade was dangerously lopsided."
>
> "The British were the flip side of this. They were saddled with enormous debts and much of it was funded by the U.S. When growth started to falter in Britain, the U.S., bound by the gold standard, had to cut rates, fuelling massive speculation. The collapse of Britain's banking system eventually spread to the U.S. by 1931. In order to stem the flow of gold out of the U.S. in the fall of 1931, the Fed had to raise rates against a backdrop of deflation. That was the point that turned a recession into The Great Depression."

Now substitute the U.S. in 2009 for Britain in the 1930's. Make a similar substitution of China in 2009 for the U.S. in the 1930's. The U.S. is now the indebted nation saddled with IOUs to China. The U.S. has already started to slow down, forcing China to cut rates, fueling in turn massive new (and somewhat misplaced) commodity, property, and equity speculation in their country. The U.S. has largely become the side-show while the latest bubble now builds in Asia. But eventually the Chinese have to see that they are playing a dangerous game that cannot perpetuate itself forever.

It is one thing to throw a great deal of monetary stimulus at an economy and create a short-term "party." But what happens if this stimulus (which is effectively somebody's effective savings – in a sense the "world's savings" that for trade flow reasons just happens to have built up in China) gets thrown into building and

construction projects that no one really wants in the end? What happens when the Chinese populous speculates in its own stock and property markets in a silly and dangerous way?

Answer: Eventually this wealth is destroyed and the world is really screwed. To a greater or lesser extent, we've "seen this movie" before when then-Treasury Secretary James Baker encouraged the Japanese to cut their interest rates in 1987-1988 in order to increase Japanese demand for U.S. goods, with an ultimate goal to thereby lessen the U.S. trade deficit with Japan as painlessly as possible. It was a nice idea, but it backfired with unintended consequences. The Baker-inspired lower Japanese rates of 1987-1988 only served to create the Japanese property and equity market bubble of 1989, and when that bubble eventually popped in early 1990, a goodly portion of global savings went up in smoke via a Japanese banking system implosion. At the time, the Japanese controlled about 25% of global savings, and they easily saw over half of that savings go up in smoke. The Japanese banks initially tried their best to hide this fact (through slow mark-to-market and accrual accounting procedures), but almost 20-years later, Japan still has not fully recovered from this economic body blow. And arguably, the global economy hasn't ever been quite the same either.

So now we head down the path of the Chinese banking system facing a similar fate as the Japanese banking system of twenty years ago. It does not have to be this way, but it is what global politicians are wont to produce. By trying to avoid and push off a nasty day of reckoning from *past* excessive debt creation with even more *current* debt creation, bubbles get created; capital is poorly concentrated and invested; and then this capital is lost.

To this extent, anyone who currently thinks that the global economic crisis of 2007-2008 is over with a sudden "v-shaped' recovery is wearing rose-colored glasses, and is simply not being attentive to what is actually transpiring in China. Such people have no appreciation for economic history. They cannot stretch their imagination to see that 2007-2008 may just have been a "first taste" in the Western world of a bigger Asian/Chinese-oriented crash *yet to come*. They do not see that America – regardless of what our well-intentioned leaders (let that read: Obama, Bernanke, Geithner, et al.) may want to do or not – is far more beholden to whether the Chinese get things right, or alternatively blow themselves up.

At this point in an economic dialogue about China, someone almost always points out: "It is not in anyone's interest to rock the boat in the Chinese-U.S. economic relationship. For the past 20-years, China has produced; America has bought; China has taken our dollars, and then reinvested them in Treasuries that admittedly in constant purchasing power terms have tended to be eroded by a weak U.S. dollar and somewhat chronic U.S. inflation. But it's been a nice symbiotic overall relationship. The ultimate beneficiary of this scheme may well have been tilted more towards the U.S. than China, but it is in no one's interest to upset this apple cart. The Chinese government primarily wants greater employment for its masses, and would only stab itself in the foot if they started to bawk too much about accepting our Treasuries. And if they start selling some of their current Treasuries, they will of course drive down the value of their larger ongoing holdings. Higher rates in the U.S would also only weaken demand for Chinese goods. The Chinese dare not start down this path."

But instead of looking at this situation from an international cross-border economic perspective, a better approach may be to look at the situation from a domestic Chinese perspective. If the Chinese economy independently starts to become over-heated, too inflation-ridden, and too filled with investment excesses, will the Chinese central bankers have any choice but to tap on the brakes by raising rates? And if the Chinese economy slows, what then happens to global demand for commodities? What then happens to an already soggy and over-indebted U.S. economy?

Let me thus suggest that the American economy is now a backwater to the Chinese economic experiment in motion. We aren't driving the bus anymore – China, or arguably Asia as a whole, is the driver. If China screws it up, we're dead. Conversely, if China can somehow perpetuate the "faux game" of economic growth (without destroying real savings by too much mal-investment) just long enough that the Western world somehow rebuilds its savings and economic vibrance, and the Chinese consumer starts to spend more along the way, then maybe – just maybe over time -- the world muddles through – but it will only have done so basically by central bank "cheating" along the way. And this latter path is both time-intensive and highly unlikely.

A path more akin to the U.S. and Britain situation of the 1930's is more probable.

For our part here at Sandspring.com, we would not be surprised to see the "Chinese miracle" come undone in a sudden earthquake (yes, we're still waiting) or alternatively, simply a change of heart on the level of government stimulus/accomodativeness by the banking authorities in China. Already we have the following types of comments well advertised by Chinese banking leaders over the past several weeks:

BEIJING, Jul 20, 2009 (Xinhua via COMTEX) --**To prevent possible risks on the property market posed by a surge of bank loans, the China Banking Regulatory Commission said in a statement on Sunday that lenders should stick to rules on mortgage for second home buyers and step up scrutiny over approvals. Down payments on second homes are currently set at no less than 40 percent of the price.**

Top Chinese bank regulator warns of loan growth risks

By Lisa Twaronite, MarketWatch

TOKYO (MarketWatch) -- China's top banking regulator issued a strongly worded warning over the weekend about the risks of his country's surge in loan growth in the first half of this year, according to reports.

"(We) must control the risk of real-estate loans," said Liu Mingkang, the head of the China Banking Regulatory Commission, was quoted as saying by Reuters.

"In the first half of the year, our country's banking loans expanded rapidly and helped play an important role in stabilizing the economy, but the loans growth has led to accumulated risks also increasing," he said in a statement dated Saturday.

Liu said banks should strictly follow criteria for granting loans on second mortgages, closely observe capital adequacy ratio standards and ensure the quality of loans.

Chinese banks made 1.53 trillion yuan ($223.9 billion) last month, more than double the 664.5 billion yuan in lending seen in May, according to data released earlier this month by the People's Bank of China.

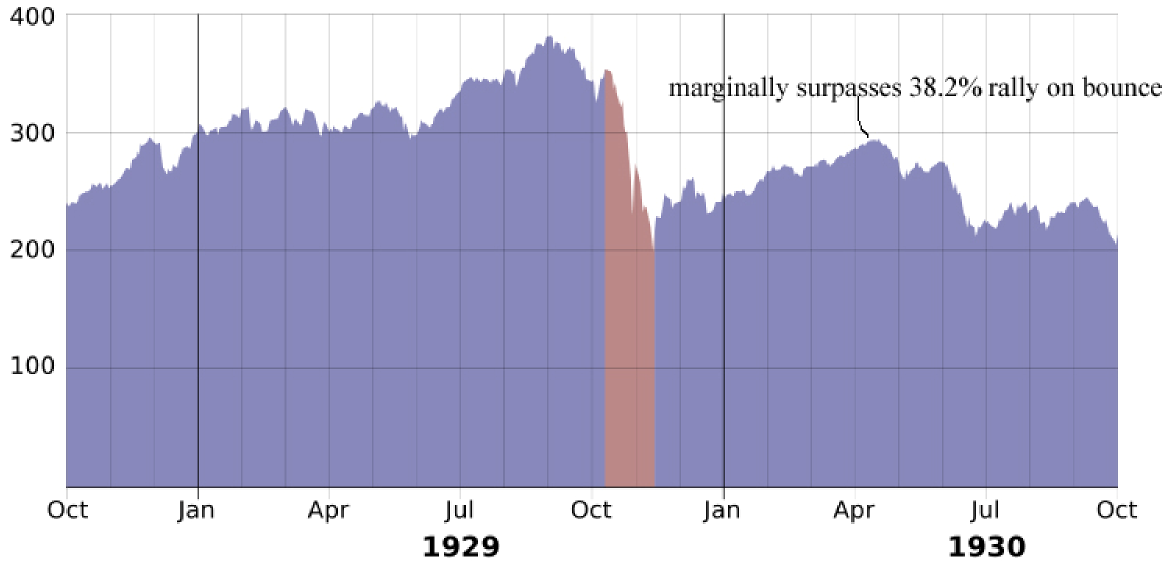
That brought aggregate new lending to date for 2009 to 7.37 trillion yuan, up 201% from the first half of 2008, and already well above the official full-year target of 5 trillion yuan.

The Shanghai Interbank Offered Rate (SHIBOR) has already been ticking higher for awhile – with no one paying much attention.

SHIBOR

It's just that nobody really believes that China would dare tighten – at least not yet.

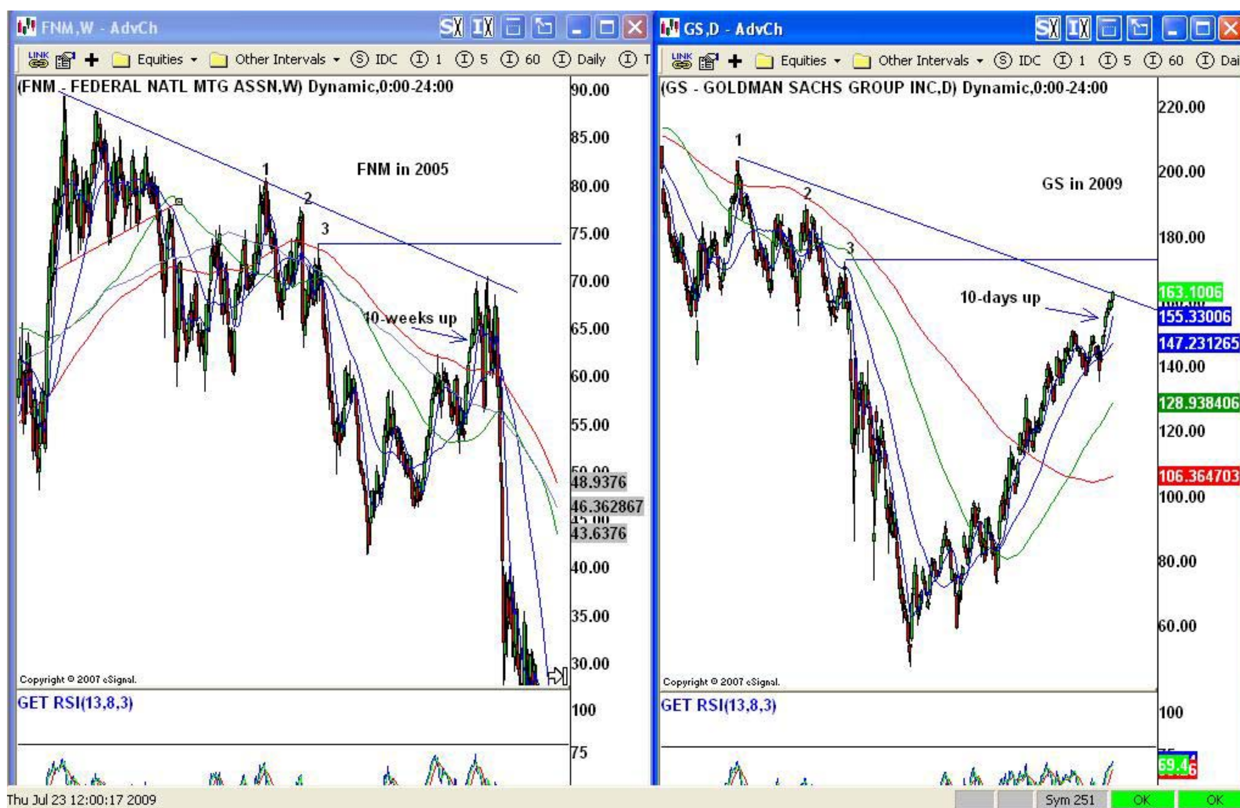
And then we come to the look of the current Shanghai A & B shares (charts are very similar) with the Shanghai A Index shown below. Note that we have now reached a 38.2% retracement of the 2007-2009 decline – a retracement level which in 1929-1930 the DJIA barely was able to surpass during its initial bounce period.



But bubbles have a way of lasting just a tad longer than any rational human being would expect (particularly us). It is certainly possible, and maybe even likely, that we might get just a minor break lower in the Chinese markets from their initial touch of the 38.2% retracement level, followed by an ever-building "ever-bigger" bubble into the early January 2010 pi cycle window. Let this latter path read: a likely "flush-like" correction in the short-term to work off the market's short-term overbought condition, but yet higher prices still to come across the intermediate-term. Such a path cannot be ruled out and might end up looking approximately as follows, with the Shanghai A shares reaching a 50% retracement in the end before the bigger-picture bear market resumes:

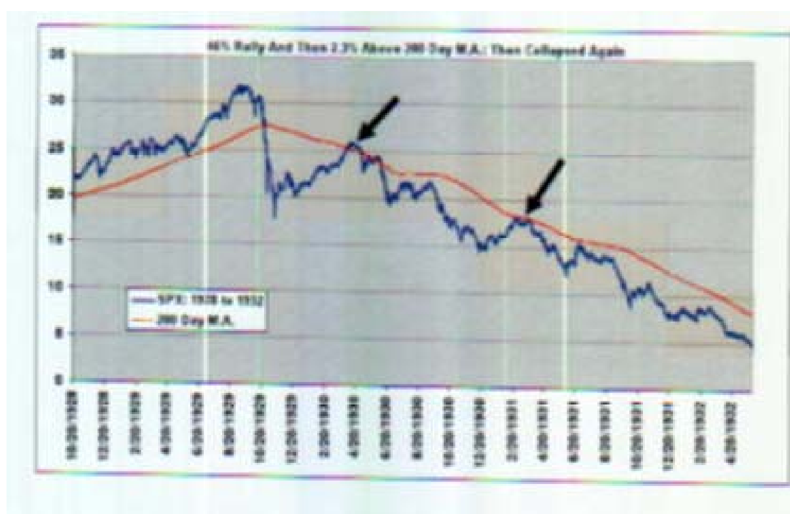
Within this environment, in either case, we are not believers in the recent upside “breakout” that everyone has suddenly become excited about on the S&P and DJIA. Yes – the market basically broke through the 200-day moving averages of both the DJIA and S&P 500, and then held above the 200-day moving averages on an initial retest. To a plebian technician, this pattern may appear bullish and potentially powerful. Throw in a Dow Theory buy signal when the DJ Transports also broke to new recent highs this past week. But still – particularly with an eye on the Chinese market depicted above -- we do not see the U.S. market as having significant “sea legs” to carry on much further.

It is possible – if not likely -- that the S&P may print 990 (and ideally would do so on 8-1-09 since 9+9+0 = 18 and 8+01-09 = 18…18 being the number of completion) to finish a rally that began on 3-06-09 at 666 (03+06+09 = 18 and 6+6+6=18). *Call it 18’s all around in time and price to keep Mr. Gann happy in heaven and numerologists happy on Earth.* But we would not look for much more than this level to the upside. We see similar implications on the chart of GS that we posted late last week in a pattern match to a past weekly FNM chart. An immediate top in GS could be followed by a flush to around 147, followed by one last vault to marginal new highs (on 8-01-09?), followed by another volatile slide. The entire GS topping formation could take several weeks to complete and would imply a subsequent sharp slide in the fall.



Whether the GS vs. FNM analog ends up working is something that we will keep a close eye on. It may easily be the best way to better anticipate whether our next early January 2010 pi cycle date will be a high or a low. For the moment, this is “one-day-at-a-time” type of forecasting, so we are formally predicting neither. We can see the case in the Shanghai market for a short-term correction, and then a push towards a 50% retracement of its entire decline later in the year, and yet…the GS chart pattern would be more immediately bearish into the fall of 2009. Stay tuned as to which path will prevail.

All that we do know is that this is still a bear market overall. Bounces in bear markets go just far enough to squeeze out bears and convince people that “just maybe” the real bottom is in. 200-day moving averages get toyed with, and even broken to the upside. Just look at the slightly fuzzy chart of the 1930’s (borrowed from Global Macro Investor newsletter) that highlights the huge 40%+ rallies of the 1930’s that subsequently petered out:



In the current 2009 situation, there is unlikely to be much follow-through because the real growth fundamentals for such follow-through are not there. Yes – courtesy of the central bankers, there is tons of liquidity sloshing around. But that is *all* there is, and this liquidity is already causing mal-investment decisions. There is also little fundamental conviction in the investment community. The market is behaving instead like a bunch of neophyte technicians are flopping around – first anticipating a break of an all-too-obvious "head and shoulders" top (not to be) on the S&P 500, and then rushing to get long the market when the 200-day moving average of the S&P and the DJIA ended up holding. There is money available for investment alright, but it is not being sanely invested. Instead, it is being invested simply from a "fear of missing out and being left behind." It is being invested with the thought that some "Greater Fool" out there is still buying (i.e. the Chinese) and that these Greater Fools will keep driving prices higher despite poor overall fundamentals. If you play along with the Greater Fools' investment process, you may win in the short-term but at the risk of a trap door dropping out from under you at any moment (and likely doing so during non-U.S. trading hours). Conversely, if you get short this market too early, you may easily use up too much psychological and financial ammo to remain sane and solvent when the next break lower inevitably arrives.

That is why we are in short-term trading mode. We do not want to be investors in this market, and at heart do not believe that recent commodity and energy market strength will be ultimately sustainable. But nor do we want to be stubborn perma-bears selling short too early in anticipation of an immediate crash. Instead, we want to attack on both sides of the market when short-term set-ups seem overly stretched in one direction or another. All positions are "rental positions" so-to-speak. We want to trade price, with a slight overall bearish bias. Currently we believe that the markets are at (or at least fast approaching) the upper end of a violent and choppy trading range. From around 990 on the S&P, we expect yet another swing move back down to around 905-925. If and when this transpires, we'll temporarily take some short-money off the table and re-examine whether on a bigger picture basis the China bubble is ready to truly break yet. Odds are that the China break is more of a 2010 event, rather than a 2009 event, but we'll see.

What we look for in this trading are ETFs and individual equity chart patterns where longer-term fractal patterns point to ultimate "missing lows." We want to trade with this longer-term wind at our back. We then trade these securities with an eye to relax (reduce) our exposure every time short-term support of some nature is reached. If we get lucky, we just might someday catch a larger crash with our core short exposures, but more likely, we will hit a bunch of singles and doubles along the way with our attack-and-retreat trading.

At present, the following set of charts appear to present longer-term "missing low" type formations, and thus offer potentially interesting risk-reward situations. We have mentioned some of these before, and some are new to these pages.

(BLK - BLACKROCK INC,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Blackrock
1.000 (249.37)
0.910 (230.36791)
0.764 (199.5976)
0.618 (168.8062)
0.500 (143.92)
0.382 (119.0338)
0.236 (88.2424)
0.090 (57.47209)
0.000 (38.47)
possible longer-term fractal target
Published by eSignal (www.esignal.com)

(GFF - GRIFFON CORP,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Griffon Corp (GFF)
1.000 (28.48)
0.910 (26.196866)
0.764 (22.49976)
0.618 (18.80012)
0.500 (15.81)
0.382 (12.81988)
0.236 (9.12024)
0.090 (5.423134)
0.000 (3.14)
clear fractal target
Published by eSignal (www.esignal.com)

(KBW - KBW INC,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Keefe Bruyette & Woods (KBW)
1.000 (49.06)
0.910 (45.57313)
0.764 (39.9268)
0.618 (34.2766)
0.500 (29.71)
0.382 (25.1434)
0.236 (19.4932)
0.090 (13.84687)
0.000 (10.36)
clear missing low longer-term
Published by eSignal (www.esignal.com)

(LAB - LABRANCHE & CO INC,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Labranche & Co. (LAB)
1.000 (17.91)
0.910 (16.481014)
0.764 (14.16704)
0.618 (11.85148)
0.500 (9.98)
0.382 (8.10852)
0.236 (5.79296)
0.090 (3.478986)
0.000 (2.05)
clear missing low
Published by eSignal (www.esignal.com)

(LTD - LIMITED BRANDS INC,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Limited Brands - LTD
1.000 (32.10)
0.910 (29.575398)
0.764 (25.48728)
0.618 (21.39636)
0.500 (18.09)
0.382 (14.78364)
0.236 (10.69272)
0.090 (6.604602)
0.000 (4.08)
likely missing low longer-term
Published by eSignal (www.esignal.com)

(MLM - MARTIN MARIETTA MATLS INC,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Martin Marietta - MLM
1.000 (169.55)
0.910 (158.8281)
0.764 (141.466)
0.618 (124.092)
0.500 (110.05)
0.382 (96.008)
0.236 (78.634)
0.090 (61.2719)
0.000 (50.55)
missing low
Published by eSignal (www.esignal.com)

(MAT - MATTEL INC,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Mattel - MAT
1.000 (29.68)
0.910 (27.799613)
0.764 (24.75468)
0.618 (21.70766)
0.500 (19.245)
0.382 (16.78234)
0.236 (13.73532)
0.090 (10.690387)
0.000 (8.81)
clear missing low longer-term
Symbol: MAT,D
Date: 02/04/10
Price: 25.3982285
Open 17.75
High 17.81
Low 17.44
Close 17.69
MA(40,C) 16.24525
MA(200,C) 14.25535
MA(100,C)s 14.4765
MA(10,C)s 17.023
RSI(13,8,3) 65.69
RSI MA1(13,8,3) 66.01
RSI MA2(13,8,3) 65.95
Published by eSignal (www.esignal.com)

(MASI - MASIMO CORP,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Masimo (MASI)
1.000 (42.0211)
0.910 (40.0348)
0.764 (36.818362)
0.618 (33.599719)
0.500 (30.99835)
0.382 (28.396981)
0.236 (25.178338)
0.090 (21.9619)
0.000 (19.9756)
clear missing low
Symbol: MASI,D
Date: 05/08/10
Price: 36.2197172
Open 23.86
High 24.92
Low 23.70
Close 24.88
MA(40,C) 24.004
MA(200,C) 27.212
MA(100,C)s 25.6737
MA(10,C)s 23.802
RSI(13,8,3) 61.44
RSI MA1(13,8,3) 54.56
RSI MA2(13,8,3) 55.54
Published by eSignal (www.esignal.com)

(PZZA - PAPA JOHNS INTL INC,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
PAPA JOHNS Intl - PZZA
1.000 (37.87)
0.910 (34.922811)
0.764 (30.150393)
0.618 (25.374704)
0.500 (21.5149)
0.382 (17.655096)
0.236 (12.879407)
0.090 (8.106989)
0.000 (5.1598)
clear missing low longer-term
Symbol: PZZA,D
Date: 02/28/10
Time: 00:00
Price: 31.1579082
Open 26.80
High 27.08
Low 26.30
Close 26.70
MA(40,C) 25.8025
MA(200,C) 22.0287
MA(100,C)s 25.4103
MA(10,C)s 26.654
RSI(13,8,3) 57.59
RSI MA1(13,8,3) 57.85
RSI MA2(13,8,3) 57.59
Published by eSignal (www.esignal.com)

(LTM - LIFE TIME FITNESS INC,D) Dynamic,0:00-24:00
GET MA(40,C)
GET MA(200,C)
MA(100,C)s
MA(10,C)s
Life Time Fitness - LTM
1.000 (65.09)
0.910 (59.382165)
0.764 (50.1394)
0.618 (40.8903)
0.500 (33.415)
0.382 (25.9397)
0.236 (16.6906)
0.090 (7.447835)
0.000 (1.74)
fractal target with time
Symbol: LTM,D
Date: 04/11/10
Time: 00:00
Price: 54.5471184
Open 27.71
High 29.01
Low 26.32
Close 27.15
MA(40,C) 20.25
MA(200,C) 15.51125
MA(100,C)s 16.8855
MA(10,C)s 22.673
RSI(13,8,3) 77.63
RSI MA1(13,8,3) 70.19
RSI MA2(13,8,3) 76.65
Published by eSignal (www.esignal.com)

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Send us your comments at information@Sandspring.com.

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