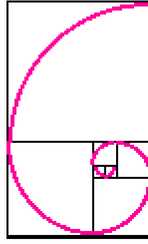

Sand Spring Advisors LLC

The "Pernicious Drift"

by,

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We wrote during early and mid-November that the financial markets felt as if someone had flipped a switch of some sort, and that we had missed the implications of this switch flipping. In our mind, the pi cycle complexion was clearly down until late January; there was news of earnings misses and warnings at Dell, Toll Brothers, and later on at Target, as well as further accounting issues arising at Freddie Mac and Fannie Mae; and yet stocks picked up a bid for little or no apparent reason in the last three trading sessions of October, and then simply romped higher for most of November.

While we take some satisfaction that our previously espoused strongest conviction trade of being long WMI versus short XLY hardly moved against us on a spread basis during this period, November was not an easy or pleasant month for us. Away from this core position, we personally also held shorts in the S&P 500, WSM, WFC, WM, COF, ABK, and PMI. Against these shorts, we were long a few special situation equities such as OTIV and NOIZ (both interesting speculative plays respectively on the identity security industry and future for broadband in airline travel), as well as some value plays such as CCC, LNN and DLP. We added in a Nikkei long mid-month which helped a bit. Then we took it off. We added shorts in the Vanguard REIT Vipers (VNQ) and then a short in TIF – the first position not immediately working, while the latter did drop after our sale with a thud. But no amount of additional scrambling on the long side or added selling on the short side could undue the damage of the general market strength. Much of our September and October profits were given back over the period. Our overall psyche and confidence came under severe pressure.

But as of about November 22nd what had just caused tire tracks up and down our proverbial back became somewhat clearer. That was the day where the Fed's October meeting minutes revealed that at least some members of that esteemed board of governors were thinking about being done with rate hikes -- if not in December, then at least soon thereafter. How funny it seems that this meeting transpired back on October 24th, with stocks taking off just a few days later. Surely not one of the 50 people in that Fed conference room mentioned anything to anyone. Yeah, sure, right. I am not normally a conspiracy theorist of any sort, but in this instance, the early November market blast-off seemed so at odds with the news at the time that I have to think that someone in or around the Fed leaked something about the overall tone of this late October meeting to outside friends.

Well, we certainly didn't get the word. *Tant pis*. Of course, had we known the tone of that day's Fed meeting as others may have heard it whispered, we cannot say that we would have necessarily traded that much better. But we certainly would have *at least understood* the market's subsequent price action a bit more. And we do of course realize that generally warm weather in the U.S. Northeast and softer energy prices in November only helped fuel the flames of November's bullish equity run.

But does a Fed turning more loosey-goosey – *if they really are* -- really matter? In the short-term, the perception of such clearly has had an impact on market sentiment, but in the longer term, we're not sure that such a perception will save the day. The U.S. consumer's household budget is already running on debt-laden fumes, while ongoing spending possibilities from home-equity refi extraction is ending. Only a sudden upswing in business expansion – both in hiring and capital spending – could at this point in time help offset some portion of this weak consumer condition. But if the consumer is already clearly in increasing financial duress, how many businesses really are going to risk moving down that path?

The pickup in U.S. employment that President Bush so proudly pointed to this past week was largely from low-wage hurricane-cleanup related jobs. In saying that the U.S. economy has "seldom been healthier than it is now," Bush myopically seemed not to notice other aspects of last week's statistical releases: namely, that the household unemployment number continues to grow, wages are stagnating, and the work week ticked down.

And at the end of the day, should a more benign interest policy actually emerge to help the consumer to temporarily keep spending, such would actually represent an *unhelpful* delay to the long-term need for the U.S. to save more and spend less. Certainly in his London speech Friday, current Fed Chairman Greenspan seemed to speak with great concern about the huge U.S external trade and government deficits. He closed his remarks on a fairly dour note:

> "If the pernicious drift toward fiscal instability in the United States and elsewhere is not arrested and is compounded by a protectionist reversal of globalization, the adjustment process could be quite painful for the world economy."

Pernicious drift, eh? What wonderful verbiage Greenspan comes up with. First the "irrational exuberance" of 1996 and now the "pernicious drift" of 2005. I'll miss this type of stuff when he finally steps down as Fed Governor. And yet, nothing bad has happened yet. The key slogan of the bulls could easily be: "Yeah, the party might be slowly spinning out of control, but why not enjoy it while it lasts because betting against the U.S. consumer has been a losing proposition for the past 20 years."

In the recent words of Bob Prince and Jason Rotenberg at Bridgewater Associates, the markets also seem to have found a weird sort of "let's play chicken" equilibrium:

> "The bond market and the Eurodollar futures continue to resist the idea that the economy is growing and will continue to grow until the Fed proactively stops it. Of course, part of today's uneconomic pricing comes from foreign central bankers buying bonds for noneconomic reasons. But domestically, the consensus view is that the housing market is in a bubble, and that this bubble fueled a lot of excess consumption, and that even a modest rise in bond yields will slow housing, pulling money away from consumers, reducing spending, causing a slowdown and an end to Fed tightening. As a result of this view, bond yields don't rise, at least not by more than a few basis points, even though the Fed keeps on tightening and has virtually inverted the yield curve. But because bond yields don't rise, housing does not collapse, which negates the argument that the economy will slow. This leaves the Fed to continue tightening, dragging long rates higher along with short rates. After years of the bond market driving the Fed, the Fed is now driving the bond market."

Something must of course eventually give way in this situation.

In a recent Bloomberg interview, Northern Trust's senior economist Paul Kasriel predicted that the destabilizing factor in 2006 could come from a collapse in the U.S. dollar – but there doesn't appear to be many signs of this in today's market's price action. Sand Spring's own view of the dollar-yen chart being set for an eventual decline toward 96.00 has been way off the mark to date.

Others predict that energy-related cost-push inflation will eventually trickle into other goods and services, and by doing so, will then impact the official CPI and PPI statistics *with a lag*. This lagged pick-up in the inflation data will then naturally unnerve the bond market by clear new statistical signs that inflation is not as benign as the Bush Administration would want people to believe. If this view is right, one should fade every knee-jerk rally in bonds (knowing anyway that there will always be overhead supply

from increasingly saturated foreign holders of this debt), and wait for the inevitable PPI or CPI number around the corner that will leave foreigners demanding a higher clearing rate for new U.S. debt issuance.

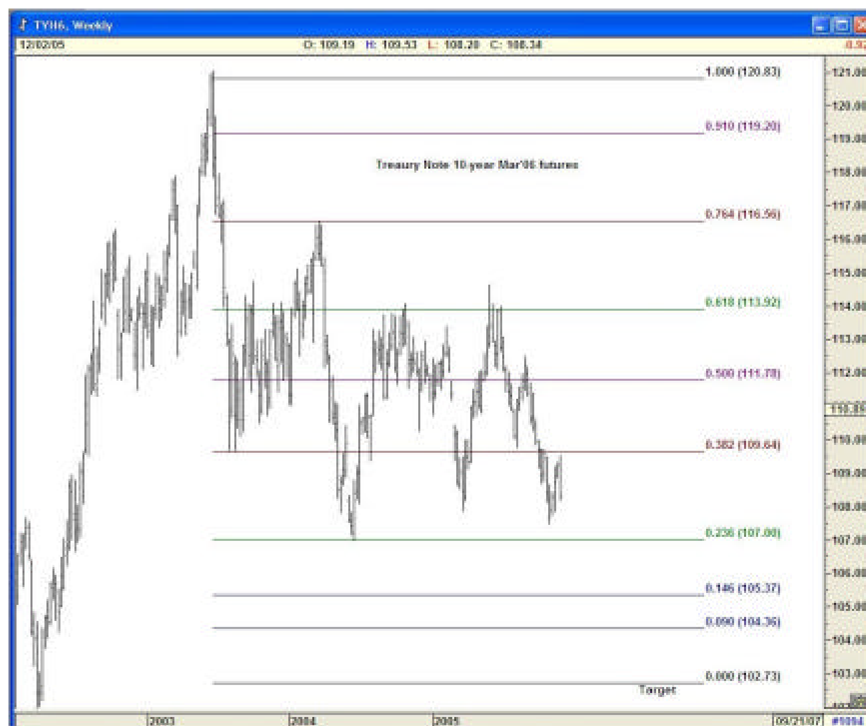
But will foreigners always really want to buy our bonds? Might they not want more than just our IOUs – something more along the lines of hard assets: real factories, companies, land, and other stores of value – such as gold? Clearly they already are -- or have at least started trying to do so (N.B. the IBM-Lenovo and Unocal situations of 2005).

Indeed, at this point of the global economic cycle, there is some talk that *if* the U.S. trade deficit is to be structurally perpetuated, the marginal buyer of U.S. indebtedness will by necessity begin moving from the public to the private sectors. Thus while we know that central bankers don't regularly go around investing in property and equity markets, on the margin we are now in agreement more with the paragraph above (concerning the impact of lagged inflation data) than the one that preceded it (concerning a 2006 dollar decline). Land in the U.S. is already red-hot, while stocks and gold are becoming expensive. Yet this is only because the alternative U.S. pool of investment opportunity – bonds – are so fundamentally unattractive to private investors. For now (while capital remains at risk of potentially just being destroyed), excess dollar liquidity accumulating abroad has to go somewhere, and global equity and commodity markets have kind of won these capital flows by default.

So maybe our bearish focus should turn from hard assets to pure IOU assets – with U.S. bonds arguably priced 150-200 basis points lower in yield at present to where they really should be. We have resisted getting involved much in fixed income market forecasting for the past year or so, having previously correctly forecast each of the legs of the huge A-B-C bond market reversal between June 2003- June 2004 (see archives of past articles, particularly our May 2003 and July-Aug 2003 articles). For the past year, all that we have seen in fixed income are hedge fund managers generally betting on higher interest rates, and becoming frustrated within a tight range.

But consider the following ironic situation: *Might it take the Fed slowing or stopping its rate hikes to actually undue the back end of the U.S. fixed income market? Raising rates too fast threatens the U.S. consumer, but raising them too slowly will scare the foreign bond investor.*

In the chart below -- one way or the other -- we can see at least one potential rhythm developing for a U.S. 10-year note futures decline to 102.73. Maybe after having recently been the most frustrating bet in town, being short U.S. fixed income is about to become the most attractive risk-reward trade in town.



Thus, in addition to our frustrating equity short exposure of late (which we have maintained with a degree of stubbornness) and our longer-term negativity towards the level of USD-JPY (not working at all -- yet), we have recently increased our short bets on longer-dated U.S. fixed income. We are broadly flat gold and silver trying to await better re-entry points.

Some combination of the above portfolio exposures simply must work over time if financial markets are to properly clear. Either the dollar must fall to restore U.S. competitiveness in goods markets and/or a substantial downside repricing of U.S. financial assets – bonds and/or stocks – must be seen to raise their expected returns in relation to financial assets abroad. The economic landscape is not as rosy and benign as Mr. Bush states. It is deteriorating and far more fragile than current financial markets reflect. Bush has his head in the sand as much with regard to the economy as he does regarding Iraq. He is embarrassing and overly simplistic leader – even if in his heart of hearts he sees himself as a hard-working patriot doing the best he can.

But here at Sand Spring, we are also admittedly "cold" in our forecasts of late. We are admittedly on the defensive. And when things aren't working the way they should, it is generally good to bring one's bet sizes down, and to sit down and shut up for a bit. If anyone has read William Poundstone's recent book *Fortune's Formula* (recommended), it is possible that Sand Spring Advisors LLC has a significant longer-term edge in its knowledge of market pi cycles and Fibonacci rhythms, but if we get our "Kelly formula" bet size wrong with regard to any single event's edge/odds, we might still not compound our capital consistently over time. Perhaps we got too excited by the September mini-pi cycle date. Some readers have suggested to us that this date could easily have been interpreted as simply a turning point in the energy markets – not the U.S. equity market.

We did adroitly speak in our August 30, 2005 letter of a potential energy market turn for September, but on a forward-looking basis we do not fundamentally believe that energy is entering a bear market – but instead, it is simply within a correction. The balance between longer-term supply fundamentals of the energy world (various major oil fields around the world slowly reaching diminished capacity) and global energy demand stepping steadily higher are simply too tight for prolonged energy market weakness.

As one side note here, global energy prices are highly correlated to the weather patterns for the U.S. Northeast (one of the largest consuming regions of the world), and according to the *Old Farmer's Almanac*, although parts of the Northeast's winter season could be milder than normal, "December and January will be exceptionally cold." This generally concurs with recent research out of Accuweather that shows that the six major weather patterns over the past several months correspond strongly with 1995 -- which was the second coldest winter of the past 10 years. On this topic, one hedge fund manager that we respect writes:

> "The heavy hurricane activity correlates well with a North Atlantic steering current that permits a dip southward in the jet stream in the eastern portion of the U.S. Recent precipitation trends, warm waters in the Gulf of Mexico, and increased upward motion in the atmosphere offshore, confirm the potential for greater than normal southward dip in the jet stream in the east."

So New York -- get ready for some cold days in the next eight weeks (first season snows are outside my window as I type, and another storm apparently on its way for this Tuesday). And in "as above, so below" fashion, maybe equity markets will turn down with the thermostat. We personally view this as a better tactical bet rather than betting on further energy market weakness at this stage. Indeed, if anyone is still short crude or other energy futures off of the September cycle turn, we certainly would suggest closing those positions at this time.

As one further side-note with regard to the book *Fortune's Formula*, we believe that Poundstone set the stage for a future book when, on the next-to-last page of the text (page 328), he quotes Stanford University information theorist Thomas Cover about pi showing up in various contexts (financial markets presumably included since Cover is also trying to set up a hedge fund) that have nothing to do with circles: "When something keeps turning up like that," Cover suggests, "it usually means it's fundamental." Let's translate that in this instance: Sand Spring Advisors LLC recognizes certain pi market and cultural rhythms that we cannot fully explain, but that we are confident exist. We can however still screw up our

interpretation and trading of any one of these cycles. So as always, please take our perceptions within this letter not as gospel, but simply as one potential market-timing tool among others.

Admittedly "cold of late," we are thus going to keep this month's letter relatively short, and end by simply pointing out some interesting Fibonacci rhythm patterns across some other markets and individual stocks. These range from an updated chart picture of WMI to a longer-term perspective of the Corn futures chart. As always, pick and choose among these perspectives to formulate your own opinion. No chart represents direct investment advice, but instead just our own personal opinion. Please also recognize that all of the stocks mentioned at the beginning of this article also remain in our personal portfolio with chart patterns that we continue to regard as having clear Fibonacci rhythms.

1) Overall equity bear market views notwithstanding, we still love the clean step-ladder Fibonacci ascent of WMI. We are looking for a minimum upside target of around 34.52.

2) Wal-Mart, to our eye appears reminiscent at this stage of Pfizer before Pfizer started its slide. WMT should fall to at least 39.52 over time.

3) Carmike Cinemas – wrong stock in the wrong space at the wrong time – soon to be headed toward 15.75 in a 5th wave decline?

4) Although September did bring a significant turn lower in energy markets, the Fibonacci rhythm of the Heating Oil futures chart strongly suggests further new highs toward 2.49 at some point. Whether this happens this heating season or in a future heating seas on is a more open question. The chart below is reasonably long-term.

5) Within the energy services sector, we love the longer-term picture of Tidewater – one of the major global tug-barge offshore transport providers. Go do some research on it.

6) Our previously espoused long in Calgon Carbon reached its first target zone around $10 (where we did some selling) and then proceeded to drop like to stone to sub-$6 on operating disappointments (where we re-increased our long position). With time, we still see this stock as having a shot at its second Fib target zone up around 11.92.

7) Restaurant chain Ruby Tuesday's appears in a stair-step decline toward $16.25.

8) If corn ever reaches a downside level around 197.75, it will be a buy.

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