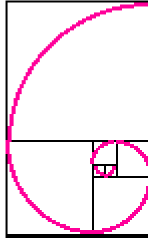

Sand Spring Advisors LLC

Focusing on Panic of 1873 & 1937-38 Analogs: Big Picture Roadmap

By,

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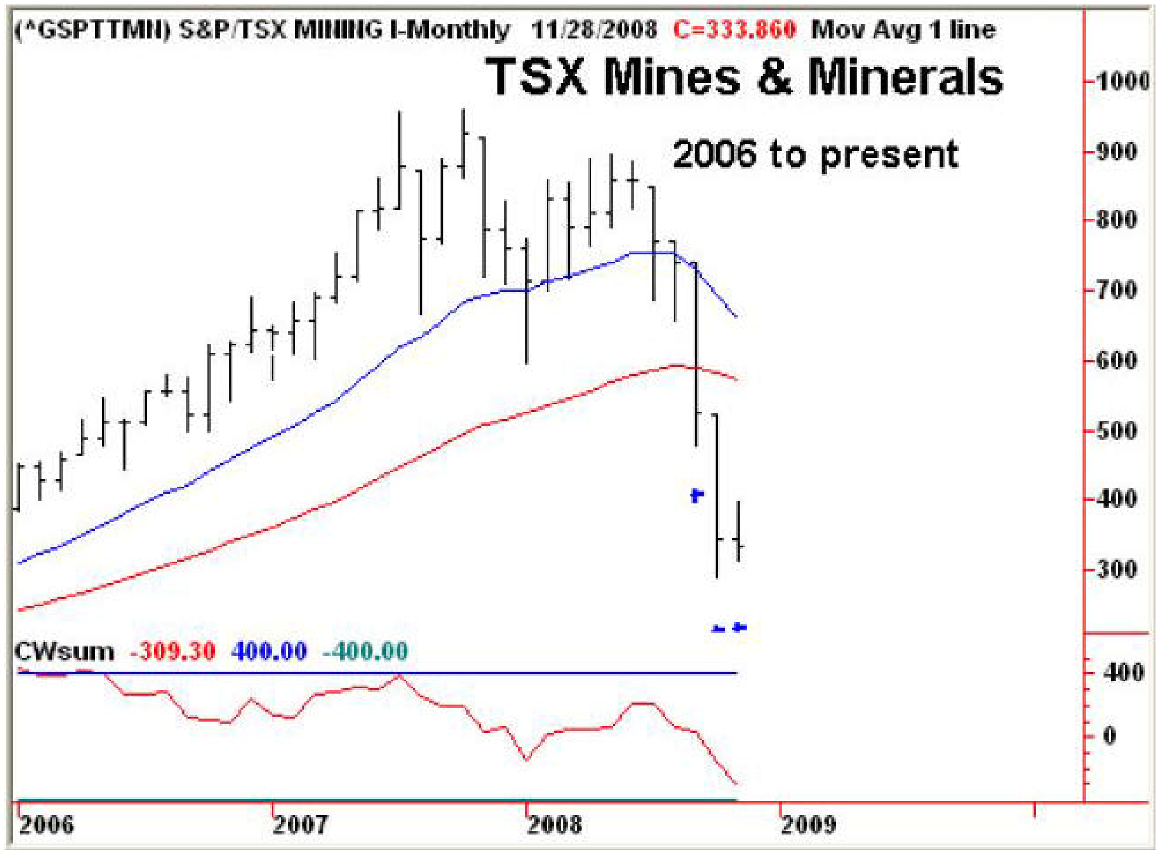
December 28, 2008

Perhaps the most interesting piece of analysis that I have received in my inbox over the past month was a comparison of the commodity boom and bust of 2008 to the boom and bust of the commodity sector in the 1871-1873 period.

More specifically, a publication called *Chartworks* published by www.institutionaladvisors.com put out the two charts below. The first chart compares the 2006-2008 period in the Toronto Stock Exchange Mines & Minerals Index to 1871-1873 boom-bust in the same sector; and the second chart compares what subsequently happened to the mining and mineral sector over the balance of the 1870s - 1880's -- drawing an analogue comparison to the way the Japanese Nikkei has behaved over the past twenty years.

Here at Sand Spring, we are generally suckers for interesting chart analogs, so in the spirit of some added free publicity to *Chartworks*, we re-produce these two charts below to begin this month's discussion.


(^GSPTTMN) S&P/TSX MINING I-Monthly 11/28/2008 C=333.860 Mov Avg 1 line
TSX Mines & Minerals
2006 to present
1000
900
800
700
600
500
400
300
CWsum -309.30 400.00 -400.00
400
0
2006
2007
2008
2009

(SMLT) SMELT-1873-Monthly 12/31/1990 C=36.000 CCI-CAP TD Sequen Buy
Mining & Smelting
1871 to 1875
500
450
400
350
300
250
200
150

The implication of the two charts is that when gold touched above $1000 an ounce, copper printed above $4 a pound, and crude oil went to $147 a barrel – all transpiring at different moments across 2008 -- this was all yet another "bubble" in the same way that in the early 1870's people believed that there would not be enough physical resources to meet the demands of the coming Industrial Revolution. To this line of argument, the current concept of "Peak Oil" combined with incessant demand for commodities out of China are both simply passing faddish beliefs that will not persist.

However, the second conclusion of the *Chartworks'* publication is that even within a general bear market in commodities, sharp rallies do transpire – and perhaps one is now due into the spring of 2009. Per *Chartworks*, these rallies will simply not be lasting, but instead brief sharp spikes.

For our own part, we believe that there are certainly some similarities between the commodities bust of 2008 and that of 1873. For one thing, measuring back from the TSX Mines & Minerals Index peaking period across 2007 to early 2008, one finds that approximately 16 * pi *1000 days earlier (137.6 years) was indeed the 1870-1871 period.

Fundamentally, there is also little doubt that people in both periods were transfixed in their belief in the inevitability of higher commodity prices. 1870-1872 was after all a burgeoning era of international trade and commerce. Railroad construction in both North and South America, and the financing thereof, was about as hot in 1870-1872 as real estate investment and development in the U.S. and China was in 2005-2007.

But starting in the spring of 1873 with a failed World Exposition in Vienna and the subsequent collapse of the Vienna Stock Exchange, a malaise soon started to creep across the entire financial system. By the summer of 1873, Britain soon found itself overextended in its railroad loans. The pyramid of foreign lending for railway construction to the Americas soon collapsed as basically one out of four North American railways went bankrupt. A total of 18,000 U.S. businesses failed between 1873 and 1875. U.S. unemployment reached 14% by 1876. The past mal-investment by the global banking community suddenly became clear, and there was a dearth of new capital available at any price. Reflecting the rising unemployment and industrial bankruptcies of that depression, British prices collapsed by almost 50% in nominal terms in an unbroken fall from 1873 to 1896.

As we currently listen to 2008 television news reports of "70-80% off sales" at many American retailers in the days after Christmas, it is tempting to say: "Here we go again. Another multi-decade period of debt and price deflation has begun."

But in our heart of hearts, we certainly do <u>not</u> foresee a two-decade long trough in commodities markets and retail prices.

Instead, we are amazed at how extreme (verging on silly) sentiment has become in financial markets. When someone felt compelled to pay $147 for a barrel of crude last July <u>was the world really that different</u> from when some other person felt compelled to dump crude at a price of $35.13 last Wednesday? Or perhaps this has all simply been akin to the entropic motion of a speculative pendulum swinging too far to the upside (on Peak Oil Theory) and now having swung too far to the downside (in fears of the next Great Depression). Is the truth of a fair price for commodity markets really somewhere in between? Likely. More importantly, does it make any sense to risk one's capital betting on either low probability extreme outcomes?

For our own part, let us repeat here our own long-term expected pi rhythm that generally should apply to both financial and commodity markets.

Now through early March 2009: general bounce period, but with a start-stop type of price behavior. Despite its elusiveness to date, there should be a strong oil market rally during this period. We are personally re-entering longs in the energy-sector exchange-traded-fund DIG at present.

April 2009-June 2011: general slow grind of downward prices in stair-step fashion. There may be more talk of similarities to the 1873-1876 period during this time. Hopefully, the U.S. government will allow the system to cleanse itself via appropriate

bankruptcies. There is a strong probability of increased global war as 2011 is approached (particularly given 2011's anticipated sunspot maxima). But will war eventually turn the economy as it did in World War II? Obama will most certainly leave office far less popular than he entered it.

June 2011 – Oct 2015: This will be a more buoyant and upbeat period. The failed Presidency of Obama will be replaced by a new President with more surgical precision and substance in his policies.

Oct 2015 - May 2017: Another downswing will transpire over these two years to finish the 17.2-year period of malaise that began back in Q1 2000. To the extent that the general malaise in commodity prices that began in 2008 were to end up stretching beyond June 2011 (in 1873-1896 fashion), then May 2017 should see a final end to such malaise. As May 2017 is approached, one should switch mindsets from a trading orientation more towards a deep value buy and hold orientation.

May 2017 – July 2034: This will be a buy and hold boom period similar to 1982-2000 and 1948-1965. It will be a refreshing period of generally inflationary growth once again.

2034 onwards: As we originally wrote back in 2001 in our article *Measuring Financial Time: The Magic of Pi,* mid-2034 is the time and place where we see everything coming apart at the seams. Speculative excesses will come undone. These were our words from that article:

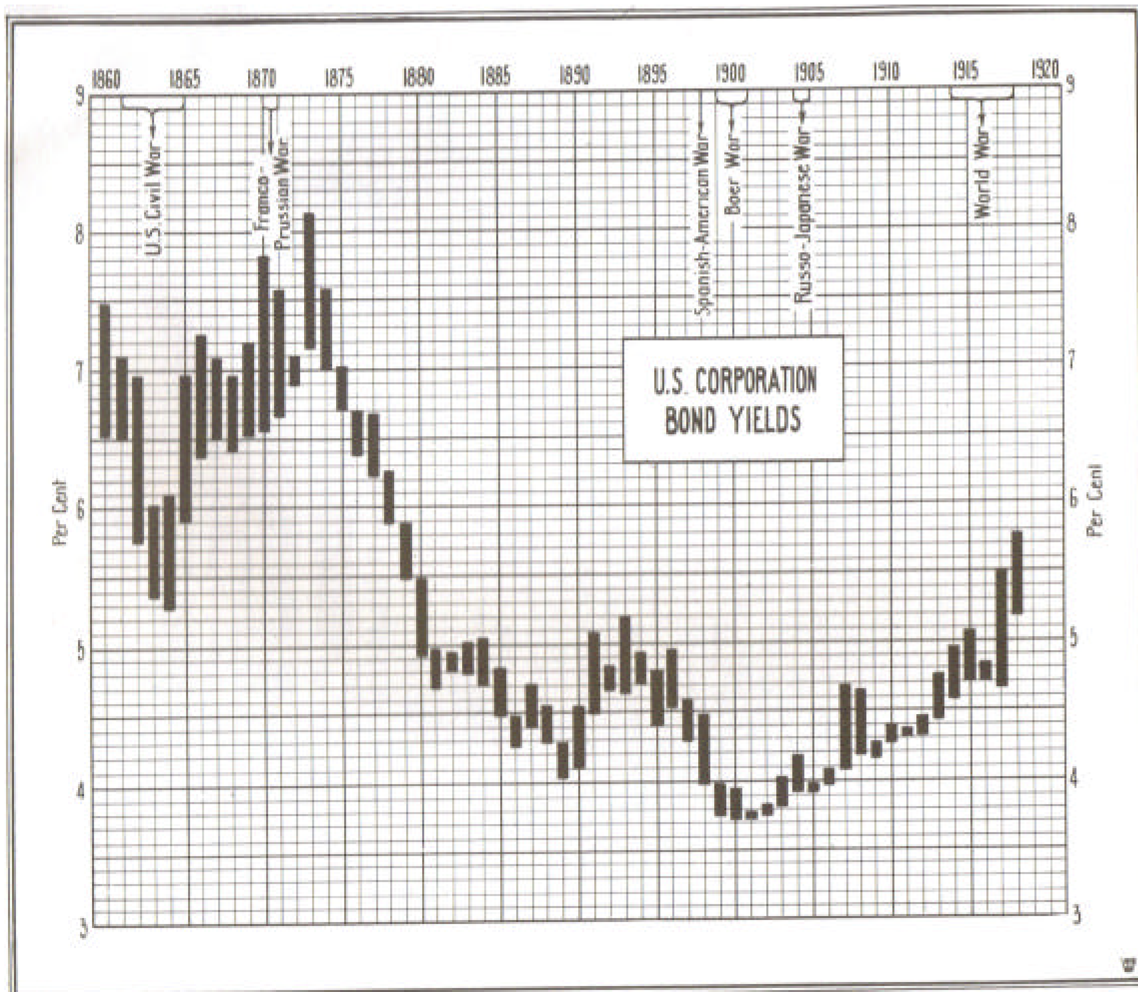
> Longer term, the next 17.2 year cycle would then fall in July 2034, which coincidentally perhaps, is 314 years (π again) from the 1720 South Sea Bubble, 942 years (3 * π) from the Crisis of 1092 and 1570 years (5 * π) from the period in which the Roman Empire was falling from power. I only hope to live long enough to witness whatever will be going on in this year. Likely America's excessive debt build-up and negative trade deficits will somehow be coming undone once and for all.

The above is our personal big-picture roadmap, and we believe in it strongly. We will err on following this roadmap more so than any other historical analog that others may propose.

But first let's go step by step within a more immediate time frame that will matter more to our readers.

For now, into early March 2009, we are initially both equity and commodity bulls. Over this past week we wrote on the Internet that the markets were likely to serve up a final puke of its energy-oriented investments, and this did indeed transpire. The March contract of Crude Oil did not reach our espoused downside fractal target, but the more active February contract did. Yet on a big picture basis, we continue to be drawn back to the general view of the DIG ETF below. It is overdue for a substantive bounce.

As a second intermediate-term view, we are generally bullish on corporate bonds – particularly on spread to ridiculously over-priced U.S. government bonds. There is absolutely no value being long 10-year Treasuries yielding 2.13%. But there are plenty of other corporate securities that should be "money-good," with 2-3 year maturities, trading at double-digit yields. This is not our area of expertise to go trolling for specific names, and one obviously wants to avoid certain industries (autos, retail, etc.) when choosing corporate fixed income exposure, but talk to your registered investment advisor and find a few nice 2-5 year corporate notes. If perhaps we are entering a general period at all akin to 1873-1896, just note below what corporate bond yields did during this time frame. Corporate yields traded steadily lower (i.e. higher in price) post the 1873 crisis. Meanwhile, equities across these years effectively went nowhere.



Source: *A Century of Prices*, originally published in 1919

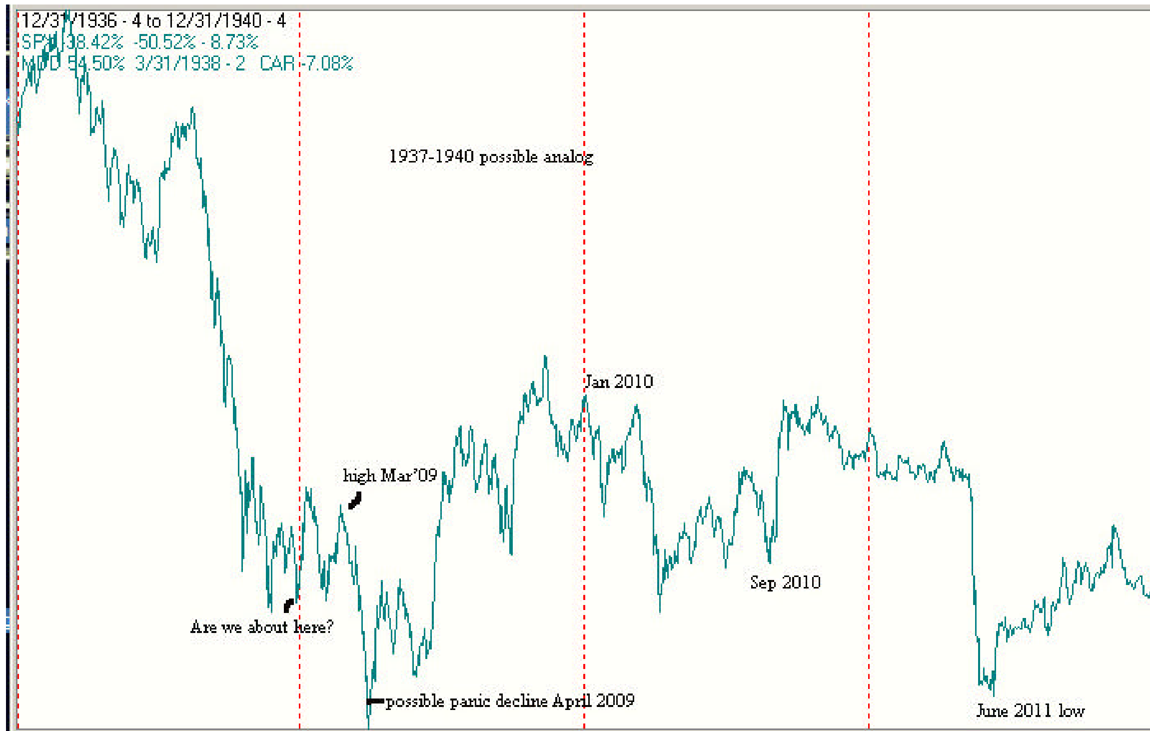
But if certain corporate bonds likely offer good value, we would at the same time stay away from any active involvement in municipal bond debt. If there is a second shoe to fall in the current liquidity crisis, we would not be surprised to hear of certain municipalities having over-gauged their taxing ability, and been generally underwhelmed by their actual revenue receipts. Muni-bonds could easily fall from grace far easier than many corporate bonds. The current flight to government debt of all sorts in general is silly. The government's general excessive indebtedness is a central part of our economy's problems, not a haven from these problems. The "flight to governments"-crowd currently has this all mixed up.

Thus, even while we are buyers of certain corporate debt, we would be sellers of the TLT (the ETF tracking 20-year government bond prices) and MLN (the ETF tracking longer-dated Muni debt).

What all this paints is an environment where equities muddle along, but corporate bond returns net outperform equities, while the government itself eventually gets "called out" by the market for its past money printing manipulative excesses. Within this environment, one would expect the dollar to generally fall and the gold market to hold its own (pulled down by its commodity aspects, but pulled up by its currency aspects). But there is the question of a low risk entry point in these latter two markets, and after the already swift rally by the Euro and gold last week, we do not see an easy trade to propose

at the moment. That said, longer-term is the euro headed to 1.935? We see little to stop it – save a small problem with purchasing power parity.

Lastly, let us end with the equity market itself. As we have discussed previously, equities are currently getting less interesting by the day – stuck in what may soon become a stultifying range. Selling option strangles (selling both calls at 1100 and puts down around 750) to take advantage of current high volatility seems like the only reasonable way to play this market. If the 1937-1938 analog period continues to play out, the ending picture for equities over the coming several years may resemble the following chart.



Of course the magnitude and the tilt of the various stair-step stumbles may be more skewed to the downside, as there is both some fundamental and technical evidence that 560 on the S&P could be seen before the current period of malaise ends. But for now, we feel strongly that the 750-1100 range will be with us for awhile.

The next period of intense importance does not come until mid-April 2009. This window of time could represent a new acceleration point to the downside – maybe on news of war of some sort (Israel vs. Iran?) which will initially be construed as quite negative (the 1938 break came on Hitler's annexation of Austria). However, this event may subsequently provide an excuse for America to band together and our markets to rebound by year end 2009.

As always, stay tuned to updates on the website.

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