Sand Spring Advisors LLC

Debt Bubble Unwind
&
A Market of Stocks vs. a Stock Market

by,

Barclay T. Leib

August 2, 2003

It feels appropriate at this time to do a mid-year recap of views that have worked for us in 2003 and those that haven't – and we unfortunately have had a bit of both this year. Within the space constraints of a file that can be easily e-mailed, this month's letter will try to bring readers up to date on as many previously espoused Sand Spring views as possible.

In February of this year, we prognosticated a relatively "gentle early spring" in the stock market, but a nasty summer. Making that prognostication a few weeks in advance of the March 12th equity low, we were a bit early in this view, but certainly less off than other market analysts such as Robert Prechter (who was predicting an immediate 3 of III wave decline at the time).

Our March 17-18th PEI cycle date then left us, quite honestly, all twisted up at the time – not sure whether the low that had occurred on March 12th was a PEI cycle trough that came a few days early or whether the minor high on March 18th was a faux Iraq War pre-victory rally that was completely misplaced. Looking back, our decision-making during this period was not helped by the fact that we were away from our office travelling at the time. With retrospect, by early April, we realized that sentiment numbers had fallen to such low levels by mid-March that there was plenty of fuel for a bigger rally than originally anticipated. As opposed to our originally espoused S&P upside target near 900, we quickly allowed that our more important 972-974 S&P Fibonacci region could easily be reached. It was – plus a bit of an overthrow.

More recently, and in a similar vein as having been a bit early in our February equity bullishness, we certainly appear to have also once again been early predicting renewed downside equity market pressure in June and July 2003. We originally anticipated an equity panic low of some sort on our July 27-29 PEI/Carolyn cycle window, and further suggested that something potentially nuclear on the geopolitical front would be occurring at the same time. This cycle window has now come and gone and offered little more than a feeling that the market has finally started its stumble lower, but not quite yet a full confirmation of such.

But our cycle dates were not without some potentially significant events that may yet grow in importance. Specifically, July 8th saw the announcement by North Korea that they already have weapons-grade plutonium (this announcement occurring behind the scenes on or about the 2*Pi*1000 day anniversary of Chernobyl), and the July 27th PEI cycle date brought the announcement by the ECB that Fannie Mae and Freddie Mac debt was no longer prudent for European Central Banks to hold as an investment. Also on July 27th, the U.S. government warned of new potential Al-Qaida airline hijackings in the offing. While none of these events caused particularly immediate equity market shock waves, these announcements may with time obviously prove to have been of some significance.

Fixed Income

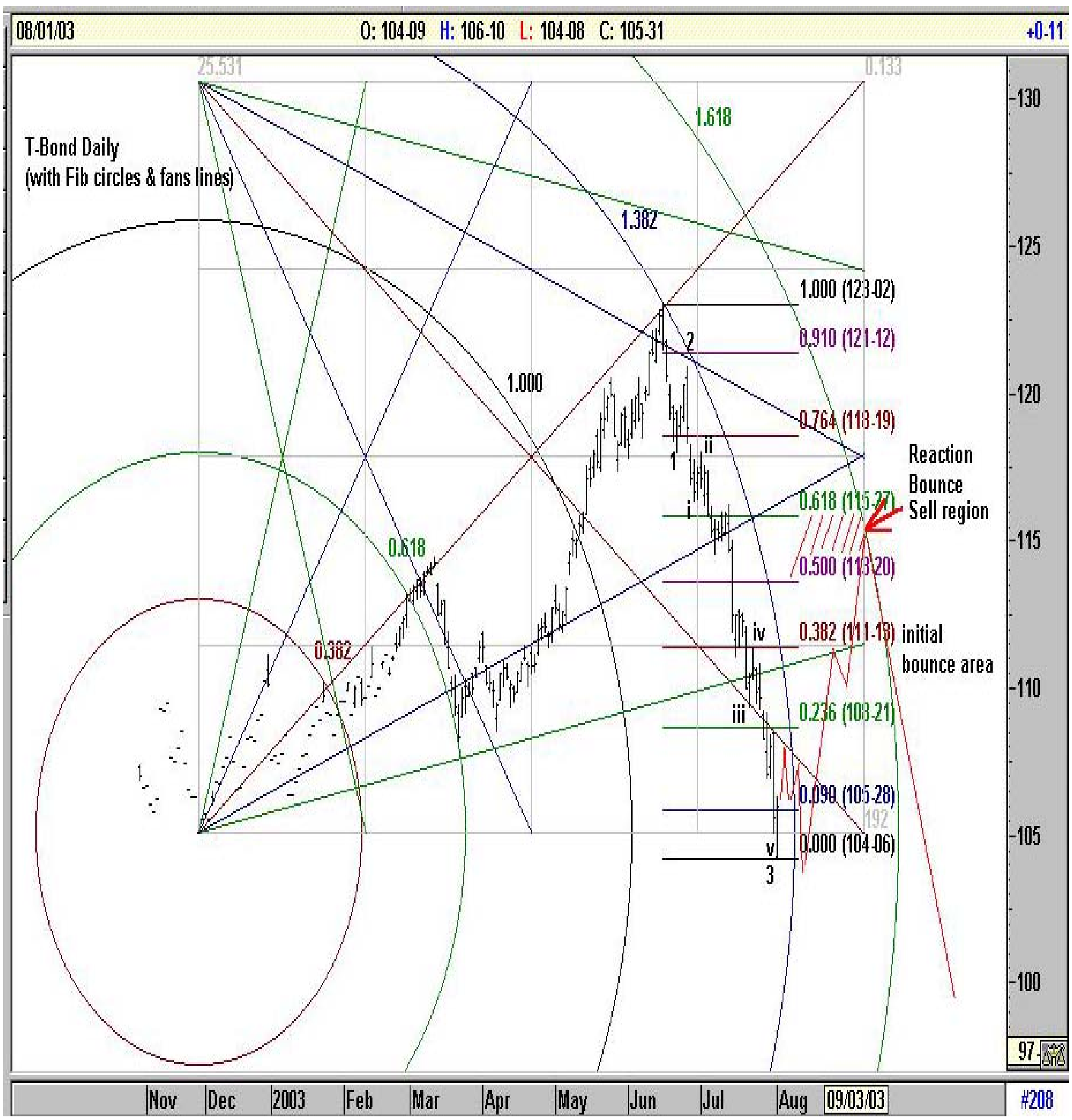
Elsewhere, if equities frustrated, we *were* correct in our espoused view written up in our May letter "Debt Bubbles and Islamic Threats" that the U.S. T-Bond and T-Note markets had become highly overbought. Since mid-June, the U.S. fixed income market has experienced its largest 6-week decline since 1994. It's almost as if all of the negative cycle and planetary vibes that we previously anticipated from early June to late July in the equity market manifested themselves within the fixed income market instead. And of course, fixed income markets being 20 times the size of the global equity markets means that far more wealth has actually been destroyed by the -15% fixed income market decline than would have been destroyed if the decline had indeed been an equity one. This is obviously not a good thing. Greenspan must be aghast that the Fed's 25 bp. June rate cut (in lieu of anticipated 50 bp) and his verbiage that long bonds would not yet be purchased by the Fed, are cited by many as the two precipitating events that started the fixed income market fall.

Within both our May and June letters, we were also correct that Fannie Mae and Freddie Mac problems were anything but behind us. The active Fannie Mae five-year note spread over Treasuries almost doubled during the past week alone, moving from 36 basis points to 60 basis points, and Wall Street fixed income traders are almost uniformly agog and confused at present as to what the overall events of the last few weeks portends for the future. Speaking with many of our trading contacts over the past several days, it would appear that fixed income and mortgage dealers at the major banks have been the ones doing the greatest amount of distressed mortgage selling, and rather than seeing Fannie Mae blithely on the bid to sop up excess mortgage supply, we are told that Fannie has largely been absent from the market. In other words, unlike past fixed income market downdrafts, there has been no buyer of last resort to turn to. With retrospect, the market simply hit its "air pocket" inflection point in June, and with everyone already complacently long (as reflected in the sentiment numbers that we were previously so focused on), it then reacted to a tad of negative news by completely falling apart in trap door fashion. Under more scrutiny from regulators, Fannie Mae was apparently then in no position to step in and stop the carnage.

Stories as to how much money was just lost and more precise details as to which banks got hurt the most will of course take some time to surface. We can have little doubt however that Citigroup, JP Morgan, and others lost tremendous sums. At Sand Spring, even we were early (yet again) to book profits on our espoused fixed income shorts at the time we posted our mid-July web-based article entitled "Presumably and Assuming…" Just after that posting, the T-Bond up-trend line on the daily chart near 112 simply got blown away. Given how easily this level broke, there is now little doubt that a major fixed income reversal has just transpired.

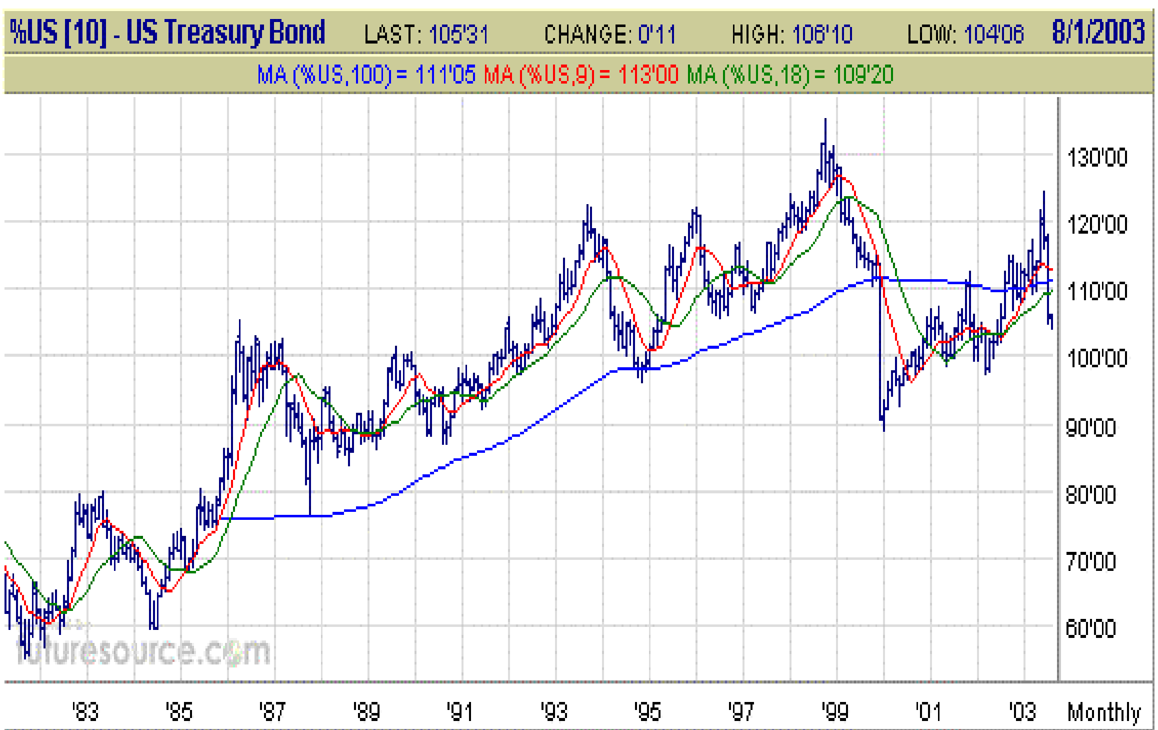
This market will of course come up for a reaction bounce at some point, but our prior expectation that one more new high in T-Bonds, as mentioned in mid-July, has now fallen into a much lower probability path given the significant 112 trendline break. Overall, the most immediate advice that we would have for traders in the fixed income markets can be seen in the following three charts, and two general propositions:

1) The market likely finished a v of 3 down on Friday, with a small 4-wave bounce to follow shortly, and then a grope for a 5 of I wave low, perhaps at just a marginal new low. Thus, we'd advise a generally flat fixed income position at present (long a few calls at most), but we will eventually expect a larger A-B-C 2nd wave bounce. This will be an opportunity at some point in the future (be patient!) to sell out any small long call positions established recently and to get short T-bond futures again against upside fan line resistance near the 61.8% retracement of the recent (or eventual) 1-wave decline. As pictured below, just under 115-27 would be the approximate region we'd be looking to re-layer into some short T-bond exposure.



2) On a potential spread basis, and of some significance, the 10-year note still resides above its 100-month moving average (blue line below), while the 30-year bond futures contract has already broken below this same 100-month moving average.

From this very simple view we can predict that long 10-year futures versus a duration waited short in 30-year T-bond futures should from a technical perspective be the path of least resistance going forward.



As another ongoing potential trade, does it make any sense that many financial stocks including that of Citigroup, have stayed resiliently bid throughout this period? Even given popular expectations of a recovering economy, we expect recent financial sector broker and bank strength is unjustified, and that George Soros's much espoused concept of "reflexivity" will lead with time to more pronounced equity price weakness in this space -- inclusive of Citi shares.

In addition, consider that Sandy Weill also recently announced his retirement from Citi. Just as IBM fell from grace after Gerstner left, and GE hit the skids after Welch stepped down, Weill stepping down from Citigroup can only be viewed as a negative sign. In our humble opinion, a downside price target between $21-23 continues to beckon here.

Foreign Exchange

Continuing our recap, our best call of the year was our bearish stance on USD/CAD espoused in a public web-based article all the way back on December 9, 2002 when USD/CAD was at 1.5650. Our call then was for at least a 1.444 target, later amended even lower in March.

Back in May, we were also correct that the U.S. dollar was ripe for a significant bounce within an ongoing bear trend versus the euro. Such a bounce has now transpired, with the euro having declined by some 5.8% since writing that letter back on May 26th. At this point we are again somewhat ambivalent about the euro -- deeming it to be somewhere midway within a choppy A-B-C range defined by 1.14 resistance up above and 1.1060 support underneath. This range will likely hang with us for awhile. If still actively trading currency options in the interbank market, we'd be looking to buy what's called a "double no touch range bet" with knockout levels set at 114.40 and 109.70 for month or two. For those not acquainted with such a product, it's a manner for interbank proprietary traders to passively sell volatility and bet on a trading range, but do so with a known and limited premium cost risk. (Yes, one can bet on anything these days – even a range holding!)

Conversely, USD/JPY continues to look poised to us to break out of its seemingly endless and very tight trading range. Just look at the chart below. Hardly ever in recent years has the yen become so congested for so long. Something is going to "give" here soon, and the purchase of longer-dated yen straddles or strangles could yield an attractive payoff both in terms of vega and gamma for sophisticated traders.

Our general proclivity is that this breakout will be to the downside, but this is not entirely certain. We are partial to the downside mostly because we think we have "seen this movie before" so to speak. To our mind, the Japanese are large holders of our Treasury notes and bonds, and in "deer in the headlights" fashion, they just got lambasted in July. In the past, when we've seen the Japanese overly invested in Aussie Samurai bonds (circa 1990), we witnessed a two-step move where they first got hurt as Aussie bonds and the Australian dollar fell while the yen-dollar relationship stood still. Then, in this past instance, and after this initial leg down, the yen started to advance against the dollar. So imagine in the current environment that some Japanese investors just bailed out of U.S. fixed income. Once these sales are settled, the dollars slosh around for a bit, but then eventually get repatriated back to Japan. The actual repatriation process has the potential to cause a strong yen rise.

Of course, maybe this time around, things won't play out this way. It is possible of course that higher U.S. treasury yields will elicit more buying of Treasuries out of Japan, instead of scared yen repatriation. But either way, the above chart is ripe to break.

Individual Equities

On an individual stock basis, we've had our share of both winners and losers this year. Some of our bigger winning views have included positive views on Enerplus, iStar Financial, and Penn Virginia. These have all now played out nicely and we are no longer involved. We were initially bearish Jack-in-the-Box and then turned bullish adroitly when it fell too far vis a vis its underlying property value. Once again, we are uninvolved again at current higher levels. After we recommended the Asia Pacific Fund (APB) on the long side, it initially sagged a bit, but subsequently rallied smartly. $12.50 is likely still in the offing here. In general, more compelling equity values are still to be found in the Asian emerging markets than in the U.S. or European markets, and thus Asian-oriented mutual funds are the only long-only equity mutual funds we'd even suggest for a traditional long-only mutual fund investor.

We have, however, also had numerous individual equity frustrations, and having made a bit more noise on some of these names than our longs, our pain has been somewhat magnified. Bearish views on Dell and Amazon have both proved incorrect – at least for now. Golden West Financial and Redwood Trust have also both continued to vault higher in the financial sector -- much to our frustration and distaste. In addition, anyone that tried shorting Pulte Home, Caterpillar, Applebee's, Tiffany's, or Bank of America will also undoubtedly have faced some losses.

But there are at least two lessons within some of these missteps. Please accept our apologies if the first appears like a lecture.

First, while Sand Spring Advisors always speaks its mind in an honest and forthright manner, we cannot always nail every view. It is important for readers to do their own thinking and to implement their own risk mitigating trading techniques. Some readers have suggested that we always provide stop-loss levels on every market view that we discuss, and in some instances where an obvious stop exists that we feel particularly strongly about, we have done so. But Sand Spring is not a Registered Investment Advisor. Legally, and to maintain this letter at all, it is important that we do not give overly specific trading advice, but instead simply espouse our macro view of different companies and the general economy. This right of free speech by newsletter writers stems from the First Amendment. It was recently defended in court successfully when the CFTC lost a major case that would have otherwise required newsletter writers to submit to significant governmental fees, audits, and red tape. We do not want to go down that path, and we also do not wish to stretch the spirit of our First Amendment freedoms. Read us for what we are: an independent voice with a technical perspective -- sometimes right and sometimes wrong – but always trying our hardest and speaking from our heart.

The second lesson from our recent individual equity prognostications is that the current market has become more a "market of individual stocks" rather than a single "stock market." An overall market rhythm with much continuity or rationality seems to have simply disappeared for the time being. The most beaten-up stocks of 2000-2002 have recently gone up the most, while other more deserving stocks have generally performed less well. Within the hedge fund community that I am quite close to, this has left many astute quantitative market neutral managers simply scratching their heads in disgust. Such an environment cannot last forever, but as 1999-2000 showed, it can last multiple months. One of two things must happen: If the bull market continues, either more solid leadership from good companies as opposed to frothy speculative ones needs to emerge. Otherwise, the only other choice is a renewed bear market.

Speaking of disbelief, I recently experienced one anecdotal event involving that well-known purveyor of sub-prime credit cards, Capital One, that was yet another sign in my mind that a “debt bubble” is most definitely upon us, and is still in its early days of coming undone. On a single day in my incoming personal mail, I received no less than 4 separate junk-mail solicitations from a single company -- Capital One – each encouraging that I establish a new credit card account with them with a credit line of up to $25,000. On the same day, I then received 2 direct call solicitations from Capital One -- one on my personal home line and one on my business line. Now mind you, I have never done any business with Capital One whatsoever. I then turned on CNBC and happened to catch three advertisements that aired within a thirty minute period sporting a Scottish-sounding Viking asking “What credit card do you have in your wallet?” while a huge slingshot vaults a diner with a variable-rate credit card into the air. Surely most readers have seen this same advert recently. As compared to all the dot.com commercials of 1999-2000, Capital One appears to me to be CNBC’s single largest advertiser at present.

Irritated but increasingly curious at this obvious massive marketing campaign, I actually opened one of mail solicitations and noted that Capital One is currently offering the following terms: no credit card fee, *and zero interest charge until 2005* on all transferred credit card balances, together with no transfer fee. Now that’s a deal that I’m sure many over-indebted consumers will grab. Indeed, why not do the arbitrage? -- Charge up a storm on other credit cards, transfer all these balances to Capital One, and then use the money with which one might otherwise have paid down normal credit card bills, for other purposes – perhaps to spend more or maybe even to save/invest. After all, Capital One’s zero percent carry charge isn’t going to cost anything until January 2005 (8.9% thereafter) – so for the moment, it’s like “found money.”

Perhaps this marketing campaign is a “big push” specifically designed by Capital One strategic planners to garner all the customers that they possible can before the national “Do Not Call List” goes into effect during the fall. But this begs yet another question: once Capital One can’t solicit as many people by phone anymore, then what’s going to happen to the subsequent growth of their customer base? Quite honestly, this new “Do Not Call List” is in my mind long overdue and welcome – but it could have significant negative ramifications for companies like Capital One that need an ever-growing customer base to mask ever-growing customer debt write-offs.

Surely this will all end in tears, and Capital One will one day regret this campaign. With rates recently vaulting higher, maybe COF’s executives already regret some of their existing promotions. But for now, Capital One continues to bombard us via mail, phone and television. I’d call them the Pied Piper of careless consumer-spending confidence. And with the chart pattern below, they are back on our target list to sell. While the Capital One advertising campaign might of course cause some metric of the company to look better in the short-term, in the long term, this company is asking for debt-default trouble. COF’s Fibonacci rhythm remains suggestive of a longer-term downside $8.64 target.

Many other companies remain on our bearish list. We do not wish to be repetitive (and for space reasons, no charts appear since these have all been sprinkled in past commentary), but in an effort to continue our mid-year update, ongoing negative views include:

Deere: upward sloping wedge on weekly chart destined to break lower. Longer-term downside Fibonacci target remains near $17.71.

Walmart: When the consumer finally rolls over, and the consumer inevitably will, Walmart will certainly notice. Longer-term downside Fibonacci target of $20.77.

Mattel: upward sloping wedge destined to break lower. $17.16 one downside target. When wallets get lean, toy purchases drop.

Fannie Mae: 87-1 assets to equity; Saturn in Cancer; and Fibs all suggest eventual fall to $39.26 target.

Freddie Mac: Earnings will no longer get smoothed; FRE is under the microscope, and thus also has less ability to engage in anticipatory hedges. We look for $33.31 with time.

Proctor & Gamble: As with much of corporate America, P&G earnings growth has all been from cost-cutting as well as other accrual accounting sources. Actual sales growth is lackluster, and historic growth in earnings is likely unsustainable. At some point this stock could be cut in half to $40.55 Fib target.

Northrop Grumman: Sick defense contractor with a Fib rhythm that may point all the way down to $33.70.

American Express: With competition like Capital One out there giving money away at 0%, who needs stodgy American Express? Does $20.21 Fibonacci target beckon?

MGIC: This company is in the center of the debt bubble and thus at considerable risk unappreciated by backward-looking investors. $7.11 is the strongest target that we see here over time – a non-trivial fall from this stock's current $54 price.

MBI: Debt bubble trouble again.

XL Capital: Ditto -- debt bubble trouble.

Maxim: Fib rhythm continues to strongly suggest missing low down near $13.56.

KLA-Tencor: Despite a large A-B-C rally since last fall, 18.63 remains a firm downside target with time.

Novellus: As with KLA-Tencor, Novellus has been a frustrating stock to be bearish on over recent months, but the big picture remains unchanged -- $14.64 our downside Fibonacci target.

CDW Computer: Corporate IT spending may have stabilized, but it is not robustly recovering. Nor do we think the "back to school" shopping season will knock anyone's socks off. This large tech consumer goods reseller, at a 23-1 P/E, is still at risk of reaching its missing Fib downside target at $17.74.

And what of **Dell**? **Amazon**? **eBay**? These all remain accidents waiting to happen in our humble opinion, but perhaps it is not worth beating our head against the wall by continuing to harp on them – particularly on Dell because there are other easier pickings. $12.50 remains a long-term target of ours on Dell, and fan line resistance continues to contain Dell's recent advance, but if and when this $12.5 target is someday reached, it will hardly have been worth waiting for. It will certainly not have been an easy path getting there.

But if the above stocks all remain dangerously poised for downside slides, surely there must be at least a few stocks we are still friendly toward. After all, this is a market of several thousand stocks. Here, the list is certainly shorter, but includes:

Delta Pine & Land: Chipping away at the upside…an undervalued takeover candidate with a lovely chart pattern, and upside Fibonacci price target of $33.75 – if not higher on a takeout.

Chesapeake Energy: There has been much leveraging of new assets purchased from El Paso going on here, but $14.25 should still be doable technically.

Waste Management: WMI dumpsters are everywhere within a true oligopolistic industry and ever-burgeoning waste removal demand. $44.50 is a Fib target level that we believe is achievable over time.

And how about some new names both long and short?

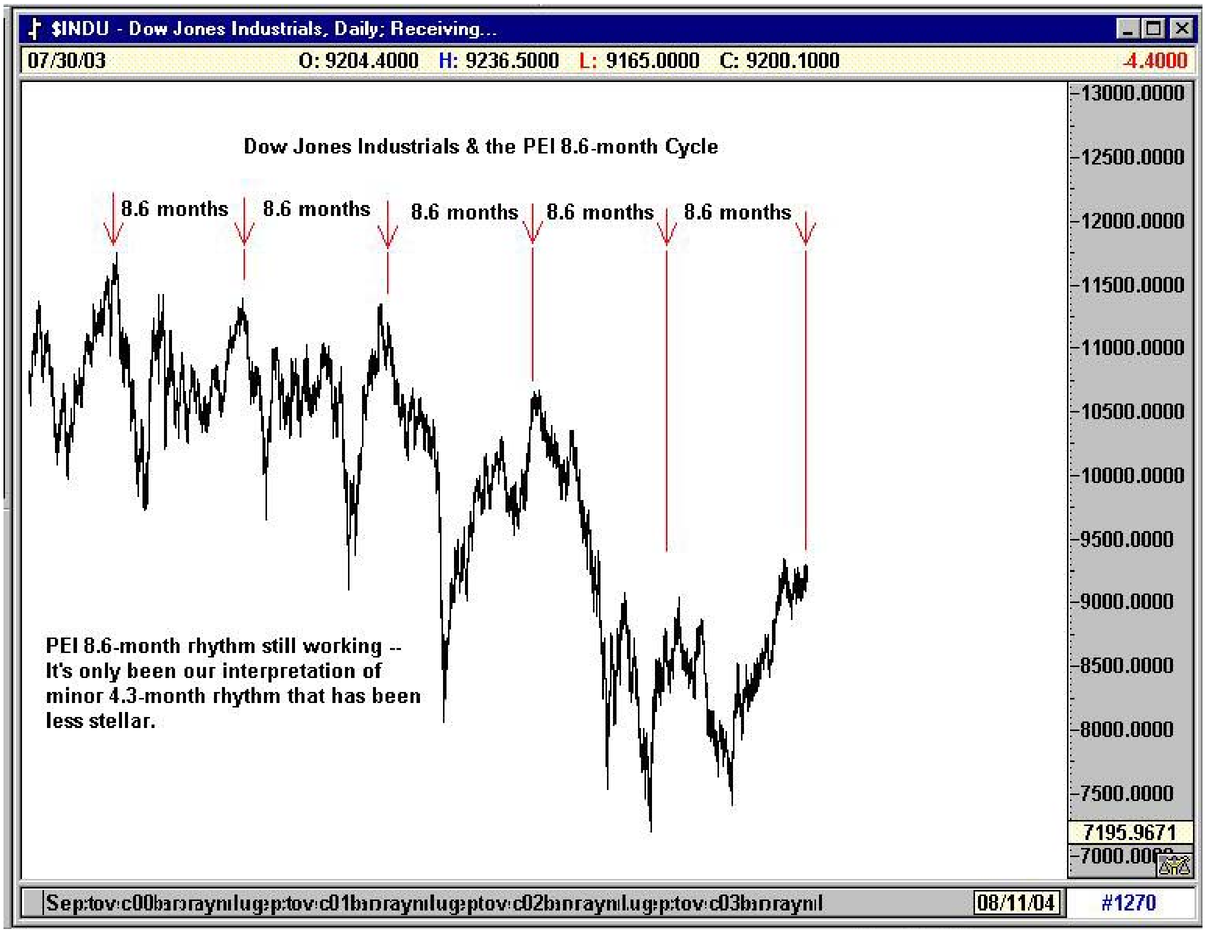
Pediatrix (PDX) is a stock we believe can rally from its current $39.10 price to $52.78, while **Yankee Candle (YCC)** at $23.50 and a 19-1 P/E (no chart) is a company we believe destined to disappoint.

The fundamental story in the former situation is that women are typically giving birth at an older age these days, and the need for infant pre-natal pediatric care has been consistently pushing higher. Pediatrix's principal mission is the clinical care of premature newborns, babies born with complications, and patients with high-risk pregnancies. Look into it on your own, but to us, this appears an attractive company in an attractive niche space. Our one technical caveat is that Arch Crawford is predicting some bad publicity for drug companies between Aug 8th-Aug 12th based on certain astro alignments, so it is possible that the entire drug-medical sector might get hit a bit if Arch is right. $34.90 would be a nice entry level here if this stock were to retrace.

Meanwhile, in recessionary times, just who needs to go shopping at a Yankee Candle store for overpriced faux historic wax? The last Yankee Candle store that I briefly visited (at my wife's behest) was near Deerfield, Mass. It was dauntingly large and full of unnecessary and overpriced crap. Yankee Candle backer Forstmann Little already is being sued by the State of Connecticut for horrific investment management related to the demise of high tech investing, and it is very possible that a disappointing Yankee Candle could be their next "fire storm" to deal with. As one might expect, both Forstmann Little and its leader Teddy Forstmann have been consistent insider sellers of YCC in recent months.

Overall Equity Market

Lastly, on an overall market basis, as mentioned earlier in this letter, the March 2003 market upswing just in front of our 4.3-month PEI cycle date was a confusing situation for us. On the one hand, we'd previously predicted a relatively gentle spring leading toward a more difficult summer. But our minor March 17-18th 4.3-month PEI cycle date marked neither a low nor a high, but instead was right amidst the market blast-off. This has made us re-examine our PEI cycles, and conclude that we simply assigned too much importance to an otherwise minor 4.3 month cycle window. As the chart below shows, the more important 8.6-month PEI cycle has continued to show a nice high-to-high overall rhythm.



Moving this rhythm forward in time, after a downdraft in the near future toward a potential trough low on or about December 5, 2003, one might expect April 13-14, 2004 as a next market high. We say "on or about" December 5th because if our March PEI cycle hit early on March 12-13, the December cycle low could also hit a few days early. Interestingly, the astro-Bradley Cycle -- pictured within June's "The Jig is Up" letter -- points toward an expected low November 23, 2003 – relatively close to our 4.3-month PEI date.

Longer term, many subscribers know that we have previously espoused December 30, 2004 to be a likely low. Our thinking was driven partly by an expectation for a bout of debt-deflation in the short-term that would cause George W. Bush to become singularly unpopular, followed by new political leadership post the November 2004 elections that would at least temporarily rekindle American optimism and confidence. It could still play out that way, but this would not of course be in synch with the high-to-high 8.6-month rhythm pictured above that would suggest December 30, 2004 as a high, not a low.

Thus, rethinking our past cycle prognostication for December 30, 2004, we are increasingly of the opinion that the rest of the Bush presidency may be somewhat of a holding period with enough sloppy price action and negatives in the economy to cause him to lose re-election (similar to his father), but with a whiff of excitement and expectation in the air once he is kicked out. This seems more psychologically probable and is more in line with the above 8.6-month rhythm. A Dec 30, 2004 high could then be followed by true disappointment when the succeeding administration does even worse. True investor despondency and our long-espoused 550-620 S&P market low could then occur on or about February 24, 2007 – a full 8.6 years post the July 20, 2998 PEI cycle high. We measure back to July 20, 2998 because in our opinion, and despite the 1999-2000 internet bubble, 1998 is when the U.S. economy truly started swinging out of control.

Let's also think of this in terms of the Capital One advertisement shown above that happens -- perhaps just by coincidence -- to offer 0% interest until January 1, 2005. COF undoubtedly will garner many new accounts with such an offer, but nothing truly bad will likely happen until that 0% promo rate pops in January 2005 to 8.9%. Once it does, the slow payments increase, the defaults increase, and the write-offs increase.

Hence, although we believe that we currently stand for something of a downside "scare" move in the market into late 2003 back toward the March 2003 equity lows, overall we are tempering our opinion compared to someone such as Bob Prechter who is continuing to predict an immediate 3 of III wave decline. Could it be that this 3 of III decline lingers all the way out in early 2005 leading to a 2007 crash low? Not only do our PEI cycles work better with such an interpretation, but this also seems more logical as it would allow further time of the U.S. debt build-up to come undone -- for Capital One to truly hang itself.

In addition, some of Sand Spring's past missteps (many outlined in this letter) are consistent in one respect: While many of our views eventually come to pass, we are often early and expect things to occur faster than events actually end up transpiring. Looking aback at my entire career using technical analysis, I now realize that a real pattern exists here that I must more actively adjust for.

Hence, we are consciously trying to slow ourselves down and allow for a full gestation period where the debt bubble will come undone in "fits and starts," but not all overnight. The mortgage-housing bubble could slowly deteriorate under the immediate Saturn in Cancer astro alignment, but the true equity market ugliness may only hit in a "reflective" cause-effect manner beyond the Bush presidency and at a time when Alan Greenspan may also be long gone.

In good American fashion, we'll likely be blaming America's stagflationary malaise on someone else by then.

Send us your comments at information@Sandspring.com.

AN IMPORTANT DISCLOSURE