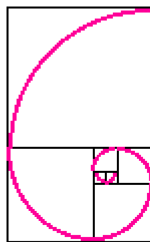

Sand Spring Advisors LLC

Bifurcated World: Queueing Theory at Work

by,

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November 11, 2007

We have dallied to write this letter wanting to await the arrival of our minor 8.6-month PEI cycle date November 12-13th, 2007. This window of time is the first of twelve minor 8.6-month cycle dates after our more major February 24, 2007 8.6-year cycle date (a date that represented historic "tights" in U.S. credit spreads) – and we have long wondered whether November 12-13th would yield a low or a high.

In a way – this cycle may be yielding *both* in the form of a market sector rotation.

You see – we currently are living in a bifurcated world where financial stocks have been in a major bear market for the past several months, while precious metal, energy, alternative energy, Chinese-related, and certain large-cap tech stocks (Apple, Google, and Research In Motion being the three lead horsemen) have been rallying with abandon – at least in faux dollar terms. (Adjusted for the dollar decline, America's selective bull market has of course been less impressive.)

As we look at November 12th-13th, we basically think that this bifurcation may take a time out.

While we are long-term believers in the theory of "peak oil" and the eventuality that crude oil will someday in the not-too-distant future trade well in excess of $100, in the short-term we believe that these markets are filled with excessive investment speculation. Ditto the metals markets. Ditto China. We do not see November 12-13th bringing an automatic cascade lower in all three of these markets, but just maybe – just maybe -- *crude oil should retrace first. Equities might initially rally on the break lower in crude, but then maybe after one more upside equity market pop, these other markets should eventually follow.*

In the meantime, we expect financial stocks meanwhile to start groping for a bottom – still too early to buy, but perhaps too late to remain aggressively short. Many stocks such as MBI, WM, and DSL that we have previously featured on these pages as short-sale candidates have now effectively reached their downside Fibonacci rhythm targets. A few financial stocks may end up going bust, but others may merge or get taken over. In our mind, trading financial stocks is now becoming trickier, and I would encourage Sand Spring readers to begin shifting their focus rotationally to other sectors.

As one new forthcoming focus: an opportunity to sell large cap tech should be forthcoming over coming weeks – albeit we would not immediately chase last week's weakness in the tech sector either. Last week was just the "footfall" to let us know that the tech patient is starting to get tired. It was the momentum high, but maybe not *the* ultimate high. The ultimate high in stocks like GOOG, AAPL, and RIMM should transpire with RSI divergences in a few weeks time.

Along these lines, we wish to offer this month more chart views than text. So let us start with where we see the most excesses, and propose some potential price paths. Thereafter, we will move on to finish with some single name equity situations where we still find bullish patterns.

As always, these are just our personal views and are not meant as direct investment advice. Consult a Registered Investment Advisor before making any investment decisions.

Crude Oil

In the title of this article we mention something called "queueing theory." This is something that engineers at places like Bell Labs and the major airlines study, but it applies to financial markets as well. There are several different arrangements for queues: single queue – single server (the grocery store), single queue-multiple server (airline check-in), and so on. Leonard Kleinrock wrote one of the seminal texts on this topic entitled *Queueing Systems* in 1976, but for our purposes here, suffice it to say that all of these systems become chaotic when the load approaches the capacity of the system. For example, customers arrive at random at the airport, so the time spent waiting on a queue can randomly jump from very short to very long. If the demand to join a queue is relatively inelastic, and if the supply of services at the end of a queue is also inelastic, the volatility of waiting time – "waiting time" considered in terms of an asset -- increases.

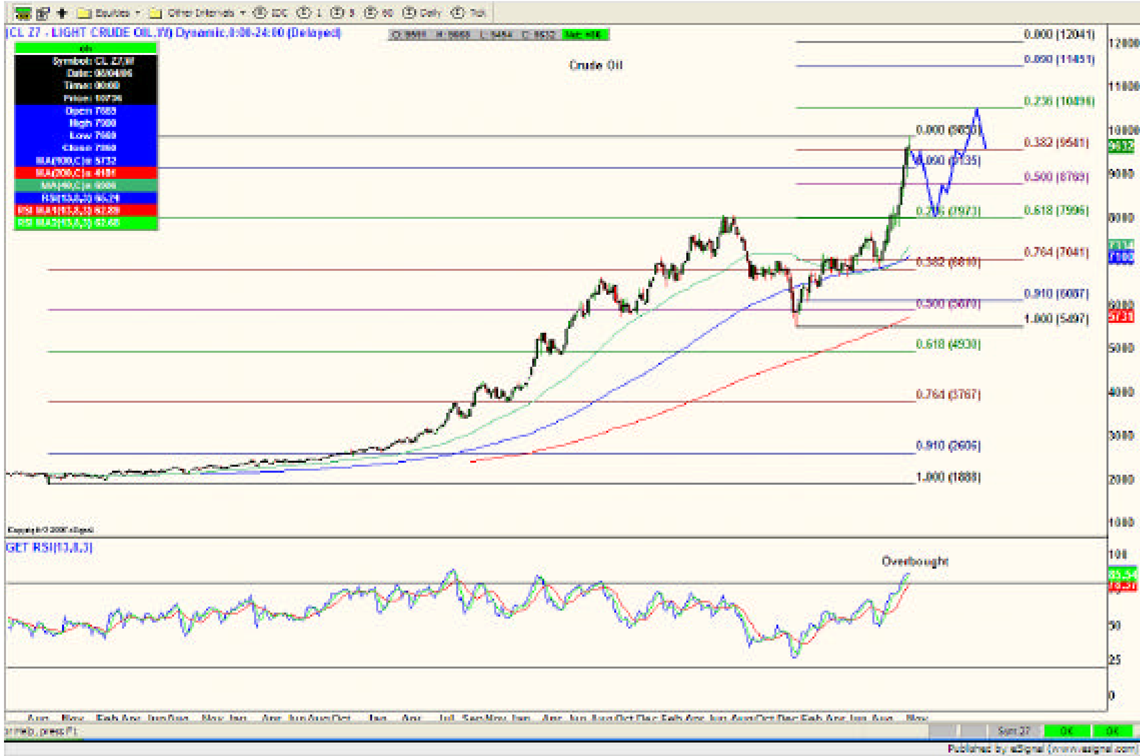
In financial markets we see the same thing in the current oil price behavior. Courtesy mostly of China growth as well as American consumers' unwillingness to change their driving behavior, demand for oil has been relatively inelastic regardless of price; and yet despite higher prices, Saudi Arabia has not been able to increase production and defuse recent price advances. Given this inelastic supply-demand equation, the littlest disruption in the world can cause a queueing backlog. As recently penned by a member of Benchmark Advisory Services writing for a *Wall Street Journal*-sponsored website:

> The fundamental reason for the oil price volatility that we are observing in the last few years is the disappearance of spare production capacity (from a spare capacity of 6mbpd in 2002, we are down to 1mbpd today). This is exactly the same behaviour as could be predicted from queuing theory of a system operating at full capacity. When a system operates at or above rated capacity, then response times becomes erratic and unpredictable. Similarly, due to our just-in-time oil production systems, any small external event —a cold winter, a hurricane or shutdown of a pipeline, exacerbates an already tight supply situation leading to wild price swings.

But as oil output is kept on maximum, so too could demand for oil temporarily wane given a sudden external influence of overly warm weather, or a sudden chill in economic growth prospects out of China. Net net, the volatility of oil increases, the market having gone from "hot" at $80 per barrel in the summer of 2006, to "soggy" at $56 per barrel last January when warm weather blanketed the East Coast, to hot again at the current $96 per barrel price level. There is

no supply-side ability to really balance and react to short-term external influences in a timely fashion.

At present – and albeit admittedly within a secular uptrend -- we believe that the crude oil market is overdue for a short-term cycle downward in the price of oil – maybe to around $80. We see the Fibonacci rhythm of the crude oil market and XOI Index potentially following the paths depicted below over coming months:



Gold

Our view of gold is reasonably similar, as shown on the daily chart below.

Interestingly, while the gold chart rhythm looks complete from a Fibonacci perspective, the XAU index of gold stocks appears as if it may have one more new high before its retracement. This might be consistent with a general short-term bounce in the equity market.

Dollar

In the meantime, the euro and British pound have quickly approached the upside targets -- 1.51 and 2.135 respectively -- discussed in last month's letter. But we are basically at the .9099 Fibonacci band of the overall expected move in the euro – in other words, not that far from being done. Often at such a .9099 level, the sledding for further short-term advances gets tough, and short-term tradeable reversals occur. The pound also now looks top heavy at 2.1150. From here, we see these currencies hitting a period of more short-term chop and retracement.

Within this period of retracement, as well as thereafter, we expect that the pound will start to weaken against the euro along the lines of the chart below of the EUR-GBP cross where a clear Fibonacci minimum upside target on the cross-rate of .7387 pops out.

Elsewhere, in our late September letter we also espoused the USD-CAD exchange rate stretching to .93. At the time, this was a fairly radical call. But this target has now been reached (and slightly surpassed). The U.S. is currently on sale versus the Canadian dollar. As crude and gold markets potentially retrace, we would also expect an upward bounce in the U.S. dollar vs. CAD.

Equities

Let us start here with our sector rotation views, and the PHLX BKX Bank Stock Index. We see this index as oversold – albeit potentially at the neckline of a longer-term huge head and shoulders top – but with a second shoulder still to be built. We have personally covered most of our financial shorts.

In the meantime, an ETF like DUG (double the inverse of the Dow Jones Oil & Gas Index) looks poised to benefit from our expected short-term reversal lower in crude oil. We see a trade in this ETF from its current price near $41 up to between $45.55 and $48.08. As a matter of disclosure, we are long DUG as a short-term trading position.

In terms of the major equity indices, the fact that the S&P cut through our anticipated support region at 1462-1465 and promptly traded down to 1450 is an interesting event. It increases the potential of the 1947 vs. 2007 S&P bearish analog posted on the web November 2nd will be a better potential fit than the path depicted on the web back on October 29th in our brief article "Panic Cycle Time."

The key to tell the difference revolves around a few levels. If the S&P busts through 1440, then watch out for a more immediate flush to the 1330-1350 region. But more likely, the market will first bounce, and then fail around the 1502 level of the S&P, and at that point do a "swan dive" move down to around 1321. This would end up matching 1947's analog very closely.

Such a view also allows for one more short-term failed rally attempt higher in the NASDAQ 100 and the "three horsemen" leading it -- Apple, Google, and Research in Motion. The levels on the NASDAQ 100 are clear: The NASDAQ 100 should fail on any bounce near 2171; then 1940 will beckon and hold on first touch for a bounce; but 1752.50 will be the ultimate target for this market's swing move lower.

In our personal trading we caught a portion of the GOOG and RIMM meltdowns last week, but we have now covered those shorts, and await an opportunity to reestablish them. A final wush higher in GOOG to 788 is possible; ditto one last push up in Apple and RIMM – as depicted below.

The key to understanding U.S. markets remains, of course, understanding China and the flow of investor sentiment there. The FXI index represents an ETF equating to the Hang Seng H share market, and it too took a hit last week. But just like the NASDAQ 100 "three horsemen" shown above, we expect one last pop in the FXI before the ultimate turn lower. Don't try to play this move (such would be akin to joining a game of "greater fools"), but we'll personally be ready to pounce (likely with puts) if and when the FXI touches 230.

Stocks we like on the long side

So overall we are expecting short-term bounce mode for equities – *excepting* energy related equities where we are bearish, and metals-oriented equities where we are suspect of the extreme in bullish investor sentiment. But also be warned: these are just trading views. After a short-term period of equity strength and energy market retracement, we will undoubtedly be flipping these views once again. Stay tuned to the website as to such timing.

But regardless of short-term swing moves, we also have a handful of stocks where we are bullish on their pattern longer term. Since some of our readers aren't natural short sellers or short-term traders, let us share two of these with you: food companies Sara Lee and Smithfield Foods. We are personally long both, and see either or both eventually being a takeover target for some Chinese company with money to burn.

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Send us your comments at information@Sandspring.com.

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