Sand Spring Advisors LLC

Calibrating Different Markets

by,

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We did not expect the ebullience of U.S. equity markets so far this autumn. We were in fact dead wrong calling for a seasonally weak September and October. The usual seasonal tendencies just did not show up, and all the astro work that we discussed earlier in 2006 that pointed towards a tense autumn may have been correct with regard to the War in Iraq and President Bush's popularity polls, but somehow nothing could stop the bullish sentiment on Wall Street.

So where to from here?

One of our readers recently sent us the chart below showing a "pattern match" between 1987 and the current S&P. On this chart the reader marked some rough expected peaks and troughs to come. If this reader is correct, November is a down month, with a small bounce into December, and then 2007 will start with a bang with a huge downside move. Our PEI cycle date of February 24, 2007 might end up as a secondary test of a Jan-Feb crash low.

This is of course possible, but the 8.6-year (3,141 days) pi cycle that we work with has been a consistent "high to high" cycle for awhile:

Oct 1972: near the end of bull market pre 1973-74 debacle

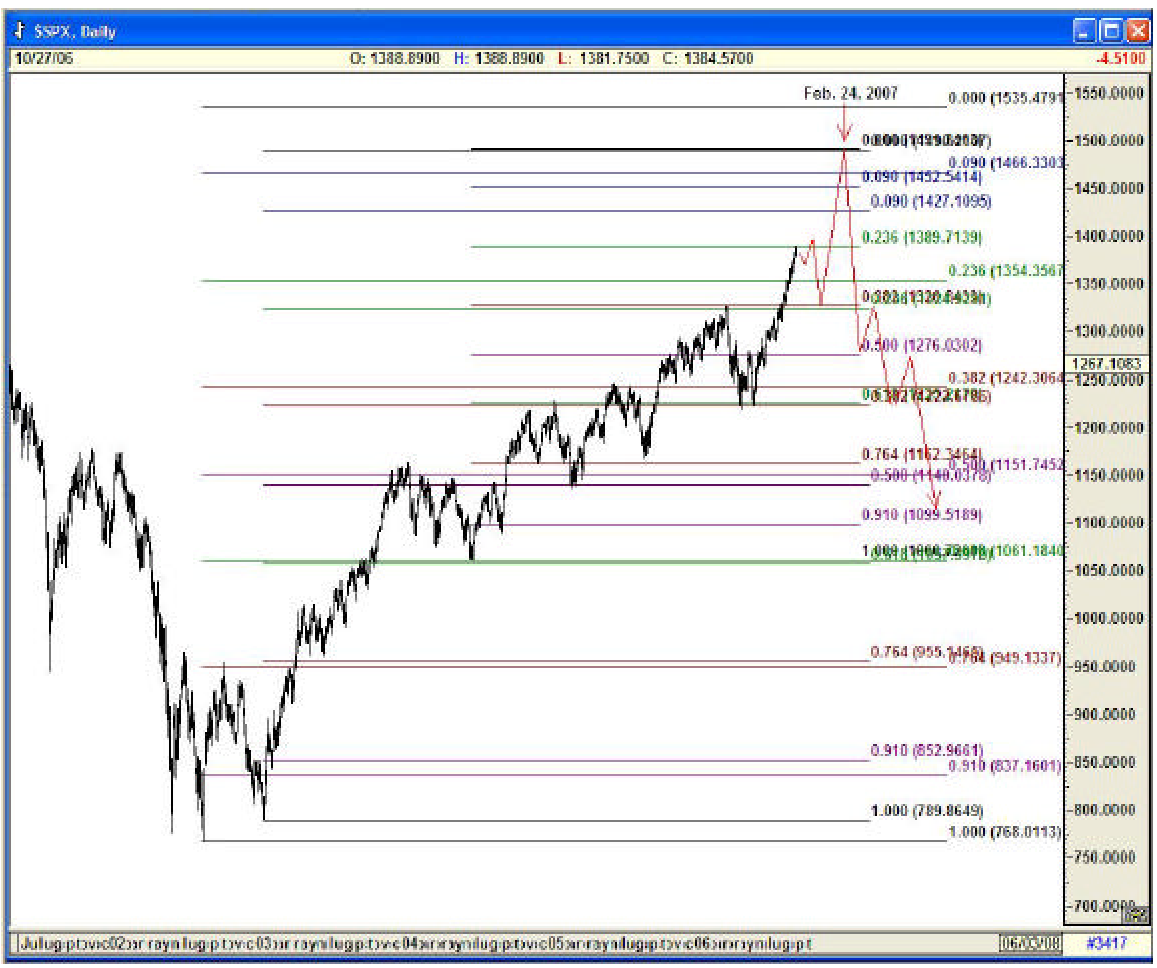
May 1981: DJIA high before Volcker tightening in the U.S.

Dec 1989: All-time Nikkei high

July 1998: Global equity market high pre-LTCM and Russian default

February 24, 2007: ???

Might the chart below also fit? In this chart, we have stretched various Fibonacci bands across different time intervals starting from both the October 2002 and March 2003 market lows. The rhythm depicted here would suggest a topping process in the short-term, leading to a medium-sized retracement down to approximately 1327 on the S&P, but then one last blow-off run for the S&P to around 1490. Such a view would allow the recent sentiment extremes (three straight weeks of Bullish Consensus numbers > 90) to work themselves off via a stiff correction in the short-term, but the market to still thereafter confound bears and return to one more dramatic new high into our February 2007 cycle window.

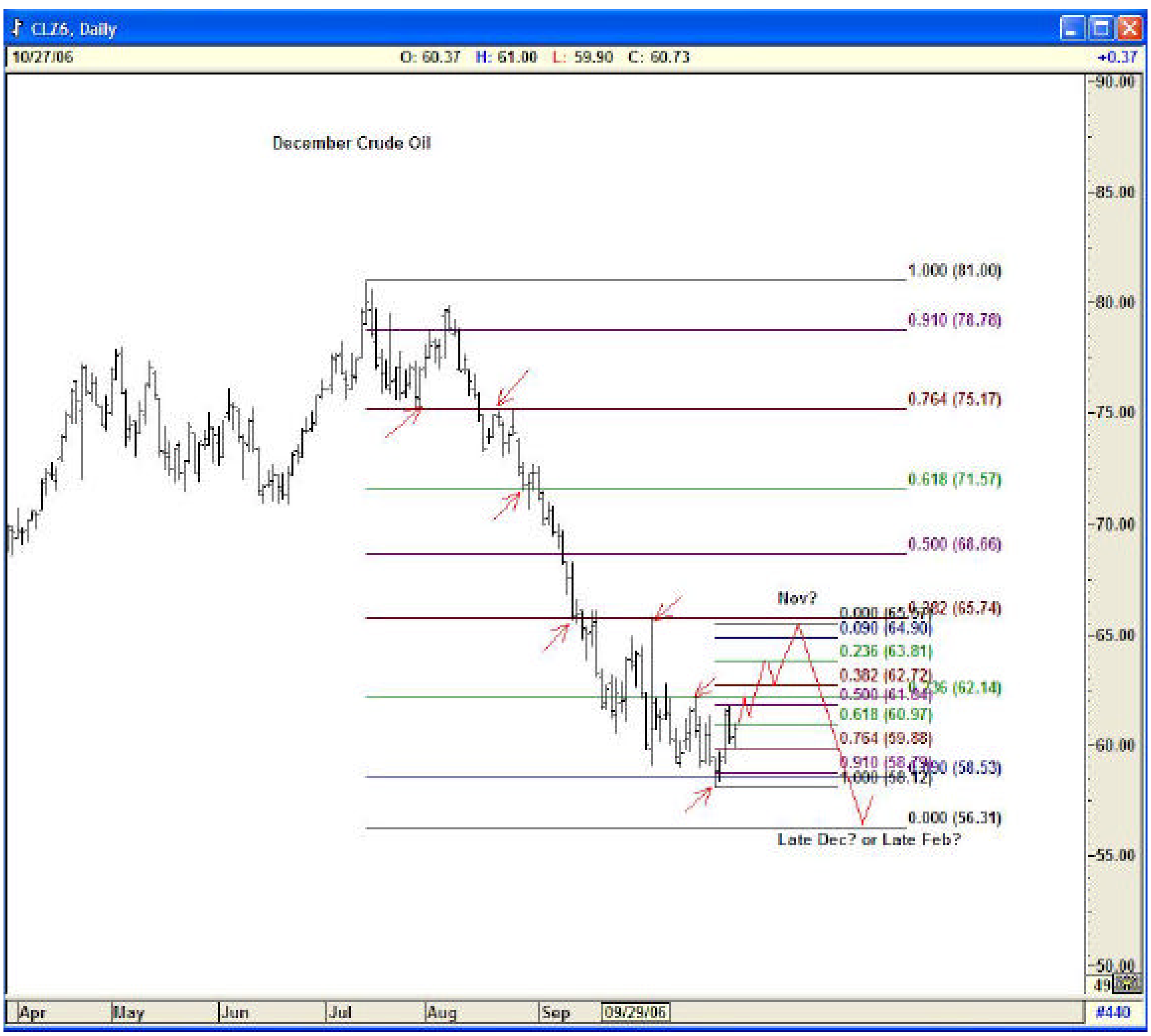


To our eye, either path is possible, and both are of course most immediately short-term bearish. The difference will come mostly in the extent and complexion of any December rally period after a November trough. Will this be just a secondary high, or a fast "wush" to new all-time highs that continues into the New Year? Either way, the volatility of the U.S equity market should be markedly increasing over the coming months. As a tactical tilt therefore within our Wimbledon Sand Spring Class L Fund LP product (where we allocate $52 million in assets to an assortment of hedge funds for qualified investors), we are currently on the hunt to find more sharp volatility-trading managers with a long volatility bias, and hope to place more allocations with such managers as soon as possible. If September-October did not bring its usual market sloppiness, December may easily also not bring its usual seasonal lull.

But these two views remain, of course, quite different. It is thus useful to try to calibrate and refine our equity view by looking at the chart patterns of other markets.

For example, part of the recent equity market strength certainly found its roots in the steep decline that the energy complex experienced over the past two months, so if we can make any observations about this sector, it may help us to forecast equity behavior with more precision.

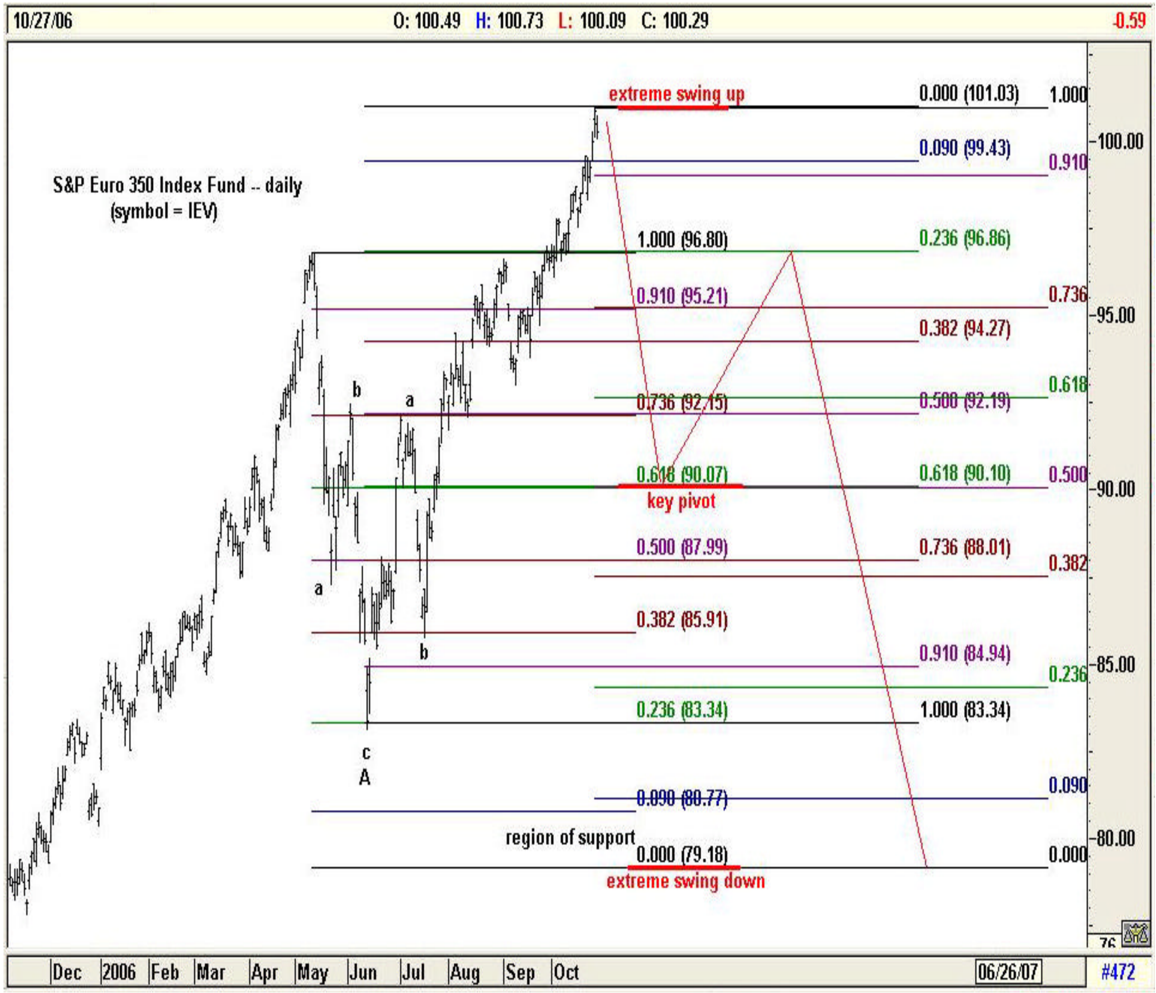
Within the Crude chart (using NYMEX December futures), there are clear signs that a short-term rally period is currently mounting, with a potential upside target of $64.90. But there is also a clear Fibonacci rhythm that nicely fits eventual new lows near $56.31.



In the short-term we would not be surprised to see December Crude push up to around $64.90, but Crude would be a clear trading sale at that level. Meanwhile, if and when Crude ever reaches a downside target of $56.31, the swing decline in the energy complex from July of this year will be ending, and with the end of Crude weakness, the party in the equity markets should also finally be finishing. Will this trough low in Crude come in late December 2006 or late February 2007? The difference could help us discern whether the first chart above of equity price behavior will hold sway or the latter.

Let's search for another potential calibrating clue in the darling stock of the recent bull market: Google. To our eye, Google is making a short-term top at present that will likely lead to a modest retracement down to 444 (during the late November trough period?), but then one last push up to a clear Fibonacci upside target that fits on both a daily and weekly rhythm basis at 514. Thus, one would not expect the bear move lower in the broad market to begin in earnest until this target has been reached. If Google stands at $514 come late December, the odds for an immediate crash lower would be strong, but if it takes until late February 2007 – so be it. (As an aside, please be warned: anyone trying to play Google from the long side, looking for the $514 Fib target is playing with fire. The Fib rhythm notwithstanding, this is not a trade that we would advise anyone to consider.)

Meanwhile, European markets often offer some calibrating clues to U.S. markets. We view the chart below of the S&P Euro 350 Index Fund (symbol: IEV) as a "pendulum" of sorts with 90.07 a clear center Fibonacci pivot point. The high last week of 101.03 represents an extreme swing move to the upside that will be replicated at some point with an extreme mirror image swing move to a downside target of 79.18. To our eye, a low into late November-early December could be followed by a secondary high into late February (PEI date) and then the plunge thereafter. This view is thus more similar to the first 1987 analog chart shown above in terms of overall shape – but with the timing of the ultimate decline stretched out a bit. The overall resulting pattern may end up resembling a “head and shoulders” top.



Sometimes it helps to turn charts upside down. The chart below is of the ProFunds Ultra Short OTC Fund (effectively 2x short the Nasdaq, symbol USPIX). To our eye, there are likely no new lows in the offing here. Instead, like the first 1987 S&P analog chart and the IEV chart above, this chart bodes for tough times for equities more or less straight away from here with an eventual upside Fibonacci target on this inverse mutual fund of around 20.73. Removing the 2x leverage, this would equate to over a 21% decline in the Nasdaq – scary stuff. The setup of this chart reminds us a bit of the way gold-yen looked back in February 2001 (see gold-yen chart at the end of past February 2001 article *Measuring Financial Time: The Magic of Pi*).

And in terms of Gold, we now see at least one more new high in the cards – likely to be in early 2007 -- near $780. Gold going up with oil in the short-term should once again weigh heavily on equities in the coming few weeks.

And what of the U.S. dollar and bonds? Are there any hints showing in these markets?

In our humble opinion, dollar-yen just experienced a false "throwover" to the sloping channel shown below. A longer term downside target of 96.30 remains, but there is nothing clear in this pattern as to timing which might help our equity market interpretation.

And in terms of U.S. T-Bonds, fundamentally, bonds are too low in yield to be attractive investments in the 4.5-4.8% yield region, but at every opportunity, they have failed to show much upward yield momentum. If stocks give up the ghost, one more new all-time high in the bond market remains possible toward a Fibonacci target yield level of 3.94% – but to bet on such a move is also a poor risk-reward proposition. More money will be made on the short side of equities than the long side of U.S. fixed income if and when the economy hits the fan. Meanwhile to short bonds aggressively would also likely be a mistake since one would be on the wrong side of the potential flight to quality trade. If possible, just leave the bond market alone.

We realize that there are no firm conclusions here except that equity volatility will shortly be on the upswing and that a topping process for U.S. equities should finally be starting. We can say that European markets and the Nasdaq look clearly weaker in their current formations than the DJIA or the S&P. We are also once again at least short-term bullish on gold and crude, and longer-term bullish on yen.

As always, these are all just personal chart views. Do your own investment research. As the markets of Sep-Oct showed, we can at times become very out of synch with the underlying fractal rhythm of the markets. Interpreting Fibonacci fractals remains an art – even while the rhythms themselves certainly emanate from the world of science.

Send us your comments at information@Sandspring.com.

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