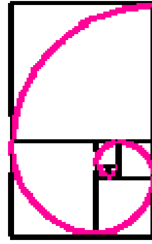

Sand Spring Advisors LLC

New Market Roadmaps Filled with Complexity

By,

Barclay T. Leib

August 9, 2008

We have waited a full week beyond our July 31-August 1 minor pi cycle window to try to ensure its correct interpretation.

Earlier in 2008 we wrote that we expected a major low in the market in the third week of March 2008, followed by marginal new lows into late July that would scare the hell out of everyone, but then dissolve into a more benign second half of 2008. In general we can say: so far, so good in this "big picture" overview.

Then in late May 2008, we updated this view with the suggestion that oil was not ready to top out until July, and that strong oil into July would likely equate to weak equities into this window of time as well. Such was certainly the case.

As of late June we started to speak about how extended to the upside the oil market already appeared, and anticipated it reversing around a crude price of 142.80. Markets seemed a tad ahead of themselves vis a vis our July 31-Aug 1 cycle date, and we pondered how much more extended things could become given where markets already were.

Then in mid-July – a tad early in relation to our July 31-Aug 1 pi cycle date -- everything reversed. Almost all energy-related stocks crashed across the latter two weeks of the month, while financial stocks spiked higher. It was a classic case of "crowded trades" being unwound in a panic. Stocks that seemed like great long-term investments befitting an era of "peak oil" or expected infrastructure build-out demands suddenly fell from grace and were short-term mark-to-market liabilities. Financial stocks that have capital adequacy problems and suspect ongoing business models vaulted for the sky.

At Sand Spring, we fundamentally (in addition to technically) felt this "sentiment shift" truly coming when the House of Representatives passed a preliminary vote to give the CFTC special powers to investigate the impact of speculation on the price of oil, and separately, the SEC started to discuss enforcing "locate" rules on short selling of certain financial stocks. We've seen this type of thing before back during the Hunt Silver Crisis of 1980 (having written a 170-page Princeton thesis on the latter topic). When the authorities start monkeying with market rules in midstream, a trend reversal is almost always afoot. We targeted a top in crude around 142.80, and admit that the last brief spike up to 147 was a bit gut-wrenching, but we are proud to say that our personal account had a great month in July, and we now stand with an approximate year-to-date gain in our personal trading of +33%. Catching the recent decline in copper further supported our personal trading cause.

However, we are not entirely clear where exactly in the "grand scheme" of things our recent successful trading is leading us. We certainly admit that when the July 31st cycle date finally hit, we were left pondering a number of thoughts as to its significance. Most specifically, we have written that while we have seen major "high" pi cycle dates hit most precisely over the past two decades – usually to the day -- more minor "low" pi cycle dates sometimes come ten days or so earlier than expected. As examples, the March 2003 low in equities came about ten days prior to the pi cycle date. Similarly, the October 2002 low hit about ten days before the pi cycle date. Was the mid-July 2008 sentiment shift similarly just a few days earlier than pi perfection?

Bothersome in general was also that there was no Fibonacci fractal "fit" to the S&P 500 low print of 1200.44 on July 15th. This level simply does not "resonate" as an important low technically. For a moment this caused us to consider that the July 31-Aug 1 pi cycle date might actually represent a point of acceleration for equity markets to the downside. But then we backed off this interpretation as well.

And then on August 4th, we noted that the XLE (a major ETF tracking energy stocks) was actually getting pretty oversold at what could become a tradable bottom. We went on to consider that perhaps the short-term swan dive in energy that started in July was actually hitting an attractive low just a trading day beyond our cycle window.

The possible permutations of views are admittedly irritating, and in general we face a far from homogenous technical set-up. Sometimes pi cycle dates are like that -- particularly the minor ones like July 31-Aug 1 variety. Last February 24, 2007 there was a more major 8.6-year pi cycle turn, but even in that instance, it took some time to discern what had actually "turned" for good. As readers may remember, stocks plunged for awhile as credit spreads widened, but then stocks later rallied back while the major credit spread indices never saw their February 23, 2007 lows again. It took awhile to simply recognize February 24, 2007 as having been a major turn in the credit cycle as opposed to a more specific turn in equity markets.

So where to from here? Leaving aside a complex pi cycle interpretation, we need to grope our way using pure technical methods, and what we end up seeing equates mostly to new complex trading ranges. As we look across different markets, we see the following expected trading ranges now starting to be established:

S&P 500: high end of range for now should be 1325-1330; low end of range should be 1166-1176.

Crude Oil: high end of range for now should be 129.80-131.70; low end of range should be 112.50-115.50.

Gold: oversold short-term, but rallies to 876 are likely to fail, and a price as low as 734 is possible in a speculative "flush."

Silver: 14.40 expected low at some point while 16.80 should contain the upside.

Euro: High end of range should now be 1.5390, while the low end of range is somewhat more open ended to around 1.4320. There is short-term support at 1.4980 that should likely yield an initial bounce.

Our technical views of each of these can be seen below, but *Note Bien*: The exact path within the ranges is more of an artistic fractal guess than a true science.

The above chart implies sloppy and somewhat more boring balance of 2008 for the S&P 500. This index is currently attempting a rally, but this rally should hit stiff resistance near 1325-1330, and slowly with time, 1166-1176 target low should still be reached. All in all – the S&P 500 should be a grindy range trader, with yet one more new low to be seen, but likely to be reached in a very undynamic fashion.

Meanwhile, crude oil in the chart below should have reached a major area of support this past Friday (allowing for a potential overshoot to 112.5) within a long-term uptrend.

And yet the precious metal markets still look vulnerable to further decline. Silver has a clear target still to be seen down near $14.40, and it is possible that gold could flush investors out all the way to around $734.

Ironically, one of the few markets where we see potential for more trendiness is in the fixed income sector: U.S. Treasury Bonds/Notes – to the downside.

On a yield basis, the 30-year T-bond yield sports the following rhythm: yields in the short-term should move up to a 5.837% high before eventually plunging to 3.763% -- this latter move likely transpiring across 2009-2011 during the next big leg of equity weakness.

Thus, how ironic it is that we may soon potentially be witnessing both gold and bonds falling at the same time (most people considering them to be inverse assets). But alas, it was also the case that these two asset classes *rose together* back in 2003. 2003 was obviously the expansive part of the cycle – as real rates turned negative (post aggressive Fed easing), and gold reacted positively. Real rates are still negative, but now we face an uglier more restrictive part of the cycle where rates go up and inflation hedges go down.

It's not that we expect the Fed to really do any massive tightening. It is more that we believe there will be a slow "buyers strike" in the long-end of the Treasury curve. Indeed, to a certain extent, we believe that by recently rushing to explicitly guarantee Fannie Mae and Freddie Mac paper, the U.S. government may actually be squeezing its own bond Government Bond auction yields higher. Please consider the following choice. Which would you rather own?

> Choice one: A *non-collateralized* note or bond yielding 3.8-4.2% issued directly by the U.S. government,
>
> or
>
> Choice two: a 5.8%-6.2% piece of mortgage paper from Fannie or Freddie that not only now has an *explicit U.S. government guarantee* wrapped around it, but also is *backed by actual collateral* in terms of real properties.

We think the latter is far more attractive – so ergo U.S. Government yields now should migrate upwards towards Fannie Mae and Freddie Mac yields. In the end, if it's all one big pot of government guaranteed debt, but simply with non-collateralized and collateralized versions, there is conceptually no reason that Freddie and Fannie paper should not someday actually trade at *lower* yields than non-collateralized straight government debt. Call us crazy if you want, but we see U.S. Treasury Notes and Bonds as a screaming sale at present.

At the end of the day, what are the current global imbalances that have built up over the past two decades? Arguably, Fed Chairman Greenspan kept U.S. rates artificially too low for too long, causing excessive and continuous debt-financed U.S. consumer spending. Low U.S. rates also led to a perpetually weak U.S. dollar to the point where purchasing power parity between the dollar and the euro now hardly exists. Dinner for four at a so-so restaurant in London recently cost me $570; a small bottle of water from a grocery store in Oslo now goes for the equivalent of $7. The dollar downside has been pushed to its limit against the euro, and an overdue snap-back is now transpiring.

The way the world gets back into better economic balance must eventually come from higher U.S. rates; a higher dollar; and a contracting U.S. consumer. Fed and governmental easing efforts notwithstanding, this is the path that we currently find ourselves moving down – and should continue to move down regardless of Fed action or inaction. It is an environment where the emphasis will shift away from commodity speculation and towards a focus on higher rates and a higher dollar. Equities will not like this environment in general, albeit the knee-jerk equity reaction at seeing commodities weaken and the dollar strengthen is understandably to cheer. But after the initial cheering stops, the reality sets in – higher rates and a higher dollar are in no way good for corporate profits and American domestic consumerism.

The market is of course filled with individual stocks with individual stories behind them. So setting aside our top-down views, here are a few individual equity views that we currently hold. As always, please note that we are not Registered Investment Advisors, and do not proffer these views in any way as direct investment advice. These views are simply our own opinions.

One stock that we have been in an out of over time is **Blackrock (BLK).** A hefty chunk of their annual fee revenue comes from fixed income asset management and the rest comes from alternative asset management (let that read hedge fund of funds). Hedge funds are already having a tough time, and incentive fee income from BLK's fund of funds business must currently be running near nil for 2008. And it is of course our view that fixed income markets are about to come under pressure. In addition, many clients of Blackrock were displeased with them around the auction-rate security fiasco. And yet the market keeps buying this stock as if Blackrock is without any blemish? We see a huge top forming, albeit we can't rule out a final faux spike higher to around 250 before we get downside satisfaction.

To pair the above financial short idea, here is a long financial idea: **GFI Group (symbol: GFIG)**. Chairman Mike Guche – who we know personally from our currency derivatives trading days – has over time built a derivatives broking empire in GFI. But when credit derivatives trading fell from grace this year, so too did the stock. Now there are confirmed reports that GFI is in negotiations to merge itself with Tullet-Prebon. We see a potential takeout price technically maybe up between $14 and $16 or so.

We are bearish on gold and silver, but as a potential counterbalance to such views, we have an eye to be buyers at some point soon of the closed-end fund traded in London **RAB Special Situations (symbol: RSS-LN)**. Managed by natural resource investment visionary Philip Richards, RAB Special Situations owns a variety of small cap natural resource companies in god-forsaken parts of the world, but with potential world-class resources in the ground. The fund owns, for example, one of the largest coal deposits in the world located in Burma, and they own a majority of Falkland Oil & Gas which may sit atop a truly huge offshore reservoir of oil near the Falkland Islands. Oil was first discovered in this region back in 1998, but with oil then trading at just $12 a barrel, the reserves were not deemed worthy of further development at that time. At $100+ oil prices, all that awaits further buildout of the Falklands is the availability of more drilling rigs. Falkland Oil & Gas is currently working to take care of such logistics via a farm-out agreement with BHP Billiton.

In the meantime, RAB has seen its closed-end fund RSS pummeled to approximately a 40% discount to its NAV. This means that a buyer of the closed-end fund can gain access to some of these longer-term small cap situations at a significant discount to their current NAV. Who knows – maybe RAB itself will buy back its own closed-end shares to take advantage of this discount.

We are buyers of these shares at a Fibonacci fractal point of approximately .52 pence. Maybe this will be seen if and when gold reaches $734. We would not be surprised by the path depicted in red below.

Another stock that we have our eye on is restaurant chain **Benihana (BHNA).** A former steadily chugging upscale growth restaurant chain that not that long ago was valued in the $20s, this stock has more recently been pummeled to value stock status. With founder Rocky Aoki recently passing away, might some other restaurant chain now want to snap up Benihana between $10 and $12.5 a share? We see value here. Prices toward $5 would be optimal for entry if offered.

Back on the financial side, asset management remains a difficult sector – particularly growth asset managers like **Invesco (IVZ).** We see a $18.81 target on this stock over time.

These are just a few eclectic situations that look potentially appealing to our eye. In addition, we are currently trolling for energy situations that may still hold long-term appeal, but which have a low-risk entry point near at hand. Dril-Quip (DRQ) may represent one of these.

Meanwhile, we are yearning for a further slight bounce in the XHB homebuilder ETF such that we can feel comfortable shorting it again. The rhythm here is most clearly seen in single homebuilder Toll Brothers where $23 or so should represent stiff resistance (and a potential short-selling opportunity), while a $12 downside fractal target still beckons longer-term.

Overall, returning to our pi cycles, December 9th is our next minor cycle turning point, and then April 18-19th, 2009 is a more important one. We remain of the opinion that April 18-19th, 2009 should be a high of some significance that will then usher in more economic difficulties and poor markets out to June 14, 2011. October 1-2, 2015 will then be due as a major high. First though we must deal with an 8.6-month period where the economy might in ways seem stronger than it really is, and interest rates head higher.

One may thus expect at Sand Spring that our attention in the short-term may be turning away from equity index market analysis for this period and towards fixed income and currency market analysis.

Stay tuned for further updates and new views via the website.

All contents are Copyright © 2008 by Sand Spring Advisors, LLC, Morristown, NJ

Send us your comments at information@Sandspring.com.

AN IMPORTANT DISCLOSURE

Sand Spring Advisors provides information and analysis from sources and using methods it believes reliable, but cannot accept responsibility for any trading losses that may be incurred as a result of our analysis. Our advice should be deemed our personal opinion and not a recommendation to invest. Individuals should consult with their broker and personal financial advisors before engaging in any trading activities, and should always trade at a position size level well within their financial condition. Principals of Sand Spring Advisors may carry positions in securities or futures discussed, but as a matter of policy we will always so disclose this fact if it is indeed the case. Sand Spring's principals currently hold positions long BNHN, DRQ, GFIG, RSS-LN and short IVZ and short various ETFs tracking T-Bonds (i.e. TLT). Sand Spring also offers technical consulting services to an outside hedge fund manager who may at their own behest be involved trading some of the securities mentioned.