Sand Spring Advisors LLC

Hedge Fund Malaise In Progress
&
A Primer on Sand Spring Fibonacci Methodologies

by,

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For any reader of our December 29, 2007 "View into 2008" article, the market events of January 2008 came as little surprise. We were personally only somewhat aghast when the markets of Martin Luther King Day saw the collapse in futures markets globally beyond the 1290 200-week moving average on the S&P. As we posted that day on the web, we bought futures down at 1276, and turned momentarily bullish for a large bounce.

More recently, as the S&P has rallied back to the mid-1380's, we are beginning to anticipate a slow grindy re-test of the 1290 200-week moving average that will likely take place into our next minor PEI cycle date on March 22, 2008. While in the very short-term prices may kiss the underside of their previous trendline break in the 1403-1407 region of the S&P 500 (and possibly 1420 on a spike), prices should start to head back down after that. A momentum low should form on or about March 22, 2008, followed by a bounce, and then yet another slow grindy move lower – potentially all the way to 1244 on the S&P. This latter move may transpire into late July.

Once 1244 is reached on the S&P we will be generally bullish on the markets all the way into next April 2009. Then the April 2009-Dec 2012 period is likely to be a horrific market similar to the ceaseless bear market of 1939-1942 or the more volatile 2000-2002 bear period.

There have been many knee-jerk reactions in recent days after the Fed cut interest rates by 75 basis points on January 22nd, and then again by another 50 basis points on January 30th. Three of these knee-jerk reactions have been to 1) buy bank and brokerage stocks (due to a steeper yield curve which is almost always a good thing for financial entities); 2) to buy home-builders (helped as well by Congress approving higher dollar limits on Fannie Mae and Freddie Mac conforming loans); and 3) to buy gold and silver (under the theory that interest rates are now solidly below inflationary levels and thereby "negative real yields" prevail.

Our view is that each of these "knee-jerk" reactions will quickly peter out, and that people rushing back into financial and homebuilding stocks will ultimately be very disappointed. While we acknowledge that a steeper yield curve is good for the financial system, we fear that the next batch of news to reach the financial pages will be that of very sharp January losses at a number of major hedge funds. Hedge funds are of course the very best customers of the brokers, and if hedge funds are doing poorly and start to lose assets under management (from both losing trades and then subsequently via redemption requests), the heyday of growing trading volumes and levered lending to hedge funds will all dry up. Wall Street will slowly downsize both in activity size and in posted profitability. And there is of course at least some risk of a hedge fund leverage implosion whereby hedge funds lose money and face redemptions from fund of funds managers who are levered and face redemptions, while large structured product service providers to the hedge fund world such as Societe Generale may face their own leverage downsizing requirements created in part by their rogue-trading losses.

None of these headlines have come anywhere near the financial pages yet, but we believe that they will over the coming several weeks. Hedge fund investors may soon be screaming "Where was my alpha?" and learning just how much "beta" they had hidden in their hedge fund investments instead.

I can say this because even the Sand Spring Fund LP that we run as beta-neutral as possible still had a bunch of managers who did not handle the January environment particularly well. My fund will lose something like -1.6% or maybe -2.3% when the dust settles in manager returns, and yet, this will look like a massive victory compared to some of the returns that I am hearing about elsewhere. One large hedge fund that I know who was heavily invested in financial exchanges lost -25% in January. At one point mid-month the multi-billion dollar Maverick Capital was down -15%; one Commodity Trend Follower that I know lost -25% in the fast equity market reversal of Jan 22-23rd. Rumors abound of a horrific month at SAC Capital. There is excessive leverage and beta showing all over the place.

And if our analysis is correct, the rest of Q1 and possibly a good chunk of Q2 will not be much easier for the asset management community. With no profits, there will be no incentive fees. With no incentive fees, one wonders how long the excessive valuations recently put on various IPOs of hedge fund managers will persist. Go find yourself a nicely levered asset manager and if a public entity has been wrapped around it, and the stock is borrowable, one may want to think about putting out some shorts. Sand Spring itself is not a Registered Investment Advisor, and is also actively involved in the hedge fund world, so we will stop short on recommending any specific names. As always, please consult your own financial advisor before committing any capital to ideas discussed here.

We also do not believe that Goldman Sachs will end up as bullet proof to problems as it has been to date. Goldman was bailed out most recently by one smart prop manager who got the sub-prime mess correct, but prop desks can't always be depended upon to deliver. One former prop trader who I knew well at Goldman made $100mm for the firm back in 2005, but promptly lost $60mm on trades in 2006, before retiring from the firm. This is the nature of the trading beast. It is hard to get things consistently right in "prop trading" all the time. Meanwhile, Goldman's core investment banking and other equity, fixed income, and asset management businesses certainly never enjoy a bear market. Lloyd Blankfein is a smart guy, as is Goldman's risk manager Bill McMahon (both of whom I respect and know well), but they are not so smart that they can prevent the entire firm from an overall blagh investment environment. We posted the chart of Goldman below in last month issue, and with Goldman's price action now advanced by a month, we leave our expected path largely in place. In our humble opinion, Goldman is a sale anywhere around 213-217, and while it should be the type of stock that you will want to trade back and forth a bit in the short-term, in the long-term for those who are patient, an eventual downside of at least 157 (and even possibly 120-130) may be seen.

One other individual stock that has yet to fall from grace is fixed-income centric Blackrock. We don't know that much fundamentally about Blackrock, but technically to our eye the BLK stock pattern looks like a complete Fibonacci rhythm to recent highs. We would not be surprised to see a step-and-stumble decline back to 147 or so with time.

While looking at charts such as the ones above, one reader recently wrote asking for a primer of exactly how we do our Fibonacci target work. He wrote that, like Sand Spring, he uses eSignal, but he could never come up with the same levels as we do.

So for a moment, let us take a step back and give some examples of when we "stretch our bands" and when we do <u>not</u> "stretch our bands." It all has to do with an artistic eye of where a move is "complete."

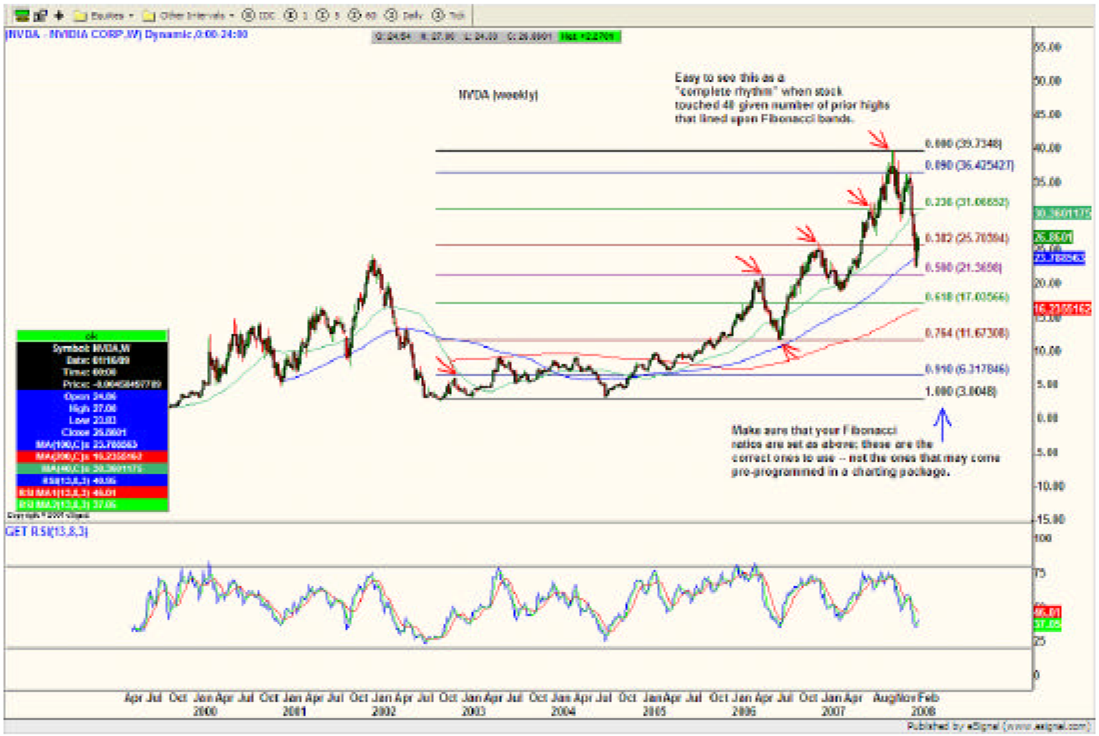
As a first step, many charting packages may come with an ability to draw Fibonacci lines, but only some packages allow you to stretch these bands. Programs like Bloomberg generally just draw the bands for you between an existing high and a low, and make it difficult to stretch the bands. Bloomberg's screen set-up is also so optically poor that it is difficult to visually see what you are doing when drawing multiple Fibonacci bands using different time intervals. Instead, one should use a program like eSignal Advanced GET; remove all background gridlines from your charts; and get a nice clean white background to start.

As a next step, it is important to realize that most charting programs come with some Fibonacci ratios pre-programmed like .382 and .618, but often they then add in .25 and .75 – <u>which are not Fibonacci ratios at all</u>. Some advocates of Gann analysis may like .25 and .75, but we don't find these ratios particularly useful. To fix this, one must go into the default settings of your program and make sure that the Fibonacci settings are the right ones. We like to use the following Fibonacci settings which are arithmetic and geometric functions of each other:

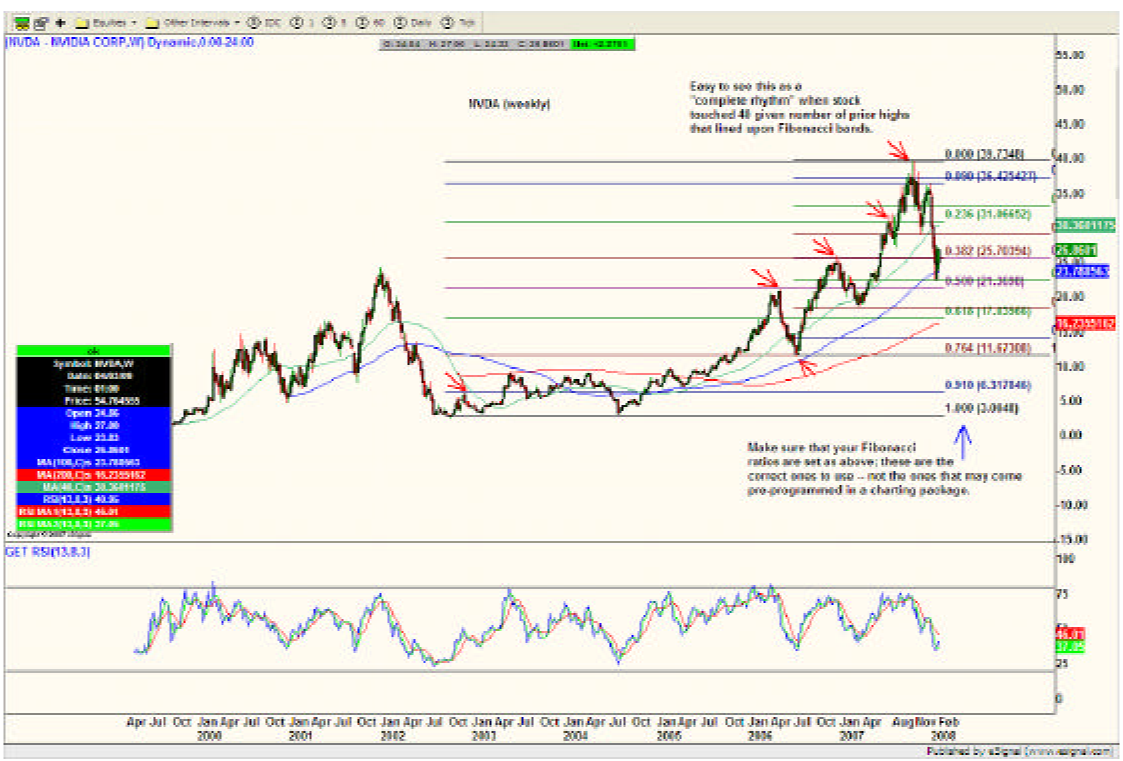
.618
.382
.50
.236 (=.382 x .618)
.764 (= 1 -.236)
.0901 (= .382 x .236)
.9099 (= 1 - .0901)

Next, one is finally ready to examine a chart pattern. In doing so, it is important to start with as much data as possible – a weekly or even a monthly chart. Get the big picture straight first, and then drill down to shorter time-intervals. If the asset being examined has been in a major uptrend, you locate the last significant major low and pull your Fibonacci bands up from that point to a recent major high. If an asset has been in a major down move, you go back to the last major high and pull the bands down to the last major low. Then you ask your artistic eye the following question: "Do the bands fit the intervening price action that took place between the high and the low that you have chosen, with each (or at least most) minor highs and lows along the way touching an intervening Fibonacci band? If they do, then you are likely looking at a "complete rhythm" and one can likely expect a trend reversal to transpire. However, if the bands do not "fit" the pre-existing price action, then the existing trend is likely not yet over, and one must <u>stretch</u> the bands to a "natural attractor" price level where the bands <u>will</u> fit the price action.

Once this is done on a weekly basis, one can then drill down and repeat this process on a daily chart, and then on a 60-minute or even a 5-minute chart. The goal is to find similar price levels where each chart is happy completing its fractal movement. In other words, to use a recent example, one might have seen a long-term Fibonacci target on a weekly chart of Nvidia popping out as a complete rhythm at around $39.50-$40.00 a share level – as we did when NVDA touched $39.67 in mid-October 2007. Just look how nicely that level "fit" earlier highs in terms of the bands touching. Several lows also hit, but fitting highs is always more important to us than fitting lows.



But to confirm this level, the next step in an analytical process is to move to a shorter time interval – perhaps a more recent low and a daily chart basis -- to see if the fractal rhythm of NVDA to $39.67 a share was also satisfied on that basis. We do so in the two charts below --- the first being a repeat of the weekly chart, but with new Fibonacci bands drawn between the more minor July 2006 low in NVDA and the $39.67 level where the weekly chart appears complete. The second chart shows these same lines zoomed in on a daily basis, with yet another set of Fibonacci lines drawn between the March 2007 low and the $39.67 high. On both we see, bingo, the rhythm looks complete again, and the daily Fib bands pick out many of the same Fibonacci lines as the more major weekly chart in a lovely "harmonic vibration" type of way. The double hit at the minor $25.70 high in December 2006 is particularly pleasing.



As a next step, on the daily chart, we will start to pull some Fibonacci bands lower from the $39.67 high to try to "fit" the price action since that time. Using just the 1-2-1-2 Elliott beginning part of the NVDA decline, we obtained a lovely harmonic vibration "fit" at $22.57 which was our actual initial target exit price on the short sale of NVDA that we did.

We then do one last step and pull bands down again to ask ourselves the question: "If NVDA were to break $22.57, what would be the next obvious harmonic vibration" stopping point?" To do this, we stretch some bands to the next level were the recent minor high-low price action would be captured between the lines and where we may already have a cluster of other Fibonacci bands. The obvious target is between $18.30-18.90.

Thus, what we would conclude for NVDA is that we are currently "within a complete rhythm" that has Fibonacci fractals that "square" nicely to each other on different time scales, and we are likely now to have a period of range trading. On a first touch up at $29, NVDA is worthy of a new short sale; and on a first touch of $18.30-$18.90 NVDA will be a buy. Everything in between is now generally uninteresting to us.

So take the above as our first example of working with a chart where rhythms are complete, and they line up nicely with each other at different time intervals and from different highs and lows. By using our bands we developed three useful opinions over time:

> Oct 19th: NVDA was likely to experience a trend reversal between $39.50-$40. The actual $39.67 high was a great "natural attractor" level to take profits on longs and reverse to being short.
>
> Oct 19th thru mid-January: NVDA was in clear downtrend mode to an initial target of $22.57. Not wanting to be piggish, we harvested profits there.
>
> Mid-January – onward: NVDA is now in a range with a $29 top and an ultimate possible low down at $18.30-$18.90. Which side of this range gets touched first is less clear, and would need to be interpreted using other techniques. We are uninvolved with NVDA at present waiting for the next major Fibonacci band to be reached either up at $29 or down at $18.30-$18.90 that will offer up a low-risk way to hit a "trading single."

Not every chart pattern is as nice and clean to interpret as that of NVDA. Sometimes what you see on a weekly chart may seem at odds with what a daily chart implies. Sometimes a chart may appear to have both a possible missing high and a possible missing low where Fibonacci bands may fit equally as well. Which will get touched first? As a general rule, there are so many stocks to possibly trade, it is best to not try to force a Fibonacci interpretation on a chart unless it pops out at you with ease. Sometimes I will look at a chart, and like a doctor, say "Ah ha, this is a clear complete rhythm," or alternatively, "Don't go short this stock yet; there is a missing high yet to be seen;" but at other times I can struggle to find a harmonic rhythm that fits on all time intervals.

Let me give a few more examples in real time of how to use Fibonacci bands. First, let's examine the current real-time chart pattern of the EWJ Japan ETF that I recently mentioned in one web-posting as having a "missing low" still to be seen. This will show you a situation where a market has been in decline, has recently had a sharp bounce, but where the low currently in place is very unsatisfying to the fractal eye. My main problem is how badly the low back in June 2006 is missed by the Fibonacci bands if the low in the EWJ is "complete" at its recent 11.60-11.65 spike print.

However, if the bands are stretched a bit to an expected 11.29 "natural attractor low," the new Fibonacci bands fit the price action much better. It does not take significant further imagination to then draw in our expected path lines in red.

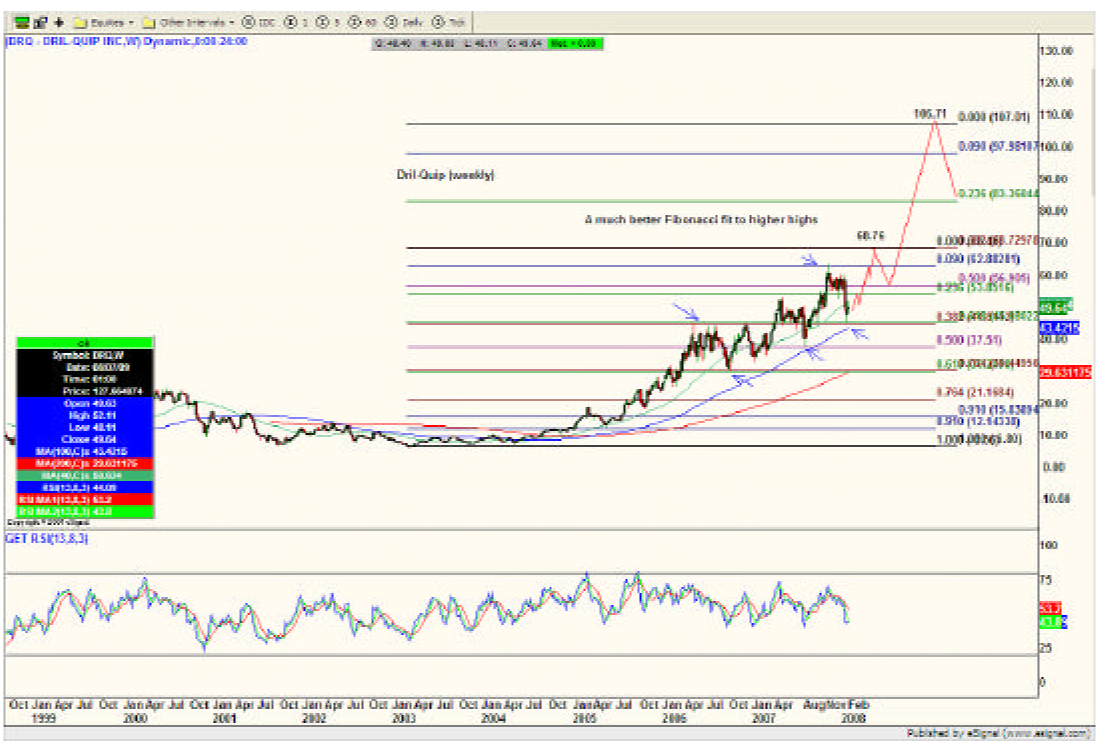
Let's look at Crude Oil in real time for one last clear example. If the recent high in March Crude Oil was a significant one, with a "complete" rhythm, one would expect that the Fibonacci bands would "fit" the pre-existing price action. But such is not the case.

However, when one stretches the bands to around 103.84, bingo, they fit so much better. Michelangelo and Fibonacci would both be pleased and smiling from their graves. Crude oil has at least one clear missing high left in it.

Thus, the recent drubbing of oil and oil services companies likely represents an opportunity on the long side. Look at the rhythm of oil service company Dril-Quip below.

The first chart to the existing high clearly is not complete. Nothing fits:

But stretch those bands a bit, and a nice fit for the Fib bands pops out at 68.76, while if you stretch the bands even further, another natural attractor level can be found up at 106.71.



It is often the case that there may not be just one, but two or even three Fibonacci "natural attractor" targets that one can develop – but the levels are always discrete and limited to just a few possibilities. One can then imagine potentially reaching these targets on different time scales. Maybe Dril-Quip reaches 68.76 in 2008, and then retraces, only to go on to reach 106.71 in 2009. We are bullish on Dril-Qwip even while we are bearish on the equity market in general.

But alas you may ask, we mentioned at the beginning of this article that we were nervous about a reversal of some sort in gold and silver. How does this fit in with a still bullish view on oil and oil service stocks?

To be honest, we are not sure exactly what the excuse currently is (or may become) for the energy and metals markets to be somewhat out of synch, but they are. Metals have been “red hot” lately while oil has been weak. We doubt that this will continue, and actually expect these trends to reverse. Oil is something that must be consumed and has constant demand and arguably constrained “peak oil” supply; while the demand for precious metals is far more financially driven by pension fund and other investors looking for diversification protection in a negative real yield environment.

But all the gold that has ever been produced is still sitting somewhere. It is not destroyed or used up. It just builds up and shifts hands. With the Bullish Consensus on gold recently touching levels near 96, sentiment is way too bullish not to have an “investing accident” of some sort brewing here. On some occasion soon when a new whiff of economic recession stirs or a retractment in Fed liquidity-pumping suddenly seems possible, we can easily imagine gold dropping $200 in a day. Neophyte gold investors who got into the market late will be badly hurt.

Indeed, at present technically, we see metals about to experience a nasty retracement lower while oil perks up. With time, it is easy to spy a target for gold to eventually touch $1005-$1009 per ounce (as espoused in past Sand Spring letters stretching back to 2000), but the path getting there from here will not be easy (or hardly worth it) for any gold bug. Prices may easily go back as far as $722 first.

We'd like to finish this month by sharing with you a few last odd tidbits.

First, please find below a natal horoscope for Mr. Ben Bernanke as sent to us by a reader. As stated on these pages in past editions, Ben Bernanke is a gentleman that America can easily grow to hate – his accountant-like monotone "whine" falling far short of Mr. Greenspan's somewhat soothing -- if often obscure -- "lawyerly prose." At heart, we know that Bernanke is a well-intentioned guy. But alas, America needs to vent on someone, and who better than a bearded slightly effeminate Princeton professor who speaks in a flat, boring, and monotone way.

The e-mail we received on Mr. Bernanke's stars went as follows:

"The Combination of Stellar Influences" by Reinhold Ebertin regarding BB natal chart:

Mars "combust" Neptune (an extremely close conjunction) in Libra:

Principle: Irritability, weakness

Conjunction: a lack of energy, the state of being unsatisfied, a feeling of inferiority.

The conjunction square Uranus: changing energy levels, states of weakness emerging suddenly.

In trine to Jupiter: a rich and colorful imagination, sensitiveness, inspiration, spiritual perception in spite of a weak vitality.

In sextile to Pluto: bursts of extraordinary energy, the obsession to work without any break, great ambition.

(When I asked an astrologer friend to comment on this aspect, not giving her BB's identity, she said, "They probably need a lot of Geritol.")

Sun in Sagittarius opposed Jupiter in Gemini (latter position "in detriment" as it twists the philosophical principle toward intellectualism):

Principle: health, joy, recognition

Opposition: a materialistic mentality, pretentiousness, negligence, heedlessness, extravagance and squandering; the inclination to spend money unnecessarily.

Moon in Pisces: susceptibility to external influences, subject to moods, the danger of unconditional yielding or drifting, a feeling of inferiority, the danger of exploitation or drift.

Saturn in Scorpio: Obstinacy, a serious outlook on life, the urge to probe deeply into difficult problems, the tendency to occupy one's mind with metaphysical spheres of knowledge, skill, endurance.

Current transits (my own interpretation):

Saturn square Mercury and Venus (operating since last summer and through Spring 2008): heaviness, restriction, depression in thought and feeling, oppressiveness, working through many details with great precision that unloved feeling.

His stars somewhat crossed, Bernanke must still deal with the following rounding bottom chart of continuing unemployment claims (sent to us by yet another reader) at the same time that he tries to deal with the second self-created chart of a now negative real yield world. Pity this guy's predicament – but it is what it is. As Paul Volcker was recently quoted as saying by author Roger Lowenstein in a *New York Times Magazine* article: "Too many bubbles have been going on for too long. The Fed is not really in control of the situation."

Continuing Unemployment Claims

Real Fed Funds Rate Net of Inflation

And as a last laugh -- now we have the guy who created it all – Alan Greenspan – "going to the dark side" so to speak to work as an advisor to hedge fund manager John Paulson. What a crazy world this has become.

From the *Financial Times*:

Alan Greenspan, the former chairman of the US Federal Reserve, is to become an adviser to Paulson & Co, the $28bn New York-based hedge fund company that achieved spectacular investment returns at the height of the credit squeeze last year.

Mr Greenspan will join the advisory board of the credit specialist investment house. Paulson will be the only hedge fund that Mr Greenspan will work with under the terms of the agreement.

Paulson was propelled into the spotlight last year as perhaps the biggest known winner in making aggressive bets against US subprime home loans. Investors estimate that its funds racked up profits of $12bn.

Mr Greenspan already holds separate advisory roles with Deutsche Bank and Pimco, the asset management firm. The financial terms of the arrangement were not disclosed.

John Paulson, president of the hedge fund, said: "Few people, if any in the world, have the experience with, and depth of understanding of, global financial markets [of Mr] Greenspan."

He said Mr Greenspan would share his perspectives with the Paulson investment management team on the direction of the economy, assessing the potential for and severity of a US recession.

Mr Greenspan served as chairman of the Fed for 18 years until 2006. His pronouncements on the economy through regular public appearances still have the power to move markets.

Stay tuned for how this economic malaise – almost deserving of its own sitcom (except that it is really so sad) – resolves over time.

Send us your comments at information@Sandspring.com.

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