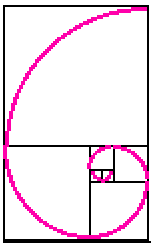


Sand Spring Advisors LLC

Iceberg Risk:
A Rumbling Earth
&
Mortgage Market Malaise

by,

Barclay T. Leib

November 9, 2002

For those with some time on their hands or simply a fertile mind interested in financial theory, let us start off this month by recommending two books: Nassim Taleb's *Fooled by Randomness* and Kent Osband's *Iceberg Risk*. The first is an easy read and the second somewhat more quantitative. But both tomes involve flaws in investment norms followed by the largest of our financial institutions today – namely the assumption that sudden geopolitical, geophysical, and extreme financial shocks are next to impossible to predict, and so rare in any case, that to plan for such would be prohibitively expensive. Thus the conclusion becomes that little can effectively be done to mitigate the damage of these events upon impact.

Both of these books came to mind in a recent meeting I attended whereby an insurance broker was discussing a potential principal guarantee around a 10-year trading program designed to slightly outperform the S&P 500 Index. Per this broker: "I have a number of insurance companies who on a 10-year horizon basis, and in return for a 1% up-front premium, would be willing to guarantee that the S&P will be higher in 10 years than it is today."

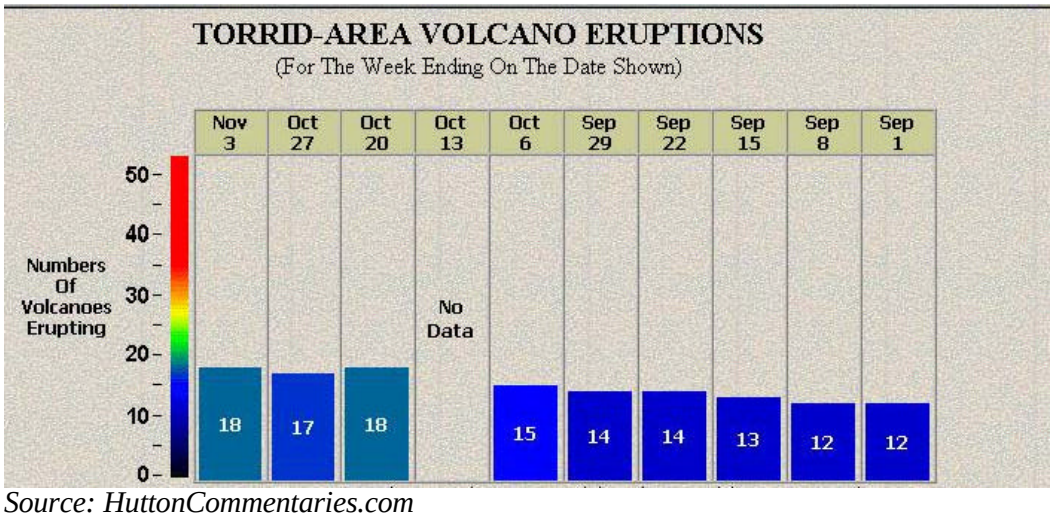
Now to hear this from the man on the street would be one thing, but to hear it from an experienced insurance broker is quite another. Imbedded in the desire to write policies of this nature is some naïve assumption that GDP is always going to grow at 2-3% per annum, and over a 10-year time horizon, the S&P will always track GDP and corporate earnings growth. Even sophisticated insurers want to believe in the power of the markets to chug forward over time, and through some element of greed in the short term, effectively book bets where for receipt of a 1% premium up front, the insurance company might potentially be liable for a 40-60% S&P decline somewhere over the rainbow.

And just what type of "iceberg event" could come along to wipe out such a complacent attitudes?

A nuclear or biochemical war with Iraq might be one outside chance some would potentially mention today. We have no value-added in prognosticating whether such is probable, but it certainly is possible.

Elsewhere, according to most astute geologists, a major California earthquake measuring 7.0 on the Richter scale (or greater) is already overdue in terms of years since the last great 1906 San Francisco earthquake. Undoubtedly this could wreak much havoc to the U.S. economy, the insurance industry, and financial markets. Certainly one cannot deny that in recent months and stretching from Mt. Etna, to recent Italian earthquakes, to Alaska's recent earthquakes, to Kilauea erupting, to Equadorian eruptions for the first time in 26 years, to Krakatau rumbling in Southeast Asia, to Montserrat slowly building to what will someday be a massive explosion -- the Earth is certainly behaving with some ferocity in 2002.

This can be seen most recently by a constant step-up in global volcanic activity. The chart and table below are often empty for weeks or months. This is not the case now.



Source: HuttonCommentaries.com

VOLCANO:	DATE OF ERUPTION OR ACTIVITY:	LAST UPDATED	LOCATION
Etna, Sicily, Italy	October 27, 2002	November 7, 2002	37.7N, 15.0E
Rabaul, Papua New Guinea	October 20, 2002	November 7, 2002	4.27S, 152.20E
Guagua Pichincha, Ecuador	October 11, 2002	November 7, 2002	0.17S, 78.6W
Karymsky, Kamchatka, Russia	September 16, 2002	November 7, 2002	54.0N, 159.5E
Kilauea, Hawaii	on going, 2002	November 7, 2002	19.452N, 155.292W
Sheveluch, Kamchatka, Russia	on going, 2002	November 7, 2002	56.65N, 161.36E
Tungurahua, Ecuador	on going, 2002	November 7, 2002	1.467S, 78.44W
Soufriere Hills, Montserrat, West Indies	on going, 2002	November 7,	16.7N, 62.2W

		2002	
Karangetang, Siau Island, Indonesia	October 19, 2002	October 30, 2002	2.78N, 125.48E
San Cristobal, Nicaragua	October 15, 2002	October 30, 2002	12.7N, 87.0W
Mount Lewotobi, Indonesia	October 12, 2002	October 30, 2002	8.53S, 122.975E
TANGKUBANPARAHU, western Java, Indonesia	October 6, 2002	October 30, 2002	6.77S, 107.60E
Ulawun, New Britain, Papua New Guinea	October 1, 2002	October 30, 2002	5.1S, 151.3E
PAGO, Papua New Britain	October 1, 2002	October 30, 2002	5.58S, 150.52E
Nyamuragira, Congo, Africa	August 6, 2001	October 30, 2002	1.4S, 29.2E
Nyiragongo, Democratic Republic of the Congo	August 1, 2002	October 30, 2002	1.52°S, 29.25°E
Villarrica, Chile	January 20-May 30, 2000	October 30, 2002	39.25S, 71.42M

Source: University of North Dakota VolcanoWorld

Where perhaps is all this increased volcanic activity all leading? One forthcoming date one might want to watch out for is December 1, 2002 – a day that will be exactly 17.2 years (2 * pi * 1000 days) from the major September 19-20, 1985 earthquake that leveled many parts of Mexico City. San Francisco is likely best avoided during this period, particularly when one considers that the study below -- put out all the way back in 1990 -- shows approximately a 1 in 4 chance of a major SF Bay area earthquake above 7.0 on the Richter Scale striking within 30 years. 12 years have of course already passed since that forecast. If any pi fractal rhythm exists within nature, Dec 1, 2002 might be a logical “hit date” or maybe we’ll be lucky and wait another 17.2 years until February 12, 2020.

30-year Probabilities of Earthquakes in the San Francisco Bay Area
1990 Working Group on California Earthquake Probabilities

Fault Segment	**Probable Magnitude**	**Probability**	**Reliability**
San Andreas - North Coast	~8	0.02	B
San Andreas – Peninsula	~7	0.23	B
San Andreas – Southern Santa Cruz Mts	~7	~0	B
Rodgers Creek	~7	0.22	D
Hayward – Northern	~7	0.28	D
Hayward – Southern segment	~7	0.23	C

The recent global earthly dislocations also continue to remind us a bit of sleeping prophet Edgar Cayce’s prediction that any clear "*sinking or rising…in the Mediterranean, and the Etna area*," was to indicate that changes in the Earth's activity had begun to be apparent. (311-8, April 9, 1932). And "*greater activities in the Vesuvius or Pelée*" [or possibly Kilauea, in Pele's realm on Hawaii], was to indicate that "*the southern coast of California - and the areas between Salt Lake and the southern portions of Nevada - may expect, within the three months following same, an inundation by the earthquakes*." (270-35, January 21, 1936).

Although Etna has indeed come to life of late, thankfully Vesuvius still remains quiet for now. But if Vesuvius were to erupt, say, in February 2003, then Cayce devotees would certainly be worried about a cataclysmic shake in California three months later. Taken to an extreme, this might even fit Nostradamus's prediction of a major earthquake in the month of May below:

Century 10 Quatrain 67:

A very mighty trembling in the month of May,
Saturn in Capricorn, Jupiter and Mercury in Taurus:
Venus also in Cancer, Mars in Virgo,
At that time hail will fall larger than an egg.

Financial Risks: FNMA

But as disturbing as the earth's current restless state may be, it is our opinion that the next financial accident is more likely to emanate from a single corporate entity: Fannie Mae. As a corollary to our thoughts above, one could of course hypothesize that Fannie Mae might prove a logical victim to a major earthquake (as homeowners renege on mortgage payments for houses already destroyed), although this 500-pound gorilla financial institution could just as easily stumble over its own massive size. We will show why we are of this opinion in the discussion that follows.

First here is a bit of history on Fannie Mae.

Fannie Mae was originally created in 1938 to purchase FHA insured mortgage loans that had been originated by private lenders -- a late last blast of FDR's New Deal. Fannie Mae has since seen its charter amended on several occasions, actually losing its explicit guarantee from the federal government all the way back in 1954, although most still consider its obligations to be implicitly guaranteed by the U.S. government today. In 1968 it received the power to issue its own mortgages, and became a publicly listed stock on the NYSE in 1970. Since that time, it has allowed its balance sheet to burgeon, currently owning a mortgage portfolio in excess of $751 billion, but with just a sliver of equity underlying all these holdings. Short-term borrowings, swaps, and other derivative instruments finance the bulk of this institution's holdings.

How much equity does Fannie Mae actually have? This very simple question itself seems a point of confusion. Per a recent research report by Horizon Research Group, Fannie Mare had roughly $12.7 billion of shareholder equity on its balance sheet at the end of 1996. Between that time and September 2002, it has reported earnings of $24.9 billion, and paid out dividends to shareholders of about $6.7 billion. It has also repurchased about 64 million shares. Taken together, these publicly known facts from FNMA's public earnings statements can easily lead one to calculate that Fannie Mae's shareholder equity should have increased by about $14 billion in the past 5.75 years to approximately $26.7 billion in total. Yet current shareholder equity under conventional accounting standards only shows up as $15 billion on Fannie's balance sheet today. $11.7 billion appears missing.

Given accrual accounting on over-the-counter derivatives hedges, has Fannie Mae somehow overstated past earnings? Or is it perhaps that Fannie Mae's true balance sheet is all tied up in deeply in-the-money derivatives contracts that have either absorbed or hidden true shareholder equity over a slow accrual process?

Conspiracy theorists would likely jump at the former conclusion, and more rational minds would likely gravitate toward the latter. Overall, this is a complex area that we will not even try to conquer. All we know is that as recently as October 25, 2002 the *Wall Street Journal* reported on how Fannie Mae had reclassified $135 billion in mortgage assets as "available for sale" and thus marked to market, and that this accounting change resulting in releasing roughly a $4 billion gain to Fannie Mae's shareholder equity column. Per the *Journal*, "Without the accounting boost, Fannie Mae's shareholder equity would have been roughly $11 billion….The debate over the company's motives underscores just how difficult it remains to parse the true financial condition of Fannie Mae, which has long resisted some efforts to require the company to provide more disclosure to investors." The basic problem appears to be that Fannie Mae isn't required to mark to market the value of its mortgage assets, but recent FAS 133 changes require derivative hedges to be marked-to-market quarterly. True shareholder equity is thereby lost somewhere between these two moving parts.

The fact remains that whether Fannie Mae has $11 billion of shareholder equity, $15 billion, or even the larger $26.7 billion number, it still has leveraged this equity to underpin $751 billion in assets. Let's call that leverage of between 28-1 and 50-1 – not quite the extremes reached by hedge fund LTCM in 1998, but not that much under LTCM's use of leverage, and certainly on a much more massive absolute scale in terms of total dollars at risk.

The fact also remains that Fannie Mae already represents 16% of the total mortgage issuance outstanding, and yet owners of this stock – primarily growth oriented mutual funds – blithely assume Fannie Mae can continue to grow its profits at 15% per annum. They do so using a rear view mirror on a decade where interest rates have <u>already</u> declined precipitously, thereby fueling home buying, home prices, and refinance activity. How likely is such a scenario to re-occur over the next decade? Where is all of Fannie Mae's new business going to come from? Or is this stock already "priced for perfection" by the same types who can't imagine the S&P 500 ever declining over a 10-year period?

Grant's Conference Perspectives

On this entire topic, we recently listened with great interest to mortgage arbitrage specialist Doug Greenig of Greenwich Capital Management speak at a *Grant's Interest Rate Observer* Conference on the current status of the mortgage industry. His speech was entitled: "Negative Convexity and Head Injuries: Understanding the Increased Volatility of the Bond Market."

Also presenting that day was Sean Egan of well-regarded and forward looking rating agency Egan-Jones Ratings Co.

Lastly, we have subsequently spoken with a senior fixed income strategist for a major investment bank that will go unnamed.

The combination of these various presentations and discussions forms the basis of our more detailed discussion of the entire mortgage industry below. Our general conclusion is that Fannie Mae's sheer size may be becoming too big for available fixed income market liquidity, and its hedging techniques dangerously slow. By sitting on its hands most of the time and only partially working to hedge away the negative convexity of its portfolio, Fannie Mae may maximize its profits in the short-term, but it also increases its chances of hitting "iceberg risk" in the longer-term.

Background fact & consequence #1: If one examines the compositional change of total U.S. debt outstanding between 1996 and 2002, the supply of Treasury debt has roughly been split in half, while the supply of mortgage-backed debt has almost doubled.

Because mortgage debt has grown so much, and because mortgage-backed debt implicitly includes a short call option component, this means that the total short gamma component in U.S. financial markets has also grown, making the financial system at large short more options to the homeowner. And because the average homeowner only tends to trade the options purchased at certain discrete levels, the nature of the options being sold by financial institutions tend to resemble in many ways clustered "one-touch" or binary options that can suddenly kick in when refinancing activity heats up. It has been estimated that this sale of volatility to the homeowners currently accounts for more than 25% of total profit in the financial sector.

None of this negative convexity will go away -- even as more and more refinancings occur. Significant negative gamma will continue to exist with mortgage rates anywhere between 4% and 7%. The only way that negative convexity will go away is if rates move significantly higher and all of the imbedded short calls are left far out of the money.

And the massive size of today's mortgage market is now overtly showing up in the volatility of the U.S. Treasury, Swap, and Swaptions markets used to hedge away duration and convexity risk.

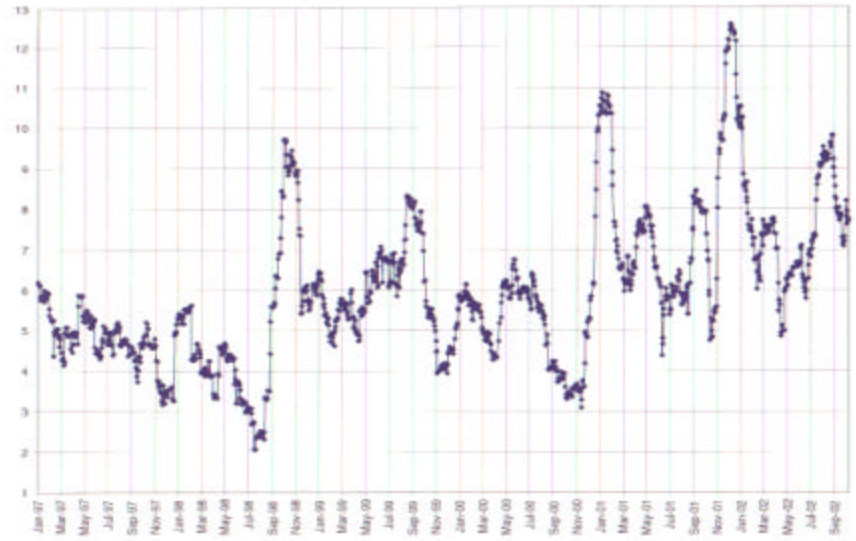
It is estimated, for example, that with $825 billion mortgages existing with a 6.5% fixed rate, the late 2001 to mid-2002 back-up in rates caused the hedge ratio on these mortgages to change by 20%. This required $165 billion in 10-year notes to be sold. Then, when rates came back down in late 2002, mortgage hedgers had to buy all of these hedges back plus several hundred billion more as it became economic to refinance 6.5% mortgages. Thus one cannot look back at the sudden 6 point plunge in 10-year Treasuries in Nov. 2001 nor the recent 5 point plunge in October 2002 as particularly surprising events. Such sharp events are instead likely to continue and potentially even get worse with time.

Consequence #2: All of the above added supply and negative convexity have created a huge and persistent added demand for options on MBS securities and swaptions, pushing option implied volatility levels higher and higher in recent years.

This consequence can be seen in the two charts below, the first of 5-year swap volatility (that has been on the rise ever since the 1998 crisis) and the implied volatility of USD 6 mo. – 10-year swaptions (as shown below compared to other major international markets). In other words, the cost of hedging all this added negative convexity has increased over time. In the words of Greenwich Capital's Greenig: "This is not the type of implied volatility behavior one would expect of a major economy in full control of itself, but instead something closer to that of Brazil – slowly spiraling out of control."

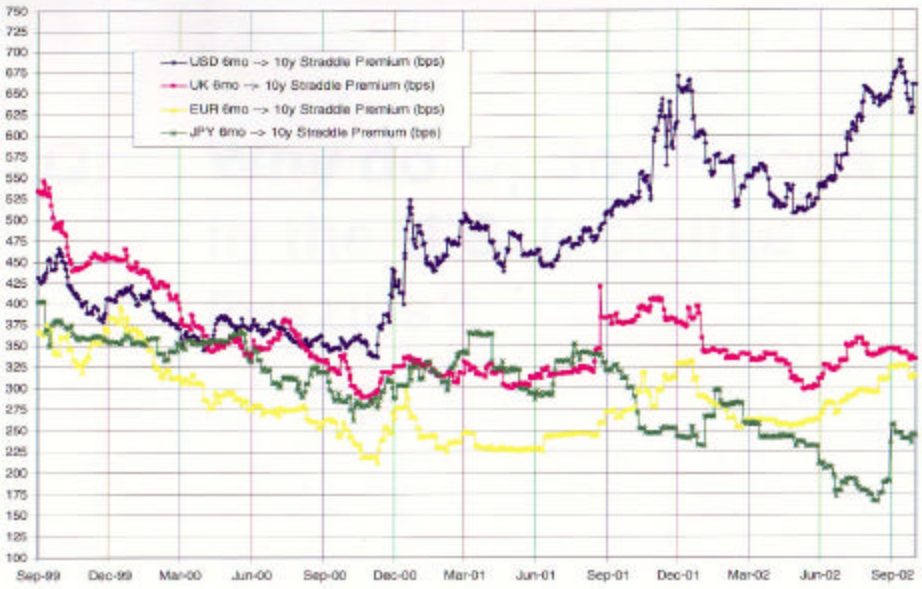
The added demand for options has been fueled not only by market forces, but also by regulatory ones. Mortgage servicers are increasingly being forced into mark-to-market accounting by FASB, and Fannie Mae and Freddie Mac are increasingly under regulatory scrutiny. In other words, not hedging properly by using options has become harder and harder to hide.

Actual 6-week Rolling Volatility for the 5yr Swap Rate



GREENWICH CAPITAL

International Comparison: Option Prices



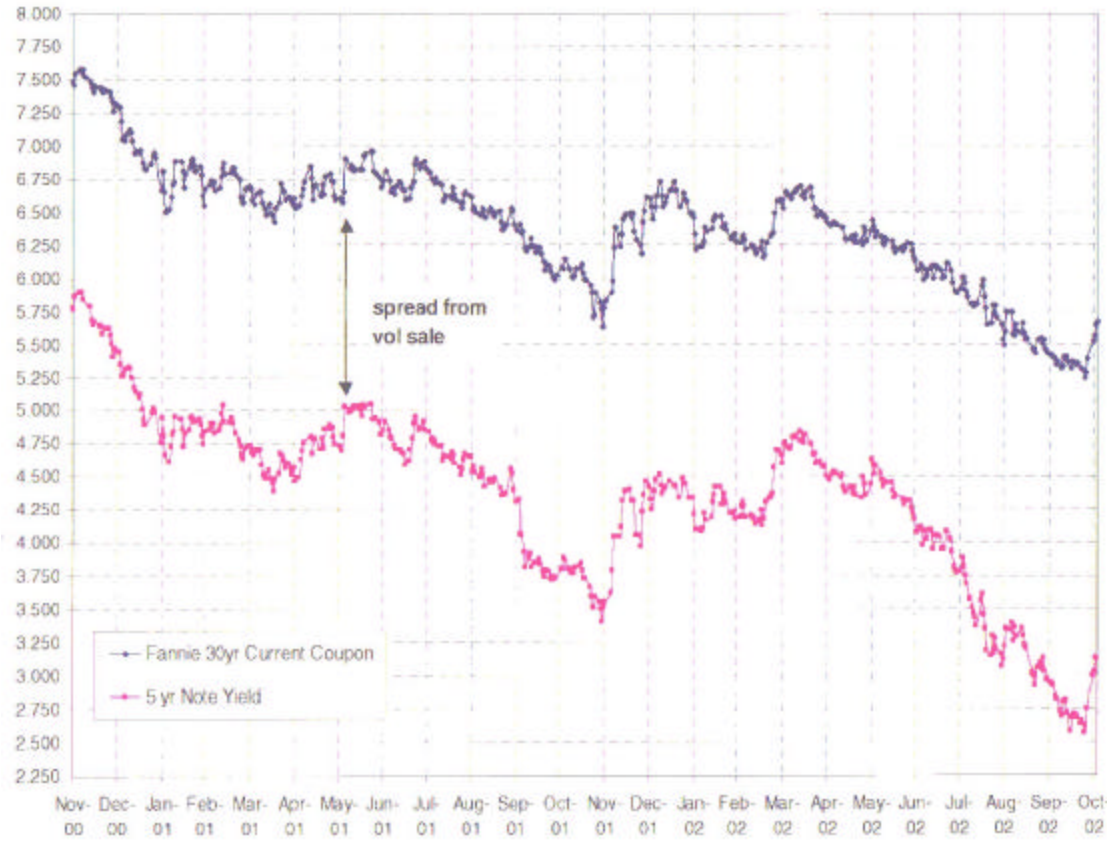
GREENWICH CAPITAL

Background event #3: Arguably, the liquidity provided by banks within Treasury, Treasury options, swaps, and swaptions markets has also declined. This is partly the result of electronic dealing portals (that have cut the profit potential of being a liquidity provider – and left tighter nominal quotes, but for smaller size and with air pockets of illiquidity – only the "illusion of liquidity," so to speak), multiple bank mergers lowering the number of competing market-makers,

and a generally lower risk appetite by banks – few of whom want to be run over by market conditions such as those that prevailed in November 2001 and October 2002.

Meanwhile,

Occurrence #4: The spread of mortgage-backed paper over equivalent maturity non-callable U.S. Treasury debt has generally not expanded by a commensurate amount. This spread has remained fairly constant between 175-225 basis points over the past several years.



These events taken together -- rising implied volatility in options yet a relatively static spread MBS yield spread over similar duration Treasuries -- means that it has become harder and harder to make money on a fully or even partially hedged carry basis in MBS arbitrage. Only a steep yield curve has helped those willing not to hedge properly (or not to hedge fully) to continue to earn attractive spread revenue.

Occurrence #5: If the above situation were not worrisome enough, the homeowner has generally become smarter at exercising refinancing options, increasingly surprising Wall Street and making traditional prepayment models somewhat antiquated.

In the words of our investment bank strategist: "At very low rates, prepayment models may tend to break down just as the volatility of price movements steps up. The impact of CNBC and other media outlets as well as advertising from mortgage providers has accelerated pre-paying, so that recently the models did a poor job of forecasting the drop of duration. I believe

the prepayments were much faster than the models predicted, and thus hedge fund durations fell much faster than expected."

Fact #6: 25% of both long- and short-term Fannie Mae paper is held outside of the United States. In many instances, European holders aren't even aware that Fannie Mae is a public company in the U.S. and naively assume that they own U.S-government securities. It is highly probable however that Congress will at some point announce a U.S. government "cap" to its implicit Fannie Mae liability. Well-regarded rating agency Egan-Jones & Co. specifically is forecasting that Congress will soon explicitly limit the Federal government's Fannie Mae exposure to just $2 billion.

The combination of poorly informed holders of these securities and growing pressures to reform Fannie Mae within the U.S. may eventually prove a toxic combination.

Risk #7: In the words again of our senior fixed income strategist: "Fannie Mae has the most scary risk management system in the history of the Western world. Until last year they didn't even know what their exposures were except on a multi-week-lagged basis at the end of each month.

"Even assuming they now monitor their exposures better on a daily basis, Fannie still consistently follows a strategy of selling gamma through their mortgage issuance and then doing as little hedging of this negative gamma as possible. After all, hedging too much eats into spread revenue, and Fannie desperately wants to maintain its status as a company able to grow revenues at 12-15% per annum. Thus, most recently, Fannie developed a 14-month duration gap as rates fell and high-yielding mortgages were prepaid. If rates had kept falling, this would have been disastrous for Fannie. But then rates thankfully backed up, and Fannie's duration swung back to neutral. This is not the first time this has happened to them. Do you know any Wall Street institution that would allow any trader to trade like this? Of course not."

The strategist continues: "As far as the specifics, Fannie knows that during a refi wave that they will lose duration, but they also know that once the mortgages are refinanced they will get all of their mortgage balance sheet back, albeit at a much lower rate. If they buy too many swaps to hedge the new supply, they will only succeed to lock themselves into a negative carry situation. So when they need duration they just buy more long-term mortgages instead. This has the added benefit of enabling them to buy a larger amount of duration faster. In the recent episode, this is exactly what they did."

Unfortunately, this luxury of adding portfolio duration by ballooning a balance sheet with added mortgages is a tactic few others beyond Fannie Mae can achieve. Indeed, in the recent spike lower in 10-year yields, one prominent mortgage-backed hedge fund, Beacon Hill Asset Management, that had produced steady positive returns for over five years and had over $2 billion under management, suddenly posted a –54% loss.

Per our analyst friend: "The Beacon Hills of the world simply do not have the ability to buy added mortgages at the wholesale level or in the bulk that Fannie can, and typically must use the Treasury and swap market to hedge. In other words, they simply can't balloon their balance sheet the way Fannie can when rates plunge and added duration is needed. Hedge funds are forced instead to shrink their balance sheet – typically by buying back short Treasury hedges."

This fellow then continues: "One thing Fannie Mae has been doing to reduce their convexity is to sell callable bonds. This way they offset the convexity of their mortgage portfolios by issuing a convex security. They have been doing a lot of this because from an

investor standpoint the yield enhancement received over bullet bonds makes it attractive, but they likely can't sell these fast enough to always stay properly delta hedged as mortgage refis boom. The absolute number of 10-year treasuries that they need to buy and sell in their delta hedging undoubtedly keeps getting larger, and it is obvious to me that in general, Fannie's positions are now just too big for existing market liquidity. If there were ever an interest rate shock that was to cut liquidity in half, Fannie would be in a heap of trouble.

"Ironically Fannie's risk is actually larger if rates go up – duration extension risk being some 40% larger than call risk. This could make for the mother of all flattening trades if the economy were ever to recover. Fannie also gets screwed though if the curve continues to flatten by long-rates moving lower in a weak economy. Fannie Mae profitability will be under pressure no matter how the curve flattens. Behind much reporting obfuscation, I hardly believe that Fannie has been as profitable as they claim for the past two quarters."

Further risks #8: Yet another mortgage expert we spoke with states: "A weak economy also obviously increases the risk of defaults in pockets of particularly weak residential real estate across the country. Fannie Mae has traditionally taken problem loans out of their pools and assumed responsibility for them. But they are not obligated to do this. Many hedge funds are too complacent owning Fannie pools, figuring the liability for these problem mortgages will always be assumed by Fannie. There are obviously even greater risks to sub-prime mortgages and non-conforming pools."

On this front, both Chapter 7 and Chapter 13 personal bankruptcy filings are already at record levels, the latter up 8% in the second quarter of 2002 from a year earlier. And this rise in Chapter 13 filings, coupled with statistics showing that a record of 1.2% of all mortgages are in foreclosure, and some 4% of mortgages are at least one-month delinquent in payments, suggests that the mortgage splurge of recent years has been overdone. According to Fannie Mae itself, nearly one in five homeowners refinanced their mortgages in the past year, with 30% of those using money pulled out of new refinances to pay down other debts. Meanwhile revolving debt -- primarily credit card debt -- has continued to increase at least 5% for each of the past five years.

America, quite simply, has been borrowing from Peter to pay Paul, with Fannie Mae the great facilitator to allow this debt transfer to take place on easy refinancing terms. Banks are now increasingly wary in their lending to businesses (given growing corporate debt defaults), but instead of extending this lending reticence to the consumer, Fannie Mae allows an increasingly unemployed populace to continue to borrow more money on the most attractive of terms. In no uncertain terms, the checks and balances of sound banking common sense have been circumvented, avoided, overridden.

Greatest Risk #9: If all of the above sounds pretty bad so far, the biggest risk of all is what is called rollover risk.

Our investment bank analyst offers here: "Fannie finances an enormous amount of its needs by issuing short-term discount notes. These are just like commercial paper, so in the same manner that a corporation has rollover risk if it is unable to issue Commercial Paper, Fannie Mae could one day have this problem if the market ever lost confidence in it. This is not necessarily a duration mismatch because Fannie does attempt to match assets and liabilities by swapping, but one day, if the market won't buy short-dated FNMA paper for one reason or another, Fannie is going to have one hell of a liquidity problem, and so too will all the Wall Street firms that trade with Fannie as their best and largest customer."

Overall, given:

- **the generally slow and potentially reckless hedging behavior of Fannie Mae,**
- **the very magnitude of the positions that need hedging,**
- **the inadequate liquidity in the market to always allow hedges to be established or adjusted seamlessly,**
- **the amount of Fannie Mae discount paper and longer-dated mortgage paper held by Wall Street financial institutions,**

…any problem at Fannie Mae – which appears almost inevitable at some point – is going to send shock waves through the rest of America's financial institutions. The mere existence of the behemoth exposure being hedged in the market is also likely to result in periodic and ongoing dislocations for hedge funds and banks trying to also hedge their MBS exposures.

We do not want to specifically prognosticate at this time if Fannie Mae is already melting, about to melt, or whether Fannie can continue to serve up steady profits in the short-term while risking longer-term pitfalls. With time, we think a price of at least $35.50 or so beckons for FNMA, but Fannie's immediate chart pattern, on a Fibonacci rhythm basis, actually allows for two rather divergent interpretations of how this target price level is eventually achieved. As shown in the charts below, the critical region to discern which path is transpiring will be around $55.70-$56.80 (the 100-month moving average) and whether this level can hold or not. A price drop below this region will likely send FNMA straight to $35.50 (per the chart on the left). The ability to hold in this region might suggest one more silly new high for FNMA before eventually falling to $35.50 later on.

Egan-Jones

But our day at the Grant's Conference was not quite done. As mentioned above, Sean Egan of Egan-Jones Rating Co. also presented that day. He focused on distressed corporations of the past two years and lessons to be learned from these situations. He pointed out that at present 40% of all speculative grade corporate bonds issued between 1997-1999 have already defaulted. He further forecast that this default rate will almost surely grow to at least 60%. Per Jones, the fallout from this situation is:

The insurance sector is currently highly exposed to further corporate bond defaults (particularly by the airlines), with many "jump moves" to the downside likely to start transpiring as some of these insurance companies try to come clean (note Cigna's recent decline).

Investors directly involved in distressed and high-yield securities may have a wide range of securities to choose from, but will still need to navigate their way through more unfortunate defaults in the future.

Jones went on to say that given:

asbestos liability issues still lingering;
pension fund liability problems & portfolio declines (hurting old industries, airlines, and insurers in particular);
foreign cost competition from China in steel, textiles, and autos;
excess telecom capacity;
and a slow economy with soft demand and margins,

that in his firm's estimation….

1) Companies already "gone" are the following:

Nortel
Lucent
Alcatel
Agere
Ciena
RCN

2) Companies currently severely "crippled" and almost sure to fail with time are:

Corning
American Tower
Motorola
Avaya
Crown Castle

3) Companies "likely" to fall into default at some point are:

Tech sector
Xerox
ABB Ltd.
Hewlett-Packard
Phillips
Arrow Electronics
Avnet
BCE, Inc.
Broadwing

Energy
Dynegy
AES
Xcel Energy
Mirant

Retailers
GAP
Guess ?, Inc.
Flemming Companies

Airlines
Most airlines except Southwest

Auto
Ford

Other
Dan River
Champion
Fleetwood
Cleveland Cliffs
Westpoint Stevens
US Steel

Financial
Fannie Mae

Amazingly enough, there's Fannie Mae popping up again -- already on the watch list of a major rating agency as a candidate for eventual default. This is truly scary stuff.

Sandspring.com Focus List

Lastly here at Sand Spring, we took our usual perusal through all of our charts in preparation for this letter, and tried to find those patterns that appeared most compelling as short-sale candidates. As we have previously written, **P&G, Walmart**, and **Deere** are three charts patterns and fundamental situations that we particularly dislike. **Fannie Mae** is obviously another name that we are also watching carefully. But there are other situations that for space

reasons we wish to simply list here. Specific chart perspectives will either follow within our public Chart du Jours or subsequent subscriber-only letters:

Coke (COKE)…Fibonacci rhythm still suggests $32 target with time.

Phillip Morris (MO)…Huge weekly pennant forming. This stock should reach $28.60 at some point, and is a sale near $49.90.

Toll Brothers (TOL)….$12.37 Fibonacci target beckons with time.

Capital One (COF)…An old favorite short of ours, is $8.65 eventually in the cards?

Bank of America (BAC)…We've been bearish and wrong to date here, but $31.70 is a level we still see being reached at some time.

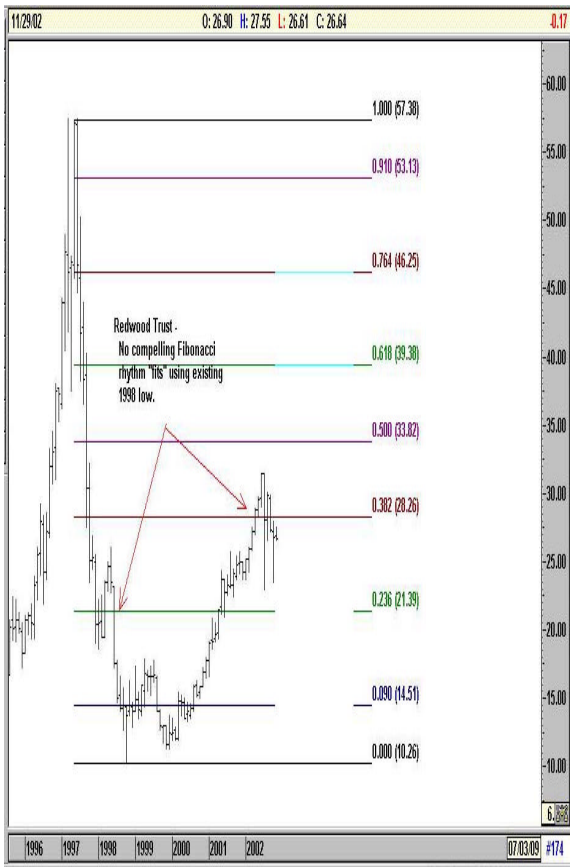
Ambac (ABK)…The financial guarantee business not the place to be. We see a $15.15 target here with time.

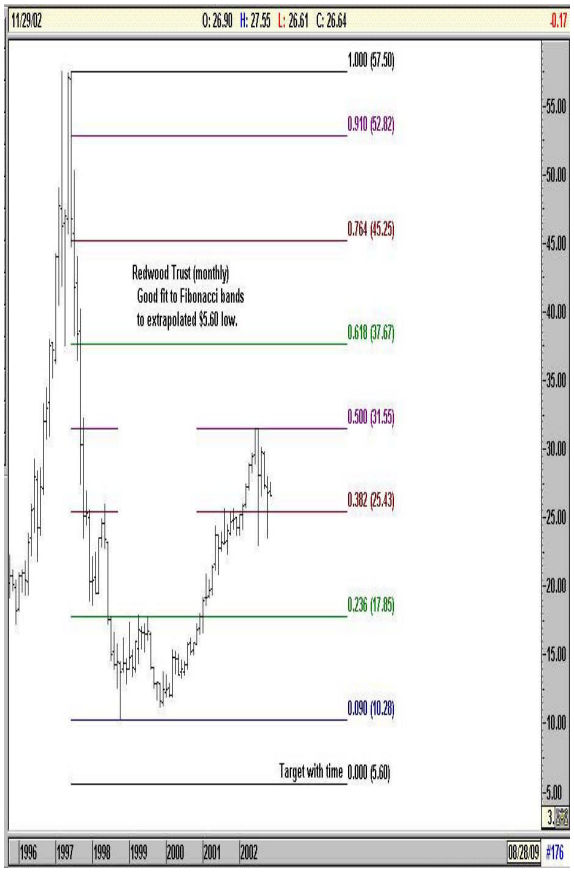
HR Block (HRB)…This company may know tax return preparation, but is quietly naïve about its sub-prime mortgage business. The stock is already well on its way toward $23.50 Fib target. We're late commenting on this one. Sorry.

Maxim (MXIM)…Fibonacci rhythm still suggests new lows near $13.60-$13.90 region.

Citigroup (C)…Step and stumble first toward $36.45 and then $20.70?

Redwood Trust (RWT)…a Mill Valley, California based residential mortgage lender structured as a REIT. We can think of no worse sector to be in at this time. Moreover, the Fibonacci rhythm on the charts below suggests that the 1998 low in this stock is not the final one. Instead, a $5.60 downside target likely still looms here.





Send us your comments at information@Sandspring.com.

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