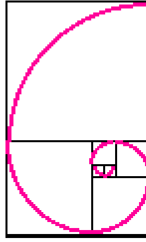

Sand Spring Advisors LLC

Latest Thoughts: No Country for Old Men

by,

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March 30, 2008

A bit like the movie "No Country for Old Men" which left one scratching one's head at a depressing and unsatisfying '70s type ending, the pi cycle reversal in sentiment that we expected around March 22nd has ended up being somewhat tricky to interpret.

The entire week of March 17-21st was indeed an "outside week key reversal" up in U.S. equity indices, and down in major commodities such as crude oil and gold. Financial stocks such as Lehman Brothers and Goldman Sachs left one day spike-low "island reversals" on March 17th as Bear Stearns fell to single digits, and was purchased by JP Morgan in a distressed fire sale. Both crude oil and gold initially tumbled by over 10% in swift fashion. This is the type of "capitulation" price action that we originally anticipated in our March 9th letter "Pi Cycle Swing Date," and as such, we might expect the equity lows and commodity highs of March 17th to hold for sometime.

At the same time, by the opening of March 24th (the first trading day after our weekend-bound March 22nd pi cycle date) Goldman and Lehman had rallied so hard that they left at least a temporary high, together with the market as a whole, and then quickly faded back lower.

So was the pi cycle date really a low that arrived a few days early on March 17th, or a trading high on the 24th? The former view would seem more logical and important from a purely technical perspective, but the latter is possible and perhaps more in tune with still shaky economic fundamentals.

Or perhaps the March 17-24 period just defined a new equity trading range that will now irritate and confound people as we drift out towards our next expected cycle turn on July 31st, 2008. We have always allowed that March 22nd could represent a momentum low in the market, with a retest and possible soggy new lows into July 31st.

Or perhaps the pi cycle date just seen may end holding more lasting importance for commodities than for stocks. Could March 22, 2008 have been a swing shift from a "stagflationary bear market in equities / bull market in commodities," to a "debt deflationary" bear market in both equities and commodities at the same time? Fundamentally, the recent rush of the masses to buy oil at $110 a barrel and gold at $1000 an ounce – right into the teeth of a recession – does indeed seem like a perilous and potentially disappointing path for those investors. If you pick up *Barron's* this weekend, we generally agree with their cover story suggesting that commodity markets will decline by more than 30% at some point due to excessive

speculative buying -- buying that will get washed out on the first sign of slowing demand from China. And yet the fact that this story is on the cover of *Barron's* in the first place irritates our contrarian juices. After all, wasn't it just on March 15-16th that *Barron's* planted a story on its front page with the headline "Is Fannie Mae Toast?" only to see Fannie Mae promptly print its lowest price since early 1995 on the following Monday, and then viciously rally over 50% ?

Unfortunately, there are no easy answers here, and it may take sometime to fully interpret in correct fashion the importance of the March 22, 2008 pi cycle date. Let us remind readers of at least one comparative situation: back on the more major February 24, 2007 pi cycle date we believed for awhile that the major turn had been in equities across that weekend, but as events subsequently unfolded, February 24, 2007 ended up marking the historic "tights" in credit spreads before the whole sub-prime mess unfolded. Equities actually rallied back to new highs into early October 2007 in spite of the brewing credit storm clouds. In the current situation, we simply may not be able to tell for awhile what the subtle shift in investor psyche on March 22nd was, but we can say that a shift of some sort has occurred. One clear shift has been towards more government intervention in, and regulation of, our capital markets instead of less.

So at present, we will be watching the price action in various markets quite closely, and reminding ourselves that this is a "market of stocks," not just a "stock market." The great thing about stocks is that there are so many of them that it is always possible to find a few interesting patterns – both bullish and bearish – and piece together a market neutral portfolio that makes technical sense while awaiting further evidence as to the health of the market overall. This is the path that we are currently embarking upon. Trading short beta is "out" for now, but it may still be too early for a long beta portfolio. We will endeavor instead to come up with some market neutral stock selection alpha.

A Name You Cannot Pronounce, But a Truly Smart Guy

Along these lines, we recently had the chance to sit down with Abhijit Chakraborti, the new Head U.S. Equity Strategist at Morgan Stanley, poached a few months ago by Morgan Stanley from J.P. Morgan where he had been a global strategy analyst for seven years. Abhijit is a character, and unlike most bank strategists, does not pull his punches for political reasons. He reminds me of a cross between Stephen Roach and Barton Biggs, but with his own unique style of analysis and thought process.

In Abhijit's opinion, the progression of sectors "falling from grace" clearly started with the homebuilders, moved to the financial sector, is currently starting to impinge on consumer discretionary and IT stocks, and will eventually and inevitably impact industrial and materials stocks. Within the financial sector, he sees Merrill Lynch (MER) and Wachovia Bank (WB) as the two U.S. institutions with the most ongoing bad loan write-off potential relative to their capital base. He specifically suggested that Merrill, which recently shrank to just $11 billion in capital before raising another $11 billion in new capital infusions to get back to $22 bln of total capital, could see that extra $11 bln in new capital wiped out in yet another round of asset write-downs. Abroad, he sees Royal Bank of Scotland (together with several German banks) as also having messy out-of-control portfolios relative to their available capital base. Overall, in Abhijit's opinion, financial stocks – while already ugly-- will still miss current lowered 2008 consensus earnings estimates by some $50 billion in aggregate, and still require significant loan loss provisioning well into 2009. Per Abhijit: "It may be too late to sell many of these stocks, but it is also way too early and too dangerous to buy most."

Abhijit further believes that the American consumer, left to his own devices, will try to continue to spend, but the credit to do so simply may not be offered by the banks anymore. The first priority of the banks is at present to shrink their current asset footings back toward historic norms, and this means shedding approximately 20-25% of current assets. When consumers do finally feel this lack of credit availability trickling through to them, Abhijit is particularly

negative on Best Buy (BBY) and Abercrombie & Fitch (ANF) within the consumer discretionary sector. And with time he sees industrial companies such as Cummins Inc. (CMI) and Ingersoll Rand (IR) as being two organizations with internal business issues that are particularly vulnerable within the industrial sector. Copper producer Freeport McMoran is yet another materials company of which he is most suspect.

Meanwhile, what Abhijit does believe in is global population growth. Whether the U.S. has entered a recession or not, and regardless of whether emerging markets face an ongoing boom or potential bust, there is one fact that will not change: the world population is marching northward, and much of it is getting richer. As recently pointed out by one hedge fund manager, Acacia Partners: "There are 6.7 billion people in the world today, up 700 million just since the year 2000, a gain of more than 250,000 net new people for every day of every one of the last few years."

Year – Worldwide Population

1800 – 1.0 billion
1900 – 1.65 billion
1950 – 2.5 billion
2000 – 6.0 billion
2007 – 6.7 billion

"China contains 1.3 billion people today, up from 400 million people in 1900. India's population, which is growing faster than China's, is expected to peak at 1.5 billion people, up from 1.1 billion today and only 234 million a hundred years ago. Pakistan grew from 24 million to 165 million people in the last century. Indonesia rose from 43 to 235 million, and others have grown hugely as well…If you add them together, China and India are home to three times as many people as there are in the U.S., Western Europe, and Japan."

Now the next question becomes: how many of these people currently have a good brand of toothpaste? And of those that don't, how many will soon aspire to do so? Colgate Palmolive (CL) is a "no brainer" long in Abhijit's opinion, its current penetration rate into India still leaving room for tons of growth. Along a similar vein, he also likes Proctor & Gamble (PG) and Coca-Cola (KO) as well as Nike (NKE) as strong global brands destined for further growth.

So the fall-out "long-short" portfolio is to be short U.S.-centric consumer and industrial companies, and long large-cap multi-national consumer staple companies with strong global brands. Now we must admit that this is not "rocket science" and we have heard this pitch to play emerging markets via U.S. large-cap multi-nationals before. But coming from Abhijit's lips, it all sounded so eloquent and well conceived that we thought that it might be worth the time to examine the fractal rhythm patterns of the stocks that he mentioned both as short candidates and long candidates. So here goes.

Abhijit's Potential Shorts with Fractal Commentary

While stocks like Citibank, Goldman Sachs, and Morgan Stanley look pretty washed out to our technical eye (having reached our Fibonacci targets already), we concur that both MER and WB both have potential missing lows still to be seen at some point. The risk-reward path getting to these targets is however less than clear. If you attempt to still play these on the short side, be careful!

MER - MERRILL LYNCH & CO INC,D) Dynamic,0:00-24:00
Merrill Lynch (daily)
1.000 (98.68)
0.910 (91.5100
0.764 (79.9203
0.618 (68.3148
0.500 (58.935)
0.382 (49.5551
0.236 (37.9496
0.090 (26.3520
0.000 (19.19)
While declines in C, MS, and GS appear done for the moment,
could MER someday print 19.19?
GET RSI(13,8,3)

(WB - WACHOVIA CORP NEW,W) Dynamic,0:00-24:00
O: 27.10 H: 27.49 L: 25.89 C: 25.99
Wachovia Bank - weekly
1.000 (60.04)
0.910 (56.470786)
0.764 (50.70148)
0.618 (44.92426)
0.500 (40.255)
0.382 (35.58574)
0.236 (29.80852)
0.090 (24.035257)
0.000 (20.47)
missing low
target yet to be seen
Symbol: WB,W
Date: 12/30/05
Time: 00:00
Price: 56.6983216
Open 54.00
High 54.55
Low 52.55
Close 52.86
MA(100,C)s 49.4862
MA(200,C)s 44.1829
MA(40,C)s 50.71825
RSI(13,8,3) 56.009
RSI MA1(13,8,3) 61.63
RSI MA2(13,8,3) 59.49
GET RSI(13,8,3)
Published by eSignal (www.esignal.com)

We quite like BBY as a potential short, particularly if one can be patient and look to sell around 44.90 with a 36.60 take-profit Fibonacci target. Meanwhile, ANF looks to our eye as having one more missing high up near 93 before it heads lower.

Meanwhile, Cummins Inc (CMI) looks to our eye to be a good short sale candidate—particularly if it were to touch 56 -- with 30.48 as the downside Fibonacci target to harvest any short sale.

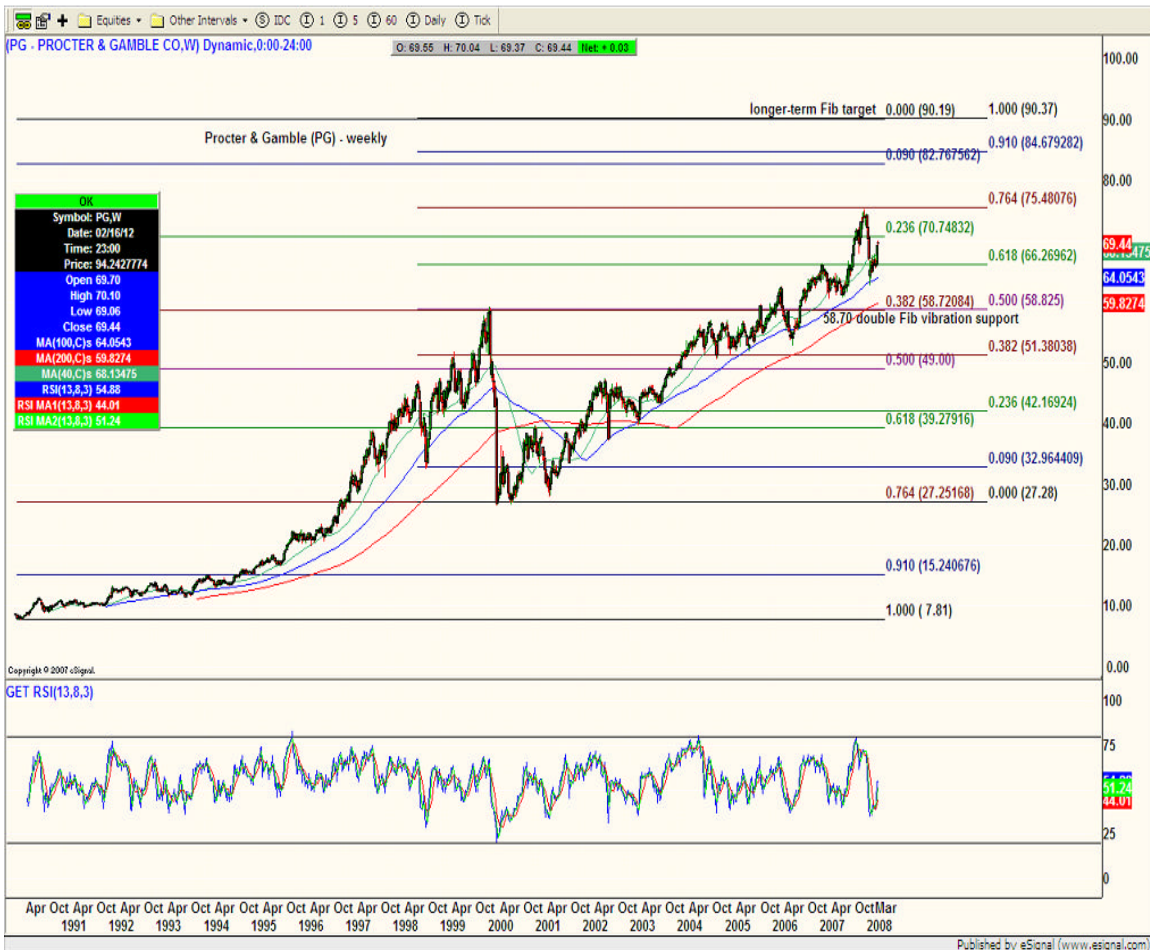
Ingersoll-Rand (IR) also has a potential downside Fib target near 30.70.

FCX looks of potential interest to short as well with a 65 target, but first needs to get through a band of support near 85.50.

Abhijit's Potential Longs with Fractal Commentary

Colgate looks like a nice long to us, with a missing Fib target longer-term up at 93.94, and while we might be more patient with P&G and try to buy it at some point near Fib support of 58.70, it too has a long-term target in the low 90's.

CL - COLGATE PALMOLIVE CO,D) Dynamic,0:00-24:00
longer term target
0.000 (93.96)
0.090 (89.390128)
Colgate (CL) – daily
0.236 (81.90000)
0.382 (74.58496)
0.500 (68.60)
0.618 (62.61504)
0.764 (55.20992)
0.910 (47.814944)
1.000 (43.24)
GET RSI(13,8,3)
Published by eSignal (www.esignal.com)


PG - PROCTER & GAMBLE CO,W) Dynamic,0:00-24:00
O: 69.55 H: 70.04 L: 69.37 C: 69.44 Net + 0.03
longer-term Fib target 0.000 (90.19)
1.000 (90.37)
Procter & Gamble (PG) - weekly
0.090 (82.767562)
0.910 (84.679282)
0.764 (75.48076)
0.236 (70.74832)
0.618 (66.26962)
0.382 (58.72084)
0.500 (58.825)
58.70 double Fib vibration support
0.382 (51.38038)
0.500 (49.00)
0.236 (42.16924)
0.618 (39.27916)
0.090 (32.964409)
0.764 (27.25168)
0.000 (27.28)
0.910 (15.240676)
1.000 (7.81)
Symbol: PG,W
Date: 02/16/12
Time: 23:00
Price: 94.2427774
Open 69.70
High 70.10
Low 69.06
Close 69.44
MA(100,C)s 64.0543
MA(200,C)s 59.8274
MA(40,C)s 68.13475
RSI(13,8,3) 54.88
RSI MA1(13,8,3) 44.01
RSI MA2(13,8,3) 51.24
GET RSI(13,8,3)
Published by eSignal (www.esignal.com)

Lastly, we see far more technical upside potential for Coca-Cola (KO) than for Nike (NKE). KO looks like a real winner.

So all in all, with the exception of ANF (where we think Abhijit may be early), we like Abhijit's recommended combined portfolio – potentially still short a few financials like MER and WB, short BBY, short CMI, IR, and FCX versus long CL, PG, KO, and maybe NKE. It makes sense to us intuitively, and looks like a winner portfolio technically.

Readers with access to Morgan Stanley research should take the time to read some of Abhijit Chakraborti's reports. He too entitled a recent one: "No Country for Old Men." On paper, this report doesn't quite have the flair of the Abhijit in person, but the core ideas are still there.

Stay tuned for more cycle and Fib updates as markets progress.

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Send us your comments at information@Sandspring.com.

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