Sand Spring Advisors LLC

Dealing with Irrationality
&
The Age of Aquarius:
Malkiel Out; Sornette In

by,

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Over the past several days, I have had phone calls from Sand Spring readers wondering just when the recent equity market rally will abate. One reader suggested that the March 18-19th PEI cycle date that we were so focused on for so long as a likely high may have arrived early on March 12th, and represented instead the reversal low. Another reader – short stocks such as Tiffany's, Dell, Amazon and others – was simply groping for some sort of risk management tool in case the "massive war rally" continued.

To the first caller, I said: "no" -- in my mind, March 18-19th stands as a cycle window of some importance without any re-jiggering of the dates. March 19th was, after all, the exact night that bombs started falling over Baghdad. Equities may have continued to rally a bit since then, but geo-politically yet another new tone for the world has been set. While the American media may de-emphasize the massive anti-American riots and rallies that have recently taken place in the streets of Pakistan, Egypt, and Indonesia (Watch the BBC News for better coverage of these!), and the equally large anti-war rallies of New York and San Francisco – the landscape to me is looking more and more like the one I saw as a boy peering from my New York City apartment as Hunter College students came down Lexington Avenue in a wild anti-Vietnam protest that included many broken shop windows and several over-turned burning cars.

Fed by a poor global economy, geo-political anger builds. March 19th represents in my mind more a beginning of troubled times – rather than an end.

And even if the markets acted in a Pavlovian type of way by deeming the outbreak of actual war as a "good" event, and thus started a 10%+ rally even before war began, we are not buyers into the historical 1991 "pattern match." Instead, we believe that the current "fast march to Baghdad," contrary to expectations of most market participants, will only serve with time to increase political risks in the region, not reduce them. Kurdish, Turkish, Sunni and Shi'ite frictions cannot be underestimated, nor can Islamic hostility that may continue to grow in other world regions. Rest assured that even if the U.S. military can overrun Baghdad, the "rebuilding" of Iraq will also be much more problematic than advertised – as well as more expensive than advertised.

Where does all of this leave us in terms of trading advice to the second individual suffering some pain on short positions in the market?

My words, talking across a cell phone, went something as follows: "My portfolio certainly went down a bit over the past week as well, and looking out into the world of hedge funds, few rational managers that I have allocations to, have been doing particularly well. So, if it is any recompense, you are not alone having difficulties in this period. Overall, the equity market remains a low probability choppy affair – full of false noise, volatility, and irrationality. The only way to deal with this is to size your positions correctly and to make sure that you have the staying power to withstand all the noise. Psychologically, having at least a few longs in you portfolio to balance the shorts may make some sense."

To this, the gentleman responded: "Well, I bought your recommendation of Chesapeake Energy and the Asia Pacific Fund, and they both have gone down."

At this juncture of the conversation, I needed to insert my requisite caveat: "I am not a broker-dealer, nor a Registered Investment Advisor in the business of managing people's individual portfolios. All I am is someone who looks at chart patterns, Fibonacci rhythms, and certain cycles, and then objectively tries to form an educated opinion as to what I see in those patterns – typically with a longer-term perspective. I truly can't go further than that – particularly from a legal perspective – to tell people on an individual basis how they should actually trade."

Now perhaps some will chastise me for such a "wimpy" type of final response. I certainly don't like giving it, nor have I particularly enjoyed the past week's market action in certain stocks anymore than others. That said, in the current situation, I am not about to dramatically change my longer-term view of the financial world simply because many previously espoused longer-term views are temporarily not working in the short-term.

The irony here of course is that throughout most of January and February we were actually warning of a market rally. At first we had an upside "surprise" S&P target of 972-974 – just high enough to break through the August 2002 highs and sucker people into believing that the bear market was finished. But on February 13, 2003 we advised in a Chart du Jour entitled "Slowly Moving to Other Fractal Rhythms" that 901.33 was likely a more realistic stopping point for any short-term S&P rally. The S&P cash high to date has been 895.89. Our greatest mistake since that mid-February prognostication was simply not maintaining sufficient patience to await this target becoming fulfilled. Patience was not our best virtue as an active bank proprietary trader for the better part of 19 years. Good original ideas do not always go hand in hand with well-executed actual trading.

Should prices start to falter around current levels, we also previously espoused a downside target of 732.2 in terms of the hourly S&P chart and 656.48 in terms of a longer-term monthly chart perspective. On the NYA Index we have previously espoused a missing low near 389.94. And on the DJIA we have pointed to downside targets of 6350 and 5815. On the Dow Jones Transportation Average, we have been looking toward 1788 as a strong downside Fibonacci target ever since the events of 9/11 hit. All of these targets remain firmly in our mind and should still be reached with time.

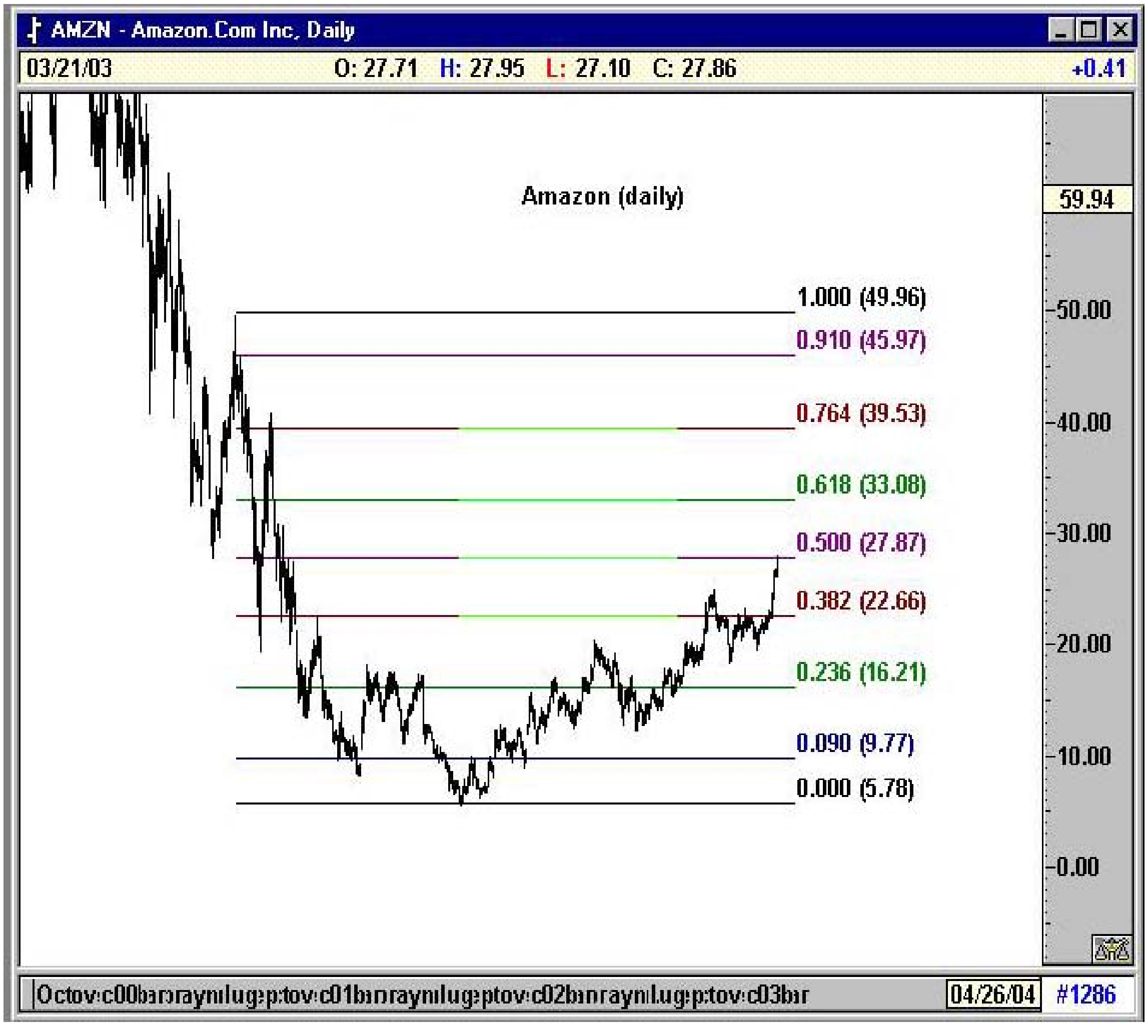
In the short-term, the primary concern that we have with the bearish case comes from the "key outside monthly reversal" that the German DAX Bank Index appears to be attempting to make. The DAX banking sector has been one of the worst performing and potentially most fundamentally troubled sectors for sometime. Loan portfolios there are under extreme stress vis a vis available banking sector liquidity. Longer-term, the chart pattern here also shows – like the S&P 500 – a huge potential head and shoulder's topping formation.

And yet, from an oversold position, a potential "key reversal" month may be in the making, and this would be the single chart pattern that we would watch to gauge whether short-term global equity markets truly have a shot to rally further. Should the last week of March achieve such a "key outside reversal month" (defined as a month with a lower low than the one that preceded it, but a close above the prior month's high) for the DAX Bank Index, then we will be impressed, and more concerned that 972-974 on the S&P still may be in the cards as well. A failure to achieve such an "outside key reversal month" would instead leave the entire March rally as just another "hurk and jerk" piece of silly market volatility. The DAX Bank Index closed Friday at 678.53. To our eye, it needs to maintain a close above 670 by March 31st to achieve this key reversal. In our heart of hearts, we doubt that it will be able to do so, but this still bears close attention.

And moving to individual stocks – particularly the ones that our underwater subscriber was getting hurt on – yes, Dell, Amazon, and Tiffany's have all rallied of late, but I challenge any technician to find a bullish interpretation of the daily chart patterns of Dell and Tiffany's below. And Amazon has just now touched a 50% retracement of its decline from its September 7, 2000 high. Is this any place to want to cover a short? We think not.

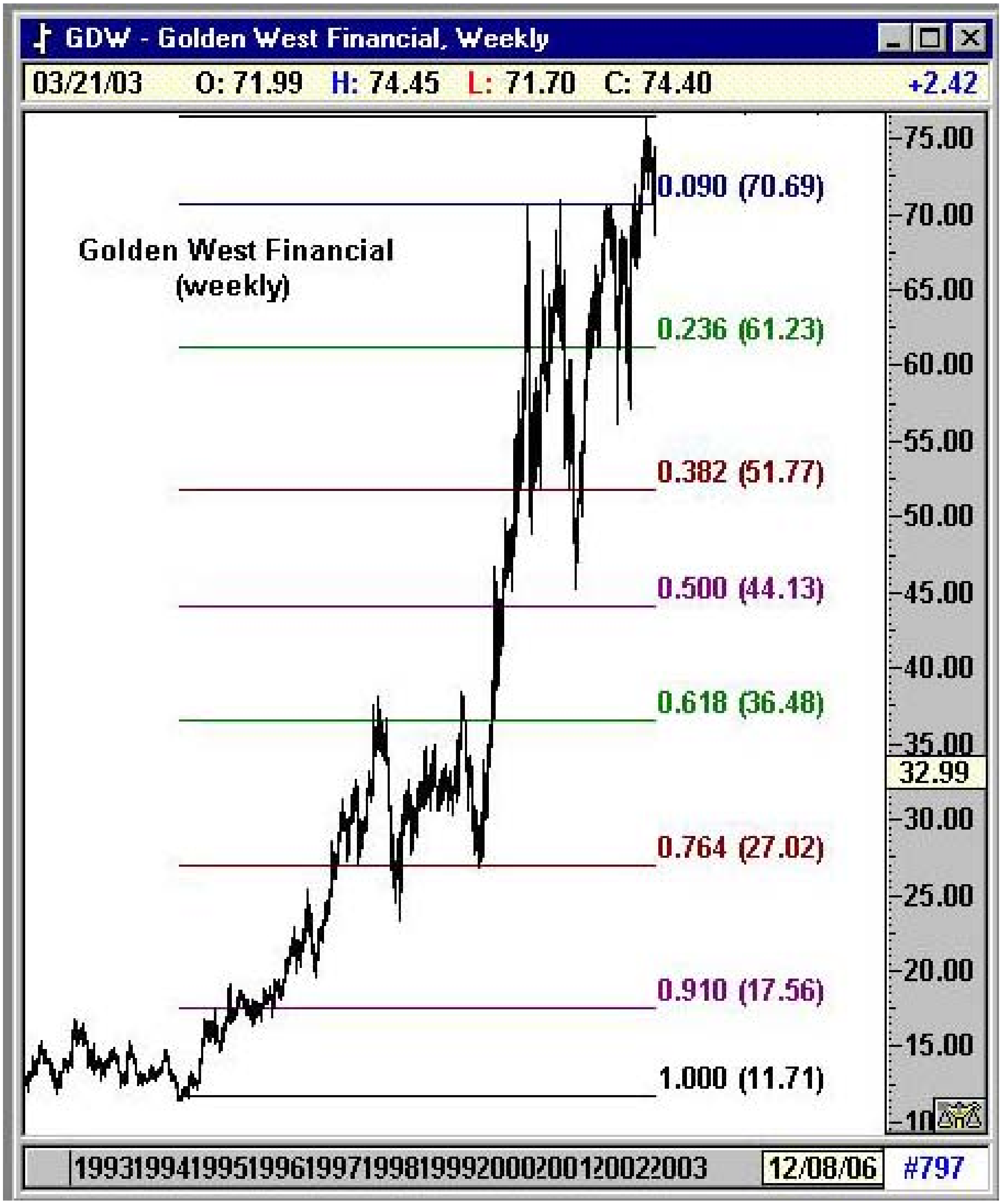

DELL - Dell Computer Corp, Daily
03/21/03 O: 28.55 H: 28.79 L: 28.15 C: 28.75 +0.65
Dell (daily)
1.000 (33.07)
0.910 (31.18)
0.764 (28.13)
0.618 (25.07)
0.500 (22.60)
0.382 (20.13)
0.236 (17.07)
0.090 (14.02)
0.000 (12.13)
35.00
30.00
25.00
20.00
15.00
02/19/03
#978


TIF - Tiffany & Co, Daily
03/21/03 O: 26.80 H: 27.18 L: 26.35 C: 26.92 +0.52
Tiffany (daily)
45.00
40.00
35.00
30.00
25.00
20.00
15.28
02/16/04
#1236



Away from these three situations, some perspective is also warranted. In December 2002, we espoused a variety of longs to balance a list of shorts. Amidst our longs, Enerplus subsequently rose from its recommended price of 17.84 to reach our espoused 19.49 target (where we took profits). PVA, SFI, JBX, and SPLS are all several points higher than when we discussed them on December 22nd. Only Northwest Natural Gas is just slightly lower than when we proposed it as a long position. Overall – these were pretty good safe haven stocks with an acceptable year-to-date result. Recent long suggestion Chesapeake Energy has retraced a bit on the drop oil prices, but longer term, we still like it a great deal. And while we have been a bit disappointed by the Asia Pacific Fund's price action, we view this position as a hedge position against the rest of our short portfolio.

As discussed above, the short side has of course been tough over the last seven trading days with Dell, Amazon, and Tiffany's amidst names that we have periodically featured as short candidates. But we also proposed other stocks as short candidates back in our December 22nd letter, and most are largely unchanged to slightly lower since then. The only notable exceptions have been Caterpillar and Redwood Trust – both up 5-6 points over the past few days. We have re-examined both charts and still dislike the complexion of both. We also espoused back on December 22 to that Golden West Financial would likely make a significant high between $73-77. That stock now stands at 74.40 with its high having been $76.40 on January 21st. This stock appears to be stalling right in the technical "sweet spot" where we expected it to top.



So when all is said and done, we've had some successes and some failures this year, but nothing disastrous, nor anything tremendously exciting to celebrate. From here, we see ongoing opportunities in both our longs and shorts – as previously espoused – but without particularly new perceptions or recommendations.

Taking a Larger Theoretical View

With the recent wild volatility of the markets as a backdrop, let us take a moment here to take a step back and discuss a bit of academic financial theory.

When I first studied at Princeton University's Woodrow Wilson School of International & Public Affairs in the late 1970's and early 1980's, most of economic academia revered Burt Malkiel -- author of the book *A Random Walk Down Wall Street.* On the basis of his reputation at the time, I asked him to be one of three advisors to me as I embarked on an ambitious Wilson Scholar program whereby I would write *two* senior year theses instead of the normal one.

The underlying question of my first thesis was focused on how, in rationale markets, the price of silver back in 1980 could have vaulted from $7 up to above $45 and then back to $10 in a short space of several months. Was that truly a "random walk" process where prices at any moment in time reflected a correct reflection of all available fundamental information, or was it an abhorrent manipulation of some sort? And if the latter, did regulators in some manner exacerbate the situation when they started tinkering with exchange rules?

The second thesis was a bit less sexy of a topic. It involved the micro-efficiency of markets, and whether a competitive market-maker system was any improvement on the then traditional specialist affirmative market-maker monopolistic system of the NYSE.

To be honest, Malkiel was of little help on either paper, and while I received an A+ on the first effort and an A on the second, I somehow came away from my interaction with Malkiel disappointed. Here was a man that Wall Street greatly admired, but that as far as I could tell, was sitting in his Ivory Tower without a real clue as to how the world actually worked.

My entire premise within both papers was, of course, that markets can become highly "inefficient" -- for both macro and micro reasons.

In the first instance, it was clear to me after much research and many interviews that the Hunts and assorted Arab cohorts had bought enough physical and forward delivery silver to cause "tightness" in certain deliverable grades of silver. They then exacerbated this tightness by buying nearby silver futures contracts and selling distant ones as a "spread position" – mostly as a tax play. The expectation was that silver would rise in price and that if this spread position could be held for six months, then under the tax rules that existed at the time (since changed), the long leg of the spread would be a long-term gain, while all short futures positions (the back leg of the spread which the Hunts anticipated would be a loss) would remain taxable on a short-term basis.

But the Hunt strategy created apparent spread arbitrage opportunities that enticed firms like Salomon Brothers and Mocatta Metals to take the other side of many of the Hunt trades, only to then find themselves in hot water when variation margin on their short futures positions started to become huge and costly, and the lack of refining space meant that the perceived arbitrage opportunities between cash and Comex March 1980 silver futures could not be made to absolutely converge. At $45 an ounce tons of silver was pouring on the market (Pity all the historic tea sets and candelabras that got melted down) but there was absolutely no way to get all this silver into 5000 ounce bars that could be delivered against the arbitrageurs' short COMEX future positions in time for the March 1980 expiry where Bunker and Herbert Hunt had the bulk of their long tax-spread positions. So the regulators of the exchange stepped in and basically ordered tapered position limits and forced liquidation of all speculative positions, and at that juncture, it was only a matter of time until the New York arbs carried Herbert and Nelson Hunt out of the silver trading pits and sent them humbly packing back to Texas.

Nothing about that situation was particularly efficient, and nothing about the way the micro-structure of today's equity markets has evolved is particularly efficient either. Just as the U.S Government mandated that ATT should be forced to compete for local and long-distance phone service and no one's phone bill (or more likely phone **bills** -- plural) has ever been particularly decipherable, or lower in price, since, Congress also mandated in the late 1970's that the Specialist monopoly on NYSE order flow be broken, and competing market-makers be allowed.

In theory this "National Market System" sounded great, but in actuality maybe it has not been that good for the fairness, orderliness, or overall efficiency of our markets.

Today, when a piece of dramatic news on a stock is released, pandemonium tends to transpire. Particularly in after-hours electronic trading, sharply divergent and spurious trades can appear on Instinet or Archipelago on thin volume. But even within normal market hours, trades are getting routed to numerous different exchanges for execution without any well-functioning central limit order book. Sometimes sweetheart deals exist for order flow (particularly in options trading) that have nothing to do with "best execution." So compared to the gentlemanly days when late afternoon news would simply result in a particularly active opening for a stock the following morning – an opening fair to all investors and speculators alike – today, there is an immediate race for reaction. And due to that race, and the disjointed markets where market orders may flow, the markets may be free – but once again, there is little possibility that they are efficient.

Malkiel's Random Walk theory was a silly naïve theory in the 1970's and it remains even more that way in today's markets. I would argue that the large majority of news impacting today's markets is causing more over-reaction in our disjointed electronic markets than this news likely deserves.

However, and not to sound trite, we are currently beginning the new Age of Aquarius, and during this age, man is supposed to gain many great new insights into his world and environment. One step closer to that new era is certainly Didier Sornette's recent book *Why Stock Markets Crash: Critical Events in Complex Financial Systems.* Within this book, we find for the first time, a well-regarded professor of geophysics from UCLA making the academic leap that the same patterns, rhythms, and "critical moments" that can be observed in the physical world also exist within the financial world. From accelerating momentums to the eventual entropy of any object or market studied, Sornette concludes:

> "Large stock market crashes are analogous to so-called critical points studied in the statistical physics community in relation to magnetism, melting, and similar phenomenon."

In other words, an inherent mathematical pattern exists in the large majority of the market crash events studied by Sornette, and within his book, Sornette specifically develops a non-linear log-periodic formula that by applying different accelerating factors and time horizons, aptly matches the actual price behavior of many markets before crash events. Moreover, Sornette demonstrates that certain signs tend to emerge prior to crash events whereby "the market anticipates the crash in a subtle self-organized and cooperative fashion, hence releasing precursory 'fingerprints' observable in the stock market prices."

Move over Burt Malkiel – Sornette is a guy who truly "gets it." Not only do markets behave in relation to definable mathematical parameters, but some of the astute among us can (at least upon occasion) actually spot the "signature patterns" and "fingerprints" that act as warning signs of impending dramatic market behavior or change in character.

Now before anyone rushes out to buy Sornette's book, please take note that it is filled with many mathematical formulas that may leave the layman investor blurry-eyed and sleepy. The general point is that the type of Fibonacci and pi fractal analysis applied to markets by Sand Spring Advisors is indeed becoming more widely accepted by mainstream academia, and we might expect that in another 20-years time, Sornette will be seen as a true academic visionary.

Sornette's longer-term vision of financial markets, by the way, suggests that the "critical point" of entropy applied to population and economic growth will likely constrain global growth on or about the year 2050. This does not appear totally inconsistent with our previous espousal in our February 2001 article *Measuring Financial Time with Pi* and our August 2001 article *Long-Term Cyclical Thoughts* where de discuss a likely "panic" low in equities on or about December 30, 2004 --a PEI cycle date and also 17.2 years (2*pi*1000 days) after the Crash of 1987 -- to be followed by a long period of inflationary upswing. We previously wrote: "July 2034 will be the most likely period for a large price spike higher, falling 314 years after the 1720 South Sea Bubble, 942 years (3 * pi) from the Monetary Crisis of 1092 and 1570 years (5 * pi) from the period in which the Roman Empire was falling from power." Add another 17.2 years onward from July 2034 to allow for inflation subsiding into temporarily healthy disinflation (in a similar fashion as the 1982-1999 period), and you reach September 2051. This is when modern economic and population growth as we know it today could easily hit a "critical point of entropy," and the world's economic engine experience a truly radical reversal.

I likely will not live that long to see whether the above prognostication comes to pass, but at least it is written here on paper -- for what that is worth. I also hope that this points out to subscribers that Sand Spring's analysis will likely only really be biased toward the "doom and gloom" side until December 30, 2004. Beyond that date, we truly hope to be able to anticipate current debt deflationary and stagflationary forces yielding to healthier markets of some sort.

But for now, we must proceed one step at a time – and we do not believe that America's assault on Iraq will be the bullish panacea for the markets as many currently suggest. We remain bearish first into June-July 2003. Depending upon the degree of that decline, we'd tentatively anticipate a bounce of variable magnitude thereafter. But we do not see an ultimate low for the current bear market until somewhere nearer December 30, 2004 – as opposed to now.

Send us your comments at information@Sandspring.com.

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