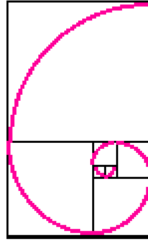

Sand Spring Advisors LLC

Musings on the Way to Late January 2006 Lows

by,

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The past week brought several notable developments: The return of lively and volatile equity markets (marked by back-to-back swing reversals in the DJIA exceeding 100+ points on several days); the naming of Ben Bernanke as Mr. Greenspan's future Fed Governor replacement; and the annual Fall 2005 *Grant's Interest Rate Observer* Conference where we were in attendance together with such investment luminaries as Leon Cooperman, James Chanos, John Hathaway, Eddie Lampert, and Dirk Ziff.

With regard to the markets, we have previously opined that a mid-September U.S. equity market high would cyclically lead to a late January 2006 low, and that along the way, the word "stagflation" would creep back into the mouths of mainstream economic commentators. We have specifically suggested shorts amidst various consumer and financial stocks (XLY, William Sonoma, Ambac, and PMI among them) while being singularly bullish on the stock of Waste Management Inc. as a spread trade.

To date, our short XLY vs. long WMI spread trade has worked beautifully, the uptrend line (on both a spread and ratio basis) now broken, and a first level of Fibonacci support reached, After a short period of retracement higher, we now see this spread headed down towards a refined target of approximately -$7.50.

On an overall basis, and amidst the irritating media hype of post-facto "explanations" of daily market swings, we will also stick to our original market prognostication: Equity markets are in trouble until early 2006, as are U.S. fixed income and high yield markets.

The specific S&P 500 Index rhythm that we see emerging now points to a downside price of at least 1154 (basis the cash index) which would represent a 50% retracement of the entire August 2004 to August 2005 upswing. In terms of the DJIA, 9928 emerges as an equivalent strong downside Fib target, as depicted below. If 9928 does not hold, then 9600 would be possible on the Dow – in what would clearly be viewed as a mini-crash.

Please do not read these prognostications as those of a perma-bear. They are instead made only within a short-term cyclical swing context. We say this because after our anticipated late January 2006 low, we are actually bullish for new highs on the S&P into the more major February 24, 2007 pi cycle date (8.6-years, or 3141 days, beyond the July 20, 1998 market high, and 2*pi*1000 days from the December 1989 Nikkei high). 1260-1278 on the S&P should easily be seen into this latter date window. But first we need to navigate some tricky and bearish times.

One date window within the forthcoming few months that appears cyclically most ominous is the period at year-end. December 30, 2005 will be 1571 days (.5*pi*1000 days) from 9/11/2001 – the day of the World Trade Center's destruction. The same window of time (specifically on January 1, 2006) will mark the 224th 8.6-year anniversary of the eruption of Mount Vesuvius that covered Pompeii on August 24, 0079. Thus in our cyclical mind, year-end 2005 will not be a time to be on holiday nor to be a seller of option premium across what are generally expected to be quiet trading sessions. This period should instead be violent and active. 2005 started of course with the Southeast Asia tsunami of late December 2004, and was then marked by the most horrific summertime U.S. hurricane season in modern history. Could the year finish with yet another violent natural disaster or storm? We note from the *Farmer's Almanac* a prediction that December 2005-January 2006 will be "exceptionally cold" in the U.S. Northeast and that a "big

snowstorm will hamper Christmas travel." In a throw-back to previous Saturn in Cancer influences, "death by water" seems to have been the motto for 2005, so maybe such continues as we move from the Gemini Full Moon of December 15, 2005 into the new moon of December 30th, 2005.

But enough of our own cyclical predictions. As a second area of interest in last week's news, Ben Bernanke did of course emerge as the official choice of President Bush to replace Alan Greenspan. The timing of this announcement itself – on the morning that Hurricane Wilma was rolling into south Florida – was clearly designed by the Bush Administration to distract financial markets from their worrisome ways, and instill some "helicopter drop money" joy to equity markets – regardless of what Wilma might inflict. In the short-term, it worked – stocks rallied, even as U.S. bond markets sagged to the downside.

But our immediate reaction to Bernanke as Fed Governor is that this may be the first step towards increased foreign distrust of the U.S. financial system. As a student, Bernanke studied the Depression and how the creation of credit could have helped avoid it. At heart, he believes in targeting inflation at a constant +2% per annum, and is not focused or overtly concerned with the magnitude of money supply growth required to do so. He has recently pooh-poohed the notion of any housing bubble existing in the U.S. In short, we see him as an academic myopic – a smart one to be sure – but maybe too smart and self-assured for his own good -- sure enough of his own theoretical assertions that he will also be dangerous. In the words of Jim Grant speaking about Bernanke:

> "He will never say: 'You never know.' He will never admit a problem, or not have a solution to it. He will think he knows the future before it happens, and because of this, he may not react when he needs to."

Bernanke, a former Princeton professor, will in our mind be something like another former Princetonian, Treasury Secretary James Baker -- with an "I can fix-the-world" type of self-assuredness. Baker of course tried to drive the dollar lower in 1985 to solve the U.S. trade imbalance problem, and when this did not result in the desired outcome, he then encouraged Japan to stimulate its domestic economy by cutting Japanese interest rates in 1987. The Japanese grudgingly obliged, and in an unforeseen outcome, the boom and bust in Japanese property markets subsequently transpired – with the economic world never having been quite the same in subsequent years. In Bernanke's case, he is likely to err on the side of being too easy, and while this may seem to work initially in the January 2006-Februrary 2007 period when he first takes office, eventually he will be sewing the seeds of much economic stress in the U.S. during 2007-2008. What Bernanke already misses is that while the U.S. economy has grown robustly at +3-4% annual levels in recent years, the U.S. household debt burden has grown far faster –somewhere around 10% per annum.

At the recent *Grant's* conference, Jim Grant himself made a wonderful analogy of the past 20-years of low inflation debt-inspired growth to the low inflation debt inspired growth in the latter part of the 19th century.

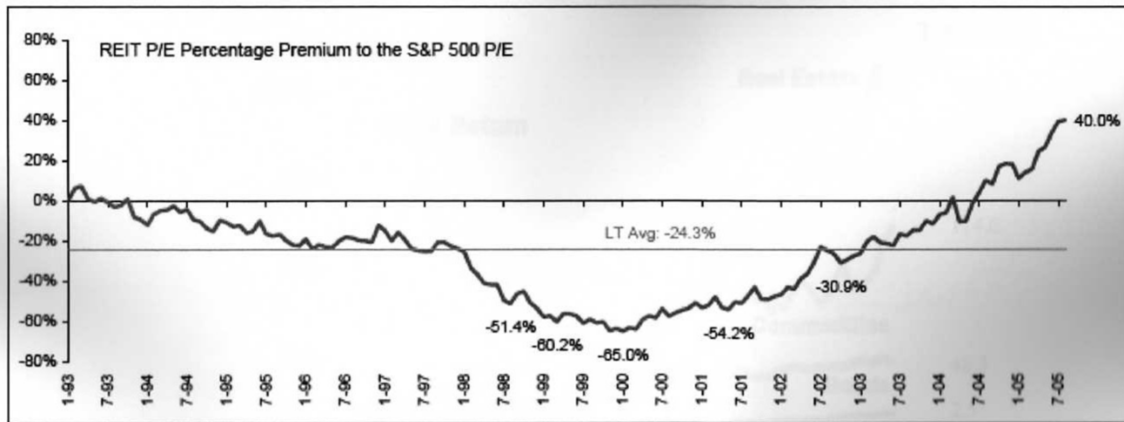
Specifically, between 1866 and 1890, U.S. inflation fell steadily and interest rates fell steadily. Eventually there was a real grope for yield, and money headed out of eastern banks to western banks where higher yields were being offered, and homesteaders were grabbing up tracts of land on easy credit from the railroads and banks. As quoted by Grant from *The Economic Background of Frontier Populism* by Hallie Farmer, the secretary of a western loan company was quoted: "I found drafts, money orders and currency heaped on my desk every morning. I could not loan the money as fast as it was coming in." "All the railroads offered lands at low prices and on easy terms…The Union Pacific offered eleven years' credit. One-tenth of the purchase price was to be paid at the time of the sale; deferred payments bore interest charges of 6%, but for the first three years the purchaser was required to pay interest only." Real estate mortgages between 1880-1889 boomed. "The competition between investors made the practice of much fraud possible. Securities which could not have been sold in ordinary times found a ready market. Bonds of Capitola township, Spink County, Dakota, were sold in this period and changed hands many times in eastern markets before it was discovered that no such township existed….The speculation which seemed to seize upon everybody directly or indirectly connected with the west…*the prosperity of the period was a prosperity based on credit*."

So too therefore does Grant look at the current period and conclude: “People are looking backwards at 25 years of bullish bond markets, low measured inflation, and easy credit, and they are in denial that anything could possibly change on a forward looking basis. And yet, like the 1870-1890 period, the past two decades have been a period of prosperity based mostly on credit. At the end of that former period, the 7-year spurt in rainfall that had made the Dakotas seem farmable and habitable ended. Most of the homesteaders went bust, and either returned eastward or moved on to California. The eastern money that had flooded into the Midwest was simply lost.”

By implication, Grant seems to ask: “Within the current grope for yield, will all the money that has recently poured its way into easy mortgage financing also be lost?” Such a lesson from history does not seem to be on Ben Bernanke’s mind at all.

Meanwhile with regard to real estate, another speaker at the *Grant’s* event, Jerry O’Connor, a veteran in real estate investing for 38 years, first with Lazard Freres, and then with his own company called the O’Connor Group, stated:

> “Real estate inventory is up; days to sale are up; prices may not be down yet, but I think the real estate market has already left its peak in July 2005. The levered spread investing game is certainly over as the cost of financing is now close to expected returns and first year CAP rates. REITs have had a huge multiple expansion from 2000 when they stood at one-third of the S&P 500 multiple, to being at a 40% premium to the S&P multiple today.



> “Insiders have also recently been selling like crazy. In the 2nd Quarter of 2005, for every one insider purchase, there were 173 insider sales. This totaled $296 billion in net insider sales – a 35% increase over the first quarter. Thomson Financial data shows that insiders at the 10 largest home builders have sold $952 million worth of stock so far this year. A few years ago, Florida condo development king Jorge Perez was only worth $10 million; today he is worth $1 billion and is featured on the cover of *Forbes* magazine, and in a prominent *Time* magazine article as well. I am reminded somewhat of 1999 when Bill Gates and Steve Jobs both made the cover of *Time*. It wasn’t that much further to the tech peak.”

March 1999 **October 1999**

Meanwhile, a friend of ours pointed out the recent *Fortune* article on real estate speculator Tom Barrack, manager of a $25 billion portfolio of trophy global assets, who states that the recent real estate market is somewhat akin to a game of amateur polo:

> "'I feel totally safe playing polo on a field full of pros. But when the amateurs are all over the field, someone can get killed. They have more guts than brains. They charge after every ball and don't know when to hold back.' It's the same with U.S. real estate right now. 'There's too much money chasing too few good deals, with too much debt and too few brains.' The amateurs are going to get trampled, taking seasoned horsemen, who should get off the turf, down with them."

Interestingly, Barrack sees the catalyst to the real estate bubble deflation emanating from a steep rise in the price of building materials and labor: "Construction costs have spiked 20 percent in the past nine months" as both lumber and labor have advanced in price, as well as the price of oil "needed to produce everything from plastic piping to insulation to shingles." In Barrack's mind, condo developers in places like Miami and Las Vegas will first get squeezed by accepting advance deposits from speculators on projects, but then spending more to construct the units than they had bargained for. At that point, says Barrack, the developers will try to raise prices. The original buyers will "either sue the developers to get the original price or take their deposits back and walk away. The developers will then put the units back on the market, and the glut of vacant condos will drive prices down. *It's the busted deals caused by construction costs that will cause the turn in the market*."

Mmm, Interesting.

Meanwhile, yet another speaker at the Grant's conference, John Hathaway of the Tocqueville Gold Fund posted the following $20,000 Zimbabwe bill at the start of his presentation:

Per Hathaway: "Just a few years ago, it took 6 Zimbabwe dollars to purchase one U.S. dollar. Today it takes $50,000 Zimbabwe to get one U.S. dollar. The above $20,000 bill is worth the grand total of 40 cents, and it is the largest denomination bill in the country. Now, I do not mean to suggest that the U.S. is anything quite like Zimbabwe. No, it is not. But our government <u>*is*</u> engaged in its own more sophisticated undermining of the U.S. currency. Real rates in the U.S. have been and continue to be below zero, and in reaction, over the past several years, gold has almost doubled in price. Capital migrates into gold under one scenario only: when the lack of investment returns elsewhere, the desire for safety, and the ascendance of risk-averse psychology at large converge. Such is now the case."

Hathaway went on to point out that the costs to build and develop new gold mines have gone up with the gold price such that mining margins are about where they were a few years ago. "The economies of this industry are still marginal, with many companies still not making new exploration commitments or

working to replace reserves. The number of geologists on Placer Dome's staff has actually gone from 400 to just 40 over the past several years as that company works to contain costs."

Meanwhile on the investment side, Hathaway explained that the "$1 trillion value of total above-ground gold reserves around the world is only 1.4% of today's $70 trillion value in total financial assets. By comparison, gold was worth approximately 21% of the value of total financial assets in 1934, and 26% in 1982. If just one-tenth of one percent of this $70 trillion in financial assets tries to move into gold, it would equate to two years of new mine supply. Such potential investment demand would be almost impossible to accommodate. It would cause a huge price dislocation. The gold industry is still tiny compared to the potential capital that could easily flow towards it."

This is a subject that we have discussed previously here at Sand Spring, and we concur with Hathaway's longer-term bullish view. Unfortunately, on a short-term technical basis, we still see gold as being overbought, and would far prefer becoming reinvolved only AFTER a washout of current speculative players. Quite often late November offers a seasonal buying opportunity in gold. We will continue to be patient to see if such is the case this year. In an ideal normal world, gold should offer up a $400 entry point at some point – although that level seems far away at present. Stay tuned.

Lastly, no *Grant's* event would ever be complete without mentioning the short picks of James Chanos. As reviewed in these pages back in May 2001, Chanos successfully suggested shorts such as Enron at 59.50 (now zero) and Providian at 55 (today at 17.80). In our November 2003 article "*What Growth? & New Thoughts from the Warren Buffet of the Dark Side*," we described Chanos's bearishness on companies such as Blockbuster at 17.20 (now at 4.50), Eastman Kodak then at 24.40 (today at 21.50), General Motors then at 41.60 (today at 27.20), Delta then at 11.40 (today at 0.60), and Leapfrog Enterprises then at 29.90 (today at 14.10). Indeed Chanos's only losing short recommendation from Nov 2003 – despite a higher equity market in 2004 – was Weight Watchers International which he disliked at 37.60, but has since risen to 52.50 today.

In 2005, Chanos continues to see Eastman Kodak destined for Chapter 11. "First the internet impacted music retailing in the 1990's; by 2000-2002 the internet was changing consumer flea markets and classifieds; from 2003 to present, it is changing the world of photography." And on a forward looking basis, he sees video rental, video programming, and theatrical distribution as being next on the hit list.

Chanos states that "In a few years, the notion of delivering DVDs by mail – the newest Netflix and Blockbuster business models – will seem naively quaint and old fashioned, and certainly not worth the 50x earnings multiple that Netflix commands today." Let's read that as a short recommendation on NFLX.

He also points to the internal Disney memo by Bob Iger that was written up in the *Wall Street Journal* a few weeks ago as a watershed event. “In that memo,” explained Chanos, “Disney basically came clean and admitted that the media world was changing. In recent years, Disney has never made any money in their actual theatrical releases. All the money has been in DVD sales. But the 45 day wait to DVD release is soon going to collapse even further, as will the subsequent 60-90 day wait until pay-per-view. Disney agreeing to allow IPOD to source recent Disney/ABC television shows is the first step towards this eventuality. Squeezed will be the traditional theatres as we know them with their $10+ ticket sales, expensive popcorn sales, and gum-laden floors. It costs $6 all-in to get a DVD to a consumer, so there is still a lovely mark-up when Walmart sells that DVD for $9.99. Compare this to the approximate $70 cost to take a family of five to the movies.”

While Chanos admits that movie theatres aren’t just going to fold up and go away, he sees the entire industry basically under siege – in secular decline as the compression of DVD release time shortens while flat screen home theater systems cheapen and improve in quality. Thus he is a bear on Regal Entertainment Group (RGC) – shown below, currently breaking down from a multi-week coil formation.

He is also suspect of Carmike Cinemas (CKEC) that has already been under much recent downside pressure, but to our eye, does show a Fibonacci rhythm potential to fall even further.

Meanwhile, on a longer term basis, Chanos also sees the Internet thick pipe delivery and VOIP as being directly problematic to satellite broadcasters such as Direct TV (DTV) and EchoStar (DISH) – both companies where Chanos views subscriber and earnings growth rates as clearly on the wane. We do not immediately see a compelling Fibonacci rhythm on either company to immediately offer Sand Spring readers.

Chanos even thinks that companies such as Comcast and Cablevision will be in trouble as Verizon and SBC increasingly penetrate their markets. At Sand Spring, we are less sure than Chanos as to the eventual winner in the telecom vs. cable wars, but relay Chanos's vision so that subscribers can judge for themselves, and at a minimum be wary of any long involvement in these securities.

We certainly do buy into Chanos's thoughts about traditional movie theatres. Although "going out to the movies" will not disappear as a low-end American pastime, the dichotomy of pricing of movie ticket pricing versus the cost of waiting for the DVD release is becoming problematic to the distribution industry. So too is the recent quality of Hollywood movie releases that has been most disappointing. If people don't stay away from theaters due to the pricing, they may increasingly do so because of the content. This does indeed seem like a lay-up trade to us.

And in terms on content and general social mood, let us ask one last socionomic group of questions. Is it just coincidental that this fall's equity market weakness has been mirrored on television by such scary and often violent new shows such as Threshold, Medium, and Ghost Whisperer -- all dealing with the supernatural? Is it just coincidental that weather patterns turned heavy and dark in October together with Wall Street – with day after day of rain recently hitting the Northeast, while America's south was also been bombarded? Or is the only Sumerian saying "As above, so below" somehow in action?

We obviously don't know the answer to these latter questions, but we do know that the PEI 4.3-month Economic Confidence Cycle remains in down mode until January 26-27, 2006. At present, the sun is shining again in the Northeast again, and markets are perhaps due for a short-term rally period, but we do not see November-December 2005 offering the same type of upside equity advances as was the case during these months back in 2003 and 2004. Instead, it should be a truly soggy holiday shopping season.

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