Sand Spring Advisors LLC

Slow Motion Melt

by,

Barclay T. Leib

September 30, 2005

In our last August 27th subscriber-only article we anticipated that equities – already in a step-and-stumble topping process since August 3rd, would accelerate lower as of the September 19th 4.3-month mini-PEI cycle date. We reiterated this prediction within a strongly-worded public website posting of September 18th. And then boom – September 19th arrived and brought with it a swift and most gratifying slide lower that at least for a moment was very reminiscent of the December 31, 2004 PEI cycle date turn 8.6-months earlier.

Much as the December 31, 2004 turn heralded much sloppiness in the equity markets globally for the 4.3-month period into early May 2005, we believe that the September 19th cycle turn heralds similar downside sloppiness for these same markets into late January 2006.

But before we get too excited about being gung-hoe short, and while we promised to try to avoid any "namby-pambiness" in our September 18th web posting, we do have two caveats to state -- particularly given the modest rally in global equity indices over the past few days.

Caveat (1) to the overall bear case: Despite showing some acceleration lower post September 19th, the price action on the hourly chart of the overall S&P 500 decline since early August has not been the most impulsive looking Elliott Wave pattern that we have ever seen. Yes, it is still possible that we have only begun a series of I-II-1-2 declines, with a 3 of III decline still ahead of us to reveal a dynamic Elliott wave fractal pattern, but to be honest, the current pattern on the hourly chart looks very overlapped and more like a 4th wave A-B-C pattern. If this is indeed the case, the first A-wave down covered approximately 45 S&P points and took 19 trading days to complete from mid-day reversal high on August 3rd to mid-day reversal low on August 30th. This was followed by a 7-trading day B-wave bounce into another mid-day reversal on September 9th at 1243.13. If we are now within a C-wave lower, then perfect symmetry would exist (when compared to the Wave A decline) if the cash S&P 500 Index were now to fall to approximately 1198.13 on or about October 6th. Using Fibonacci rhythm techniques, and a parallel channel angle to the slope of the August decline, we see the possibility of an overshoot to about 1193 and a time window for a potential short-term low extending out to Monday, October 11th. Monday, October 3rd. is of course a solar eclipse, with a lunar eclipse to follow on October 17th. *This period should be very active and stressful – maybe even with new seismic activity of some sort somewhere.*

Caveat (2) to the bear case: Presume for a moment that we do get a trading low on or about 1193-1198 in the Oct 6-11th time window. Then what? As one may remember, post the December 31, 2004 cycle high, certain equity indices did poke there way back to new highs in early March 2005 – as irritating and temporary as that move ended up being. In a similar fashion, it remains possible that once again, the market could make one last stab at a new high – maybe to our long elusive 1258-1263 region on the S&P.

But if we do get that one last high, then we believe that the set-up will be entirely perfect for the impulsive move back down into late January 2006. Any new highs will simply be a "guffuck" move to catch and stop out weak shorts, just as an immediate move down to 1193-1198 might first represent a false trendline break to stop out a lot of bulls – the "path of most pain" so-to-speak for both bulls and bears alike. On an overall basis, these are all just short strokes to a 4.3-month overall trend lower that we now extrapolate on a daily basis to potentially end up looking as follows:

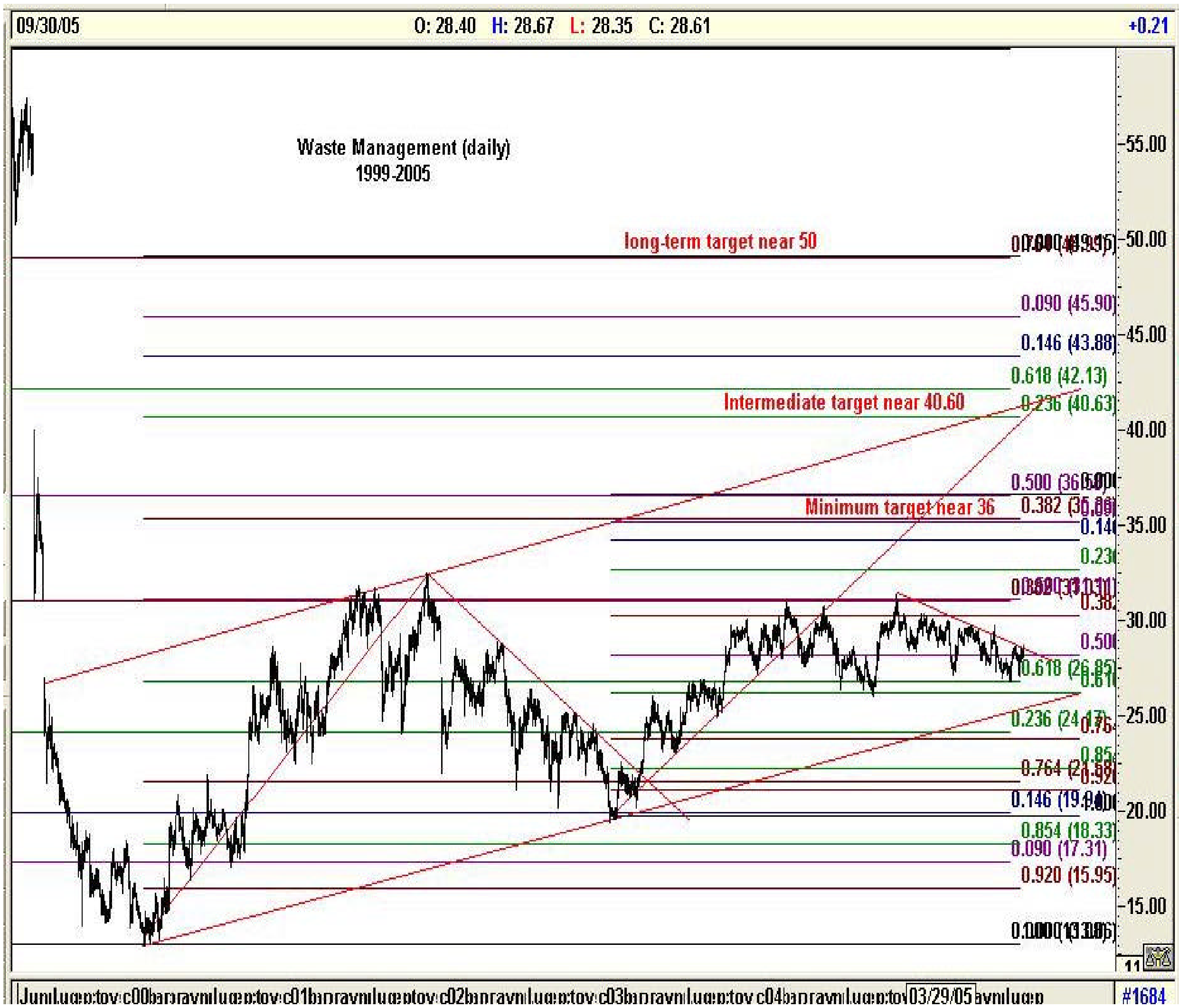
Only if 1193 on the S&P were to be blown away in a decisive manner would we quickly shift to a more dramatically bearish daily view. Under this latter perspective, the current S&P "step-and-stumble" chart formation can be seen as a lopsided Head and Shoulders topping pattern (with a head to neckline distance of approximately 50 points), and with a downside minimum objective of support not until around 1150-1160. Should we move toward this second path, one can imagine that any bounce from 1193 back up to the H&S neckline would be the critical moment of price momentum (or loss thereof) to watch.

But whichever of these paths actually transpires, within this ongoing topping process, we believe that consumer stocks will certainly under-perform in any last hurrah, and that stocks such as Waste Management Inc. (a beneficiary to the massive Katrina/Rita clean-up effort still to come over the next five years) will outperform.

Waste Management (symbol -- WMI) as a company trades at just 13x current earnings – far below 20-25x P/E levels seen in such competitors as Allied Waste, Republic Services, and Waste Connections. Yet its 11.25% 5-year EPS growth has actually been greater than both Allied Waste and Republic Services, and has not been that far below the earnings growth rate of Waste Connections. Arguably, Waste Management has also invested more in its infrastructure resources than some of these other companies, and post an accounting scandal back in 1999, has generally used more conservative accounting practices than some of its competitors. As of today, the stock pays a 2.6% dividend yield – higher than the 1.6% dividend of Republic Services and the zero-dividend policies of Allied Waste and Waste Connections.

Now think of this company in terms of the Louisiana clean-up. WMI holds the contract for much of New Orleans neighborhood trash pick-up. While in the very short-term WMI has lost a few trucks and revenue by not being able to reach its clients, and they also have problems finding workers in the area who are not displaced from their own homes, in the longer term, WMI will have tons of business – quite literally. A toxic brew of oil, chemicals, bacteria, debris, and garbage must be cleared and the ground scrubbed before New Orleans can be rebuilt. The landfill demand is somewhere north of 750 football fields piled 50 feet high with assorted stuff. While FEMA has already contracted with outside clean-up experts such as Ashbritt International and Phillips & Jordan to come into help with this effort, WMI owns eight landfills in the region, and all of them are up and running. They have 200 municipal garbage-hauling contracts. Louisiana has an estimated 30 million tons (75 million cubic yards) of debris to remove. For perspective, this is five times that generated by Hurricane Andrew in 1992. The 9/11 World Trade Center destruction only created an estimated 1.64 million tons of debris. At a pace of around 100,000 tons of removal per day, this is at least a year's worth of work. Some think it may take closer to 5-years to complete. Overall, Waste Management Inc. should be a most significant beneficiary of this situation.

Plus the chart of WMI (shown on the following page) appears to our eyes to be constructively poised. There are a number of different Fibonacci band rhythms in this chart (please forgive us), but clusters of upside target areas can be found near $36 at a minimum, $40.50 over the intermediate term, and perhaps $50 longer term. Principals of Sand Spring Advisors LLC are long this stock as an obvious fundamental play on the Katrina-Rita clean-up, and because of the positive technical picture.



But if we are taking long exposure in WMI, but doing so into an overall declining equity market, let us also propose "pairing" a long in WMI versus a short in the XLY Consumer Discretionary SPDR. Composed primarily (65%) of consumer goods and services companies such as Target, Walt Disney, and E-Bay, as well as restaurant and media companies (30%) such as Time Warner, Comcast, and McDonalds, the XLY should be a good representative benchmark short-sale to express the thematic view that the overly indebted consumer – now hit by high gasoline and heating oil prices, at the same time as mortgage refi activity is waning and interest rates are creeping northward -- will simply have to cut back on spending.

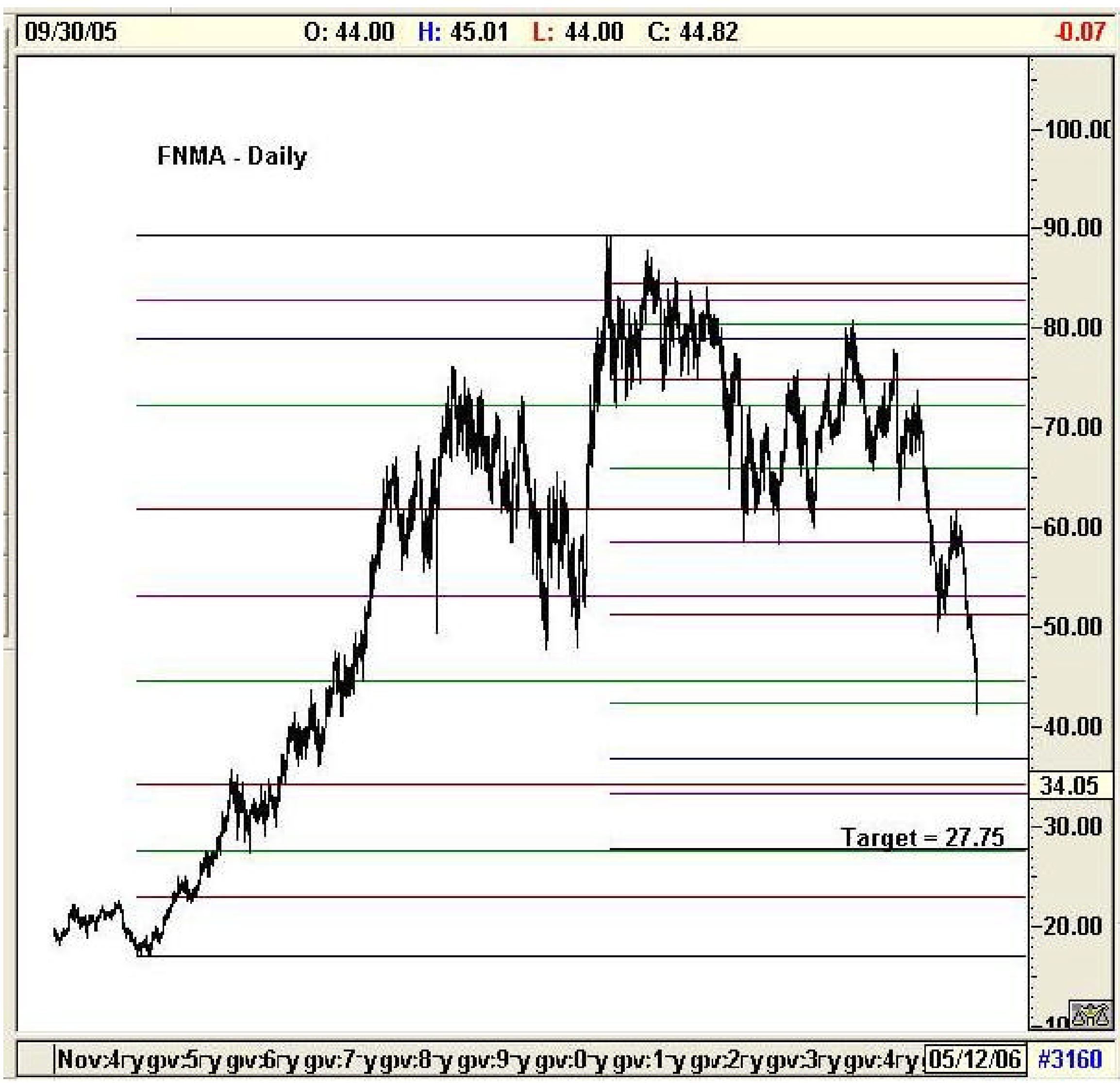
In addition, if at the end of the 2nd quarter, credit card delinquencies stood at their all-time high of 4.68%, one must wonder where they are today post Rita and Katrina? Car loan and mortgage defaults must also be creeping higher at present. That is why one may want to supplement any XLY short with short exposure to companies such as Capital One, Americredit, or Washington Mutual – all of which appear technically soft to our eye. As HSBC chief U.S. economist Ian Morris recently stated in a conference speech (paraphrased here): "If you think that there is a housing bubble or a bubble in credit underlying housing, you should not necessarily just go out and sell housing stocks. Instead, you may want to sell realtors who sell houses (since transactional volumes, if not prices, are likely to fall), the bankers who support the housing market (since defaults are likely to rise), and the debt providers that are behind consumer discretionary spending (since consumer weakness will show up in these areas first)." Translated more succinctly, even if house prices remain high for awhile longer, a mere slowing of transactional real estate turnover could hurt many other things.

Moving back to the XLY, its short-term 60-minute chart and longer-term daily chart appear below. We would be looking for an immediate new low in coming days down near $30.13 which fits nicely on an hourly rhythm basis, and also falls close to a 38.2% retracement of the entire daily chart advance between March 2003 and December 2004. Thereafter a bounce could occur back up to around $32.23, but longer term, this chart appears destined for downside levels between $24.40 and $28.30.

And when one looks at the dollar spread chart between XLY *minus* WMI, three downside targets emerge, while on a ratio chart of XLY divided by WMI, a 73.5% downside target is seen across several different Fibonacci rhythms. Since this ratio spread currently stands at a 113.5% level, all in all we are looking at a common sense trade that could experience a 40% gain if the Fibonacci rhythm seen here comes to fruition.

Another interesting statistic about hurricanes Katrina and Rita is that of the estimated $160 billion of damage, *only about half will be deemed insured* (net of no coverage for flood damage, etc). If one conservatively assumes that half of this uninsured property equates to real estate and that another half of this real estate is somehow ultimately held or financed by Fannie Mae (symbol = FNM), and some people walk away from their mortgages, one might end up assuming that Fannie Mae could soon own some $20 billion of defaulted properties literally under water. This is, of course, an overly simplistic mathematical exercise since Fannie does sell some of its mortgages to others in securitized form, but just for giggles, consider that $20 billion represents half of Fannie Mae's current total market capitalization, approximately the entire book value of the company, and more than a year's worth of anticipated revenue. With only $340 million of cash on its balance sheet (yielding a paltry Current Ratio of .57), and yet total debt footings of $940 billion, we've spoken before that FNMA would stand at significant risk to a major earthquake or hurricane. What would happen to them now if California were to experience a major earthquake? Is it merely coincidental that a new potential accounting fraud at Fannie emerged in the media last week, or is this company already sending "help signals" to the U.S. government that they have an increasingly difficult liquidity problem on their hands?

We would not advise selling FNMA into the hole right here. Vis a vis its potential spread revenue production, the stock's P/E ratio has fallen to single digit levels under 6 making it a dangerous stock to short at current levels, but technically we still see FNMA headed to around 27.75 over time.



As a side note, one might also look at the entire topping pattern of FNMA that transpired over 2004 as a potential "pattern match" leading roadmap for the price action that we eventually expect for the daily XLY chart above.

One must also remember that in a major poll conducted not that long ago, some 37% of foreign holders of FNMA debt did not realize that they were even holding the debt of a private corporation. These investors – both retail and institutional alike – believed instead that they were invested in straight U.S. Government paper. FNMA, as a GSA-entity, does of course offer at least an implicit degree of government support, but one must still wonder if increased problems at FNMA might not soon set off a general foreign selling spree of U.S. fixed income markets. In terms of simple 30-year bond yields, we are fairly confident that an upside yield target of 4.69% (near the 38.2% retracement of the May '04 to June '05 decline) will be seen shortly, and maybe even a second Fibonacci target up at 5.03% (61.8% retracement level).

But moving on to other markets, in our August 27th letter, we also wrote about Crude Oil:

"The week of Aug. 29, 2005 does represent the 21st cycle of 8.6-month mini-pi cycles from the August 1990 crude price high…Looking at the hourly rhythm of Oct'05 Crude futures, and stretching our Fibonacci bands up from the late May 23, 2005 Crude oil pivot low, we see an extrapolated line of resistance for Crude near $70.70. Could next week – or perhaps the PEI equity cycle date on Sep. 19th – bring such a high? We certainly will be on the lookout for a Crude reversal if $70.70 is approached during either of these periods."

Crude oil topped the following Monday, August 30th up several dollars from when we penned those words at $70.85 as Hurricane Katrina hit – albeit given the circumstances, this was admittedly a very tough trade to take on the short side. Perhaps this is what tops are all about – a moment of complete fear and panic when only an idiot or someone already long (or someone looking at Fibonacci rhythms like us) would ever dream of selling. This high has of course been followed by weeks when the media has consistently blabbed on about higher oil prices and future potential energy shortages, and yet the actual price of oil has *declined* significantly since Katrina rolled ashore. Of some note, crude did bounce into a secondary reaction high exactly on the PEI September 19th date. At this point we are opinionless to slightly bearish on crude, but see no easy risk-reward trades to really get involved with. It's time to simply leave this market alone for awhile.

So too is it likely time to harvest profits in the gold market. The media is currently abuzz with talk of $500 or even $1000 gold. But in our mind, the $475-$485 region (long a Fib target of ours) taken together with extremely high Bullish Consensus levels around 87, and high Commitment of Traders speculative buying, all suggests that this is a good time to book out at least a substantive portion of one's precious metal gains. Another slightly upsetting fact is that as gold has made new highs, silver hasn't, and metal stocks themselves have been lagging the price of the metal futures for sometime. This is less than optimal for the ongoing bullish case. Based off of Fibonacci extrapolated rhythms, there are just two levels to expect a silver high – either right around here or up around $9.22. If readers feel compelled to play for the bigger move up, we'd advise at least turning long positions into synthetic calls by adding some nearby put protection to holdings.

One market where we have not been astutely positioned is our bearish view of the U.S. dollar against the yen with a long-espoused technical target down around 96.50. Of late, people have wanted to buy the U.S. dollar for its increasing interest rate differential edge. Meanwhile the Nikkei has been very strong under the perception of a domestic Japanese economic recovery with real sea-legs, the anticipated postal system reform by Prime Minister Koizumi, and perceived U.S. dollar strength as something supportive to Japanese corporate profits. Call this a somewhat virtuous circle for the moment.

Back in earlier issues of Sand Spring's monthly missives and web postings, we too were more bullish on the Japanese equity market than we were on the U.S. equity market. We pointed at that time to a 13,632 upside target for the Nikkei 225 Index based on our extrapolated Fibonacci fractal daily price rhythms. Today the Nikkei 225 stands at 13,574, and made a high last week of 13,678. Here once again, we would advise taking money off the table. Current levels basically represent a 38.2% retracement of the entire 1996-2003 downswing in the Nikkei, and even if this market were to poke its way up to around 14,190, the entire region represents a logical area for a topping formation.

And as U.S. markets – both bonds and stocks --start to stumble lower, while metals and commodities also potentially stall, what might of course happen? At the margin, Japanese savings should pull out of foreign capital markets and move back into domestic Japanese short-term deposits. Ergo: the demand for safe-haven yen should rise. Thus we have not given up on further yen strength emerging over time. We have simply been early and wrong on this for now.

All in all then, multiple asset classes from equities, fixed income, to commodities could simultaneously fall over the next 4.3 months.

"But surely this money has to go somewhere?" many people ask.

Alas, what these enquiring people always forget is that *money does not necessarily have to go anywhere.* Instead, as ugly as it is to talk about, *wealth – poorly invested -- can simply be destroyed as asset prices fall.*

Send us your comments at information@Sandspring.com.

AN IMPORTANT DISCLOSURE

Sand Spring Advisors provides information and analysis from sources and using methods it believes reliable, but cannot accept responsibility for any trading losses that may be incurred as a result of our analysis. Our advice should be deemed our personal opinion and not a recommendation to invest. Individuals should consult with their broker and personal financial advisors before engaging in any trading activities, and should always trade at a position size level well within their financial condition. Principals of Sand Spring Advisors may carry positions in securities or futures discussed, but as a matter of policy we will always so disclose this fact if it is indeed the case. The principal of Sand Spring Advisors LLC is currently short XLY, short the U.S. dollar, short 30-year U.S. bonds, long Anglogold and other gold securities, and long WMI. We will also specifically not trade in any described security or futures for a period 5 business days prior to or subsequent to a commentary being released on a given security or futures contract.