Sand Spring Advisors LLC

Stubborn, Myopic, or Just Overly Cautious and Early?

by,

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March 25, 2006

A few readers have written in recently asking if we have not been too stubborn and myopically bearish on U.S. equity markets.

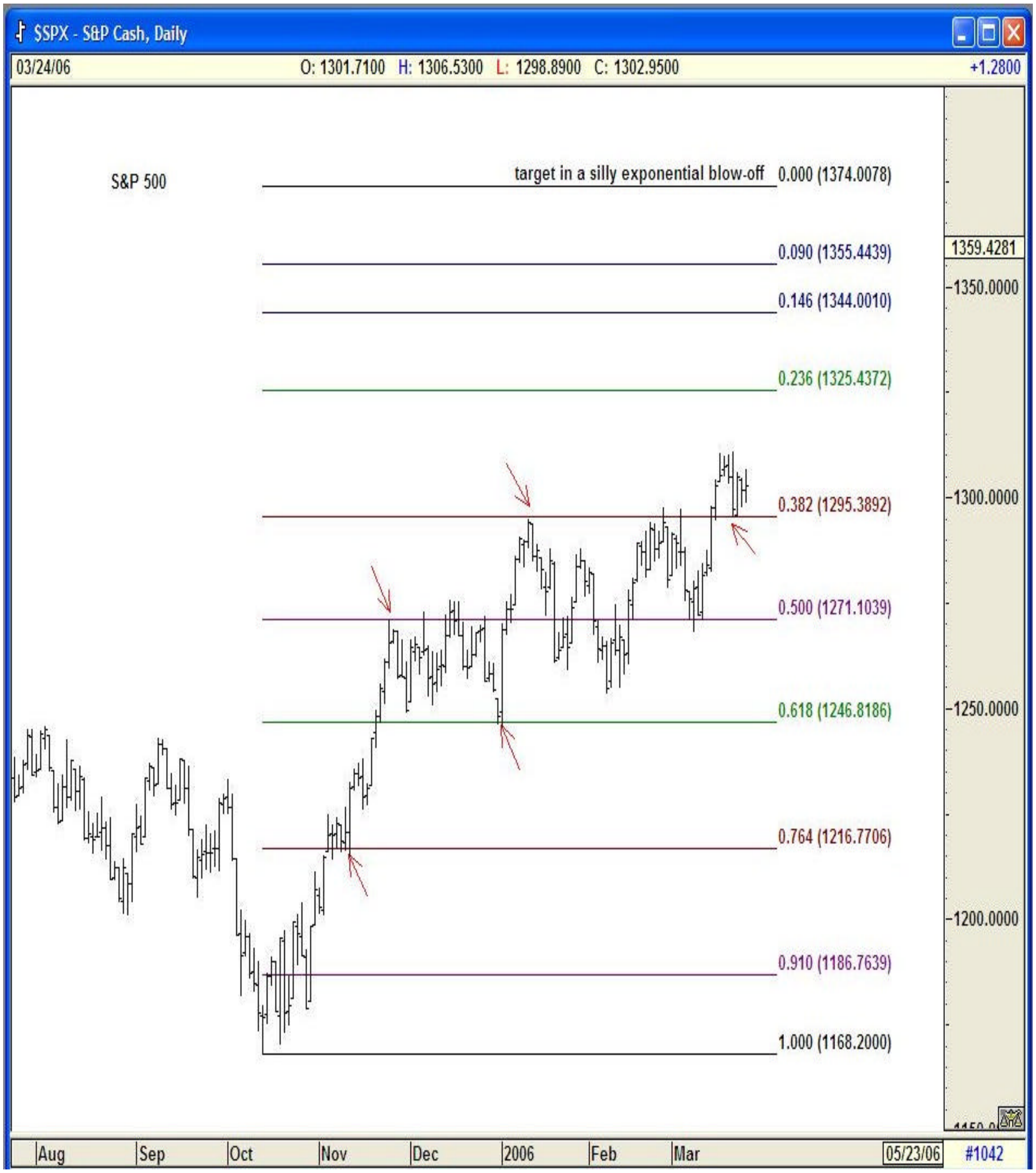
In response: we clearly have been, and we are contrite about all of our periodic "boy who cried wolf" warnings of an imminent turn lower in stocks.

First, last September/October presented us with an equity swan dive lower that we adroitly predicted – but one that we interpreted at the time as more sustainable into early 2006 than subsequently became the case. Then our 4.3-month PEI cycle date in late January 2006 looked like it was going to be a lovely set-up for a major high; but the ensuing downswing lasted just a few days. Then we became excited again about a potential top into the end of February. The Fibonacci day count perspective looked perfect for this one. Again, we got just a few days satisfaction before equities turned north in mid-March yet again.

Dare we cry wolf yet again? Or should we turn bullish?

In Sand Spring's e-mail box last week, one subscriber asked: "It's clear to me that this is a classic bull market that is climbing a wall of worry. All I ask is to just give me a level beyond which you won't be bearish anymore."

Fair enough – it is the goal of every good technician to pick a level to get out of the way of unexpected market action. Along these lines, we wrote to readers many moons ago that if 1260-1265 on the S&P were broken, then 1370-1375 would be the next major zone of Fibonacci resistance. Cyclically of course, our major 8.6-year PEI Economic Confidence Cycle will not peak until February 27, 2007. So we must be careful. Overall strength in the economy (or at least the perception thereof) could last all the way into that cycle window. While it has not been our preferred view, it is certainly possible that markets just push higher into this date in some sort of exponential feeding frenzy blow-off. Indeed, our most bullish potential Fibonacci rhythm on the S&P 500 daily chart is shown below.



But even if 1370-1375 is eventually seen, the path getting there is what we have been more worried about. We warned in our *2006 Overview* article published in January that from an astro perspective, the June-October period of 2006 looked particularly stressful. In our minds-eye, and widening our perspective from the daily S&P rhythm shown above to include more trading history, our favored view has been that a more volatile pattern would emerge somewhat similar to the path depicted below.

Frankly, e-mails like the few recently received also remind us of e-mails that we received during late September 2002 and early October 2002 when Sand Spring was actually bullish, and yet people were writing in asking: "At what level will you change your mind, and admit that a major crash scenario is about to unfold?"

In answer to this mindset, on October 1, 2002, we wrote in a public posting:

> **It is… becoming awfully chi-chi to be short. Perhaps it is just coincidence, but in the past two weeks I have met two hedge fund managers who were both mega-bullish in late 1999, and are now both mega-bearish. It makes my contrarian sensitivities bristle. The herd mentality is at work, and how these folks can look themselves in the mirror and live with their lack of personal creative thought -- both back then and once again now -- is hard for me to fathom.**
>
> **Similarly, Market Vane has now been registering a Bullish Consensus number well above 90 for the 10-year T-Note for multiple days now (somewhere close to 94 at present). This also makes my contrarian nature sit up and pay attention.**
>
> **Is the stock market really going to serve up a crash right now (as Robert Prechter appears to be espousing for those who may have read his latest newsletter)? Or does it make more sense for us to experience a surprise relief rally now, followed by a longer period of purgatory and "slow death by boredom" market that simply grinds lower (along the lines of Morgan Stanley's Barton Biggs' recent views)?**

Back on September 3rd, I espoused that a B-wave down would develop into a September 20-30th time window that would likely scare the hell out of people. That's what B-waves do (and has certainly done in this instance). I suggested this decline had a high probability to probe all the way to 814 on the S&P 500. The market went through this level a bit Monday on an intraday basis, but closed above it. Further short-term probing back down could yet occur. Maybe the S&P will even make new lows -- vis a vis its late July lows -- as the Dow and Nasdaq have already done. It's certainly possible. I do not want any reader to try being a hero at this point in time and use leverage to go massively long.

But what is the probability of a real crash from here, right now, into our early November cycle date?

If there is further weakness, I believe that it is <u>not</u> going to be "the 7,600 to 3,000 'air pocket' slide on the Dow Jones" that Prechter puts forward. With the T-Note Bullish Consensus already at 94, moves like that just don't tend to occur. Too much fear has already built up -- at least on a short-term basis.

So please do not call us perma-bears. We are not. We have been bullish in the past, and we admit in the present time that 1370-1375 on the S&P is possible – perhaps even probable – into the February 27, 2007 PEI cycle window.

But at the same time, we will say now that even if U.S. equities do continue to vault higher in 2006, it will hardly be worth playing, and anyone who tries to do so will be accepting too many unacceptable hidden risks. Bullish momentum traders may easily end up with their "heart in their throats" somewhere along the way.

Looked at another way, if the upside potential in the U.S. equity indices is at most 5-6%, and yet short-term money-market instruments yield almost the same returns with less risk of one's principal, which is the better investment in terms of risk-adjusted capital preservation?

So as a direct response to our reader's e-mail, and as a line in the sand, we will pack in our bearishness and shutter Sandspring.com if the S&P 500 were to rise above 1400 (allowing some cushion above 1375 for spike noise potential) in the coming year. We know that's not saying much given that the S&P is still some 7.5% below such a level today, but at the current time, when we combine the technicals and the fundamentals, it is simply very difficult to pick a magic level below there to flip a switch and be easily bullish. We are simply not good at playing a short-term "greater fools' game" of buying the market just because it has been stubbornly frothy to date. Instead, we prudently want to anticipate how and when that wall of worry may turn into a fast slide of acute pain. And it will – in time.

Let's go through a few of the risks as we see them today.

1) <u>Astro (short-term)</u>

In a recent e-mail, our astro-analyst friend Arch Crawford wrote to us:

"I started doing my annual overview letter of 2006. But to be honest, I choked on it, and never got past May.

I was looking at this month and next, and became astounded and horrified. The Solar Eclipse 29 Mar drawn for NYC has Stationing (same day) Pluto on the Midheaven – TO THE MINUTE (of arc)!

Terrorist event? – Possibly Nuclear?

Or maybe just a radiation leak from 3-Mile Island again.

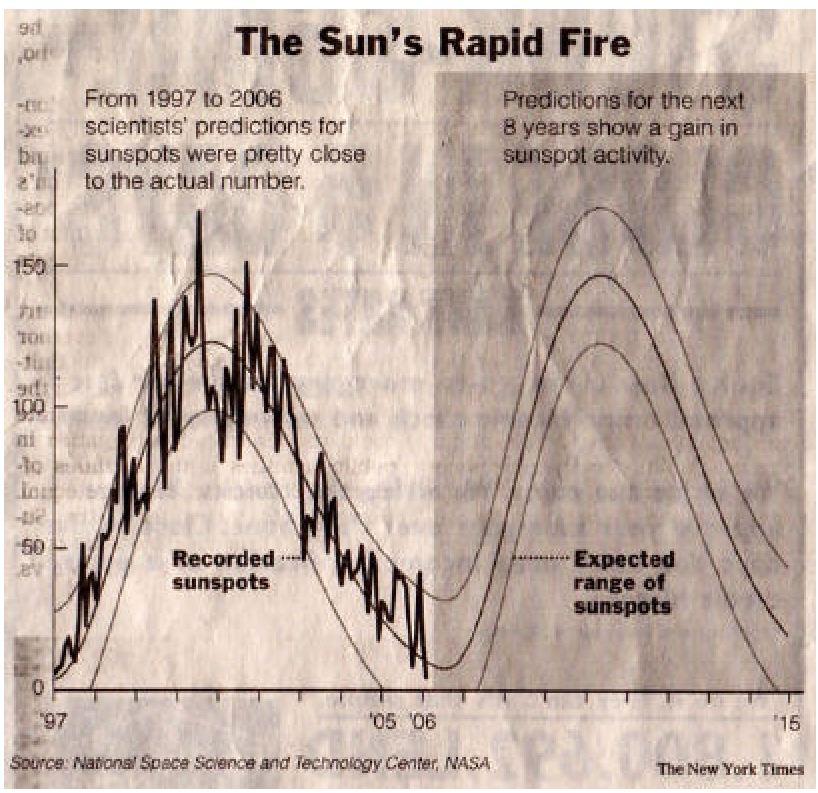
Then, Saturn station on Apr 4 has Mars negatively contacting BOTH Eclipses on the same day!

The Full Moon on Apr 13 is not pretty either."

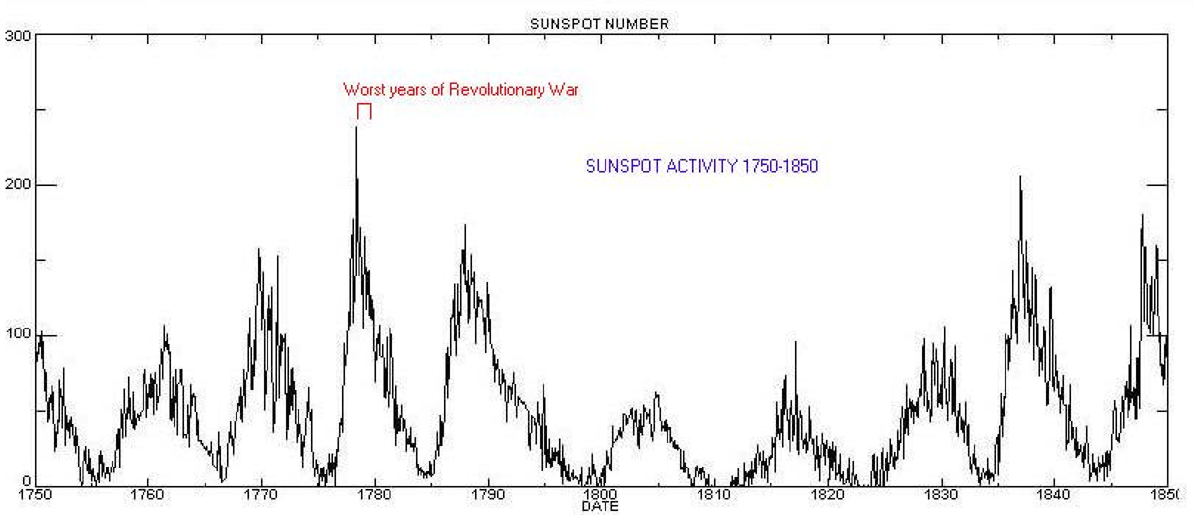
Here at Sand Spring, we are not ourselves astro-analysts, and admittedly, we have seen Arch Crawford sometimes highlight perceived stressful date windows that ended up passing benignly. But on more occasions than not, we have also seen Crawford be amazingly prescient. We specifically remember him nailing prognostications of both the Three-Mile Island and Chernobyl disasters to the day with similar type words as those above. Some of the trading sessions this past week were almost eerily quiet in small ranges. The market simply feels like it wants to break loose someday soon. Maybe Arch will nail the turn (and the cause of the turn) better than we have. It might be a good time to avoid New York City just in case. Of course, the astro outlook for mid-June-mid-October made by others (see our *2006 Overview* article, published in January) is also stress-filled. Only from mid-October into February 2007 do some of the negative astro influences abate.

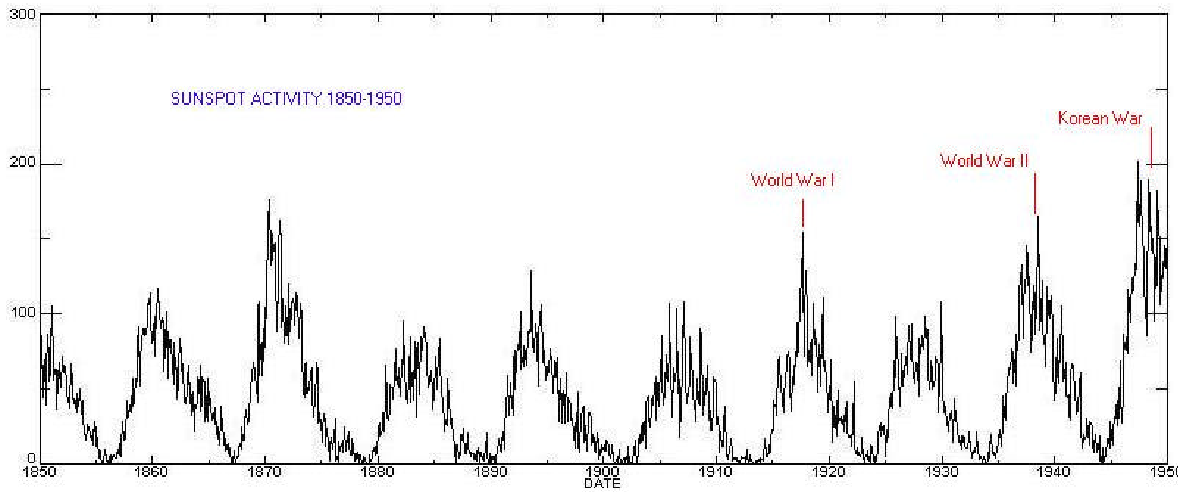
2) Astro (longer-term)

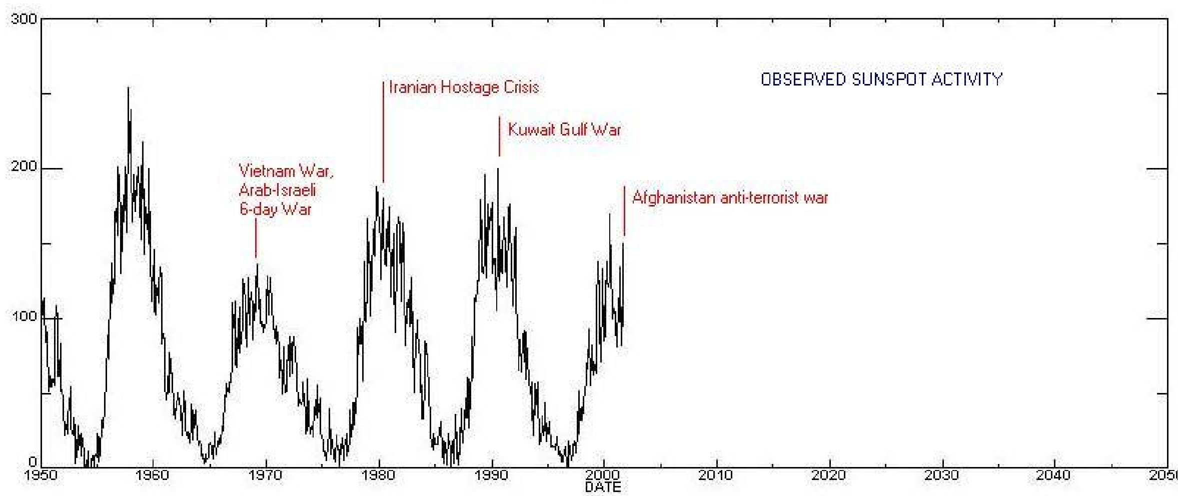
The chart below recently appeared in *The New York Times*, and shows the well-known 11-year sun spot cycle.



Back in 2001, we wrote about the sunspot cycle and its correlation of peaks to major wars across the centuries in Sand Spring article *The Cycle of War*. Some of our original charts from that article are repeated below.







Given what is happening in Iraq these days, one might hardly expect this, but as shown in *The New York Times* chart, the sunspot cycle is currently troughing at a low. It will soon be headed higher, and only due to peak toward the end of the Mayan Calendar in 2012. All of this suggests to us that while Mr. Bush may assure us of victory in Iraq soon, global geo-political tensions and violence are going to get *even worse, not better*. War will increase. With a 5-7 year view, it is hard to believe that markets will like this.

3) **Derivatives markets: CDS market has grown too huge**.

The magnitude of Credit Default Swap (CDS) market has become too large. CDS contracts now often dwarf the actual corporate bonds available to deliver in times of default. This has not been well publicized to date, but there has already been a great deal of funky price behavior in the corporate credit markets around default events. Specifically, starting last year with the Collins & Aikman default, on-the-fly cash settlement procedures have been adopted by the International Swaps Dealer Association (ISDA) in several instances. More recently, consider the extraordinary actions recently taken by ISDA to patch up the settlement of CDX and TRAC-X contracts that include Dana Corp:

> **(March 17, 2006, Rickcenter.com) ISDA yesterday announced the publication of a 'protocol' solution, created to facilitate settlement of credit derivative trades involving Dana Corporation, a U.S. company that filed for bankruptcy on March 3, 2006.**
>
> **Dana is an auto parts supply company that is included in various credit derivative indices, including those published by Dow Jones CDX and TRAC-X.**
>
> **The 2006 Dana CDS Index Protocol offers market participants an efficient way to settle trades on credit derivative indices that include Dana Corp. The Protocol enables institutions to amend their documentation for such index trades from physical to cash settlement and to participate in an auction, scheduled for March 31, 2006, which will determine the final price for certain Dana bonds. Markit and Creditex will administer the auction.**
>
> **"The Protocol mechanism continues to provide a uniquely effective means of ensuring a smooth settlement process for derivative index trades where a credit event has occurred," said Robert Pickel, Chief Executive Officer and Executive Director, ISDA. "All sides of the credit derivatives industry continue to work through ISDA to achieve a longer term solution, as set forth in its Net Physical Settlement Proposal."**
>
> **With the 2006 Dana CDS Index Protocol, ISDA enables parties to amend credit derivative index documents on a multilateral basis rather than through one-on-one negotiations between all counterparties. In addition to greater efficiency, time and cost savings, using the Protocol will provide enhanced legal certainty.**
>
> **Single name trades will not be part of the auction process provided for by the Dana Protocol. Thus, single name trades on Dana Corporation remain subject to the physical settlement procedures in those trades' governing documentation.**
>
> **The Protocol is open to ISDA members and non-members alike. The adherence period for the Protocol is March 16 to March 23, 2006. The text of the Protocol and form of adherence letter, guidance on the mechanics of the Protocol, answers to frequently asked questions and details on adherents, are all available at www.isda.org.**

Thus effectively, ISDA has contracts and delivery rules that are supposed to work, but the market is already resorting to one-off cash settlement "patch-ups" when these rules logistically fail to function. If and when GM declares a default, the CDS market will face its biggest test yet. Our longer term prognostication is that at some point new CDS settlement procedures will be implemented by ISDA during a period of stress that will end up being litigated. Perhaps a major derivatives counterpart somewhere will suffer a credit event themselves, and the "collectability" of these contracts will be more severely questioned than is the case today. People who own protection via the CDS market currently feel secure that they have hard and fast legally enforceable contracts. But if these people ever have trouble collecting on their insurance, the entire foundation of this market could come into question, and panic across all capital markets could easily ensue.

4) Does anyone care about Avian Flu?

It seems almost trite and "doomsday-ish" to speak of the growing risk of an Avian Flu pandemic, but consider the notes below taken by a friend while listening to a speech by Margaret Chan, Assistant Director-General--Communicable Diseases of the World Health Organization. Note in particular the section of these notes that we have highlighted in red.

1. There are three different kinds of flu that the media is discussing with some confusion.
Avian Flu. Seasonal Flu. Pandemic Flu.
How are avian, pandemic, and seasonal flu different?
Avian flu is caused by avian influenza viruses, which occur naturally among birds.
Pandemic flu is flu that causes a global outbreak, or pandemic, of serious illness that spreads easily from person to person. Currently there is no pandemic flu.
Seasonal flu is a contagious respiratory illness caused by influenza viruses.

ALL seasonal flus are of bird origin.
And almost all seasonal flus we have today are mutations of the last pandemic flu, 1968's H3N2.
These are called inter pandemic seasonal flus.
Annually approximately 500,000 people die of these seasonal flus globally. That is 499,896 more than have died so far from H5N1.
104/185 humans who have contracted the disease have died so far. This is a high fatality rate and one of the reasons they are worried.

2. We are not experiencing a Pandemic yet. To be called a pandemic there are several requirements that include: a. A new virus b. human infection and c. Sustained human to human spread of this virus. On their 5 phases of a pandemic, we are at phase 3. She admitted that they nearly declared a pandemic falsely in June 2005 based on suspected viral mutation in Thailand or Vietnam, but upon further examination they did not and she spoke of her relief at not causing a false panic. When H5N1 first raised its head in Hong Kong in 1997, it was harmless to ducks, geese and swans who were viewed as hosts of the disease. It scares them that it is now killing these hosts and has killed cats, leopards, tigers, and several other mammals. She spoke openly about what will happen when they "push the button" to take this to level 4 or straight to 5. "This will create a financial panic and people will drastically curtail their travel voluntarily."

3. To date, 180 million birds have died or been culled in the spread of this H5N1 strain. This has cost the world approximately $10 billion. But this number vastly under estimates loss from the fall in poultry and egg prices.

4. Between the 2003 re-outbreak of H5N1 in Asia through 2005, 15 countries experienced infection of birds, wild or domestic, by this bird flu. In the last 2 months, 30 more countries have experienced this flu. This geographic expansion has worried the WHO. She alluded to under reporting on the two continents that have not yet reported incidences of bird flu, NOAM and SOAM. "What you do not test for you cannot discover."

5. The scariest outbreak she's seen so far was in Turkey where the cases of human infection were in clusters and were coming in a pattern that warns the WHO of possible human to human infection. Upon further investigation, they found that most of the infections came after a cold spell where the Turks were bringing their family chickens into their homes. Then after killing and eating them, the children were playing football with the heads of the dead birds. She said the risks are extremely low, in the current environment (before the mutation to a killer pandemic flu), for those of us living in the first world and not playing around with

chicken parts to contract this disease. She advised that children never be involved in the preparation of poultry and reminded us that its not just bird flu in poultry but the Salmonella and other bacteria that make it a bad idea at all times.

6. She said that she is still eating chicken and eggs and duck regularly and has no fear of spread in this fashion. Beef was wisely served at lunch.

7. She didn't present a roadmap of what happens next because she was humble enough about the disease's possible mutations and its spread. She said their job was to inform, educate, observe and gather intelligence daily on the spread of the disease.

If and when the CBS Evening News reports someday that Avian flu has mutated to human-to-human transmission, it will be an ugly day in financial markets. Will one really want to be playing the greater fools' game of being invested in a portfolio of growth stocks? We think not. Avian Flu may already be out in the open and perhaps somewhat over-hyped by the media. But this does not mean that it should just be written off as being unimportant. Sometimes even the most obvious and over-hyped things *do get worse*.

5) Protectionist pressure is rising. This is bad.

Starting with the blocked Chinese bid for Unocal last year, and repeated with the recent hullabaloo over the Dubai Ports World potentially becoming the operating owner of many U.S. ports, the American reaction to foreign money being recycled into the U.S. via direct corporate investment and takeovers has already become more protectionist. The message being sent is: "Foreigners are welcome to buy our Treasury Bonds, but please don't try to take control of too many of our companies." Americans want to "have our cake" (huge foreign trade deficits financed by debt issuance) and "eat it too" (still maintain control over our own corporations). Longer term, this mixture can't last.

Meanwhile, pressure is increasing in Congress to pass some sort of tariff on Chinese imports to "punish the Chinese for not revaluing their currency fast enough." The recent Reuters blurb below highlights the push:

WASHINGTON, March 15 (Reuters) - Two U.S. senators have scheduled a news conference at 10:30 a.m (1530 GMT) on Wednesday morning to discuss plans for an expected trip to China and legislation threatening that country with across-the-board U.S. tariffs if it does not revalue its currency.

Sen. Charles Schumer, a New York Democrat, and Sen. Lindsey Graham, a South Carolina Republican, have been expected to travel to China this month to urge the Chinese leadership to take action on currency and other issues.

The senators are co-authors of a bill that threatens China with a 27.5 percent tariff on its exports to the United States if does not revalue its currency within a specified period of time. That measure got the support of 67 senators in a procedural vote that took place nearly a year ago.

The senators have been promised an up-or-down vote on the bill by the end of March and have been expected to decide after their trip whether to have one or not. Each time, a previous deadline for a vote on their bill has approached, the senators have agreed to a delay to give China more time to act.

((Reporting by Doug Palmer, editing by Neil Stempleman; Reuters Messaging: doug.palmer.reuters.com@reuters.net;

American hubris is amazing, and our trade policy is headed in the wrong direction. Someday, if we push too hard, the growing protectionist mindset in America is going to cause major problems. In addition, as a side note about protectionism, many European countries also continue to bristle about the recent increase in cross-border takeovers. Pressures and tensions within the European Monetary Union are certainly increasing.

6) There is no China growth story if China continues to pollute its land and people at the pace that has recently been the case.

At some point every day on CNBC, the China-Asian growth story is currently discussed with much reverence and enthusiasm. But in our mind, there is no China growth story if China cannot stop polluting itself – particularly in terms of its water supplies. Consider the excerpts below from two articles. Is this progress? Is this type of thing sustainable?

> **Pollution is worsening water shortages as factories dump waste into rivers and lakes, says Marcus Lee, an officer with the Nairobi, Kenya-based United Nations Environment Program and the author of a study on China's water supply.**
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> **Seventy per cent of China's rivers are contaminated by toxins, according to the water ministry.**
>
> **In November, a nitrobenzene spill at a PetroChina Co refinery in the north-eastern province of Jilin forced authorities to temporarily cut water supplies to more than three million people. The incident prompted the resignation of China's environmental chief.**
>
> **A tributary of the Yangtze River, China's longest, was polluted last month after a zinc smelter spilled cadmium, a toxic metal that can cause neurological disorders and cancer.**
>
> **In Liukuaizhuang, a village of 6,000 people near the northern city of Tianjin, water pollution drove the cancer rate to 25 times the national average in 2004, the government-run People's Daily reported last year, citing an investigation by China Central Television, the state broadcaster.**
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> **Wang Fengtao, a farmer in Liukuaizhuang, blames the cancer rate on paint and chemical factories that dump waste into the Fengchan River and canals that run through the town. 'The water in this village stinks,' says Mr Wang, who uses river water for irrigation and drinks bottled water. 'We've complained to government officials, but nothing much is being done.'**
>
> **[In addition to major pollution issues over the quality of water in China,] shortages [of water itself] are most acute in arid north-western provinces such as Gansu, Inner Mongolia and Shaanxi. China's northern provinces are home to 45 per cent of the nation's population and just 19 per cent of its water resources, says Yukon Huang, a Singapore-based adviser to the World Bank who headed the lender's China unit until July 2004. 'There's growing tension among rural interests, urban interests and factories over who gets water in China,' he says. 'Water will become a major problem for China in the next decade.'**
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> **A lack of basic resources such as water will undermine the government's goal of extending economic growth to the rural majority, says Chris Leung, an economist at DBS Bank Hong Kong Ltd.**
>
> **'If you deny such a large portion of the population the opportunity to generate wealth, it will be difficult to sustain the current economic growth,' he says.**

WULI VILLAGE, China - Wei Dongying dumped 30 plastic bottles from an oversized plastic bag onto her living room floor.

"Look at all the different colours: red, black, yellow, brown," said Wei as she picked up the bottles containing samples of water taken from the canals and viaducts surrounding Wuli, a village of 1,500 people in eastern China.

"The water used to be clear here. Now look at it. Filthy, undrinkable polluted water."

Wei, 38, is a fisherman's wife who became an environmental activist after a personal health scare she believes was related to the intense pollution in the village.

In late 2002, Wei discovered two hard lumps on her lymph nodes.

"I had them removed and the doctors said it was a 90 percent chance that the problem was related to the environment," said Wei, 38, rolling down her collar to reveal the scar across her throat from the operation.

Although her growths proved benign, about 60 other Wuli residents have contracted cancer, including her brother-in-law who died in 1998 at the age of 47.

Wuli is described in China's media as being one of the nation's so-called "cancer villages", a legacy of the pollution caused by a chemical industrial park with 25 factories that was set up there in 1992.

Located about 220 kilometres (135 miles) southwest of Shanghai along the Qiantang river, it is not just the water that has been degraded but also the air.

Gaseous, bitter chemicals assault the nose, lingering on the tongue and itching the throat.

The situation in Wuli is a depressingly familiar one around China, especially along China's heavily industrialized eastern beltway where factories take advantage of the natural waterways to expel toxic waste.

More than 70 percent of China's rivers and lakes are polluted, while underground water supplies in 90 percent of Chinese cities are contaminated, according to government reports.

Chen Weifang, vice chief of the Xiaoshan district environmental bureau that has jurisdiction of Wuli, said one of the main problems was that fines for polluting factories were too low.

The factories often discharge their chemicals into the water at night to avoid detection and are happy to pay the fines when they were eventually caught, according to Chen.

Corruption involving industry and local government officials is also widely regarded as a major problem, environmental activists say.

Meanwhile, on many factory walls in the village, such as the one at the Hangzhou Dazhan Biochemicals Company, are notices calling for the environment to be protected.

"Control the pollution in order to survive, protect the environment to develop," the notice reads. "The protection of the environment is everyone's responsibility."

Chen said that while the rates of cancer in the village were not higher than surrounding areas, he still believed there could be a link between the pollution and the deadly disease.

"To be frank, I think it (Wuli's cancer rate) would be much lower if the village were not polluted," Chen said.

The story is disturbingly similar across the border in Jiangsu province, if not worse.

> **In Yixing, a city of more than one million people, water pollution in its townships is so severe that the area has received numerous official visits by top party brass, including Premier Wen Jiabao.**
>
> **Wen admitted at the end of the China annual parliamentary session in Beijing last week that the ruling Communist Party had allowed the unbridled economic expansion of the past two decades to severely damage the nation's environment.**
>
> **"We need to step up our efforts to carry out special environmental and ecological campaigns. ... we need to pay attention to the protection of major waters, air and land," Wen urged.**
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> **But amid the heightened party worries that China's growth model is environmentally unsustainable, little is being done because immediate economic interests continue to come first, environmental activists say.**
>
> **"The government and industry are connected to each other like a chain, they are inseparable," said Wu Lihong, a local environmental activist in Yixing.**
>
> **"The central government is good but it can't see what's happening here with the local government colluding with the factories." - AFP/ir**

Note to investors – particularly those who want to continue to trade from the long-side: figure out which companies in Asia will help solve China's pollution and water problems, and you will likely find in that research a compelling longer-term investment. A good place to start such research is located at http://www.summitglobal.com/water_articles.html -- a selection offered up by John Dickerson of Summit Global Management, a hedge fund manager that we know and respect involved in playing this theme.

Lastly, for those still bemoaning our inability to "get with the program and be bullish," remember that our very strongest idea from earlier this year was the spread trade of being short the XLY Consumer Discretionary ETF versus being long Waste Management (WMI). We specifically espoused a downside target of this spread where XLY should eventually be trading approximately $7 below WMI. The recent bull market moves notwithstanding, this spread has moved steadily towards our target. Watch the website for ongoing updates covering the XLY-WMI spread trade, as well as other security-specific views.

Send us your comments at information@Sandspring.com.

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