Sand Spring Advisors LLC

Ugliness Coming

by,

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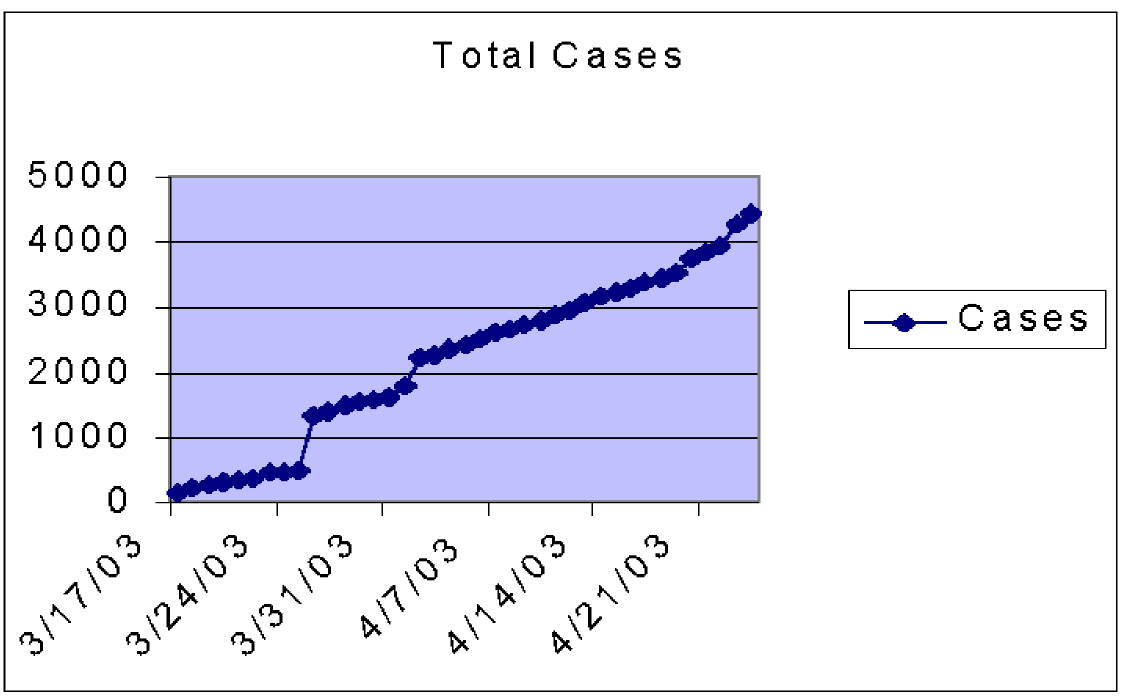
The past two months have in my opinion been the most irritating and difficult to trade of the past three years. Markets have zigged when they were supposed to zag, and being short "frothy" names such as Amazon or eBay has been nothing short of just plain painful.

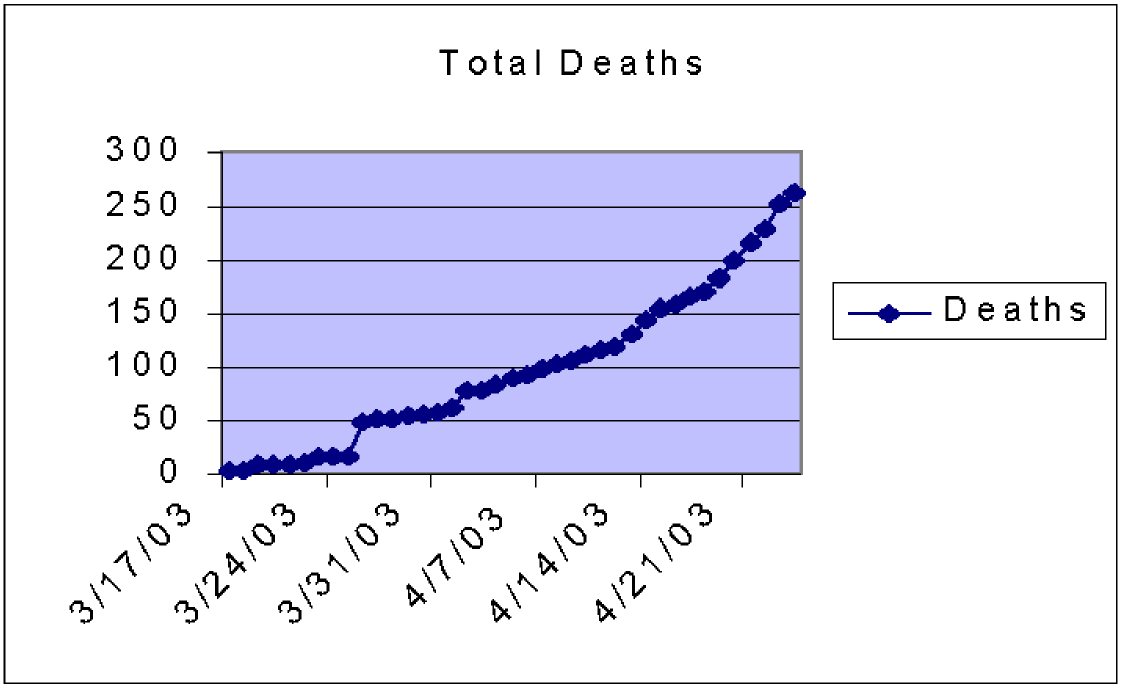
While my personal trading account for 2002 was up greater than 25%, within a few week period between early March and early April, I suddenly found myself in a –7% drawdown, and I didn't like the feeling. I thus must admit that one day in early April I simply walked into my office and cleaned out many of my prior individual positions. I did so not because I had changed any of my technical views, but more from a risk management point of view and in an effort to cleanse my mind. In the end I left myself with a more simple portfolio of three core positions: long Sky City Entertainment & Canbet (see the May 2002 Sandspring.com article "In Search of Survivable Themes"), short a bit of the S&P, and holding a bunch of cash awaiting the opportunity to go more short the S&P. In the past week I have started to add to my S&P short once again.

Now don't read this as any specific instruction to alter your own portfolio to a similar fashion. All of our technical and fundamental work still points to negative moves still in the offing for such stocks as Novellus, KLA Tencor, and Dell. Deere, Walmart, Mattel, Caterpillar, and P&G are still high on our radar as attractive short candidates as well. Ditto Tiffany's and Citigroup. Even that lone strong holdout within the Dow, the 3M Company (MMM) posted a pretty nasty reversal last week, as people started to anticipate 3M's global sales will be hurt by the SARS epidemic. Notably, 3M actually even makes the 95% particulate surgical masks that you see everyone in Asia wearing, but its other Asian sales apparently stand at more risk than the bonanza in surgical face mask sales is worth.

And what of SARS? Some say that it has been blown out of all proportion by media hype. Others, such as Morgan Stanley's Stephen Roach point to it as the likely catalyst for the onset of a global recession.

Despite the World Health Organization's best efforts, SARS is certainly not "under control." Instead, the number of cases and deaths, while still small, appears to be growing – and doing so with an exponential type of appearance. (See charts below.)





Few of this generation may realize that in 1918, the Spanish Influenza swept the world in an era when global travel was far more limited than it is today (but admittedly, health practices obviously less advanced as well). Unlike SARS, which first surfaced in China, the 1918-19 health disaster began in the United States. The influenza pandemic of 1918-1919 eventually killed more people than World War I - somewhere between 20 and 40 million people – one of the most devastating epidemic in recorded world history. More people died of influenza in a single year than in four years of the Black Death bubonic plague from 1347 to 1351. In the United States alone, this flu hit 20 million Americans, and killed a staggering 675,000 Americans -- as many as died on both sides in the Civil War.

Now we are not medical experts at Sandspring.com, but we do read that "SARS flu-like symptoms, accompanied by fevers of 100 degrees or higher, pneumonia or pneumonia-like symptoms, breathing difficulties, coughing and shortness of breath, are about identical to those seen in the WWI-era pandemic."

And while we have also read that the onset of the summer season may help squash the virus, it is interesting to note that the first outbreak of the 1918 Spanish Influenza came on March 11, 1918 – almost the exact same date that SARS appeared in 2003. The summer of 1918 did not kill that prior virus, but instead, the virus lingered into the fall of that year, and truly blossomed in October and November 1918. In that latter month 14,000 Londoners alone died from the flu.

At Sandspring.com we have previously espoused a 17.2 year (2 * pi* 1000) rhythmic cycle to the world. Coincidentally perhaps, five 17.2 year cycles from 1918, or 86 years = 2004 – a period we have long anticipated will usher in relative investor despondency and debt deflationary forces. Could SARS now be the added trigger (let that read "excuse") toward this vision being fulfilled?

Even if SARS comes and goes without the huge death toll that the 1918 flu brought, let us imagine just the psychological reaction of the markets if and when the first SARS cases or a first SARS death is reported within New York City. This is of course a realistic probability in the upcoming months.

All of this is worrisome enough. But we are also at a point in time where the U.S. may have won the war in Iraq, but still risks losing the peace.

Those familiar with 16th Century prophet Nostradamus may remember from his Quatrains that he talks of a third Anti-Christ named Mabus rising up out of the Middle East to cause havoc to the world. The word Mabus read backwards in a mirror equals Sudam, so presumably Saddam Hussein was or is the third Anti-Christ, with the first two antichrists having been Napoleon and Hitler. But Nostradamus also predicts that this third anti-Christ is killed relatively early on in global tensions. Quatrain II: 62 specifically suggests that it is only *after* the death of the third Anti-Christ, that something very bad occurs:

> Mabus shall come, and soon after shall die,
> Of People and beasts shall be a horrible destruction,
> *Then on a sudden the vengeance shall be seen*
> One hundred powers, thirst, famine, when the comet shall run.

While it might be possible to interpret the third italicized line as referring to America's vengeance for 9-11 and our actual swift attack of Iraq, there are obviously more sinister possibilities as well.

And what of the "comet running" portion of this Quatrain? Surely most people might imagine that such a reference might refer to a year when Hailey's Comet or Hale-Bopp or some other comet might appear in the skies. To the best of our knowledge, nothing of the sort is expected for 2003. But don't forget that we just saw the Space Shuttle Columbia streak across the sky in its unfortunate disintegration. To Nostradumus, five centuries ago in some murky nighttime vision, might such a streak across the sky have been best described by him as a comet?

Here's one truly scary last thought along this vein: Given the squalor and poor health conditions already in China and the Middle East, what might ever happen if SARS somehow made its way westward from Beijing into Iran and Iraq? Could this cause a mass exodus of the Islamic population toward Europe trying to escape a deadly virus? Don't laugh, but this is exactly what some Nostradamus experts claim his predictions eventually foretell.

Back to Economic Basics

But let's put away these prospects of potential doom and gloom, and focus instead on current economic reality. In our mind, the equation of the current situation is simple. Post the equity valuation excesses of 1999, America found itself with an overly naïve investing public that had misplaced expectations on the "long-term" return profile of buy and hold equity investing. This mindset left many investors "frozen in the headlights" when the 2000-2003 bear market hit, and most remain that way today. We must then add to this situation a strong dose of consumer and corporate debt built up over 20 years of Fed economic manipulation to avert or dampen each and every period of economic stress that came along. And we must further add a slow gestation period for many of the implications of the recent bear market to become fully apparent to investors courtesy of complex FASB 87 accounting. FAS 87 has specifically caused billions of dollars of real equity market losses incurred over the past three years to yet be realized on an accounting basis by corporate America.

Add these three things together and what do you have? In the words of one astute pension fund consultant: "It's like watching a train wreck in slow motion. You can see the disaster coming, but there's not much anyone can do about it."

According to a recent study by Milliman USA, over the past two years, there has already been a $340 billion loss in funded status by the 100 largest corporations in America – but this is only what actuarially needed to be accounted for. The longer the bear market lingers, the worse this problem is going to become if future return targets are missed. These return assumptions are currently still up around the 9% annual level. As of 2002, 87 out of the 100 companies surveyed were already in a pension funding deficit compared to 60 in 2001 and only 20 in 2000. This has forced corporations to step up their new funding contributions from $9.2 billion in 2001 to $33.6 billion in 2002, and to an anticipated number of at least twice that size in 2003. In lean cash flow and economic times, most of these added contributions have been made either in corporate stock (dilutive to shareholders) or by additional borrowings (adding balance sheet leverage), or a combination of the two paths via convertible bond issuance.

And people are starting to realize the problem. Sandspring.com first wrote about the pension fund situation in late March 2002, noting GM's pension problems in particular. It took the *New York Times* until September 2002 to offer the topic similar attention, and that paper only did so after a major Wall Street firm finally downgraded GM on the basis of its pension liabilities. GM stood at $60.50 when we first wrote about it, just under $40 when the *Times* finally got around to the topic, and at $35.60 today.

But since then, the light bulb has continued to "click on" for more and more analysts and investors. "I have gotten more questions on pension plan discount and return assumptions in the last year than I have over the past 15 years," said John W. Ehrhardt, Principal and Consulting Actuary of Milliman at a special presentation on pension accounting that we recently attended.

And well people should ask, as Ehrhardt estimates that every 1% drop in corporate pension return assumptions causes an $8 billion immediate hit to the bottom line of the 100 companies Milliman surveyed. Of the Milliman survey, those with the most underfunded current status included:

	Current Pension Funding Level
Proctor & Gamble	44.8%
Northwest Airlines	48.3%
ConocoPhilips	49.3%
ExxonMobil	50%
Valero Energy	53.1%
Hartford Financial Services	57.5%
Delphi	57.9%
Delta Air Lines	58%
Visteon	59%
Cigna	59.3%

And yet the longer the bear market carries on, the worse this problem is going to get. Ehrhardt summarizes: "The 1990s were not normal in terms of pensions. The days of pension holidays are now over and companies are learning the funding rules all over again. Companies are also learning that they must look forward and anticipate a bit, or else risk hitting a double cash funding need just at the wrong time. The IRS now actually requires that pension contributions be made quarterly instead of just annually. In 2002, many companies came very close to minimum corridor tests on actual asset values versus pension liabilities. Companies that faced such a situation added contributions to their plans in order to avoid dramatic balance sheet write-downs that would have been akin to falling off a cliff. Such an accounting nightmare had to be avoided at almost any cost."

"But can't some of these plans just be terminated or truncated somehow into lump sum payoffs?" we asked.

The answer came back: "Future benefits for employees for work not yet completed can of course be changed -- negotiated lower -- and we are currently seeing much of this in the airline industry and elsewhere. Future benefits for new workers are getting cut, and corporate contribution matches eliminated. But early termination of pension liabilities that have built up from past years would in most instances be financial suicide for companies. It would accelerate the realization of equity losses from the past few years by taking away the accounting façade that future return assumptions will be sufficient to fully fund plans. For most companies, it's really too late to think about the lump sum plan termination route."

We continued to question: "But if plan termination is not an option, do we risk a 'death spiral' someday where pension plans decide that they have a 'bet the company' type situation on their hands and decide to simply dump their equity portfolios before it is too late?"

Answer: "So far, only Boots in the UK has followed that route, doing so in early 2001 when they replaced their entire equity portfolio with high grade debt. If more people follow their example, you certainly don't want to be dallying by the equity exit doors too long. But at current equity vs. fixed income price levels, it's almost assuredly too late for most corporations to get whole if they were to do this now."

Question: "So what are most corporations going to be able to do?"

Answer: "Some may decide to move more marginal dollars into alternative asset classes like hedge funds, but in general, most will simply *hope* that the markets come back. If the markets don't, then they will be forced to reach again and again into their corporate coffers to increase plan contributions."

Our end-all conclusion from this discussion thus becomes: *An entire group of investors is currently underwater on their portfolios, but not yet close to being marked-to-the true-market on these positions, and are simply depending mostly upon hope and patience alone to get bailed out. This is a bad situation that is likely to get worse.*

Congress is, of course, currently mumbling about relaxing pension unding burdens on corporations. The excuse being focused upon is that many corporate pension liability calculations were hurt by the Treasury's elimination of the 30-year Treasury security which made 30-year rates plunge perhaps more than they otherwise would have done. Lower rates equate to a higher present discounted value of future pension liabilities. But according to the same Milliman expert, "This proposed new law is like a drop in the bucket. Even if enacted, it would only really help those corporations that can still elect a lump-sum payoff, so you might see a bit more of that type of path taken, but that's about it."

But let's move back to that list of large companies with pension fund shortfalls. The real question is not so much the "percentage funded" or "underfunded" that a given company may be running, but how much this underfunded status represents in relation to total annual earnings. Put another way, let's assume an average pension fund life of say 15 years per plan, and just consider past pension liabilities that are currently underfunded when true mark-to-markets are used without considering the further liabilities that will be created in the future. How much would annual pension contributions deduct from future annual earnings should portfolio investment returns average 0% instead of 9% in coming years? This is an overly simplified and generous question of course since the underfunded status of corporations would only grow worse under such circumstances, but offsetting this generous assumption, one must also remember that companies often borrow funds to make contributions, and thus can temporarily lesson (hide) the immediate impact on earnings. In any case, these procedural problems to our question recognized and admitted, here's a new list sorted by the largest gross underfunded plans:

	Total Underfunded Amt at end of 2002	/15 years =annual contribution required	% Drag to annual net earnings (if profitable) *or* % Drag to annual cash flow (if not profitable)
GM	$25.4 billion	$1.7 bln per annum	90.6% of earnings
Ford	$15.6 billion	$1.0 bln per annum	6.5% of cash flow
Exxon Mobil	$11.3 billion	$.75 bln per annum	6.7% of earnings
Boeing	$7.1 billion	$.45 bln per annum	18.8% of earnings
IBM	$6.4 billion	$.42 bln per annum	12% of earnings
Delta Airlines	$4.9 billion	$.32 bln per annum	(earnings and cash flow both negative)
DuPont	$4.4 billion	$.29 bln per annum	15.8% of earnings
Lockheed Martin	$4.2 billion	$.28 bln per annum	55.4% of earnings
Delphi	$4.0 billion	$.27 bln per annum	79% of earnings
Northwest Airlines	$3.9 billion	$.26 bln per annum	260% of cash flow

None of these situations is enviable. The cross section of our two lists specifically include Delta and Northwest (Does President Bush realized how serious the airline solvency situation in America really is?), as well as Delphi – a stock that on the recent rally bounced some 33% from its $6.39 low. We would not want to be long Delphi at its current $8.34 level.

And how is it that stocks with such poor pension fundamentals as Delphi had such a large bounce recently? From a sentiment perspective, one statistic that existed throughout most of April was that Market Vane's Bullish Consensus measure on the S&P 500 was a bit low – hovering down around the 33% bullish level. In addition, anecdotally, *Barron's* sported a cover in early April warning of "Internet Bubble II." Clearly, the market was a bit skeptical, and yes, in the short term, the market climbed this "Wall of Worry." But today, notably, the Market Vane stats on the S&P are back above 40%, and the *Barron's* front page is entitled "High on Wi-Fi." More complacency appears to rule once again -- ironically just as the market is starting to show signs of a downside reversal.

Plethora of Problems

Overall, therefore, we see the unfinished Middle East situation, some nasty prognostications by Nostradamus for the global environment post the death of the third Anti-Christ, a SARS epidemic that could potentially get truly nasty or at least scare the hell out of people, an over-indebted consumer quickly drawing down the recent refinancing of property values, and a pension accounting nightmare in corporate America that is surpassed only by that of Social Security and most public pension plans.

The market may recently have been climbing a proverbial "Wall of Worry" (as real bull markets sometimes are known to do), but where is the potential escape valve to the current situation to really warrant a new bull market?

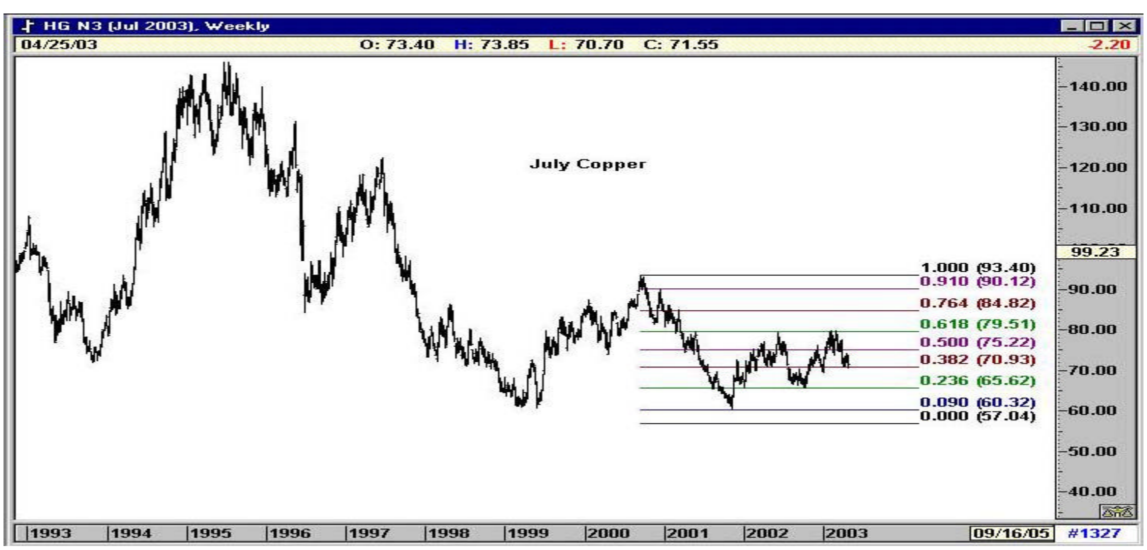
Some might point to lower oil prices as the economy's potential savior. This is possible, of course, but will such an occurrence really be enough?

Others may point to Mr. Bush's proposed tax cut – if he can get it passed. Attached to that tax bill, one of our subscribers has written in to say that there is apparently another bill under-appreciated at present. This bill, the Homeland Investment Act, could potentially offer US multinationals a one-year tax holiday on foreign earnings that are repatriated. Some have estimated that this could cause $135 billion to be brought home (a quarter of the U.S. current account deficit!). But any such sudden fund flow would also drive the dollar higher and immediately hurt sales for U.S. exporters. If this bill is passed, it could indeed be a short-term shot in the arm to major U.S. corporations, and there might certainly be more cash sloshing around U.S.-based coffers (likely to be put into pension plans instead of issuing more debt), but exports would also likely take it on the chin. More on this bill can be found at: http://treasurystore.com/search/search_article.cfm?areaid=1222, but what we'd really like to know is: Who dreams up these types of one-off schemes?

Whatever the short term attempted machinations to prop up he U.S. economy, we think that the time is quickly approaching when the piper will have to be paid. The time is quickly being reached when two decades of debt-induced spending will hit a brick wall and when no matter how much the Fed tries to print money, the multiplier effect of money will still slow as people feel compelled to pay down debt and attempt to save rather than consume.

In the long-term of course, inflation will win. But in the short-term (let that read 2-3 years) debt-deflation could rule. The housing boom has past. The bulk of mortgage refinancing has past. Now we await the almost inevitable realization that "rabbit-out-of-the-hat" one-off get-well solutions have largely been used up.

This is why, we remain steadfast in one of our strongest technical views of 2003: copper is headed to new lows of at least 57 cents (approximately a 20% decline from current levels) and perhaps substantially lower. Something on the order of a third of global copper production ends up in home construction, but after the rate-induced home building boom of the past three years, the price has only been able to muster the most feeble of rallies. It is technically missing at least one more new low. The Fibonacci rhythm of the chart pattern shown below almost demands such, as would most Elliott wave analysts who would be unimpressed by the non-impulsive overlapped a-b-c rally that has transpired since November 2001.



And if copper goes down, and the consumer is scrambling for liquidity to service and pay down debts while corporations are scrambling for liquidity to fund pension plans, is anyone in the short term going to really have a burning desire to go out and buy gold or silver? After all, neither is immediately fungible into these other funding needs.

We thus both fundamentally and technically believe that silver is still likely also headed lower in the short term to around $3.77, while gold could easily move back to more solid support in the $300 region. Would we short gold and silver? No. These markets are too small and the moves could be too viscous to the upside if we are wrong. In general, we remain long-term gold bulls, but only want to be short-term uninvolved bears. In our humble opinion, and as always seems to be the case, gold proponents may require infinite patience and discipline before they are able to reap huge rewards someday down the road.

But we do feel comfortable shorting copper. After all, given SARS is mostly in China at present, and the fact that China has been one of the largest builders of new office buildings in recent years, how many new building projects are going to get started over there in the near future? The pace should at least abate for a bit until the SARS crisis ends.

Have we rambled through a great number of topics this month? Yes, but it would not be fitting to end without a few more thoughts. Many moons ago, we spoke of an eventual devaluation of the Hong Kong dollar, and we have also written in the past about the fragility of the Saudi government and Saudi riyal. SARS obviously only increases the chance that the Hong Kong dollar "peg" will eventually be abandoned, and forward point movements are starting to reflect this possibility once again.

In addition, the same subscriber who pointed out to us the potential multinational tax holiday proposal on repatriated U.S. funds, also points out that there have been several government officials killed in the northwest provinces of Saudi Arabia in recent weeks, and that Riyadh "appears to be losing control" of this not so prosperous tribal region that may have Al Qaeda ties. Maybe U.S. troops will be re-visiting northwestern Saudi Arabia next – not Syria.

This same subscriber also mentions that over the next two months Malaysia and several supporting Arab nations will be promoting the gold-based Islamic dinar in an attempt to create a competitive alternative to the U.S. dollar. Specifically, Malaysian Prime Minister Dr. Mahathir Muhammad will address an international seminar in Kuala Lumpur on the adoption of the Islamic dinar as the unit of currency for international trade, especially between the Muslim countries. This takes place June 25-26 under the patronage of the Institute of Islamic Thought, a Malaysian think tank.

There had been talk to do this back before the 1997 Asian Crisis, but that crisis put such plans on hold. The proposal to give the Islamic dinar a greater role represents a low-probability wild-card situation that might potentially change our current bearish view of gold.

As an aside, the subscriber who pointed this out to us is more closely tied into watching such fundamental developments than we are, and is also launching his own newsletter which will be free for a trial period of time. If anyone has interest in following commentary on things such as the gold-based Islamic dinar and developments on the Hong Kong dollar or Saudi politics more closely, you are welcome to drop us an e-mail at information@Sandspring.com and we will provide your contact information to this gentleman.

Lastly, let us end this month with a final ironic observation about the pension fund accounting crisis in the U.S.

Many know that Warren Buffett has been as vocal on the subject of pension accounting problems as we have, and that he has established a low 6% return assumption for Berkshire Hathaway's pension plan. Many also know that he has placed a substantial portion of Berkshire's pension assets in fixed income securities – not stocks.

But few would likely guess at the second most conservatively positioned company in America in terms of its pension assets. This company is none other than Merrill Lynch. While Merrill may advertise being "Bullish on America – buy common stocks," behind the scenes Merrill's pension managers are buying not stocks but bonds. Thus, while most of their clients got killed in 2002, Merrill's pension portfolio blithely surpassed its 6.25% return target. Together with Berkshire and Loews Corp, Merrill was one of only three companies on the Milliman list of 100 major corporations to have actual 2002 pension returns above assumed returns.

Now there is yet another curve ball from Wall Street that is reminiscent of the old adage: "Watch what I do, not what I say."

Send us your comments at information@Sandspring.com.

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