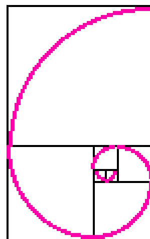


Sand Spring Advisors LLC

What Growth?
&
New Thoughts from the "Warren Buffett of the Dark Side"

by,

Barclay T. Leib

November 21, 2003

When we can attend it, the annual *Grant's Interest Rate Observer* Conference held annually at the St. Regis Hotel in New York always offers a few interesting insights. This year's conference was its 20th annual, and was sold out last week.

Two years ago, in our article entitled "Expert Picks," we combined the fundamental visions of short-seller Jim Chanos who presented at that year's conference, with our own technical perspectives. At the time, Chanos's five favorite short sales were:

Coca-Cola…then at just under $47 a share…now at $54.37
Enron….then at 59 ½…now defunct.
Americredit…then at just under $48 a share…now at $13.35.
Capital One …then at $65 a share...now at $56.50, but having traded as low as $24.05.
Providian Financial…then at just under $55 a share…now at $10.80, but having traded as low as $2.46 in between.

Not bad! Just one small loser, and four fairly huge winners. Of course, the overall market downswing into July-September 2002 helped just a bit.

At this year's conference, Chanos once again presented. In the latter part of this article, we offer an update of his most recent bearish views – this time more thematic than two years ago, but still of great interest. We add to these views, as always, our own technical perspectives on Chanos's stock pans in an effort to meld fundamental and technical analysis into one overall picture.

Derivatives Speak

First though, we found it amusing at this year's conference how Jim Grant started out.

With a dead-pan face, he told the audience that he thought the burgeoning derivatives market was something important to understand, and that he was trying his hardest to do so. In fact, he had picked up a copy of *Lehman Brothers' Guide to Exotic Credit Derivatives*, but for the life of him, he just could not make out the following description of a "CDO of CDOs." Could anyone in the audience help him out?

> "Typically there is a mezzanine 'super' tranche CDO in which the collateral is made up of a mixture of asset-backed securities and several 'stub' tranches of synthetic CDOs. Principal losses are incurred in some of these principal losses if the underlying portfolio of the synthetic tranches exceed the attachment point of the super-tranche. Looking forward, we see growing interest in synthetic-only portfolios."

As laughter in the audience subsided, Grant espoused that the only thing really growing with regard to this product is likely to be the derivatives trading revenue of Lehman Brothers.

At that point, Grant went on to ask the question about the possible asymmetric opportunity that may exist shorting 5-6 year Japanese corporate debt. He went through a whole slew of 5-6 year bonds issued by such credits as Sony, Secom, and NTT -- all with coupons offering a scant annual payment of 50-60 basis points, yet bond prices trading at or above par. His line of thought was as follows:

"If Japan recovers, and rates go higher, these bonds will fall. If Japan does not recover, then some of these companies may no longer deserve their current credit ratings, and these bonds will fall as well. It would appear to me as a win-win situation, at very little risk. 5 years is a long time, and people forget how much the world can change in such a period of time."

We agree, although gaining the ability to short such bonds (and be able to borrow them to sell), or better yet, to participate in the purchase of cheap credit default swap insurance against the subordinated debt of certain highly leveraged U.S. financial institutions (let that read, Fannie Mae, MBIA, etc.), is very much of an institutional-only type trading opportunity.

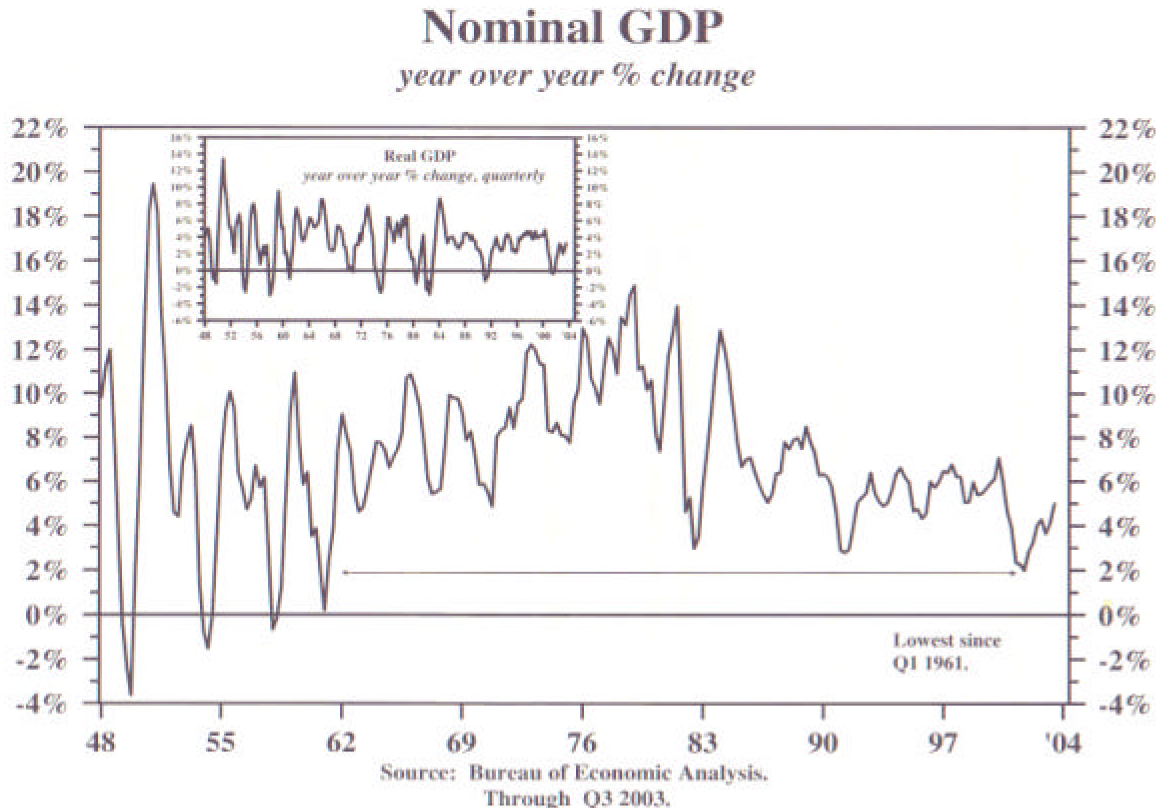
What Growth?

But just to counter his espoused bearishness on Japanese corporate bonds, Grant then introduced fixed income manager Van Hoisington of Hoisington Investment Management.

In a series of charts only partially reproduced here, but publicly available in their entirety at: http://www.hoisingtonmgt.com/Himco_Grants20031113.pdf , Hoisington laid out the case that the U.S. economy was far weaker than the recent stats make it out to be.

For one thing, according to Hoisington, almost everyone who examines releases from the Bureau of Labor Statistics tend to concentrate on "Real" GDP growth. But "Real" GDP includes a variety of adjustments for the quality of goods sold. Per Hoisington, these just aren't actual hard "dollar and cents" contributions to growth. These adjustments simply don't end up in anyone's pockets. Instead, much of recent "real" growth has been a phantom of statistical adjustments, and according to Hoisington, grossly overstates what is really transpiring with actual demand.

He starts with a chart of Real GDP (upper left inset box below) that shows the recent recession to be relatively normal and mild. But when one looks at nominal GDP (larger chart), a different picture emerges. The 2000-2001 recession in nominal terms brought the worst year-over-year change in GDP since 1961.



Source: Hoisington Investment Management

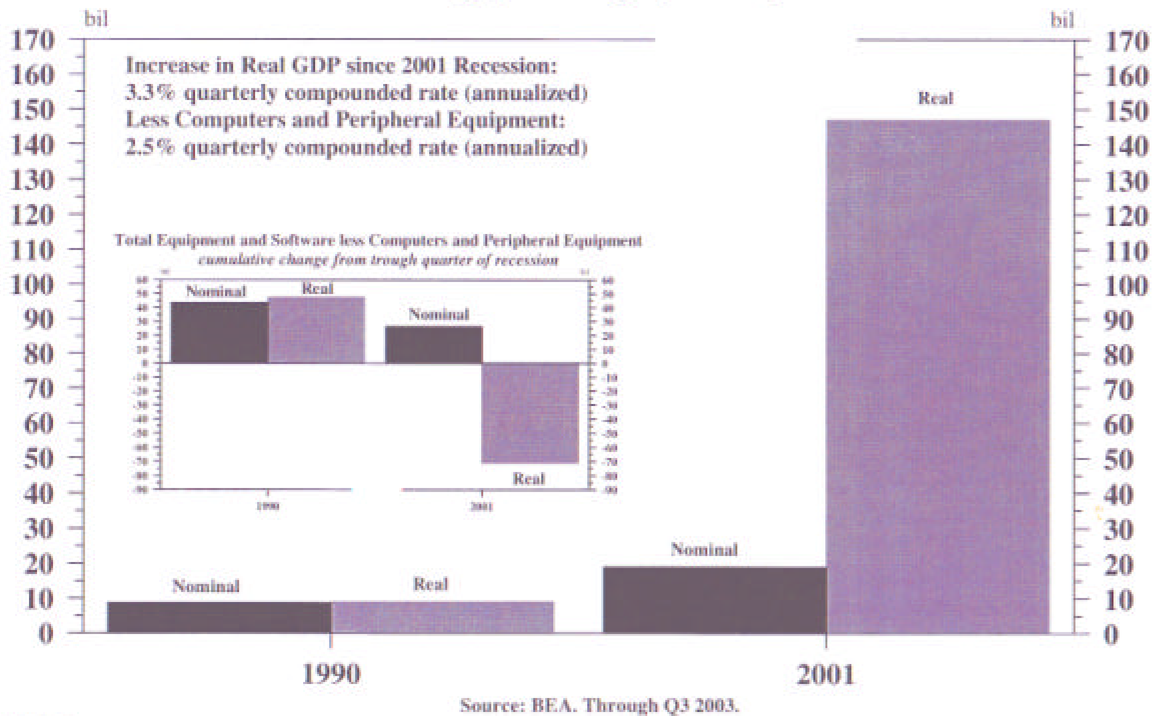
The cause for the difference can be found in part from the way that the Bureau of Labor Statistics calculates "Real" GDP. When a car sells for $25,000, but it is a better car than one produced in the prior year, with more standard features and gadgets, the BLS bumps up the "Real" GDP calculation. So too does it do so for things like computers that may be declining in actual cost, but if the computers are faster and better, can be counted in "Real" GDP as if their sales price went up.

While some most might argue that this is all fair and appropriate, or perhaps just a minor adjustment not to be too concerned about, the key point is that the grossed up dollars don't actually pass between buyer and seller. Thus, if the 3rd Quarter real GDP growth printed at +7.2% -- and after accepting that some of this growth was clearly caused by one-off tax cuts, Fed rate cuts, one-time mortgage refi cash-out transactions, and huge fiscal deficit spending – one must delve down a bit further and question how much of this growth was comprised of statistical manipulations.

Bridgewater Associates has estimated that adjusting out the impact of various one-off pieces of 2003 stimulus, Real GDP growth would have been closer to +3.2%, not +7.2%. But when one further adjusts this number to put it into nominal terms and exclude BLS "improved product" adjustments, the GDP growth number basically gets cut in half again.

It has further been shown that *an extremely large part of this growth came from the Government sector – not private enterprise.* As Fred Hickey of the High Tech Strategist recently penned: “Over the past couple of weeks, I’ve listened to scores of tech company conference calls. In nearly every case, from Cisco to Foundry to Motorola to CDW, the story was the same – the best customer has been the U.S. government.” *In other words, has there really been any true recovery in private corporate spending? Or is the GDP growth that we have recently seen all just a product of statistical manipulations and a U.S budget deficit that expanded by some 137% in fiscal 2003?*

The chart where the BLS “real” versus “nominal” GDP growth differences shows up the clearest is indeed the computer sector. The Hoisington chart below shows computer and peripheral sales over the period from the supposed recessionary trough in early 2001 to present. Nominal computer and peripheral equipment sales have been approximately $21 billion. Yet in “real” terms, the BLS counts these sales as $147 billion since the quality of computers sold has gone up. This type of nominal vs. real accounting divergence did not exist back in our last 1990 recessionary period. In 2003, no one has actually received anything greater than $21 billion in sales. Indeed, when one backs out this single computer & peripheral sector from total equipment and software sales, recent real sales of equipment (inset chart below) have actually declined by $70 billion.

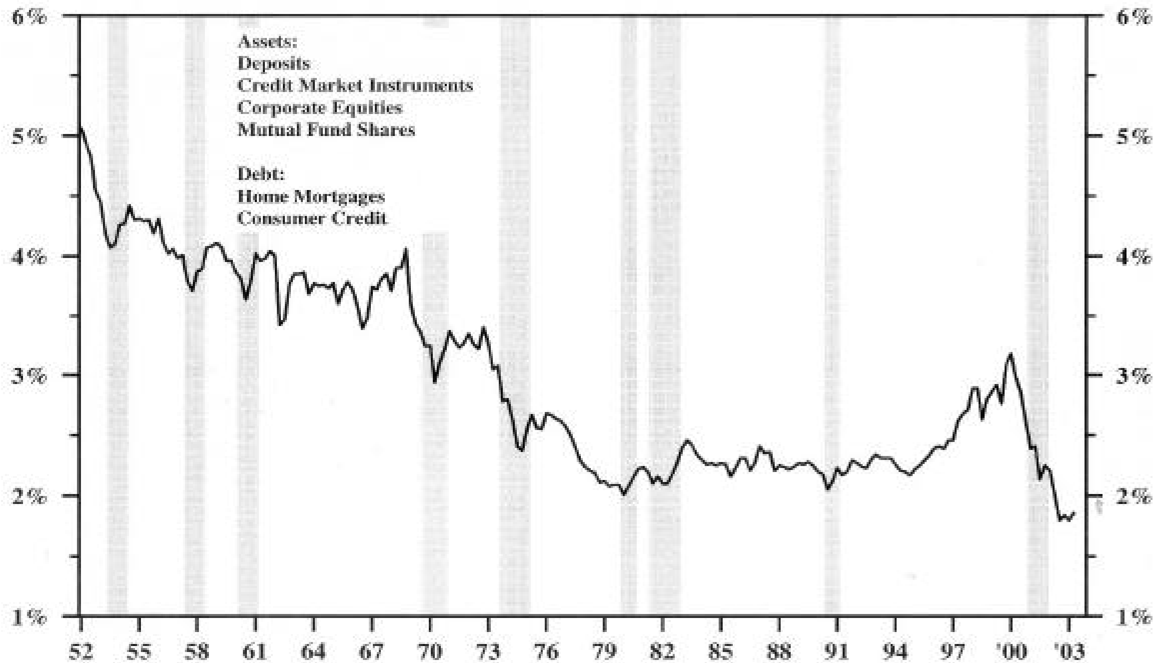


Source: Hoisington Investment Management

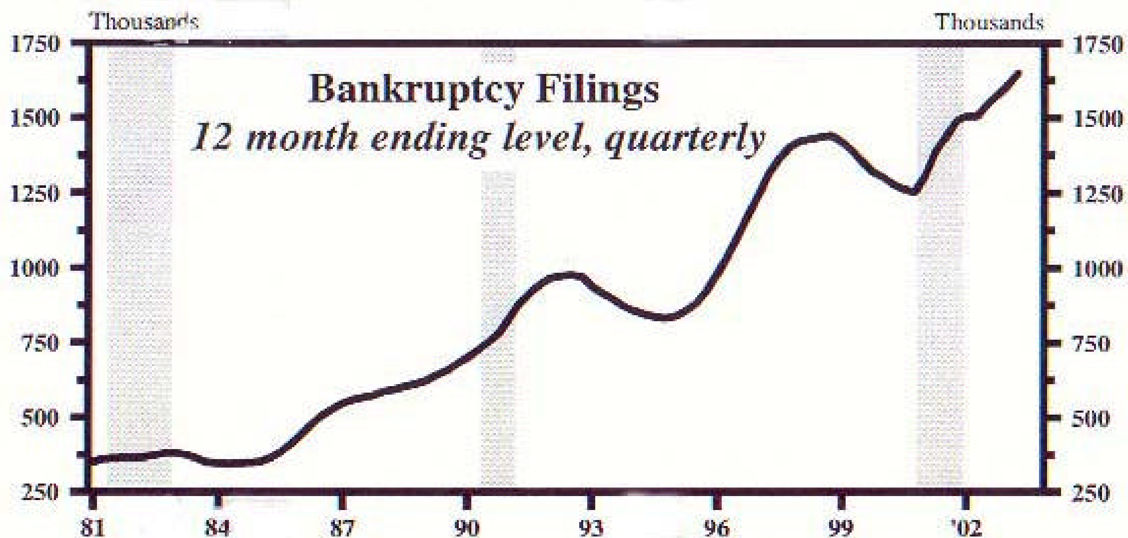
We truly live in an era of complex accounting gimmickry, and the figures that we are regularly provided by the U.S. Government are as full of misleading manipulations as any complex private corporate balance sheet.

Meanwhile, look at a few other Hoisington charts below. The first shows consumer liquid assets vs. debt (defined as mortgage debt plus consumer credit). This ratio is at an all-time

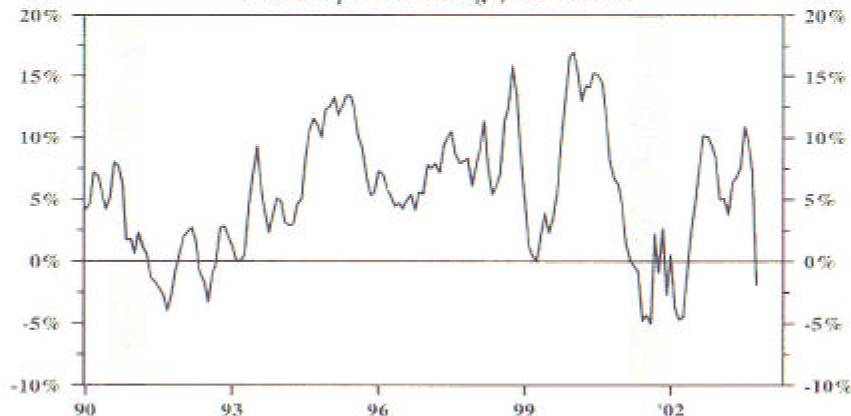
low of 1.8%. Note how this ratio – within an overall secular decline – typically repairs itself somewhat during shaded recessionary periods. This has *not* been in the case most recently since the official 2000-2001 recession.

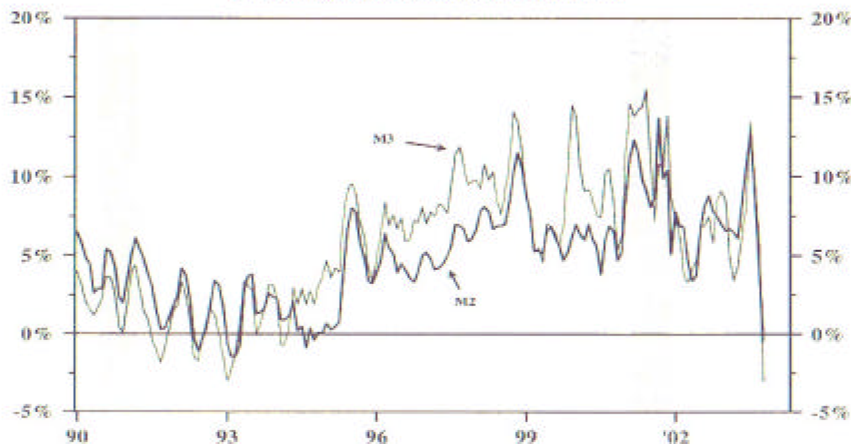


The second chart shows total personal bankruptcies at an all-time high. Is this what is supposed to be happening in an economic recovery? Should personal bankruptcies have climbed +6.75% in the most recent quarter (as they did) if the economy is recovering?



The third and last set of Hoisington charts shows commercial bank loans and leases plus non-financial commercial paper, as well as the 3-month percent change of money supply. Despite a late 2002 spurt, these indicators of system liquidity are currently falling again.



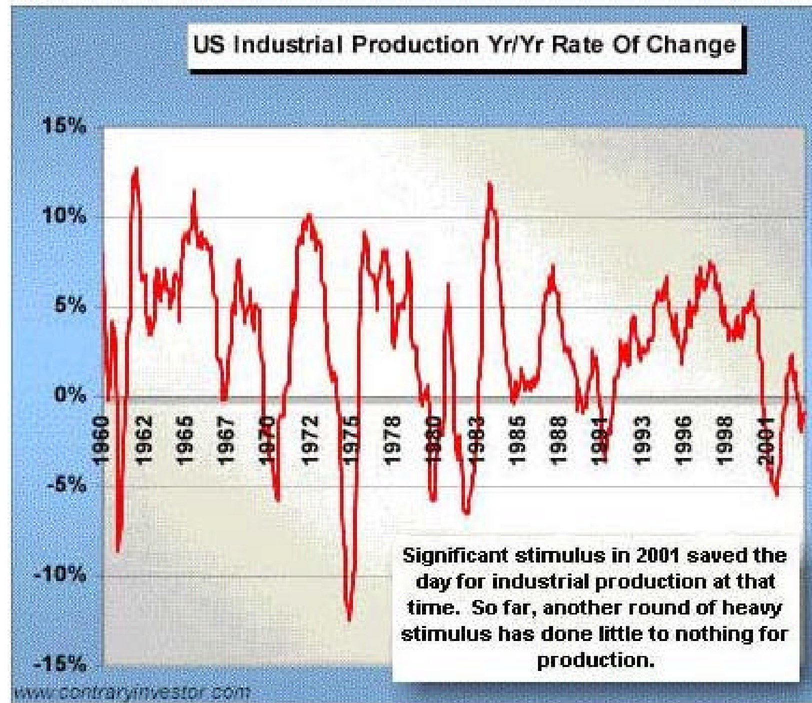


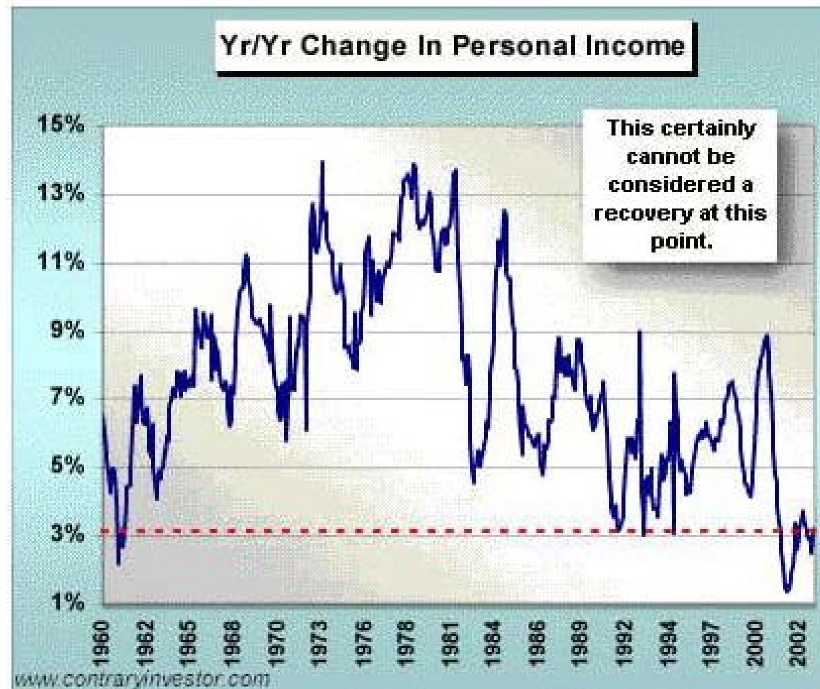
In Hoisington's words: "If you don't see bank loans start to rise soon, this looks like the exact pattern that the Japanese markets of the 1990's took. Bank intermediation and loan facilitation falls off a cliff even as the actual cost of money is low." This will certainly be the path should banks suffer any solid body blow from their current exposure to mortgage-related paper – an exposure that stands as a percentage of total banking system assets at an all-time high.

All in all, the bottom line from all of these fundamental perspectives can be summarized as follows: The margin by which consumers can service their debt has become ever thinner, and

in the meantime, liquidity from the banking system seems to be on the wane. This could be a toxic combination should the consumer suffer any further decline in liquid net worth.

And if one does not buy into Hoisington's set of charts, just look at the bunch below recently put together by ContraryInvestor.com. Once again, we must ask, what growth? What recovery?





Hoisington concluded his presentation with a conclusion that while most traders currently believe that bonds are a secular sale as the economy "recovers," and the Fed is eventually forced to tighten, he thinks that bonds are a buy.

The risk to his hypothesis is of course *stagflation* – a stagnant economy where the Fed is pushing on a string to bolster economic strength, but instead, the only thing that happens is that bond holders eventually revolt and try to sell their bonds after being constantly diluted by new debt issuance and a declining dollar.

With 43% of our debt now held by foreigners (another all time high), the risk of such a revolt is certainly higher than it used to be. Some may argue that foreigners simply have no choice: With the world already on a defacto dollar standard, foreigners simply *must* accept dollars in return for purchased goods, and then these dollars by definition are eventually recycled into U.S. investments by someone. The holder of last resort tends to be foreign central banks. Yet we continuously bash these holders of our debt for not allowing their currencies to appreciate against the dollar (and thereby debase the value of their U.S. Treasury reserve holdings). This is no way to treat people who effectively now control our economic destiny.

Yet, this is likely too complex for President Bush to understand. Instead, he recently raised tariffs on Chinese textiles – sending yet another "ding" at our Chinese friends across the Pacific.

Warren Buffett of the Dark Side

But enough macro. We promised at the beginning of this article to take a look at some of the specific equity situations upon which Jim Chanos is currently bearish -- together with our own technical overlay.

As an introduction, Chanos began by noting the recent re-appearance of many new day trading ads on CNBC. "Bubble Vision is back!" he quipped.

Yet sprinkled in with commercials for day trading outfits, what else do we now have? If you haven't noticed, Fannie Mae is currently engaged in a massive advertising campaign blitz on both television and radio – presumably to improve its sagging image with investors and on Capital Hill. Maybe a rule should exist that anything actively advertised on CNBC should be immediately sold.

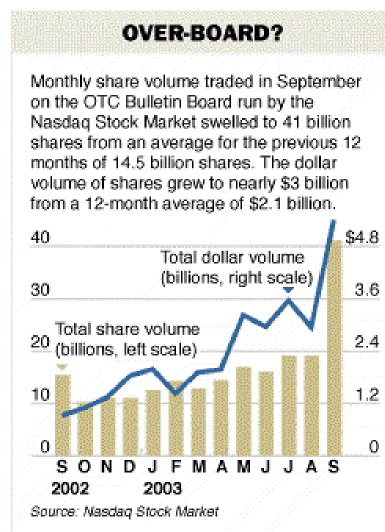
"And isn't it just amazing how companies always just beat their lower earnings expectations by a penny?" Chanos expounded, "just like they used to in 1999. Nothing has changed. I recently saw a study that showed that of the 67% of companies that beat First Call earnings expectations, 50% did so by just a cent. Either corporate America has become truly prescient in predicting earnings, or these earnings are so filled with manipulated revenues and accruals, that they are false representations of true corporate results. Good analysts these days just focus on true cash flow. Earnings have become pretty useless."

And then there is always the rosy glow to an ugly story. "When AMAT recently missed its revenue expectations by some 16%, what did CNBC focus on?" Chanos asked. " AMAT's 'forward guidance,' of course. And when Wal-Mart missed earnings, and its Chairman said that the company saw increasing signs of a potentially tapped-out U.S. consumer living paycheck to paycheck, CNBC could only offer the few words – 'Well, they only missed by a few pennies.'" There is no desire to confront reality by our media.

More recently, on a day when stocks had melted by some 170 Dow points, Bloomberg Radio largely focused on "a secular rotation into healthcare stocks – the best performing sector of the day." No sooner was this drivel on the airwaves, than healthcare's relative strength petered out just a day later.

It is truly becoming hazardous to allow one's ears to listen to this babble.

Chanos finished his overview by noting that Nasdaq Bulletin Board Volume has recently been running near record highs, and that stocks under a $1 have experienced the most significant rallies in 2003 – both signs of speculative froth.



Source: Wall Street Journal

Within this overall frothy context, however, it is perhaps ironic that Chanos went on to pick his favorite short-sale candidates mostly from among old-line stocks. He specifically chose stocks that he believes have recently rallied in hopes of a standard cyclical economic recovery (which as we show above hardly exists), but where underlying secular industry changes are pulling in the other direction.

First among these companies was **Eastman Kodak (EK)**. Per Chanos: "Management has admitted that they have a major problem. Demand for traditional photographic film and processing is simply being overwhelmed by the digital age. Kodak is going to try to buy their way into the digital business through an acquisition. But they have only about two years to make this succeed – corporate integration and everything. Maybe management can pull it off, but I don't think so. I think that they are moving too late. Watch for any acceleration in the decline in film sales as the potential death knell here. "

From a technical perspective, Eastman Kodak, already within a significant downtrend, certainly appears to hold the potential to reach at least $17.70 or so to our eye. So we are technically not quite as bearish as Mr. Chanos sounded.

As another victim of the digital revolution, Chanos points to **Blockbuster (BBI)**. "The same thing that you saw happen to the music retailers is likely to be headed Blockbuster's way. Already, movie studios are experimenting with DVDs priced at $10, and if you can buy a DVD at $10, you aren't likely going to have that much interest to pay $4 to rent one from Blockbuster. Illegal movie downloads from the web represents another problem. I understand that a bootleg copy of almost any movie can already be found on the web, and while the download time may be slow and necessitate a computer running overnight, the lack of cost can't be beat."

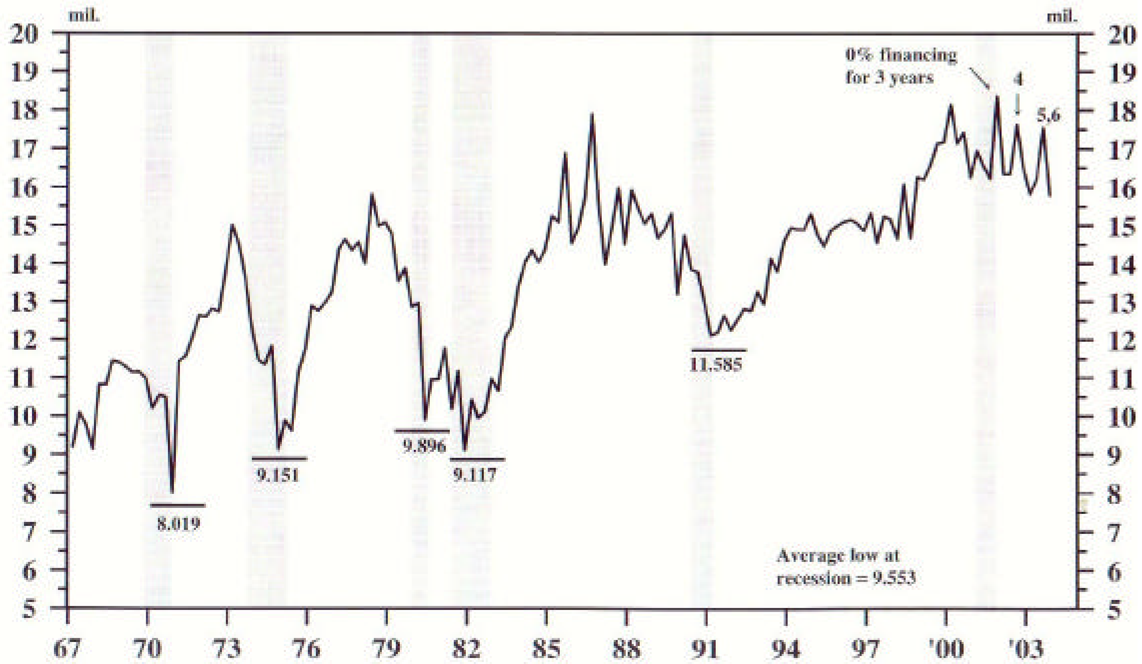
Blockbuster to our technical eye certainly looks sick. Does this Fib rhythm lead all the way to $1? In general, at this point in time, we like this digital revolution thematic short better than EK.

Next among Chanos's pans was **Delta Airlines**. "The mixture of entrenched unions, high wages, and new low cost competition – competition that actually offer better service -- will eventually bury the old line carriers," said Chanos. "Recent airline equity bounces have been caused by people confusing a perceived economic upswing with a long-time decline in this sector."

Delta to our eye looks technically weak, but we could not develop a sufficiently compelling Fibonacci technical target to merit showing its chart here.

And in a similar vein, **GM** and **Ford** are, per Chanos, "in slow death mode." "If it wasn't for the freebie financing – first 1-year, then 3-years, then 5, and now 6, the chart shown below of Vehicle Sales would have dropped precipitously. But what are they going to do for an encore: Offer two cars for the price of one?" In point of fact, one Hyundai dealership in the Northeast recently advertised such – albeit only on their lowest line of cars.

The last three bounces in the chart below of total car sales (each bounce equating to a new expanded 0% financing incentive) reminds us a bit of the 2003 USD/CAD chart right before the USD collapsed.



Technically we can come to no definitive vision on Ford, but as shown in the chart below, $24.26 clearly beckons on GM

Chanos then went on to offer us his annual "one-trick pony": **LeapFrog (LF)**. This stock is currently a $30 stock (already down from $45), and despite having developed a nifty LeapPad learning product for kids, has consistently missed its earnings numbers. "And just figure out the demographics," offers Chanos. "Their main product is for kids 3-8 years old. There are approximately 20 million such kids in the U.S. at present living in approximately 16 million households. Of these households, maybe 12 million can afford the $49 retail LeapPad price. If optimistically 80% of the households that can afford LeapPad actually buy one, that is still only $384 million in total retail sales, not even counting wholesale discounts. Yet this company trades at a market capitalization of $1.8 billion, 29 x current earnings ($43mm), and over 6 times book value."

Technically, to our eye, LF appears headed towards a price just under $19.

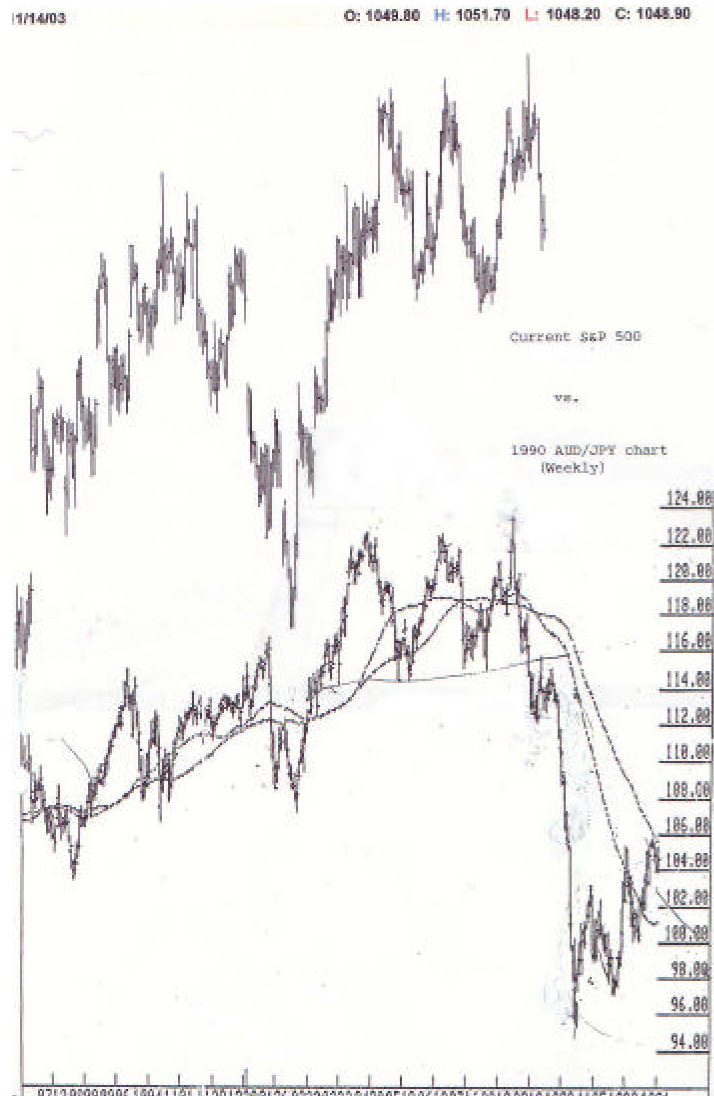
Lastly, Chanos turned thematic again in his skepticism of Weight Watchers International (WTW), a stock that currently trades at $37.60, with a P/E of 39-1, a Price to Book ratio of 85-1, and a staggering debt to equity ratio near 10-1. "Just look all around you. Everyone is moving to a low carb diet. Weight Watchers is on the wrong side of this shift. They are going to lose clients, and given the amount of debt that they carry, this will not be pretty."

We see WTW technically headed for $26.26.

Rest assured: We'll come back in a year or two and see how Chanos's latest calls and these Fibonacci targets end up working out.

Overall Cycle Picture

Upcoming of course is a December 5th PEI minor cycle date. Given the current "triple top" complexion of the S&P hourly chart pattern (as shown back in our December 16th public web posting, and reproduced below) with 1990 AUD/JPY as a weekly analog, we would not be surprised to see Dec 5th mark a possible panic low of some sort.



Given that it is already November 21st, how far could this anticipated move take us?

The AUD/JPY analog chart declined 2.5 times the width of its triple top, and the current width of the S&P hourly trip top is approximately 20 S&P points (between 1063 and 1043). Thus, if the analog holds, the total initial decline in the S&P decline should be at least 70 points (initial width + 2.5 times this initial width) to around 993-999. This is indeed where we also see some initial Fibonacci fractal support.

If the current slide were to peter out near 993-998, one would thereafter expect a bounce of approximately 38.2% of the decline, or up to potentially around 1020-1025. However, it is important to note that the entire extent of the AUD/JPY decline in 1990 was from a high just above 123, to a low under 70 – a 45% drop! We are dealing with true fire here.

Looking at a larger Fibonacci scale in the weekly chart below, it is even possible that the initial drop leads the S&P all the way down to around 949 before a bounce, followed by yet more wealth destruction. Thus, we would generally advise against trying to bottom pick this market even if it were to fall to 993-998 in the near future. Only a reversal from a sharp slide on or about December 5th would get us potentially in short-term scalping buy mode. But no longer than for a quick flip.

Looking further out is more difficult. If the Dec 5th PEI date is a low, would that mean the next cycle date due on April 14th, 2004 should be a high? And what about the PEI cycle date out at the end of December 2004 that we have previously called important since it is also 17.2 years (a full 2*pi*1000) cycle from the 1987 equity market crash?

While continuing to reserve the right to shift this prognosis should subsequent market action so demand, and with an eye on what subsequently happened in our AUD/JPY analog over 1991-1992, we currently believe that it may be possible Dec 5th, April 14th and Dec 31st all will become successive cycle lows. April 2004 could easily become the end of a wave 3-like decline, with a final 5th wave low lingering further out on Dec 31, 2004. In terms of price, 550-620 appears a reasonable long-term target price range for the S&P to reach.

Should this path transpire -- what a kick in the teeth this will be to Mr. Bush!

But Jeremy Grantham of Boston-based Grantham, Mayo, & van Otterloo would appear as prescient as ever. In a recent *Barron's* interview, Mr. Grantham espoused that recent equity strength is likely "the largest sucker rally of all time."

Time will tell on this, but we certainly agree.

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