## Sand Spring Advisors LLC

# Zig-Zag Markets
# &
# What Will Go Thud That Hasn't Already
# by,

**Barclay T. Leib**

**January 19, 2002**

Sometime ago we posted the chart below of the S&P 500 on the Sandspring.com website. When we did, it had the same red arrow lines as the ones that appear below. Although choppy range-bound market conditions left us displeased by our last minor cycle date back on October 11, 2001, and we are equally unenthusiastic at this point to predict much for our next minor date February 19, 2001, we will keep our overall interpretation that a large A-B-C corrective period is currently underway. Corrective periods are always more difficult to prognosticate than impulsive ones, but at this point we'd hazard to suggest that the market will likely migrate toward a mid-year low (successful temporary retest of last September's lows, at least basis the S&P) followed by a very sharp rally into an early November high. Point B on the chart below may thus reside a bit further out in time than originally drawn.

One problem that prevents us from being even more bearish than this is the amount of Fed-induced cash currently slopping around our economy. This easy credit will likely prevent our markets from accelerating below the September lows right now, although longer term, we see 2003-2005 as being an extremely difficult debt-deflation-oriented market. First though, it's a chicken and egg type situation: commodity prices must come roaring back to put pressure on the Fed to re-tighten. Until that happens and the Fed does in fact tighten – likely in November – the current equity market slide should still yield to strong fall rally.

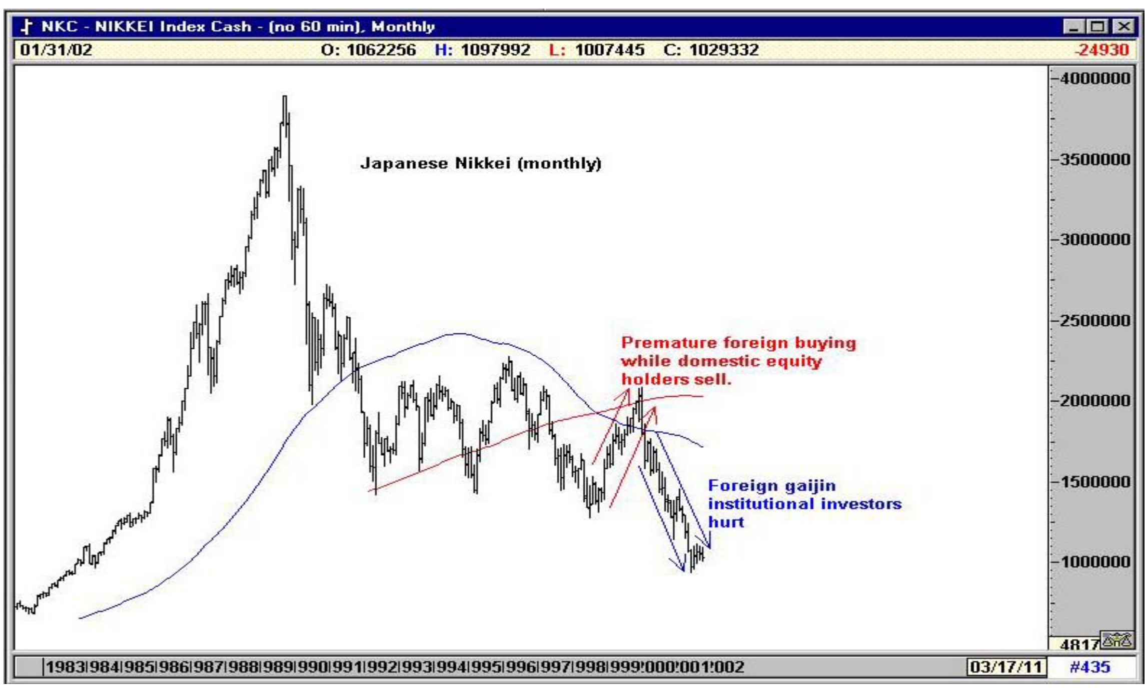
This does not mean that we won't "scare the living hell" out of people in the short term. Sharp C wave rallies must first find their roots in fearful and despondent B wave lows, shaking investor sentiment just far enough that the C-wave rally actually emerges as a significant surprise. Right now, sentiment stats are too high, complacency is too high, and the money flow into equities is far too low for any sustainable short-term strength to continue.

Consider the following Liquidity TrimTabs statistics. Back during the last two weeks of December 2000, equity mutual funds saw inflows of $20 billion. During the same holiday period in 2001, equity funds actually had outflows. Now clearly some of this difference can be explained away by tax-loss selling by individuals and institutions alike, but there has not been a significant pick-up in equity inflows during January. In the words of Liquidity Trim-Tabs, "Ameritrade's on-line investor has been net selling since December 20th. Yes, those who respond to surveys are bullish. But the fringe player is leaving."

The bad news is, of course, that if sentiment is too high, and the Volatility Index is still relatively low (as previously shown in one of our daily Chart du Jour missives posted on the web), and the positive equity-bound cash flows just aren't there, then the new issuance calendar -- which builds with every new year as sure as moss grows on trees -- will be very hard to absorb. More by the laws of gravity than anything else, a step and a stumble lower in equity prices is natural to expect.

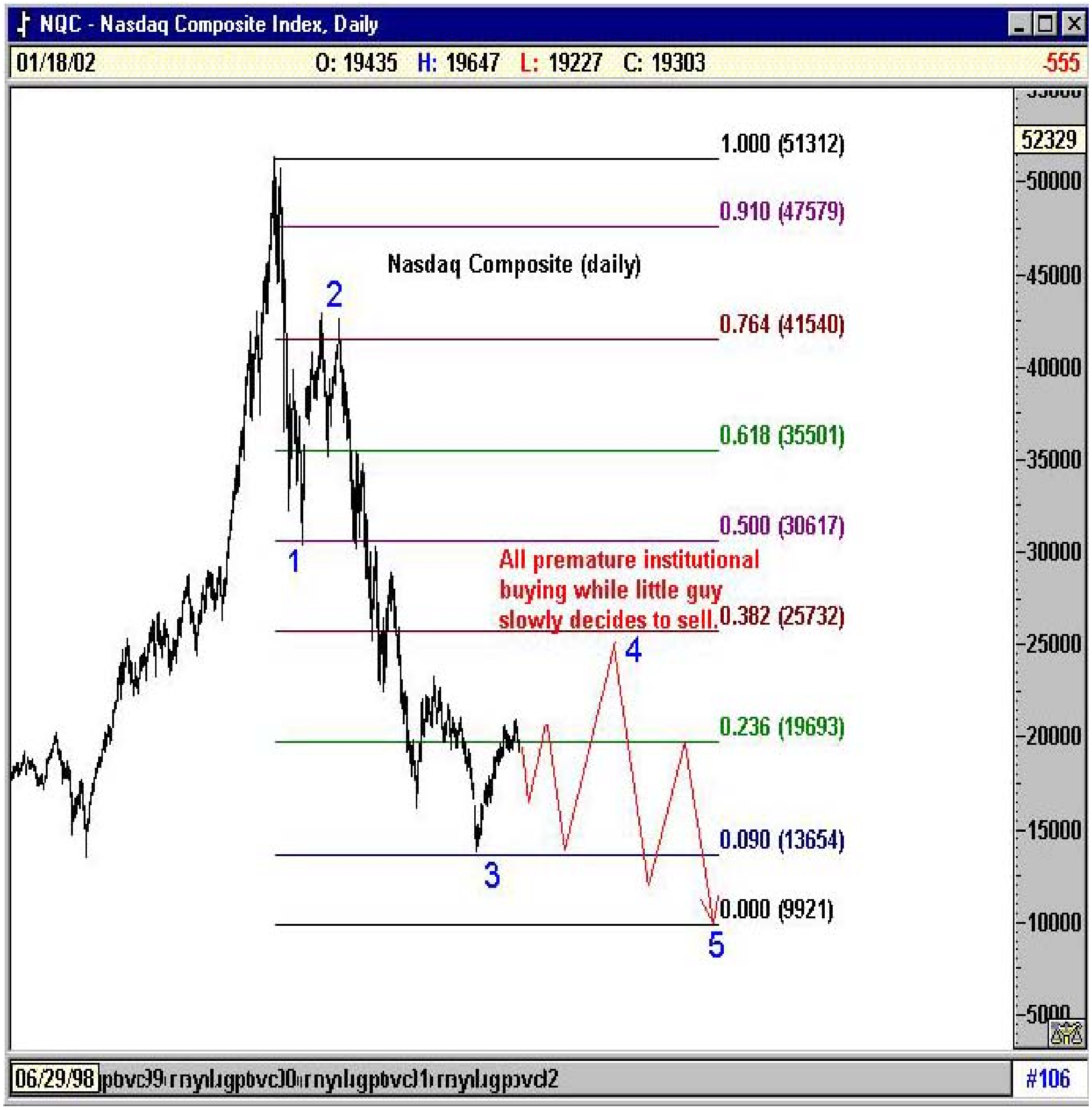
And yet we talk about excess Fed liquidity giving this market a natural supportive floor. We also acknowledge that for now a foreign pool of institutional money in Japan, Europe, and elsewhere -- inspired by a seemingly invincible dollar -- continues to pour into this country. It's a phenomenon as old as the Roman Empire where the collapse of some of Rome's fringe economies sent money temporarily pouring back into Rome itself in seek of "core' safety, until of course, Rome itself fell.

The combination of low domestic equity buying and yet high buying from overseas also reminds us a bit of what happened in Japan's market not that long ago – as depicted below.




Thoroughly warn out by a decade-plus long bear market, Japanese domestic investors have long since given up on their own equity market and have been net sellers in recent years. Conversely, foreign institutions (or so-called *gaijin* investors) have been most bullish on Japan, with very heavy flows into that country taking place -- particularly in 1999 to early 2000. But unfortunately for the foreign institutions, the result to date is that the local investor has held sway, while the gaijin investor has taken a serious black eye – albeit having yet to give up. Could something similar to this now be happening in the U.S. where domestic retail investors start to abandon the boat, but foreign institutional investors continue to step in on the other side? Is perhaps the Enron disaster the wake-up call that will cause the little guy to become more cynical in his/her personal investing and start to take money off the table?

We think this may well be the case, and can even analogize the above monthly Nikkei chart to that of the daily NASDAQ. If we were to prognosticate a path for the NASDAQ Composite, it might look something as follows – with the wave 4 rally period completing in November '02, and a downside target eventually toward 1000 somewhere beyond.




All of the above suggests of course that away from the anticipated June-November rally period when some element of rah-rah enthusiasm may temporarily return to equity markets, that a serious period of disappointment remains in the cards for traditional buy-and-hold types. "Bop and weave" short-term swing traders may have a better time of it – although they will likely still struggle with much spurious market noise that 4th waves are renowned for. Even long volatility traders may suffer – despite choppy market conditions – as the market compresses into a perceived range over time, and "implied" volatility levels languish (although that would certainly not be our short-term call at this very moment).

All this means that the quick "V"-shaped bottom to the economy's recent downdraft that some are calling for (such as Ed Hyman of the ISI Group) won't be that simple. Instead, a gentle malaise should set in that is already trickling through to consumer spending habits.

When a recession hits, the first thing to go, of course, is that extra trip to Disney World for a family or that extra not-really-necessary business trip for an executive -- especially if any terrorist threat still lurks in the travel process. We understand this and so too does the market. Hotel and other travel-related stocks remain under deserved pressure.

But the second thing to go is spending on big-ticket items such as a new car or truck – unless of course you can pick one up for free, as has been the case of late with 0% financing. But 0% financing can't last forever, and what car sales were made under these schemes in late 2001 likely came straight out of 2002's demand. The car companies have simply taken a lesson from the chip companies in so-called "channel stuffing."

The genuine business sense of these 0% financed giveaways can also be questioned on a pure credit basis. As one hedge fund manager recently quipped to me: "Why is it that car companies insist on selling cars to the most people on the cheapest terms at the worst possible time – right before many of them will likely lose their jobs?"

And if Detroit's recent car show is any indication, the average $25,000 price tag that most cars now carry is way too high for the average family to truly afford. So more and more people are forced to lease cars, and a few years later, these pre-owned vehicles find their way back onto the market, undercutting the new car market's very attractiveness. There is even a reasonable chance that a particularly unpopular-styled pre-owned car may end up sitting in a field somewhere as an unsaleable piece of metal collecting rust on behalf of a car company's finance unit. These cars may be carried as largely depreciated assets by many of the car companies. But has this unsaleable inventory truly been fully depreciated? Has Detroit priced the imbedded put in their lease agreements correctly? Maybe they have for a normal economy, but how about in lean times? This is not our area of expertise, but we can't help but wonder about these questions.

And if cars have still been moving off of showroom lots for now, the sale of truck rigs has ground almost to a stop. FedEx has stated that they have no Capex budget for any new trucks over the next several years. Nor does the U.S. Postal Service that with recent budget overruns to fight Anthrax, has cancelled all truck orders into the foreseeable future. Many used trucks just a few years old are now trading at 25 cents on the dollar. Just to show you how serious this is, consider that in an effort to pump up short-term sales, Freightliner (a division of GM) previously offered many of its better clients a two-year "70 cents on the dollar" put option on their truck sales. The executive who dreamed up that ploy has now been fired, but a used truck overhand continues to abound. Manufacturers have thus recently been slashing new truck production. And when old trucks aren't selling, and new trucks aren't being made, guess what else isn't selling? The trailer rigs that go with them.

This brings us to our first fundamental short-selling candidate of this letter**: Wabash National Corporation (WNC).** Wabash manufactures and markets standard and customized truck trailers under the Wabash and Fruehauf tradenames. But new demand for their trailers is now hard to be found. The company's sales have been suffering steep quarterly year-over-year declines, and a 45% cumulative decline in sales over the nine months ended Sep '01. Gross margins before depreciation and amortization have been severely depressed. And yet the company has significant debt representing 54.9% of its capitalization that needs to be serviced. Wabash is cash-flow negative and may not survive as a company without bankruptcy protection unless that elusive "V" shaped recovery emerges (which of course we doubt).

Now as one caveat, the stock of WNC is already down quite a bit from its previous $20 trading handle to trade at just $7.50, but we feel confident that this stock will see $4 sometime soon as its financial situation continues to implode. We pick $4 on a Fibonacci rhythm basis (as shown below), but maybe WNC will even pull an Enron and go puff.


But if truck trailers don't excite one on the short side, or the chart above looks to one's eye as having fallen awfully far already, one might want to consider another company, **Sotheby's Holdings (BID)**, whose auction business of fine arts and luxury residential real estate is not only floundering (revenues down 12% year of year in 2001 vs. 2000, and down almost 50% since 1999), but is also a company with eroding financial position and mounting interest expense ($20 million in interest expense in 2001 vs. just $5.6 million in 1999). Once can then add into this mix the fact that management has ongoing antitrust legal problems and many key executives have recently left. To our eye, this makes BID's current market capitalization of just under $1 billion look pretty rich.

On a Fibonacci rhythm basis, we see some support for Sotheby's at just under $5, but longer term is Sotheby's going broke? The Fibonacci bands actually suggest it might. CSFB was after all unable to find a buyer for the company when hired to do so back in 2000.

So trucks and truck-trailers are out, and so too are auctioneers of high-priced art and real estate. But can't Sand Spring come up with a short-selling play still near its all-time-highs?

We still dislike IBM of course -- a stock still irritatingly close to its all-time highs. We continue to anticipate our elusive move to $74.70 will take place at some point. Maybe last Friday's $5.65 downdraft finally started this.


We also of course continue to be highly suspect of financial stocks such as JP Morgan, Morgan Stanley, Bear Stearns, AIG, and Bank of America. Post-Enron, complicated financial engineering is less coveted than it once was, and all of these firms stand over time to suffer as a result.

Bank of America continues to have a particularly strong $31.60 downside Fibonacci target.

And there is likely a low-risk selling opportunity still developing against the trendline depicted below in junk-mail credit-card company Capital One.


But another sector we continue to think vulnerable is the restaurant space. After vacations go out the door, and new car/truck purchases get cut back, discretionary visits to local eateries will eventually diminish as well. This will transpire toward the same moment in time when many of these companies try to maintain their "growth status" with Wall Street analysts by opening up new stores in less than optimal locations.

**Applebee's (APPB)** now has 1348 restaurants in 49 states and 8 countries and advertises itself as the "world largest casual dining concept." It wants to push that number of restaurants to 1800, bragging about eight consecutive years of opening more than 100 restaurants per year. It has indeed shown consistent sales growth of 14% per year, and recently even rolled out a new more upscale core menu.

But on the negative side, the chain is also increasing its costs by spending 13% more this year on a new network television advertising campaign. And its earnings per share growth rate has recently been slipping a bit. While APPB's balance sheet is relatively conservative, can 20% annual growth in sales be maintained forever? APPB management will try to convince the analyst community that it can, but are these restaurants really that special or different, or have such high quality of food, that they are impervious to an economic downturn? We think not. Both unit growth and same store sales growth are starting to diminish. General and administrative expense as a percentage of total expenses has been creeping higher since 1998, and we also wonder for how long can this company keep up a stock repurchase program averaging $45 million a year? Are APPB's shares really that much of a bargain, or simply a disappointment waiting to happen? We've had APPB as a short recommendation before, and been burned, but we'll renew our bearishness now.

Without going into quite as much detail, **Darden Restaurants (DRI)**, operator of the Red Lobster and The Olive Garden restaurant chains, among several others, also looks close to being fully baked to us. Guest counts were up a bit in December, but can that continue in the current environment? Toward an upside Fibonacci price target of $39.65, we'd look for Darden to peter out.


**Brinker International (EAT)**, operator of the Chili's Grill & Bar chain and assorted other Mexican grills, also looks to have reached significant Fibonacci resistance. Short-term overshoots are of course possible, but we'd keep an eye on this one as well for a short-sale candidate.


There are others out there that we dislike in this space – **Outback Steakhouse, Wendy's, and Krispy Kreme Doughnuts** (at 108-1 p/e no less!) – among them. Longer term of course, a sudden outbreak of e-coli or more news on a suspected Mad Cow contamination of the U.S. food chain both remain an open-ended wild-card risk to many of these stocks -- Krispy Kreme excepted.

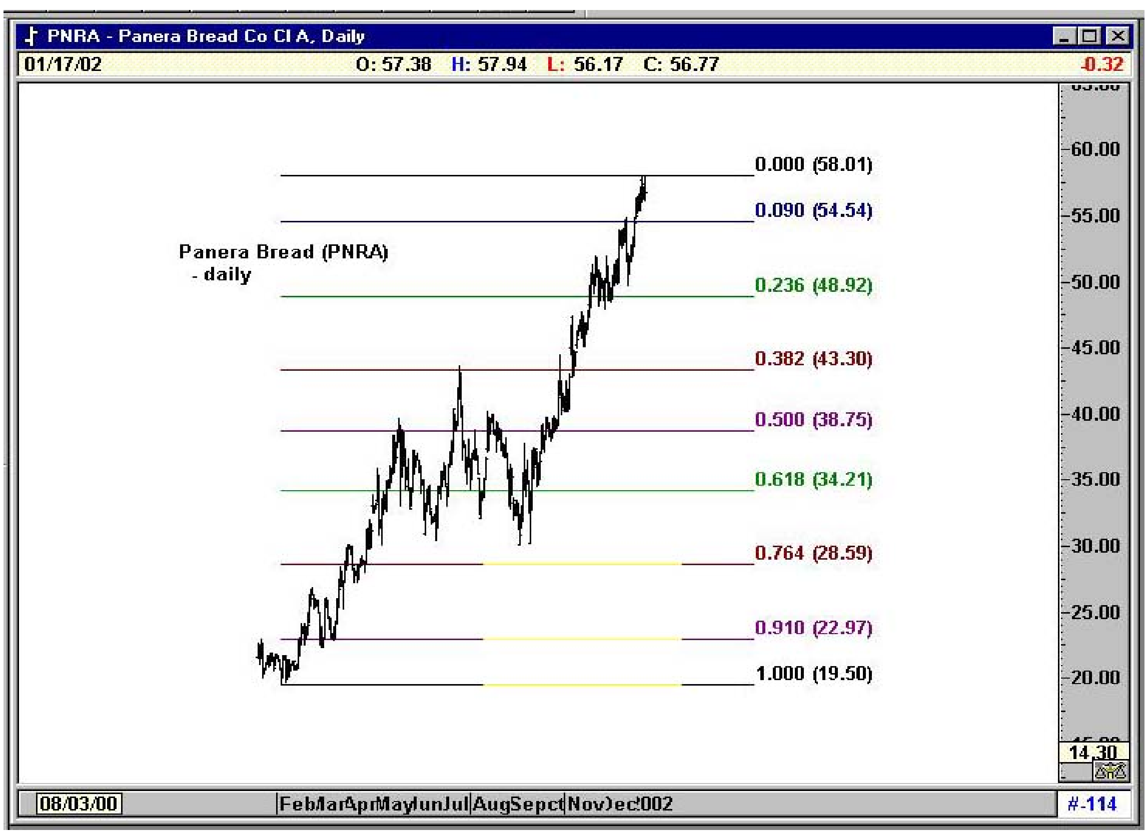
But even Krispy Kreme faces newcomer competition, as does that previous go-go stock **Starbucks (SBUX)** now trying to claw its way back from a sharp retracement (and quickly becoming overvalued again at a p/e of 22-1). The newcomer is **Panera (PNRA)** and it is brought to you by the original founders of Au Bon Pain (who sold that company in 1999). The concept is of a bakery café specializing in high quality breakfast and lunch items. But while predecessor Au Bon Pain was mostly an urban concept, Panera's target audience is mostly a suburban one.

Now I must couch my comments with the caveat that I have yet to visit a Panera Bread outlet, but at an 81-1 price-earnings ratio , trading at 8 times its book value, I presume Panera Bread must be a pretty nifty place. Given its intention to displace the local suburban coffee shop (likely at higher prices), it better be.

The problem is that if you remember what happened to Au Bon Pain as a stock, you might want to think twice about investing in Panera. Au Bon Pain was a very hot stock for a period of time shooting up into the stratosphere (above $80 a share as I remember) as new store units were opened. But then in an equally fast manner, it soon collapsed into single digits (on the back of disappointing earnings, market saturation, and debt servicing problems). Eventually its founder sold Au Bon Pain to another group – but it was still at a single digit share price at time of sale.

It would thus appear that this fellow may be trying to do the same trick a second time with Panera, only likely with the intention to avoid the ugly fall from grace at the end of the process – hopefully by selling out earlier. Maybe this time the suburban bakery concept and fast growth in store openings will work better than in the first instance. But once burned, investors are warned to be twice shy. Another Boston Chicken-fad this might be.

In general, and on an overall basis, the market seems to be treating America's mid-quality concept-restaurant business as some sort of safe haven in recessionary times. We can almost hear some Wall Street analyst say: "People still have to eat after all." At current stock valuation levels, however, we just don't buy that argument, and with Fibonacci rhythm bands across a wide variety of these stocks all looking "complete" or nearly so, we think an end to recent equity froth in the restaurant space is near.



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. 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.