Sand Spring Advisors LLC

Starting To Shake

by,

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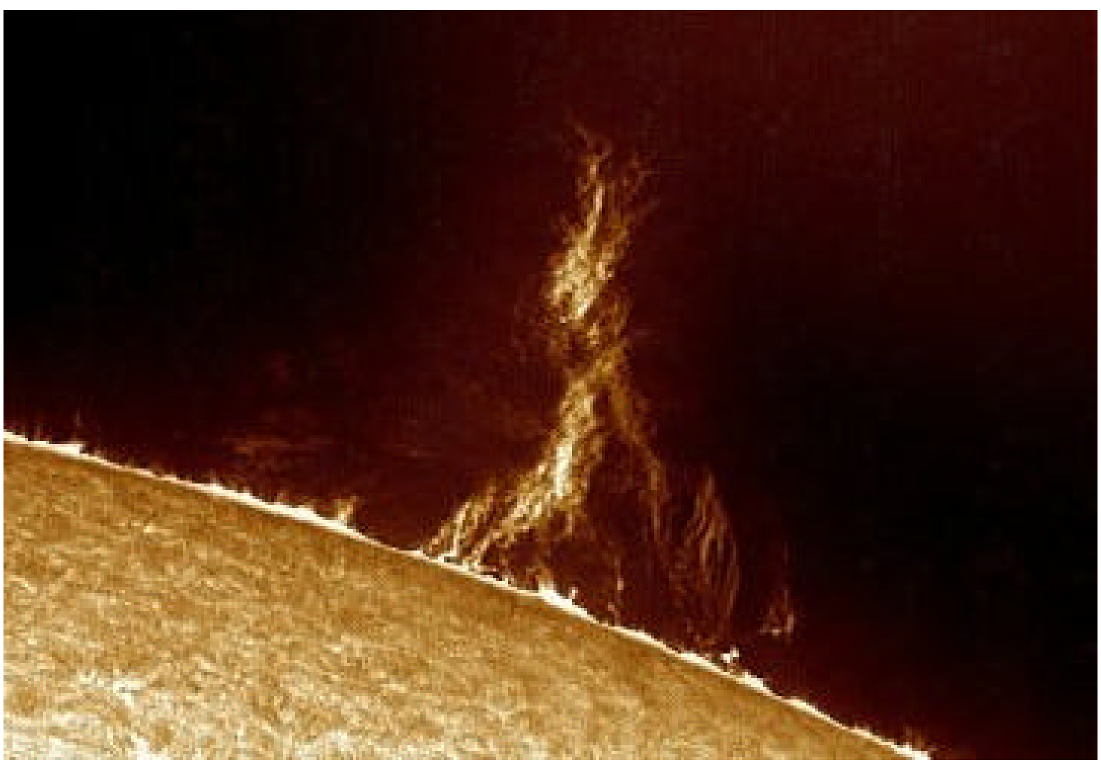
April 8, 2007

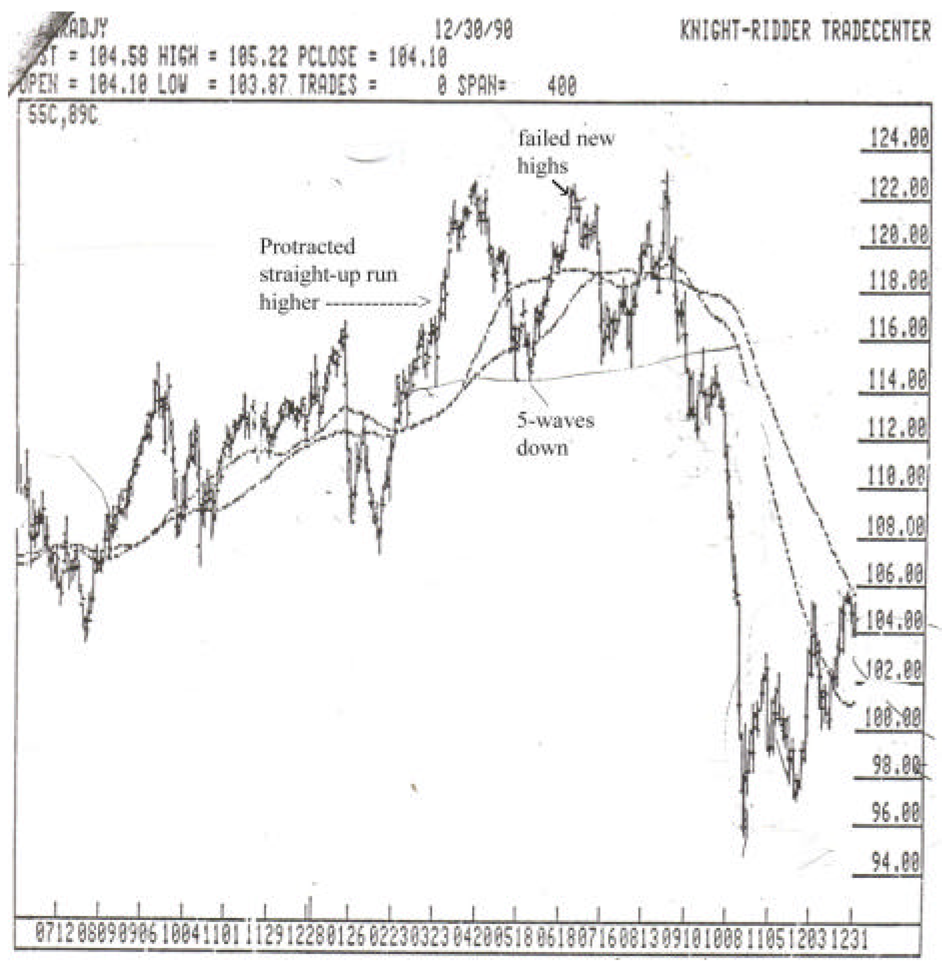
The earth is starting to come alive of late with earthquakes hitting southern Sumatra on March 6^{th}, killing 70 people; a major 8.1 magnitude earthquake hitting the Solomon Islands on April 1^{st}, killing 34 people; a modest earthquake hitting the Azores on April 7^{th}; and a huge volcanic explosion currently taking place on the island of Reunion in the Indian Ocean. The pictures below show lava from Reunion's angry Piton de la Fournaise currently pouring into the sea.

Meanwhile, befitting the ancient Sumarian belief in "as above, so below" – solar flare activity on the Sun has been most intense. The tornado-shaped solar prominence pictured below is currently towering 5 Earth diameters above the sun and sending magnetic rays due to hit the Earth April 9-10th. No, this will not be Armageddon – just a normal cycle of solar rhythms – but we would not be surprised to see more turmoil hit the Earth, and perhaps the human psyche of equity traders, after the long Easter weekend.



April 9th-10th also sticks out for other reasons. While the next Armstrong PEI 4.3-month cycle date will not hit until July 5, 2007, master "trading day" cycle analyst Bill Erman of Ermanometry Research (www.ermanometry.com) points out that there are certain other fractal harmonics into early April. One of these starts with measuring the day count in trading days between the 1974 S&P bottom and the August 9, 1982 bottom which was 1981 trading days. Then take 1981 days and multiply it by pi (3.1416) and one gets 6223.5 trading days. If one then adds 6223.5 trading days to the 8/09/82 S&P low, a potential Erman "Ezone" focus period for a reversal pops out for 4/09/07 or 4/10/07. As Bill would say, this is just a window for a reversal in fractal time, and such techniques will not bring a reversal in every instance. But it is a mathematical fractal to ponder and be aware of – particularly with Friday, April 13th also representing Armstrong's 34th trading day post the February cycle high, with such 34th days often being a point of downside acceleration after a significant high.

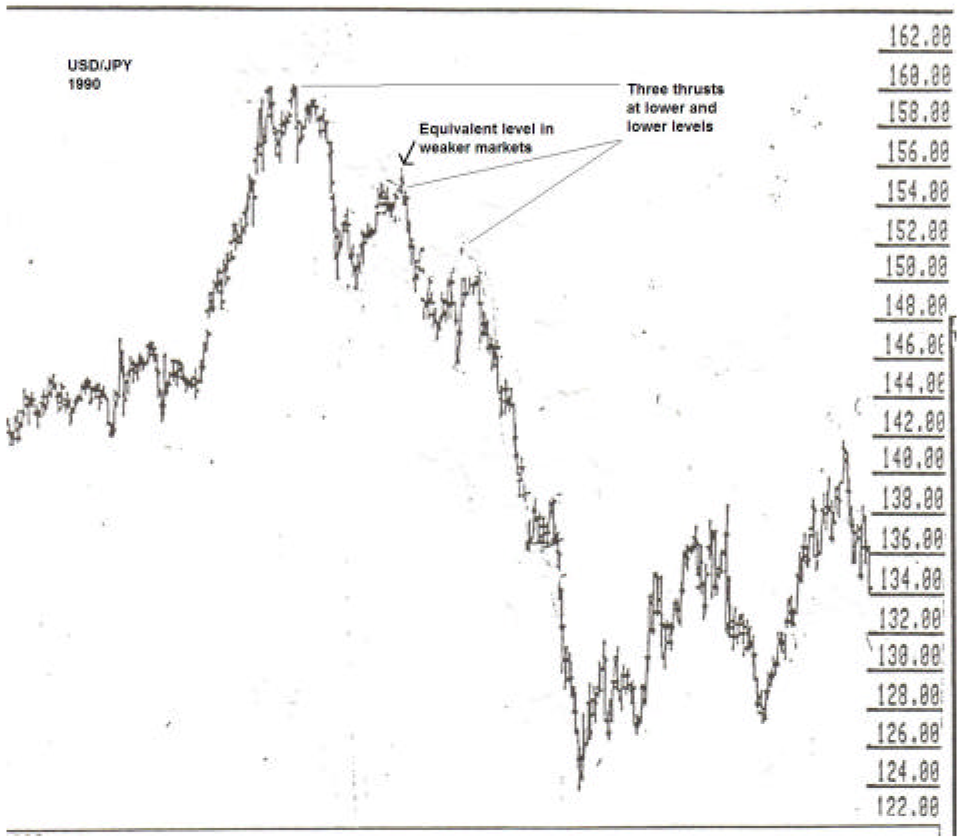
In general, the effort by the equity market to rebound from the early March slide has been impressive, and left some of our earlier March 3rd "straight down" market analogies looking silly. But what we see at present is a market likely making a failed attempt to take out the late February highs. Indeed, as we think back across almost 30 years of chart patterns that we have witnessed, the past market chart analogy that now comes to mind for 2007 equities is that of AUD-JPY in early 1990 when it left a huge triple top formation. This prior chart pattern was marked by a swift and persistent upmove (similar to the Oct 2006-Feb 2007 run in 2007 equities); a sharp initial decline (similar to the February 24-early March 2007 5-wave equity downswing); and then a sharp retracement higher (perhaps equating to where we are now in 2007 equities) followed by yet another slide, and then one last rally with a "false breakout" higher high, before an eventual swift collapse. In this prior analog, it was almost as if *the longer* AUD-JPY fought to go higher, the more energy it used up, and *the larger and more dangerous* the eventual decline became.



Looking back at several PEI cycle turns – most notably the one on July 20, 1998 that brought immediate extreme fear in a swift and deep 8-week decline – the bear market then faded away as quickly as a summer squall. But when a PEI cycle date starts like it has in 2007 with more of a step and stumble "tug of war" move lower, and overall denial by the market that anything has changed, this may mean that the decline period will actually extend for 18-24 months in the end (as it did post the 1972, 1981, and 1989 PEI cycle highs). On an analog basis, are we now near the "failed new highs" arrow on the old 1990 AUD-JPY chart above?

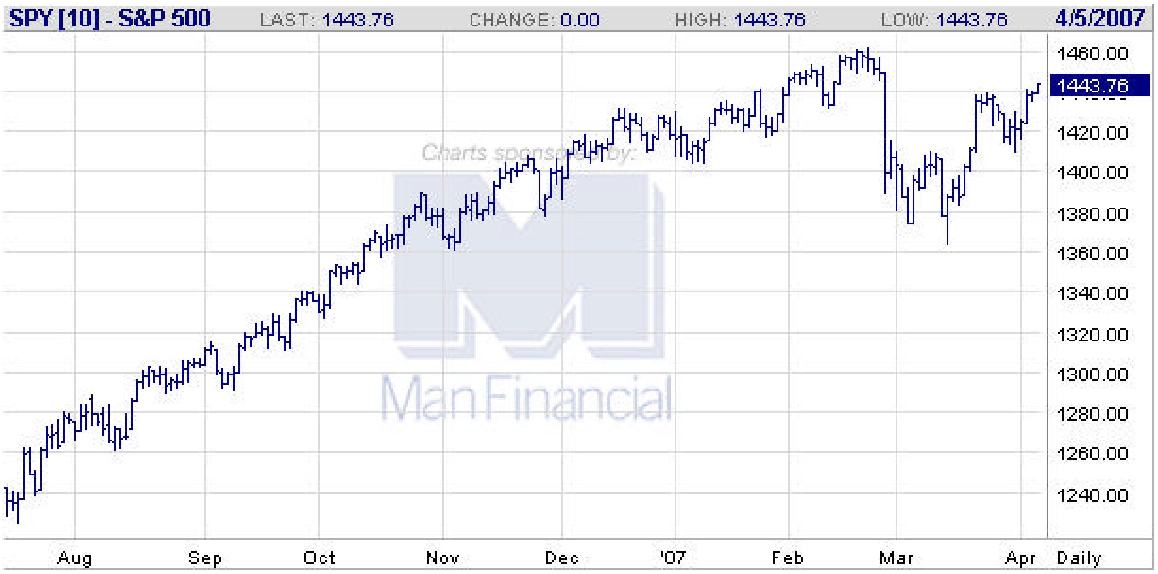
Some indices have of course not even approached their old Feb 24th cycle highs with far more anemic bounces. As one example, just look at the anemic bounce in the Dow Jones Transportation Index below which also resembles many retail and financial sector indices such as the Consumer Retail ETF XLY and Financial sector ETF XLF.

For these latter markets, we might suggest that the triple topping formation shown in the AUD-JPY analog above will start to "slide" more into the type of chart pattern seen by USD-JPY across the same 1990 period. Each rally attempt will become more anemic over time.

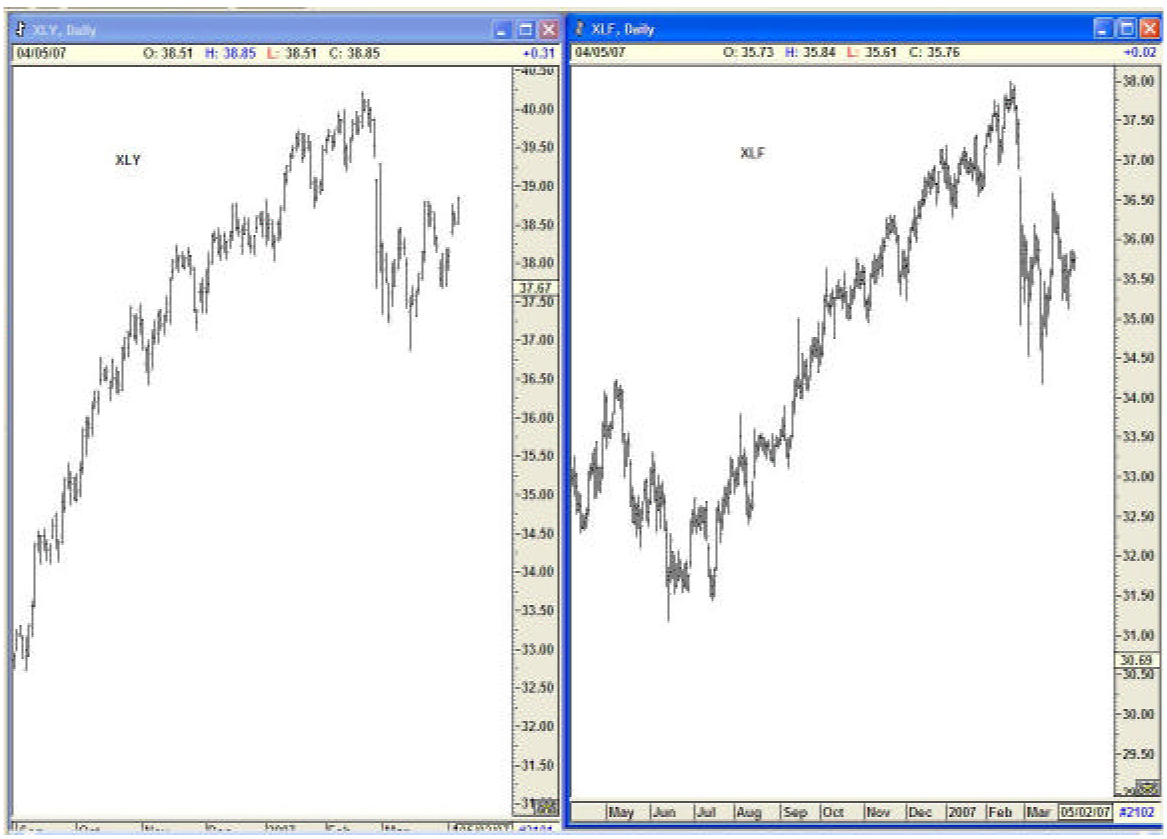


Imagine the first AUD-JPY chart above being something akin to the current DAX or the S&P 500, while the second USD-JPY chart will end up looking more akin to the Consumer Cyclical ETF XLY or the Financial ETF XLF.

Patterns potentially akin to 1990 AUD/JPY

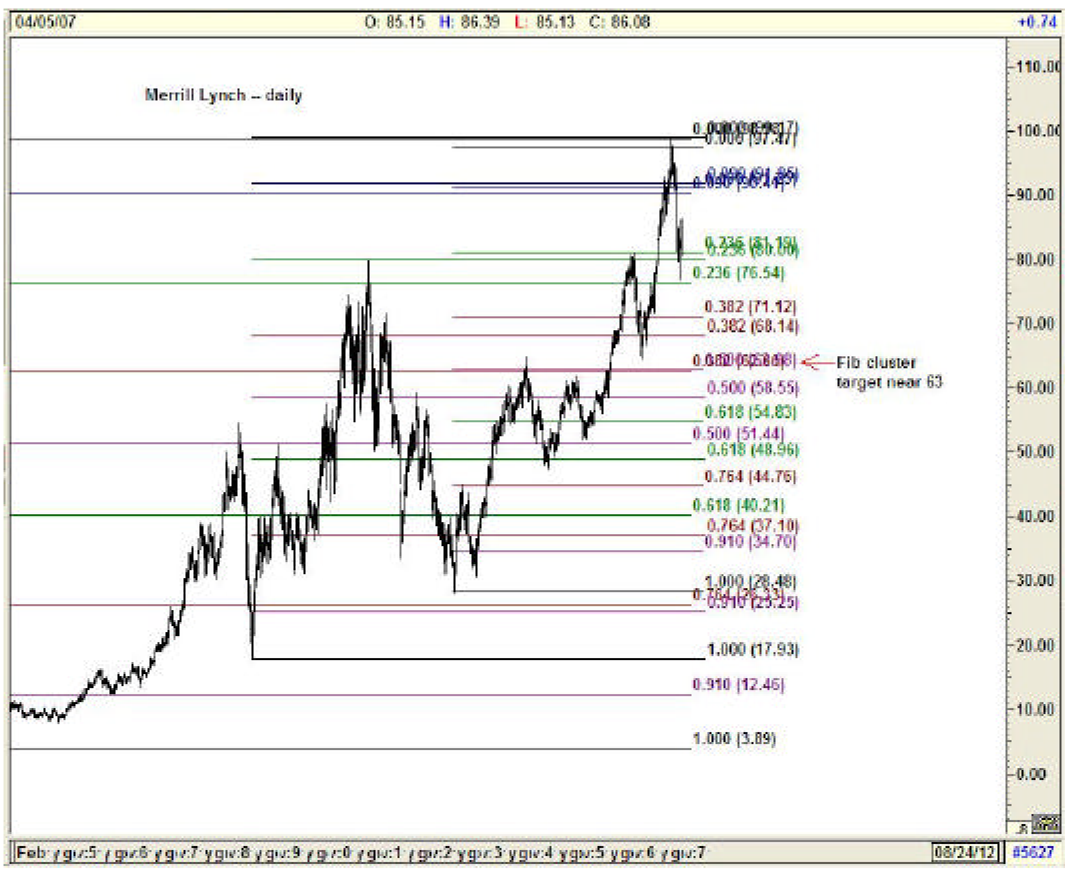


Patterns more like 1990 USD/JPY….

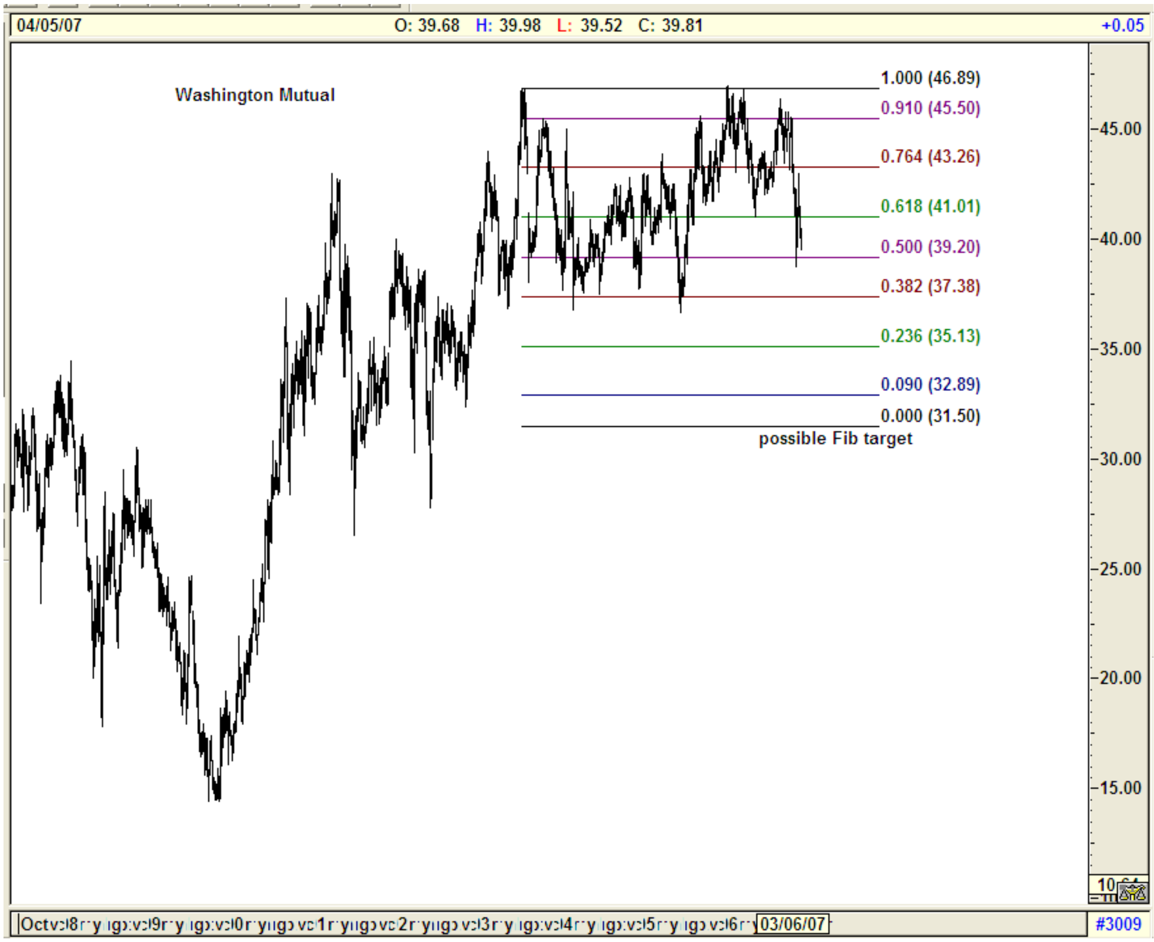


Individual chart patterns that strike us as having a compelling downside potential currently include JP Morgan, Merrill Lynch, and Washington Mutual.

04/05/07
O: 48.35 H: 48.89 L: 48.34 C: 48.77
+0.21
JP Morgan - Daily
0.910 (68.69
0.764 (60.28
0.618 (51.9
0.500 (45.05
0.382 (38.2
Fib target 38.24
0.236 (29.8
Fib target 29.83
0.090 (21.41
0.000 (16.2
#3102



04/05/07
O: 85.15 H: 86.39 L: 85.13 C: 86.08
+0.74
Merrill Lynch -- daily
0.236 (76.54)
0.382 (71.12)
0.382 (68.14)
Fib cluster target near 63
0.500 (58.55)
0.618 (54.83)
0.500 (51.44)
0.618 (48.96)
0.764 (44.76)
0.618 (40.21)
0.764 (37.10)
0.910 (34.70)
1.000 (28.48)
0.910 (25.25)
1.000 (17.93)
0.910 (12.46)
1.000 (3.89)
08/24/12
#5627



Let us finish this month's letter by spending just a bit of time discussing the mortgage market and Washington Mutual in particular.

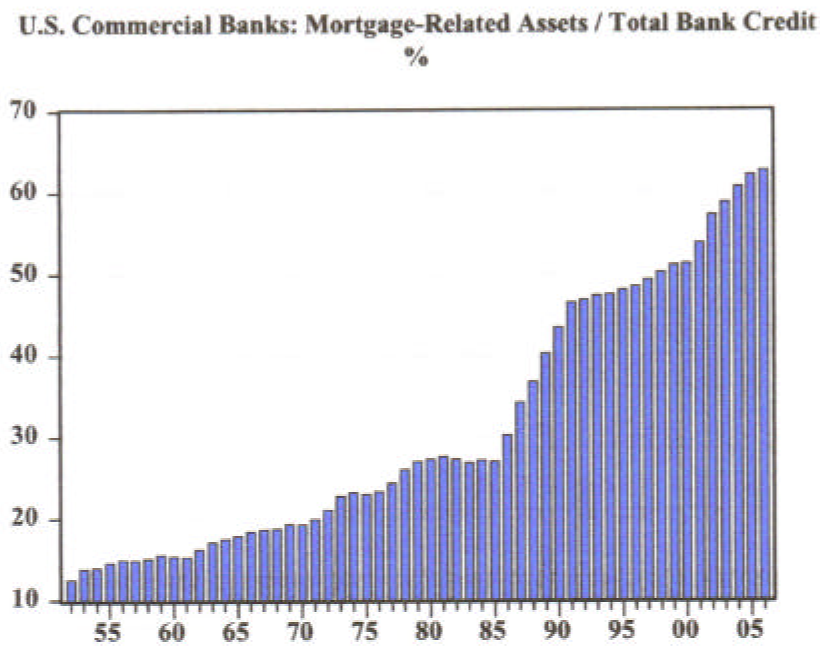
Countrywide was one stock that took a particular pounding across the recent sub-prime lending fall from grace, but arguably Washington Mutual has an even worse mortgage portfolio problem brewing than Countrywide with slightly poorer overall portfolio loan quality.

Similar to Countrywide, Washington Mutual – in its effort to continue to grow even as the housing market became overpriced for many of its potential customers, and traditional mortgage margins eroded as interest expenses increased – specifically embraced "option income ARMs." Option income ARMS are like subprime mortgages in drag. They may have been sold to a slightly higher clientele than sub-prime loans, but they typically are issued with low teaser rates for the first year or two that adjust upwards thereafter. The most popular feature is the "option" which allows the borrower to choose each month between paying the fully amortizing normal mortgage payment, the interest-only payment, or a below rate "cost of funds" payment that makes the loan negatively amortizing. Previously, home buyers were typically allowed to qualify for these loans based on the lowest payment options.

While Washington Mutual may claim only a 10% exposure of its portfolio to sub-prime lending, about 30% of Washington Mutual's originations and the same portion of loans on its balance sheet are option income ARMs. Back in 2005, 43% of first time buyers put no money down for their house, and 2005 was also the biggest year for option ARM loan issuance. This was not a problem initially when home prices went up, but it is now. Indeed, doing the simple math, <u>it is easily possible that many homeowners now owe 10-15% more principal on their mortgages than their home is worth.</u> In 2004 default rates were low and only 1% of Washington

Mutual's option income ARMs were in negative amortization. In 2005 loans in negative amortization jumped to 55%, with some estimating that by 2006, 70-80% of these option income loans became negative amortizing. This negative amortization effectively equated in 2006 to $1 billion of non-cash income on Washington Mutual's income statement, and represented approximately 20% of WM's reported pretax earnings. Do investors in WM understand that in lieu of earning real interest, that their bank is becoming a larger and larger property owner each and every day, and that some of the property that they own may no longer be worth the price on WM's books? Apparently not, as Washington Mutual as late as mid-2006 called option ARMS its "flagship product" which it was trying to increase, even as it also reduced provisions for mortgage defaults. Is WM the next Enron house of cards in the works?

What other problems lurk in the land of bankers given the record high exposure by the U.S. banking community to commercial and residential mortgages, as shown on the chart below (courtesy of Northern Trust)?



Source: Northern Trust

These are indeed worrisome questions to ponder as we also move into the 25* pi* 1000 anniversary of the May 17, 1792 birth of the New York Stock Exchange. This birthday hits on May 16, 2007, and represents yet another interesting cycle date within our toolbox.

Send us your comments at information@Sandspring.com.

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