Sand Spring Advisors LLC

Cycle Update as of June 2005

by,

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We spent most of our last letter discussing individual stocks with appealing chart patterns – doing so particularly within the water industry. Many of these water stocks -- including SJW Corp, Lindsay Manufacturing, and Layne Christenson -- have performed admirably in recent weeks.

Prior to that letter, we turned generally bullish on the market in late April 2005 just in front of our mid-May PEI cycle date, and specifically suggested in our April 30, 2005 article *"Time for the Rabbit Out of the Hat"* that the summertime would likely to be relatively benign in broad equity market terms. We said this despite our concomitant view that crude oil would make yet another vault from its then current price level near $49.50 towards an upside Fibonacci target of $61.22. Our actual words were:

> "So overall, May 11, 2005 could easily bring a shift back to an earlier positive inflation thematic – 'Buy Assets! – Buy stocks, buy oil, buy gold.'"

Overall, we have thus been in relative synch with the markets – maintaining our longer-term skeptical and bearish view of the world, but not allowing ourselves to be run over by the bull in the short-term.

The next minor PEI cycle date will be September 19, 2005 – and despite our short-term "free-pass" given to the equity markets -- we have previously suggested that the period between mid-September and January 27-28, 2006 is likely to be an extremely stressful one. Conceptually, we can envision a number of fundamental reasons for this:

- The U.S. consumer may stagger through the summer with his wallet open and credit cards in active use, but can the consumer make it through Christmas as well without retrenching? We doubt it. A point of entropic reversal for the U.S. consumer is coming when the consumer will be unable or unwilling to service or expand his/her debt load. This point may just not be "fully baked" quite yet.

- The property market remains hot and supportive of the consumer at present, but it will surely not be so for much longer. Anecdotal signs of excessive speculation are everywhere. In recent months 32% of private residence property sales in Denver have been made to buyers for investment purposes, and interest-only mortgages have now reached a similar percentage vis a vis total mortgages for many mortgage companies. According to Loan Performance Inc., 9% of new mortgages granted in Q1 2005 were actually of the negative amortization type. Back in 2003, only 1% of mortgages granted were of this type. None of this will end well.

- Mr. Greenspan leaves office in early 2006, and with that departure will come more natural uncertainty whether the economic "magic" that he is perceived to have brought over the past 18 years can be perpetuated by his replacement – whoever that lucky person is. This should be somewhat similar to the previously encountered "Jack Welch effect" on GE's stock after Welch retired. GE stock actually held up very well before Welch left even though everyone knew that he was leaving, but then promptly collapsed thereafter.

- The onset of winter in the Northern hemisphere will bring with it increased risks of energy shortages and the possible pandemic spread of Asian bird flu globally. Call these "wildcard" risks that are currently being under-estimated by the market.

- New FASB incentive options accounting practices (as outlined in their Statement 123R) will be applied to public company financial results starting June 15, 2005. This will expose North American earnings growth to lackluster year-over-year performance that the public will likely only take notice of come the fall release of 3rd Quarter earnings.

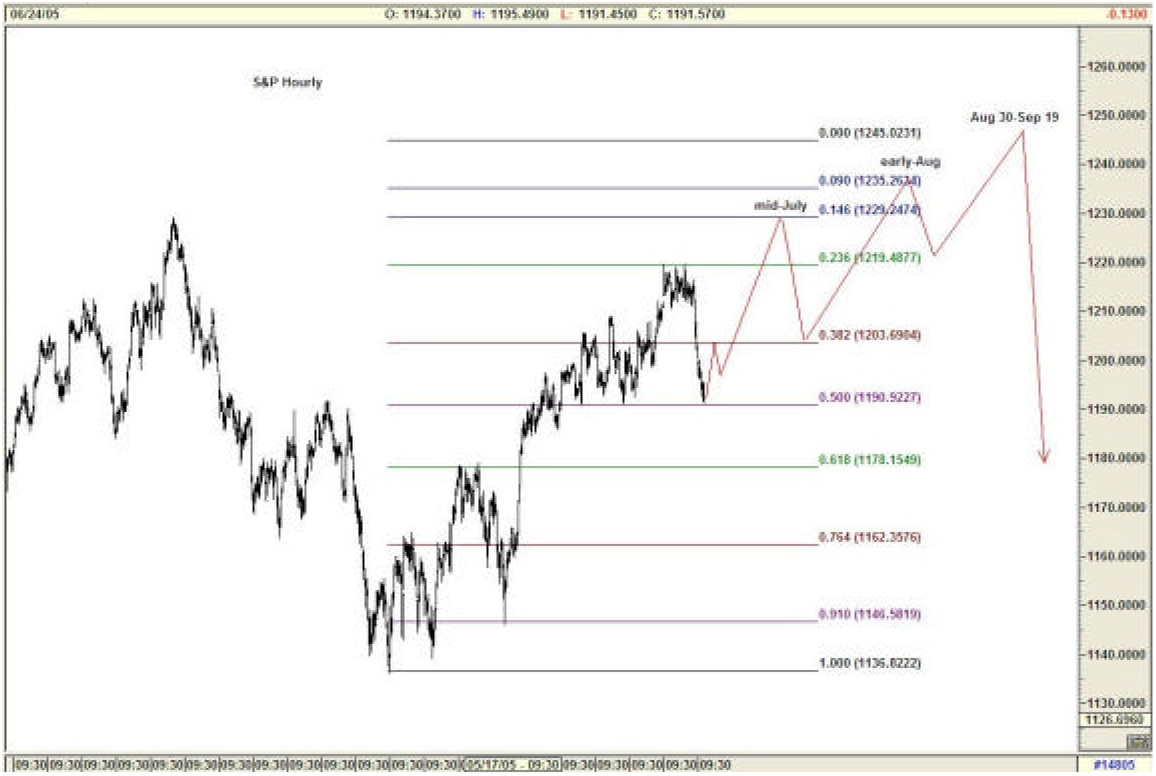
Cyclically, we also worry about the following:

- July 17, 2005 will mark .618 * pi * 1000 calendar days since the March 24, 2000 high in the S&P and NASDAQ 100. A full 3141 day (pi * 1000 cycle) from that date will then not come until October 29, 2008. Could the .618*pi marker come at the secondary reaction high on the way to a major low in October 2008? July 18, 2005 also represents a minor pi cycle rhythm related back to the August 12, 1982 equity market low. July 16, 2005 further marks the geocentric movement of Saturn into Leo – a bear planet moving into the sign of the market and speculation.

- The Bradley Cycle is due to leave a double peak first on July 14, 2005 and then again on August 30, 2005, and from there will move into "hard down" mode from August 30th until mid-December 2005. Astro cycles turning lower in front of our PEI September 19, 2005 cycle date simply reaffirms the importance of this date in our mind.

- December 30, 2005 will be .50 *pi *1000 days from 9/11 – a perfect time to expect America's mood to have turned truly sour, with Bush ratings in the polls likely at new lows (something also fairly typical of the Presidential Cycle during this window of time post a U.S. Presidential election).

In "three steps and a stumble fashion," we think that it may take each of the July 17th, Aug. 30th, and Sep. 19th cycle dates to slowly turn this market lower, but once it has turned for good, acceleration lower should be swift. Most immediately, however, we <u>do not see</u> the weakness of the past few days as likely having much downside follow-through. This market should instead continue to make the life of short-sellers difficult – perhaps with a path somewhat similar to the one depicted below on an hourly S&P chart.



We are imagining the July-Aug 2005 period as a whole to be somewhat similar to the Aug-Sep 1987 period of froth – before the horrific October 1987 Crash – a period where equity prices were already too high to buy, but where one needed to be very careful not to sell too early.

What could possibly cause a last hurrah of equity market ebullience?

The Fed meets this coming Thursday, June 30th and is widely expected to raise rates another notch to 3.25%. But as always, Wall Street will more focused on every nuance of the FOMC's official statement rather than the actual rate hike. If from these words analysts somehow glean that the Fed has reached its perceived level of interest rate "neutrality," and that a pause in rate hikes might thus be forthcoming either at the August 9th or September 20th FOMC meetings, we'd expect market jubilance and celebration in the short-term – even if in the long-term such a statement and its ramifications would have little overall importance.

Perceptions that the Fed may slow down the pace of their rate hikes would also be supportive of gold – particularly during this time of year when jewelry fabrication demand typically picks up in anticipation of the Christmas/Holiday season. Seasonally July and August are almost always up months for gold.

Gold in euro terms has recently been rallying the most, and in terms of this chart, we see a clear upside Fibonacci target near 414.60 euros.

Gold itself shows an upside Fibonacci target near $472, which would imply that the euro might reach a downside level near 1.1387 (slightly beyond a 38.2% retracement of its 2000-2004 advance)! But if gold overshoots to $490 or $500, the euro could also just be sitting around current levels around 1.2060. In general, we have little opinion about the euro on a standalone basis, but we do like gold-denominated-in-euro and gold itself!

Lastly, let us talk a little bit about U.S fixed income. Few would have ever expected that with $60 oil, $430 gold, and a strong equity market, U.S. 10-year yields could still be at a sub-4% yield. Macro hedge funds have been losing money on their bets short U.S. fixed income; so too have hedge fund arbitrage firms who are short U.S. Treasuries as *rho* hedges against their interest rate exposure from convertible bonds and other high yield, asset-backed, and mortgage-backed paper. Indeed, here at Sand Spring Advisors, we have come to the conclusion that U.S. Treasuries going *up* (Treasury yields down) at the same time as credit spreads really *widen* (a combo of events few might ever expect) could easily someday represent the "path of most pain" that hurts the most supposedly sophisticated market participants at the same time. If any reader is invested in hedge funds, it may be best to get out of complex strategies that involve short U.S. Treasury hedges and other credit derivatives trading, and reallocate your funds to simpler strategy areas that are not involved in this space.

In the short-term, we have no opinion on 10-year notes. Indeed, of all the markets, we currently dislike the concept of taking *any* position within fixed income the most. We all know that there is generally too much U.S. debt outstanding; we all know that much of this debt is held by foreigners who may be ill-inclined as time passes to add to their already massive holdings; we all know that the Fed is currently tightening; and we all know that inflation is on the rise while the U.S trade balance is out of control. But the U.S. fixed income market simply does not go down. It instead seems to be forecasting a recession or depression. It picks up a strong bid on each and every minor swan-dive lower by the S&P. Longer term, the rhythm depicted below suggests that a 10-year T-note futures price above 129 is possible. We will *not* be involved in betting on such a move, but we will also *not be so stupid* as to bet against this double-edged market that seems to be causing so many so much pain at present.

Watch the web for potential updates of our views around the mid-July 14-17 cycle window.

Send us your comments at information@Sandspring.com.

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