Sand Spring Advisors LLC

Some Key Levels Yet To Be Broken: A Brief Update

by,

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In our late June letter entitled "Active Applause" we espoused a swift equity market decline towards 1000 on the S&P and 566 on the NYA Index, followed by a reaction rally into late December.

While this path remains very possible, if not probable – particularly given the July market sloppiness that transpired after we penned that prognostication -- we have to be realistic and admit that certain key levels in the market have yet to be breached to fully confirm such a path.

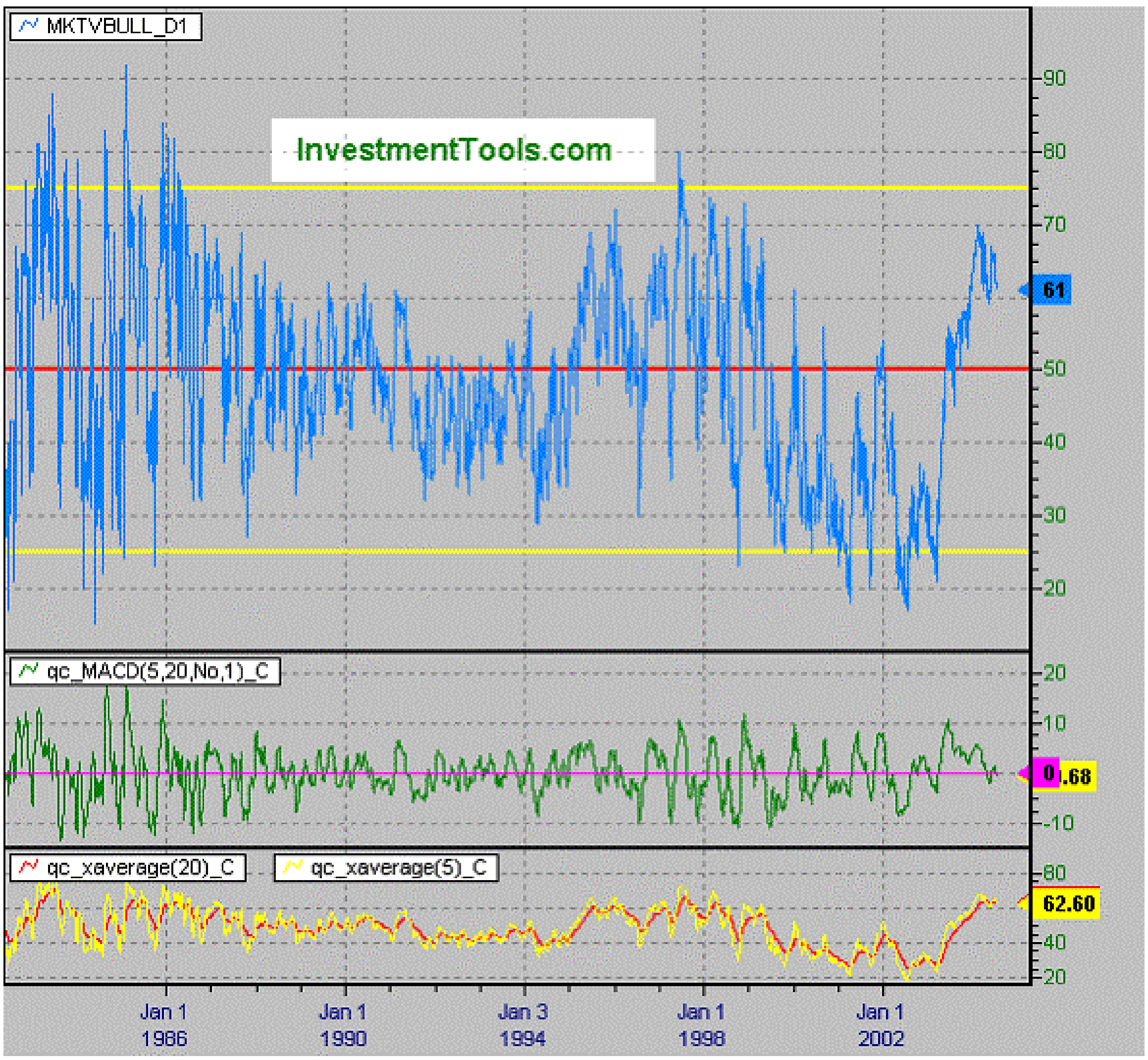
Specifically, the S&P 500 has yet to take out its low of mid-May 2004 at 1076.32. Nor has the NYA Index yet to fall below its mid-May low at 621.14. Instead, as these levels were approached in the early afternoon this past Monday, July 26th (the S&P coming within a scant 2 points of its May low) both levels were at least initially rejected, and the equity market closed the final trading sessions of July more buoyant than we would have liked to have witnessed for the bear case to be clearly intact going into August.

Caution is thus warranted before remaining too dogmatic in any one view of the market at the current time. We have reached a key juncture where close attention is needed to differentiate between whether the equity market decline is just beginning (as so many financial stock chart patterns appear to suggest), or whether the February-July period has been some sort of large sloppy 4th wave within a larger corrective A wave rally that is yet to be completed.

Fundamentally, an argument certainly exists that fixed income markets have over-discounted the pace of the forthcoming Fed rate tightening cycle, and Fed-watching types could easily breathe a sigh of relief (let that read, launch an equity rally) if the Fed policy makers were to dither in rate tightening at any of its upcoming monthly meetings.

But elsewhere on a fundamental basis -- as the triple whammy of the 2003 tax cuts/rate cuts/mortgage refi activity now fade into the past – consumer retail spending does appear to be waning, and companies from Walmart to Nokia have recently started to disappoint Wall Street with earnings growth shortfalls.

Mutual fund cash holdings (chart not shown) are also now back down to a very low 4.2% -- a level last seen in March 2000, while Market Vane sentiment numbers remain stubbornly high even as equity prices have fallen. This latter occurrence is particularly bearish in so far as it indicates an unbroken mindset of investor complacency despite poor market action. The last time we saw such type behavior was in early 1994 in the fixed income market where portfolio managers (many savvy hedge fund managers among them) simply refused to conceptualize how far down fixed income markets could potentially fall.



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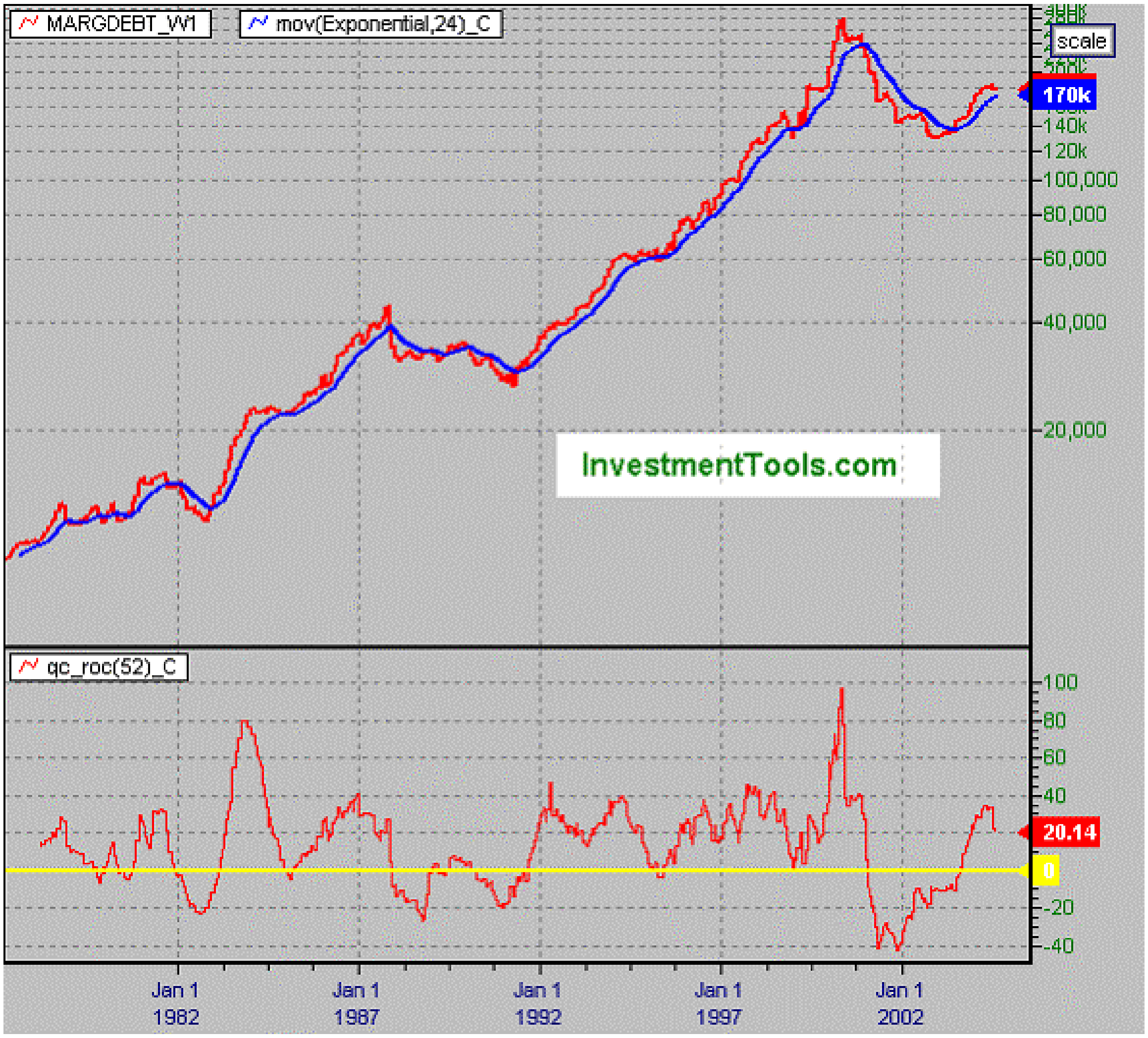
The bear market since 2000 has also hardly put a dent in total margin debt.



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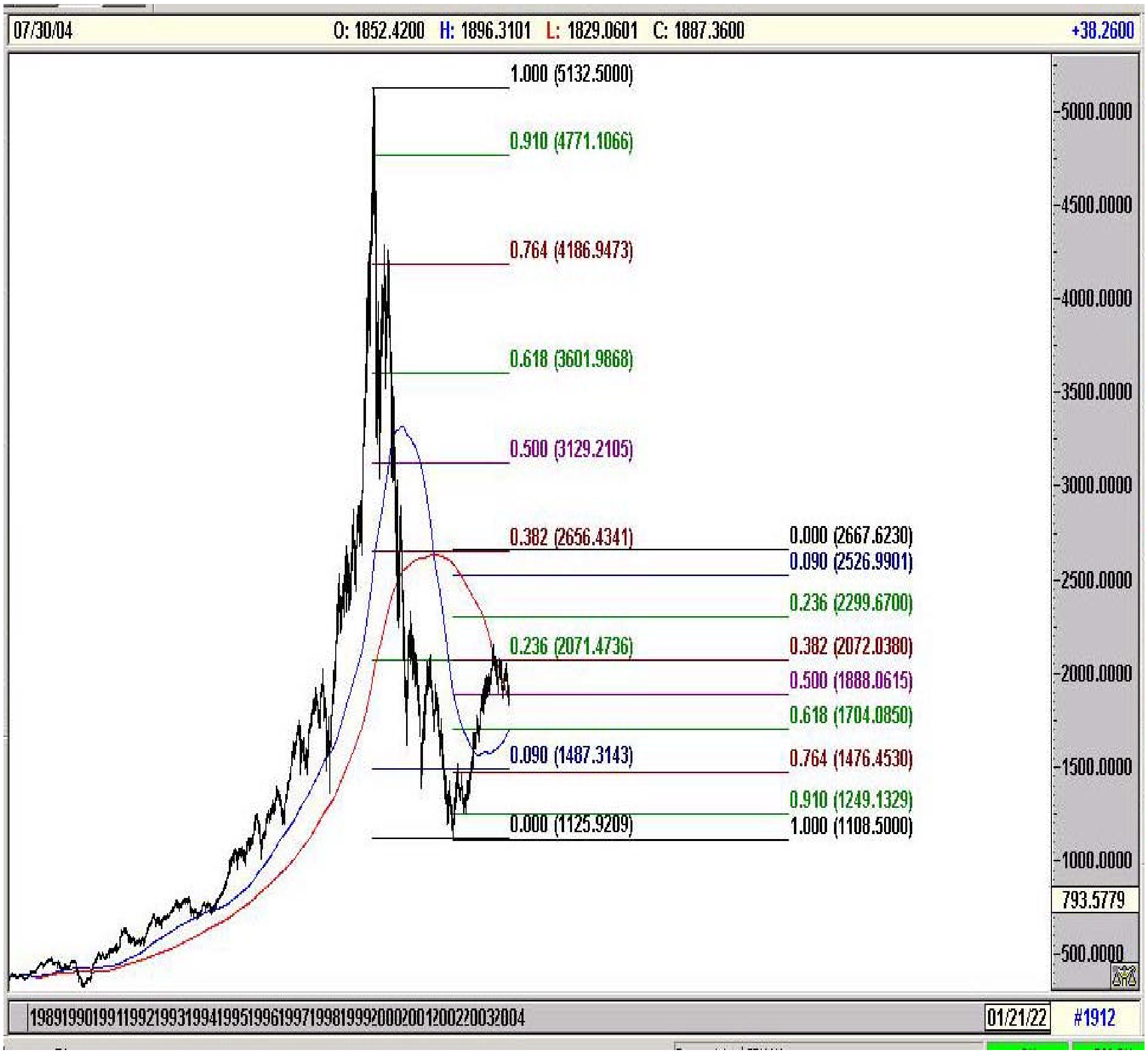
Overall, economically we see early signs of emerging "stagflation" – a condition Wall Street generally abhors – yet this is starting to transpire with almost complete investor/media/political denial that any real economic problem exists.

Returning to the technicals, a key view supporting the bear case is that while the S&P and NYA failed to decline through their May lows, the NASDAQ Composite Index did so rather easily. As shown in the chart below, on a Fibonacci rhythm basis, the NASDAQ Composite could easily be headed toward Fibonacci support regions first at 1757 and then at 1633.

And yet, to remain wholly honest, in this same NASDAQ Composite chart, there is little evidence yet of an "impulsive" 5-wave Elliott decline pattern. While there certainly could be a series of ominous I-II-1-2-I-ii patterns, some might argue that 2004 as a whole is more a typical wave 4 where both bulls and bears alike have been frustrated by the constant chop. The recent break in the NASDAQ below its uptrend line could conceivably be a false throw-over so often seen at the end of 4th waves.

Under this line of argument, while the NASDAQ Composite effectively failed earlier this year at its 23.6% retracement level of the 2000-2002 decline, it could yet make a surprise vault to the 38.2% retracement level up near 2656 -- leaving the recent period of chop as nothing more than a "flag" pattern approximately half the way up the entire corrective pattern.

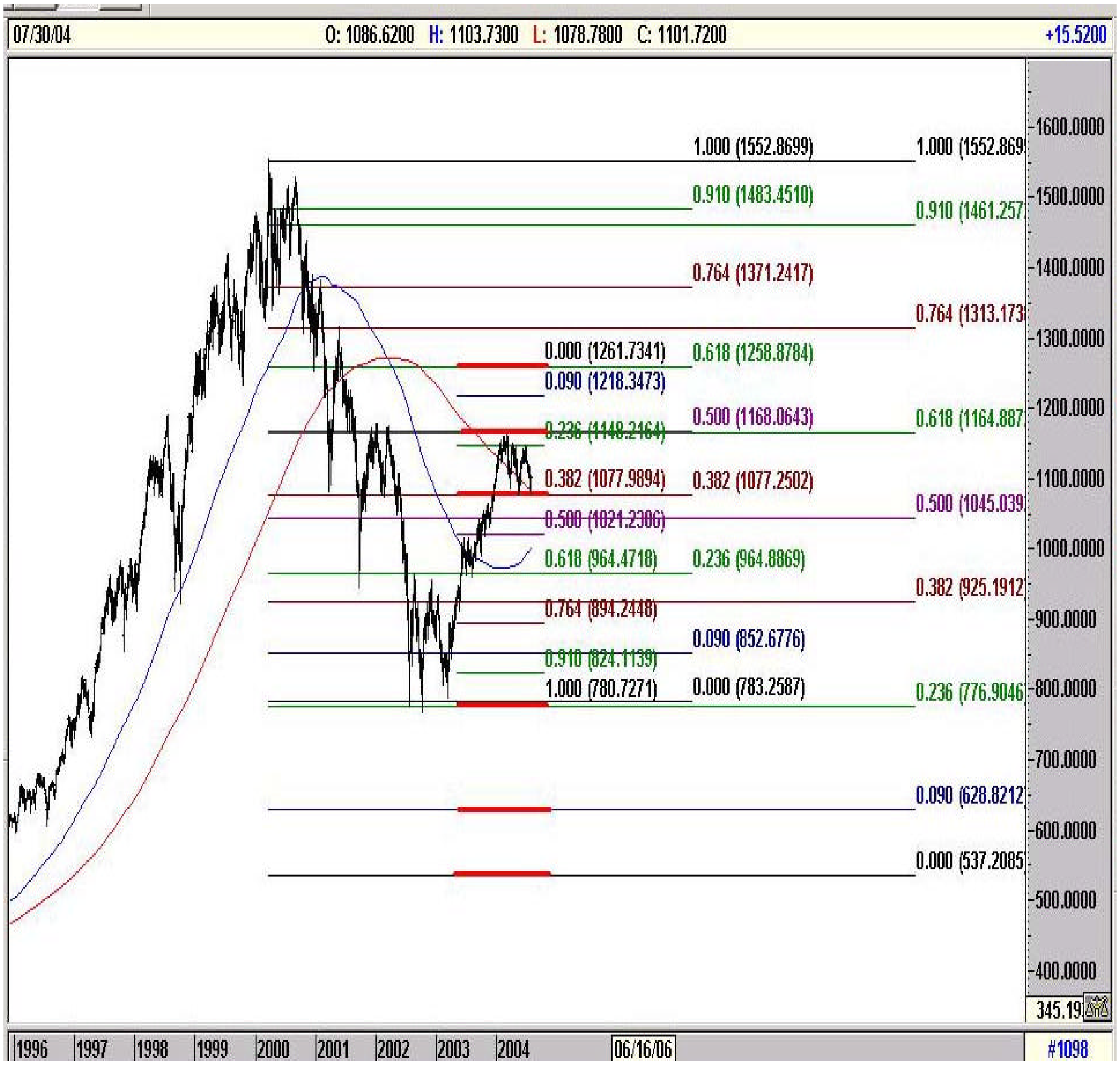
As discussed above, we don't think the fundamentals are there to support such a move, but we have learned to "never say never" in terms of potentially crazy and stupid investor behavior. As a matter of historical comparison, when gold fell from its 1980 high at $850 down to its 1982 low near $308, the subsequent bounce that it experienced was a **38.2%** rally to $515, not just a **23.6%** one as seen so far with the NASDAQ. Gold of course then remained in a bear market for another decade.



So while we do not want to sound wimpish in our overall bearishness, we must remain realistic and attentive to further technical footfalls and clues. We really need to see 1076.32 break on the S&P and 621.14 break on the NYA Index to truly confirm that an overall equity smash to the downside is taking place. Until such occurs, we cannot be entirely sure of anything.

In general, the red lines on the chart below define in our mind all of the key Fibonacci target levels to watch on the S&P in the coming years. The big picture is that levels such as 629 and 537 on the S&P are likely to eventually be seen. But in the shorter-term, could we get one more leg up in the recent counter-trend rally to 1260? This is the more uncertain $64,000 question.

Most people on the street currently believe that stocks will go up in the long term, but are being weighed down in the short-term by a messy Iraqi War and a presidential election that is too close to call. We actually see the opposite. In the long-term stocks will fall, but in the short-term a variety of alternative paths are possible.



We are hopeful that the first few weeks of August will be enough time to clarify this still sloppy picture. Perhaps the expected August IPO of Google will mark the last hurrah of the bulls. Most commentators currently expect Google to fetch a total market capitalization of $29 to $36 billion – a value potentially greater than the total capitalization of General Motors. Does that really make much sense? Or will this be another late-stage Internet bubble oddity destined for the history books?

Send us your comments at information@Sandspring.com.

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