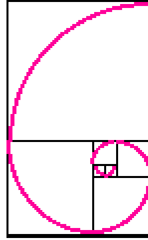

Sand Spring Advisors LLC

The Importance of June 2, 2001

by

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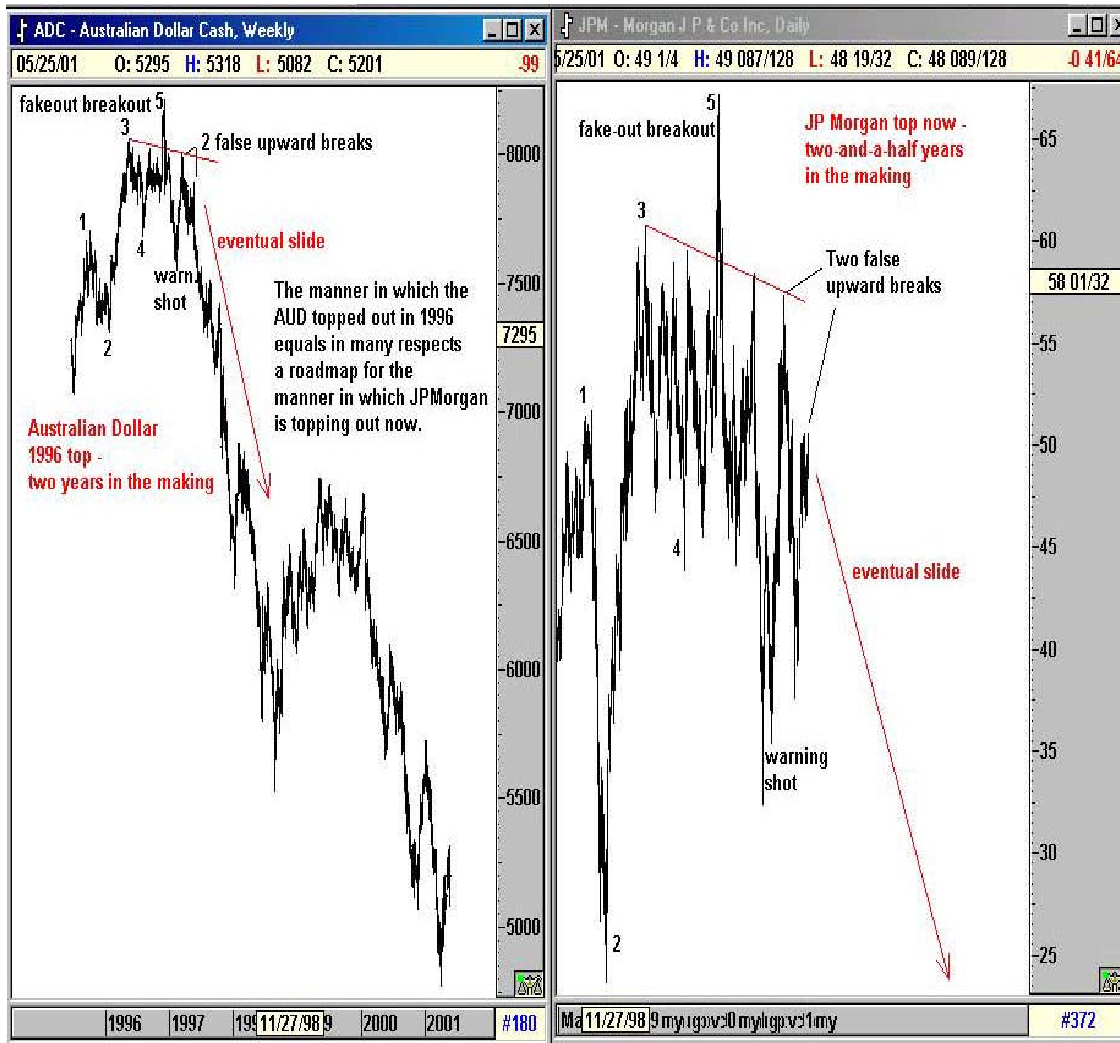
On July 20, 1998 major European and American major equity indices suffered a major reversal that few at first took note of. By mid-August of that year, the twin Russian and LTCM crises had hit, and everyone had noticed a financial world run amuck. Since that time, we have experienced a wild ride both higher and more recently back down in equity prices, but within it all, the U.S. equity market has had a definite rhythm of peaking every 8.6 months.

The dates haven't hit precisely, and the S&P, NASDAQ, and DJIA have each followed a slightly different drummer at different times, but overall, there has always been a shift in the wind to the downside every 8.6 months. Specifically, if you go back and closely examine U.S. equity price action, April 8, 1999 represented a momentum high in many Internet stocks; December 26, 1999 represented a momentum high in the DJIA just under our idealized 11,541 Fibonacci target (with just marginal new highs to follow into early January 2000); and September 13, 2000 represented the beginning of a major slide in global telecom stocks and a horrendous 4th. Quarter for the NASDAQ 100. We now are now quickly approaching another 8.6-month cycle date of some importance: June 2, 2001. Will this date represent yet another turn to the downside?

We think it will, only this time, we think it will be the financial sector stocks that are likely to come under the most significant new pressure. Here's an analog "pattern match" that we have had our eye on for sometime. It compares the manner in which the Australian dollar topped in 1995-1997 to the manner in which JP Morgan Chase has been topping between 1998-2001.



We consider the chart of JP Morgan on the right to be a zoom-in snapshot of the way AUD was behaving back in 1995-1997. Back then, it took a full 2-years for the AUD to chop around in a number of false breakouts, before finally leaving two false upward breaks, followed by a collapse. If our analog works, JPM should almost be ready for the collapse part of the analog.

Although far from a perfect match, the overall pattern we are discussing here even resembles that of the Dow Jones Industrials itself – a sloppy, choppy mess, but basically composed of a false break higher, followed by a false break down, and then a rebound to a downward sloping trendline across recent tops that we can now lean against for stop-loss purposes.

And what pre-tell could get a bank like JP Morgan Chase in trouble, leading both it and the wider DJIA to tumble? We have previously pointed to the excessive amount of soon-to-be non-performing consumer debt that resides behind the balance sheets of companies like Capital One and Providian, but surely J.P. Morgan doesn't have significant problems in this area.

What J.P. Morgan Chase does have however is the largest derivatives book by far in the world. We have yet to hear of a big derivatives accident a la the 1998 LTCM debacle in the current equity downdraft, and yet so much potentially-leveraged wealth has been destroyed between March 2000 and today, that surely one or two derivatives accidents may still be lurking out there – incubating themselves and becoming more serious with the passage of time (and financing costs).

In a similar vein, JP Morgan Chase also has various venture capital arms (Lab Morgan, Chase H&Q, etc.) that were particularly aggressive in financing and investing in high-tech start-ups before last year's meltdown. For example, at one point profitability from private equity holdings in Chase's portfolio contributed over 25% of that bank's total earnings back in 1999. Now many of those companies need another round of equity issuance to survive, and investment-banking sources tell us that aggressive new roadshows are being met with disappointingly few takers.

Previous darlings to earnings performance may thus quickly be turning into dead weights. And without adequate rounds of fresh financing, dead weights can quickly turn into write-offs.

All this takes time of course. It doesn't happen overnight. But we'd keep a close eye on JPM as June 2 approaches to see if it does not kick off the financial sector weakness we anticipate for the next 8.6-month period.

As one small sidebar, it was of course the legendary man JP Morgan himself who helped save the financial world in 1929. How ironic and sad it will be if it is now his bank at the center of a new financial storm at the start of the twenty-first century.

We would not be surprised if both JP and more recent Morgan head Lewis Preston are both rolling over in their graves at what has already become of their once venerable institution. And yet the bank's potential problems and weaknesses haven't even surfaced to the public's attention yet. Maybe by mid-summer they will.

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