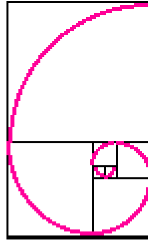


Sand Spring Advisors LLC

Perspectives on Where We Are
&
Why ISDA Documentation Will
Not Prevent Derivatives Accidents

by,

Barclay T. Leib

September 10, 2001

Let us start off this month with a strong caveat: No one knows exactly know how far down and for how long the current equity market ugliness will last. Spotting the original equity "bubble," and all of its various warning signs of undue froth, was relatively easy. Timing a final top was less easy, but we came close in our February 2000 missive "NASDAQ Crash: First Downside Stopping Point." Recognizing that equity valuations are still historically too high today is also easy. Longer term, we agree with the comment below recently made by conservative fund manager Caldwell Asset Management in a letter to its investors:

> "Price/earnings ratios will drop from current 26 times earnings to normal historic levels of 14 to 15 times earnings probably after 'spiking' even lower before settling. These P/E ratios indicate a Dow Jones Industrial Average of 5500 to 6000 based on current earnings but will actually go lower as the earnings component falls from present levels. Dividend yields currently at about 1.5% per annum provide no real measure of support. In previous bear markets higher dividend yields provided some measure of support representing a bottom in stock prices when average yields reached 5% to 7%, but we are obviously no where close to there at this time."

But will all that happen in a straight line?

Only when we look at the current chart pattern of J.P. Morgan do we think it might. As commented before, we see in J.P. Morgan all the technical warning signs of a huge move to the downside that has hardly begun. Our JP Morgan pattern match published this past May 28th continues more or less on target to date, and suggests a huge move down in this stock could be just beginning.

Elsewhere, however, we have to admit that many stocks have already reached, and in some cases gone beyond, downside Fibonacci target levels that we have previously established for them.

In our November 2000 article "Don't Look for a Bottom Until…" we established the following list of downside stock price targets, re-transcribed here, with subsequent price action in red:

Microsoft 44 ½… 36% lower from 11/8 close
- reached 12/19/00, and since has bounced to stand at $55.40 today

Global Crossing 15 ½….26.5% lower from 11/8 close
- reached target in Dec. 2000, bounced, and then collapsed further to current $3.58.

Intel 23…… 46% lower from 11/8 close
- reached 4/4/01 (the low closing day), and has since bounced to stand at $25.89 today.

UAL 28 ½….25% lower from 11/8 close

- yet to be reached, but currently just $3 away.

Cisco 40 ¼…23% lower from 11/8 close

- reached 12/20/00, and has since collapsed dramatically further to $14.36.

GE 46….. 15.5% lower from 11/8 close

- reached 1/2/01, currently lower at $39.56;
  New downside target of $25.69 suggested in early June pattern match.

Lucent 14 ¼…40.6% lower from 11/8 close

- reached 12/21/00, and currently is even lower at $6.11.

Gateway 32 …...33% lower than 11/8 close

- reached 11/28/00, currently has dramatically collapsed even further to stand at $8.51 today.

In further daily and monthly Sandspring.com missives subsequent to that November report, we established other downside Fibonacci targets for a new grouping of stocks -- primarily in the financial sector. Many of these targets have <u>yet to be reached, but are fast approaching.</u>

Morgan Stanley	Longer term target $12, shorter term target $38.25. Our initial downside projections were made when stock above $60, reiterated when the stock was above $80, with MWD now trading at $48.06.
Bear Stearns	Current downside target $38.28, still approximately 23% below today's $49.70 close.
American Express	Downside target of $31.33 previously proposed when stock was near $43. Stock now fast approaching that target standing at $34.60 today.
Americredit	Proposed as short sale candidate prematurely in early May's "Expert Short Picks" article. The stock went higher first, leading to renewed short sale recommendation on Aug. 8th at $60.50. The stock currently stands at $40 with indefinite downside targets.
Providian	Another stock recommended as a short sale candidate in early May's "Expert Short Picks," then at 54 ½, with an initial downside target of $24.50 that we subsequently proposed on 7/20/01 – this target now being less than a dollar away.
Check-Free Holdings	Recommended short in early May at $39.50, with a $14.50 Fibonacci target. This stock has now fallen to $18.99, quickly closing in on its downside objective.

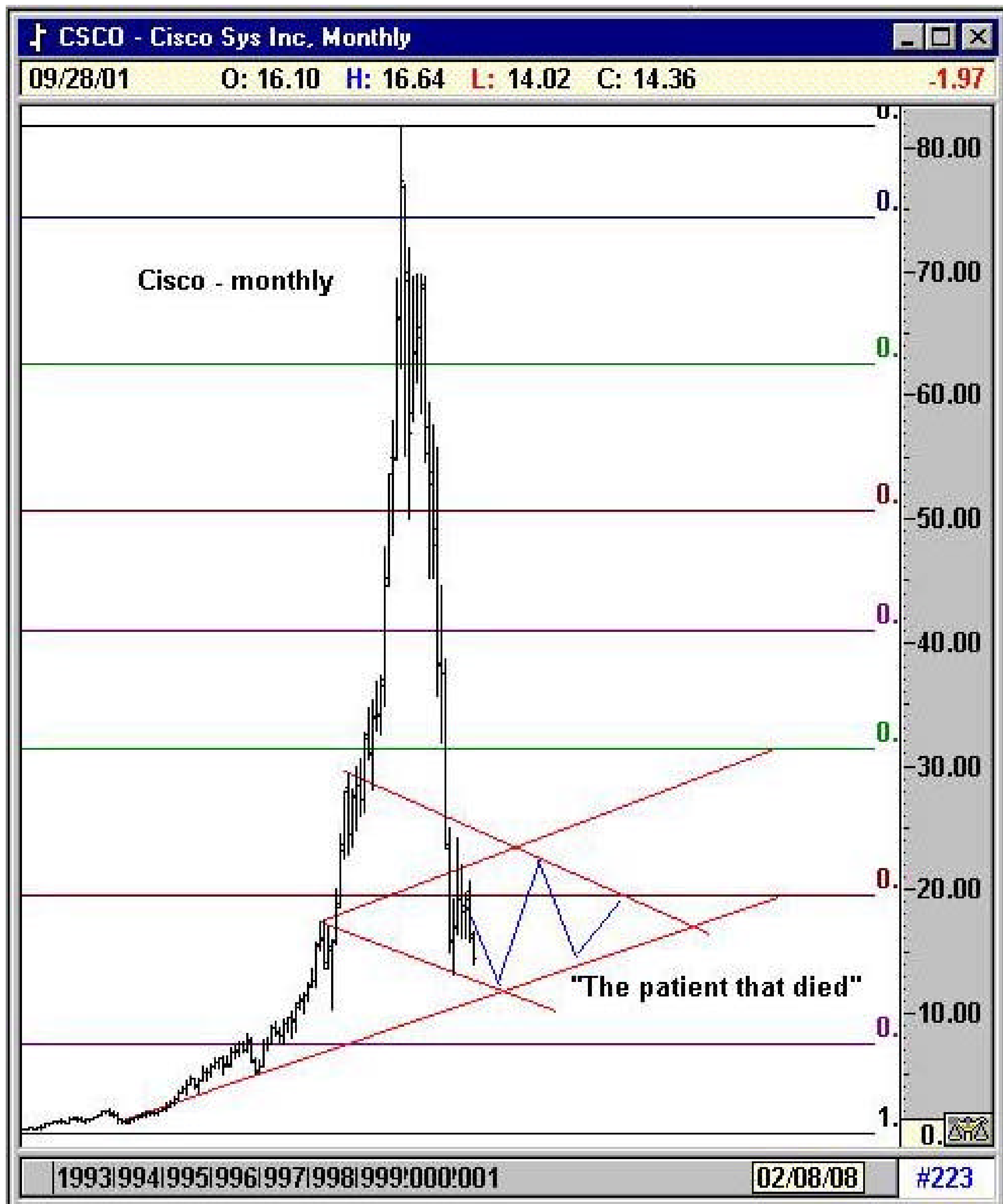
Capital One Financial	65 1/8 at the time of our initial May short sale recommendation, this stock spiked up to $72, but currently stands at $48.50. On the daily chart, we see some Fibonacci support at $43.42.
Bank of America	Bearish BAC at $59.25 in mid-June, we received a curve ball when this stock continued to rise to a recent high just above $65. Now it is on its way down again at $58.59, and we continue to look for an ultimate target here toward $31.70 as depicted with similar looking Bear Stearns chart below.

In certain non-financial stocks, we have further suggested:

Coca-Cola	We first wrote about Coke as a short sale candidate back on February 13th when the stock stood at $60.25. Within May's "Expert Short Picks," we took another look at KO with the stock trading near $47, and we proposed a $32 target. Coke today is marginally higher than it was in May at $49.73.
Enron	At the time of "Expert Short Picks," ENE was $59.50, and we suggested a minor downside Fibonacci target of $47. Now down to $37.62, we think ENE is mostly finished in its immediate descent. Longer term, $27.32 remains possible as a downside target, but not right now.
Walt Disney	We turned bearish DIS on the release of "Pearl Harbor" bomb of a movie with the stock trading near $34, and suggested a downside target of $24.20 – that has now been reached this past week.
Wendy's	Bearish since the Spring on fast-food stocks, Wendy's has been irritatingly resilient to date. The stock finally made something of a reversal down last week, closing at $27.58, and we maintain an eventual downside target of $8.68.
Bed Bath & Beyond	In early August, with BBBY at $32, we called for a top in this stock and remain generally bearish on it now at $25.72, but with an indefinite Fibonacci objective.
Micron Tech	On August 13th, with Micron trading just above $39, we suggested an ultimate downside target of 21 1/8. The stock has since slid to $32.75. We have just another 30% decline to go.
Dell	Most recently, on August 8th, when Dell Computer was trading $27.50, we pointed toward one more gut-wrenching decline that could take this stock as far as $12.50. Dell currently stands at $21.55, still looking sick and vulnerable.
GAP	In August we argued that the broader market decline was unlikely to be complete until GAP reached $15.55. The stock then was $20.71, and now has reached its target, falling to $14.99 last week.

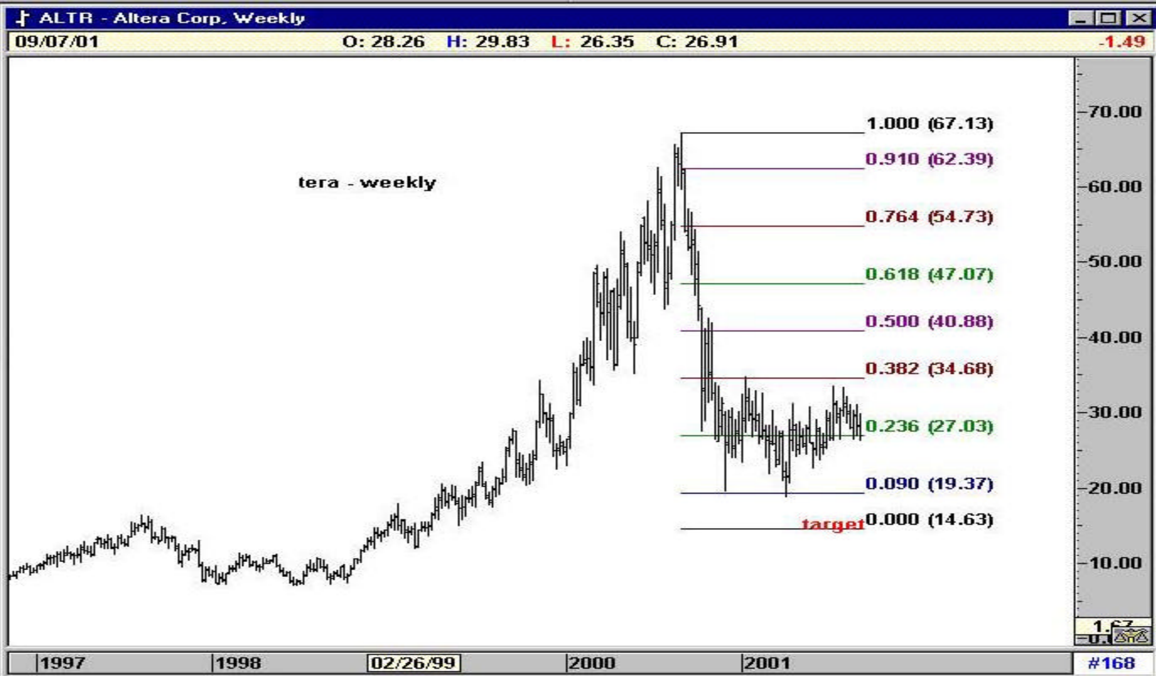
Filtering through all these various views, we now see the following themes and new thoughts emerge:

1) **The tech wreck is finishing in some stocks (maybe JSDU for example that appears to have run out of downside momentum), but it is not quite done elsewhere. Some readers may remember our Cisco "patient that died" chart from last Spring that shows Cisco likely to remain between $12 and $23 for a considerable period of time. We reproduce that picture on the next page, and stand by it as broad-brush roadmap for Cisco's future.**



The one sector within tech that is clearly <u>not</u> done to the downside is the semiconductor sector. Stocks in this group found misplaced favor from investors in the second quarter and, as a result, still appear to have substantial room to fall. For example --and in addition to still being bearish on Micron -- we do not particularly like the chart patterns and fundamentals of KLA-Tencor, Altera, Linear Techologies, and Integrated Device Technologies. The

chart patterns of each of these stocks are also depicted on the following pages, together with the SOX index as a whole.



LLTC - Linear Technology Corp. Weekly
09/07/01
O: 41.01 H: 42.88 L: 37.25 C: 39.75
-1.33
Linear Technologies - weekly
1.000 (74.74)
0.910 (70.58)
0.764 (63.86)
0.618 (57.14)
0.500 (51.70)
0.382 (46.27)
0.236 (39.55)
0.090 (32.83)
target
0.000 (28.67)
1998
1999
2000
2001
11/22/02
#363

09/07/01
O: 30.69 H: 32.18 L: 26.94 C: 28.02
-3.07
Integrated Device Technologies
-- weekly
0.910 (95.95)
0.764 (82.94)
0.618 (69.92)
0.500 (59.39)
0.382 (48.86)
0.236 (35.84)
0.090 (22.83)
Fibonacci target
0.000 (14.70)
2000
2001
07/20/01
#516

09/07/01
O: 56272 H: 57224 L: 50437 C: 51391
-4881
Philadelphia SOX Index
0.910 (127421)
0.764 (113205)
0.618 (98990)
0.500 (87493)
0.382 (75996)
0.236 (61781)
0.090 (47565)
Immediate target
0.000 (38777)
1996
1997
1998
1999
2000
09/29/00
2001
#251

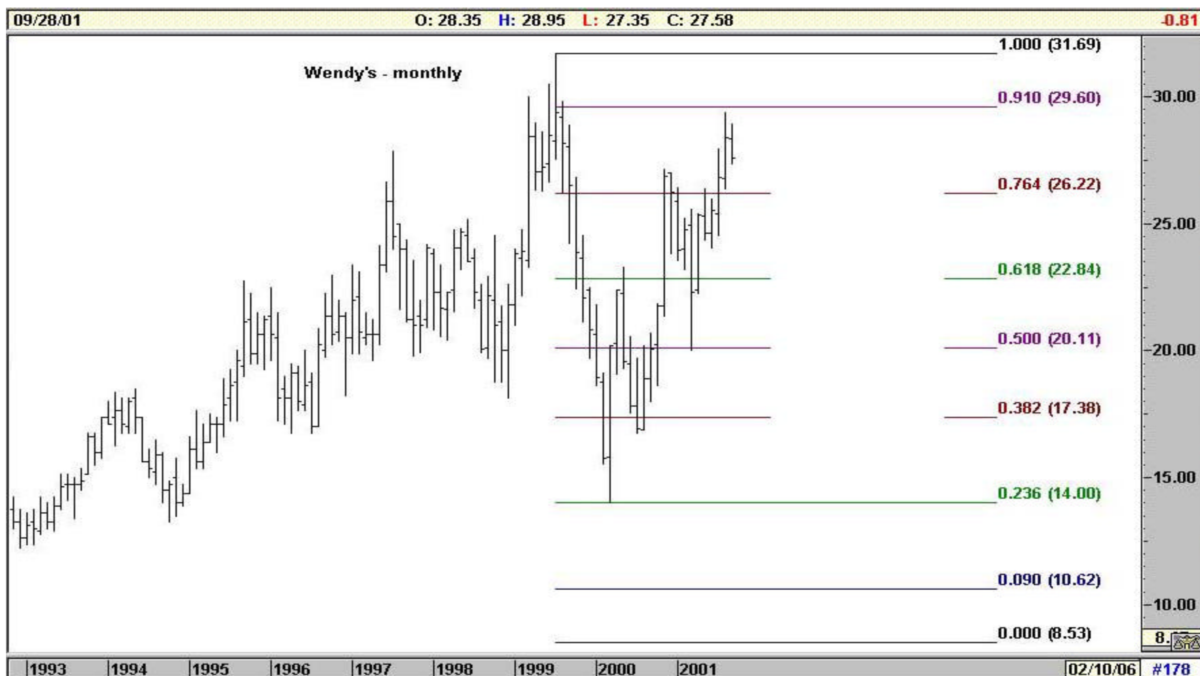
2) Within the broader tech sector, and with the above semiconductor charts in mind, we are still not particularly drawn to try bottom picking other tech names – at least not quite yet. We say this given our tendency to habitually be a bit early in our calls and with a solid eye toward our cycle date of October 11th to potentially represent a momentum market low.

On the long side, along with the gold sector (that we have spent undue time harping about as a potential buy – with limited satisfaction to date), the only other group of stocks that appear to be gaining strength at the moment are the oil and gas exploration and production companies such as Apache (trading at just 6.6x trailing earnings) and Anadarko Petroleum (7.4 x trailing earnings). These stocks are over-discounting the economic slowdown, and have Fibonacci rhythms that imply new highs yet to come.

In addition to the positive chart patterns of these oil and gas explorers/producers, and their low P/E valuations, they also fit our cyclical call for a spurt of inflationary pressures into late 2002. The Fed rate cuts have been intended to help a beleaguered tech and manufacturing sector. But what we really think these rate cuts have done is to help the consumer to keep spending on housing, fuel, and other products, whereas without the rate cuts, the consumer would otherwise be trying to more actively cut back. The rate cuts have made the consumer the last to capitulate, and left the consumer with a sense that the Fed will eventually engineer a recovery in their investment portfolios as well.

This may actually lead to a positive growth shock in the next year that will wreak havoc on those running low energy inventories in anticipation of economic weakness. It may also wreak havoc on those betting on strong bond markets just because of a weak tech market. In other words, just because we have a plethora of DRAM inventory and excess PC supply, crude oil prices don't necessarily go down.

3) **Certain feel-good consumer-oriented companies such as Disney and GAP are likely at or near short-term bottoms. Others such as Coca-Cola are not. We remain steadfastly bearish as well on fast food companies (such as Wendy's shown below) that appear to just be beginning their decline.**



4) **Some of the credit card lenders such as Providian have largely reached initial downside targets, but many of the broker-dealers and bank stocks have not. American Express is a bit ahead of the pack, with only another 8% to go before Fibonacci support kicks in, but MWD, BSC, and BAC all show further 20% decline possibilities before Fibonacci support areas are reached. GE should still reach the $25.62 target we pointed out in our June 2nd web pattern match comparing its chart pattern to that of the 1936-1937 DJIA. That chart pattern is updated below untouched.**

Overall, we harken back to another previous chart that we have published of the XBD Broker-Dealer Index, and think this sector is clearly headed at least to a 61.8% retracement of the 1998-2000 up-move near 351.50. This is still over 13% lower than last Friday's 407.59 close.

5) **And then we come back to JP Morgan. If most of the banking stocks appear to have some support 8-20% away, how can we look at the chart of JPM and think it has a chance to be shaved in half, if not more?**

   We could of course be wrong about JPM, but if we are not, a financial accident involving derivatives is the likely answer. Indeed, we are surprised -- given the stress global markets have been under -- that we have not experienced such an accident already. And the key point here in terms of JPM is that <u>one out of four derivative trades transacted globally today somehow involve JP Morgan Chase.</u>

For those who don't know how bank derivatives trading works, here's the drill from someone who previously spent 18 years working for big banks in this area.

As a trader, you are put in charge of a given derivatives area – say foreign exchange, fixed income, or equities. You receive a set of trading lines for global trading counterparties and customers based on their credit, your need for trading liquidity, and in the case of a customer, the perceived potential profitability of doing business with that customer. Credit lines are typically based on a replacement value basis, sometimes with a degree of stress testing superimposed upon it. If the customer is not a great credit, or a smaller entity, margin may be required from that customer to support derivatives positions. Better clients often can bargain for reciprocal margin relationships. But regardless as to whether a "Margin Addendum" is put in place or not, everyone signs what is called a standard ISDA Agreement (ISDA standing for the International Swaps Dealer Association).

So far so good. Banks take the risk they deem appropriate, and securitize these risks with margin as they also deem appropriate.

The problem comes from the daisy chain of global trading. Here's a generic example. JP Morgan buys an option from Bank of Tokyo Mitsubishi that it deems a reliable credit, but Bank of Tokyo Mitsubishi in turn, buys the option from a less well known Japanese corporate client, who in turn buys the option from a Thai exporter imbedded in a import-export contract. If, by chance, the Thai exporter defaults on his obligation, the Japanese corporate may default, and if enough Japanese corporates are defaulting on their ability to stand by an obligation, Bank of Tokyo Mitsubishi may default on JP Morgan.

The second problem comes from the fact that almost everyone executes an Amendment to the ISDA agreement, and the terms of these Amendments can be very different between counterparts, and sometimes diminish the very value of what otherwise might be deemed an appropriate hedge.

When the daisy chain collapses at all, someone turns to the trader of the derivatives book and asks out of the blue, "What's your exposure to Drexel Burnham? What's your exposure to Long Term Capital Management?" And in most instances, the trader won't initially really know. All he knows is that he hasn't broken any limits pre the shit hitting the fan. He will have bought and sold multiple options with the given counterparty – often on the basis of trading lines that do not capture or net exposures with that counterparty done by other areas of the bank – and when that counterparty becomes impaired, it ultimately falls to the lawyers to figure out how much money has really been lost. The lawyers then turn to the documentation and try to wriggle their way out.

But surely we exaggerate. We do not. Consider for example a leftover legal suit from the 1998 Russian debt crisis. Everyone has heard of the Long Term Capital debacle. Fewer have

heard of what transpired to the High Risk Opportunities Fund run by Illinois Institutional Investors (III).

The High Risk Opportunities Fund was exactly that: a hedge fund that promised to take leveraged bets on higher yielding global fixed income investments. The Fund bought a slug of Russian GKO debt, but its managers were also smart enough to realize that a Russian ruble devaluation was the single biggest risk to their position. So they decided to hedge that possible event via currency derivatives trades called Non-Deliverable Forrwards (NDFs). For every GKO the Fund bought from Citibank or Deutsche Bank, the Fund also bought a NDF forward hedge to sell the ruble, doing so with a second set of banks (the difference in counterparties likely being to somewhat hide their arbitrage strategy).

And when the Russian Duma did proclaim a national emergency on August 17, 1998, floated the ruble, and prohibited dollars from being delivered out of Russia, HRO's ruble hedges quickly moved 70% in-the-money. The only problem in the strategy became the fact that several of HRO's counterparties, including Credit Lyonnais and Societe Generale, basically declared that all bets were off, and failed to honor the spirit of the hedge contracts by withholding margin HRO deemed was due. SG was able to do this because of specific verbiage in its ISDA Addendum that said that should "SG –New York or any of its affiliates" become impaired by any change of law or added taxes in Russia, that SG-New York was allowed to pass on any such added costs directly to HRO.

In point of fact, SG-New York had covered its NDF risk with SG-Vostok, so when SG-Vostok was unable to honor its NDF contract with SG-New York, SG-New York was staring at a potential $300 million dollar loss. SG-New York then quickly took the attitude that the missing hedge was HRO's responsibility to bear, and thus claimed HRO actually owed SG-New York money, even though the ruble had fallen 70%. Credit Lyonnais meanwhile told HRO that their individual confirmations superceded the ISDA documentation, and specifically allowed for Credit Lyonnais to not deliver any margin to HRO as long as there was a Russian "Exchange Event" (poorly defined elsewhere in the contracts).

The bottom line is that while HRO thought that it had an appropriate hedge to avoid a disaster, the fine wording of the ISDA Addendums and Confirmations gave the banks enough wiggle room never to have honored these contracts. From III's perspective, it was like having bought insurance against one's factory burning down, and then being told post an actual fire that the contracts were invalid because there was no night-watchman on duty.

Unable to collect on margin due from SG and Credit Lyonnais, the HRO Fund was at the mercy of other banks that held GKO exposure against the Fund, and these banks quickly forced the HRO Fund into receivership. Left on the table were several hundred million dollars that neither SG nor Credit Lyonnais have ever had to pony up to HRO.

HRO's receivers brought a $1 billion suit against both banks, and hired top-gun lawyer David Boies to represent them. From a moral obligation perspective, they likely had a good case. But swayed perhaps by the letter of the law in the executed ISDA contracts, the courts have yet to offer HRO any satisfaction. Indeed, a Supreme Court judge recently threw out the SG suit altogether, claiming that even if SG had posted margin to HRO, such margin was "non-rehypothecatable" (in other words, couldn't have been re-pledged elsewhere) and thus would not have kept HRO from declaring bankruptcy.

In our opinion, Boies went for the jugular, and missed. By over-pushing HRO's claim that SG's withholding of margin was the very cause of HRO's demise, Boies has now created a

precedent on the books that a big bank who buys a derivative from a foreign entity and then re-sells it to a client, can still walk away from that obligation should the lesser foreign entity default. It's daisy-chain city.

This microcosm of a problem can get much bigger and far more serious and complicated in the future. It will be far easier and less costly for banks to let clients take them to court rather than honor in-the-money derivatives that may, for some credit-related reason, have lost its corresponding hedge. Indeed, one must even question whether there was malice aforethought by SG for having written a hedging contract to HRO that SG knew in advance -- via the fine language of the executed documentation -- would hardly ever be a collectable piece of insurance.

Returning to the present, we do not know specifically from what direction a larger derivatives accident might come. Guessing a bit, it might well be in the most nifty new product area of Credit Default Swaps where millions of dollars can hang in the balance depending upon whether a counterpart has or has not officially defaulted.

The legal verbiage can be very tricky and open to various interpretations here. For example, is Conseco in default yet or not? Under last year's legal ISDA verbiage, the answer was: yes. When in September 2000, Conseco negotiated a technical restructuring of various bank loans, a credit event transpired. Default swaps got triggered (costing JP Morgan dearly by the way). But today, under new modified language, perhaps this would not have been the case. ISDA has new language out that puts certain limitations on considering a loan restructuring as a credit event, and limiting the securities that may be delivered under a default swap in such an instance. This area is particularly rife for a legal heyday, and when the money at stake becomes big enough, the courts are where many derivatives contracts will undoubtedly end. One might want to watch this space regarding Xerox and Lucent in the weeks and months to come.

So it is that we must conclude that a stock like JPM probably does have further downside possibilities than a Bank of America where derivatives trading is a less central part of banking activities and bank profitability. If the shit really hits the fan, JP Morgan's 1995 Sumitomo copper trading fiasco (still in the courts, by the way) could look pale in comparison to new legal actions. The 1994 Bankers Trust/Orange County fiasco might equally be far surpassed.

As one last note, on a separate front, there is as well a trail of leverage that permeates markets today. Hedge funds may leverage their holdings on a normal Reg-T basis, but banks regularly now allow investors to take a basket of hedge funds and re-leverage that basket at 2-1, 3-1, or even 4-1 leverage. In an unfortunate situation, we could easily see a 10% market drop cause a group of hedge funds to lose 20%, and then further cause leveraged institutional investors to lose 40% or 60%. Pity the day that this ever happens, but it likely will.

Summary

So overall, we have covered much ground in this month's Sand Spring offering, but we have also deftly avoided making any definitive prognostications on the major S&P, Dow Jones, or NASDAQ averages as to definitive downside stopping points. To be honest, we can stretch our bands on the major indices to numerous levels – both near and far away. It is thus not worth going through all these potential levels here. All we can say about the major averages is that:

If the NASDAQ Composite makes new marginal lows or reaches as far down as the 1350-1409 region, with either event occurring into our Oct 11th time window, we will likely feel more comfortable bottom-picking then than we do now. And whatever the case, we

will not try to do so in financial stocks. If a new derivatives accident ever starts to transpire, step on JPM first and ask questions later.

But derivatives accidents aside, and without suggesting specific price levels, the rhythm in the major indices that we would expect to see in the months to come looks as follows:

Late September – early October: continued, possibly intense pressure to the downside.
Oct 11: Momentum low(s) in certain indices.
November: reaction rally of some magnitude.
December-January: sluggish secondary downside test of October lows and possible marginal new lows in several indices.
February, 2002: Blastoff for an 8.3 month "growth is higher than expected" rally, with stronger gold and oil prices.
November 2002: Market high preceding debt-deflation / real estate leverage problems that intensify into late 2004.

This rhythm is derived from a combination of PEI cycle turn dates and our analog 1980-1981 gold chart vs. current NASDAQ chart depicted in last month's "Long-Term Equity, Gold, and K-Wave Cycle Thoughts."

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