Sand Spring Advisors LLC

Active Applause for Fahrenheit 9/11:
Beginning of Bush Demise & Early Signs of Real Estate Crisis

by,

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I saw Michael Moore's *Fahrenheit 9/11* Friday evening. The line for the movie was long and the theatre completely full by show time. The film has been attracting packed audiences across the nation this weekend, with one theatre in New York City so overwhelmed with demand that it elected to show the movie 24-hours a day.

The audience reaction at the end of the specific showing that I saw was most clear. There was very active applause.

The movie does of course present a slightly conspiratorial and slanted view of the Bush-Bin Laden-Saudi-Iraq saga, but it rings true with just enough substance to make George W. Bush look like a myopic fool and idiot. Sitting with Florida school children for multiple minutes even after the second plane hit the World Trade Center seemed the most icredulous piece of stupidity on Bush's part. Being on vacation for 42% of the days before 9/11 was almost as bad.

As shown in initial rankings by viewers posted on the Internet Movie Database (www.IMDB.com), the large majority of viewers (62%) gave the movie their highest rank of 10. Yet in a highly non-normalized and non-leptikurtic manner, 31.3% gave it a rank of only 1 or 2.

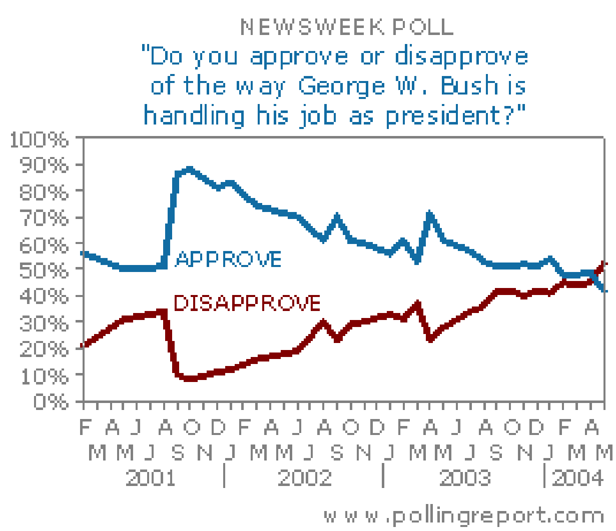
Ranking	**Percentage of Respondents**
10	**62%**
9	4%
8	1.1%
7	0.6%
6	0.2%
5	0.3%
4	0.2%
3	0.4%
2	**2.0%**
1	**29.3%**

Source: IMDB.com

This dramatic split represents a clear ongoing bifurcation of American political opinion -- interestingly enough divided by almost perfect Fibonacci Golden Ratio harmony.

The 62% majority who loved the movie also clearly represents the beginning of the end of Mr. Bush's presidency. By this Sunday's Evening News, when weekend box office sales are initially reported, we expect *Fahrenheit 9/11* to have racked up record ticket sales that will rival any blockbuster Hollywood release -- even though it only appeared in 868 theatres which is tiny by typical Hollywood standards. We clearly expect the media to be further abuzz next week with commentary like: "The first Hollywood release of a documentary that appears to be impacting Presidential election sentiment in real time."

Bush's poll numbers should show a notable drop from their already sagging trend, and financial markets will start to fear the onset of "non-business friendly" democratic rule from Mr. Kerry.



As such, the recently quiet and complacent equity markets remain at significant risk of decline. The up-down/up-down alternative days of aimless and irritating meandering should shortly be over. 1010 on the S&P should be seen, and maybe even 988.

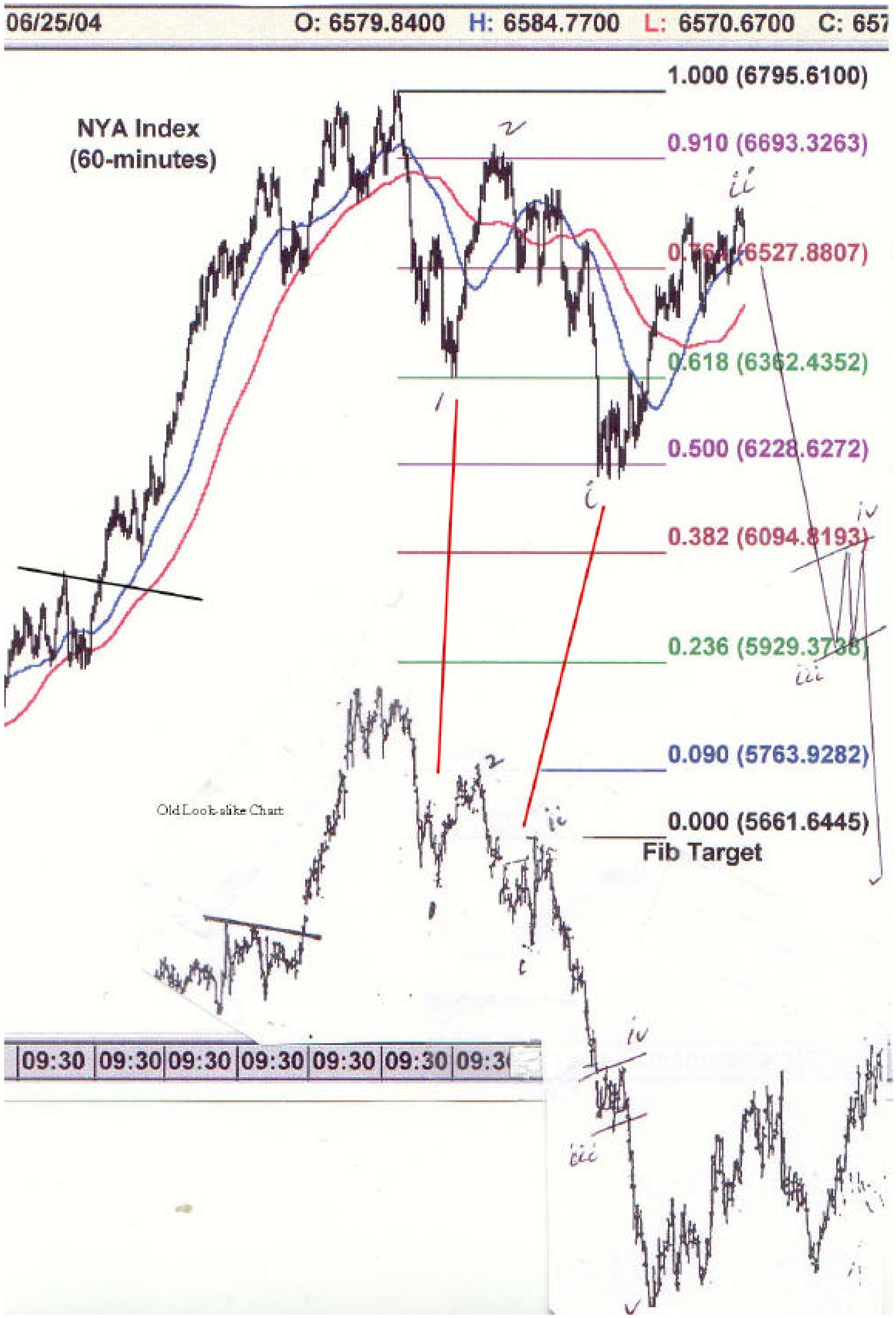
Don't get us wrong. We still largely expect 2004 to be something of a "hang year," with true market chaos lingering until 2005-2006. A rally period still potentially exists into our December 30-31, 2004 cycle window. It is even possible that at some point 1260 on the S&P could be seen – **but we feel reasonably strongly that if the current bull market has further sea-legs, such will manifest itself only <u>after</u> the 1010 region on the S&P 500 is touched.**

As we now enter the last week of June – the 233rd Fibonacci week from the January 2000 market top in the DJIA and the 89th Fibonacci week from the October 2002 market low – recent range trading should resolve itself. With Bush being heckled by protestors in Europe and Turkey and *Fahrenheit 9/11* playing at home, all the warts of American hubris are on display. Confidence in our financial markets should thus take it on the chin. The mere fact that applause rippled through the Fahrenheit 9/11 audience in the theatre Friday night indicates that the psyche of the American people is turning cynical and dour.

Separately, it is interesting to note that that in a Katie Couric piece on NBC this past Friday morning, a fashion consultant also espoused that excessive display of "skin" by celebrities and fashion models is starting to be "passe," and more conservative wardrobes and longer hemlines instead being the new trend down model walkways. Congress also passed new stiff fines last week for indecency on the airwaves. Not to sound too much like Bob Prechter, but both of these anecdotal pieces of news are clear socionomic signs of a new bear market "psyche" in motion.

In an idealized world, a market that rolls over to the downside this coming week should bottom in the late summer/early fall, and still leave room for a rally into December.

In terms of an expected path, we offer three charts below – one of the NYA Index compared on a pattern match basis to a prior topping formation that we pulled from our chart library; another of one possible path for the S&P 500 on a weekly basis that looks reasonable to our eye (with a best-case and worst-case rally into December depicted); and the last, an updated version of our DJIA chart highlighting once again the cycle importance of December 30-31, 2004.


06/25/04
O: 6579.8400 H: 6584.7700 L: 6570.6700 C: 657
NYA Index
(60-minutes)
1.000 (6795.6100)
0.910 (6693.3263)
0.764 (6527.8807)
0.618 (6362.4352)
0.500 (6228.6272)
0.382 (6094.8193)
0.236 (5929.3736)
0.090 (5763.9282)
0.000 (5661.6445)
Fib Target
Old Look-alike Chart
09:30
09:30
09:30
09:30
09:30
09:30


SP M4 (Jun 2004), Weekly
06/25/04 O: 1134.60 H: 1146.20 L: 1123.50 C: 1135.20 +1.20
S&P 500
(weekly)
1.000 (1574.00)
0.910 (1501.51)
0.764 (1384.25)
Dec 30-31, 2004
0.618 (1266.99)
0.090 (1126.94)
0.382 (1011.66)
0.618 (918.42)
0.910 (803.14)
June 2006
1600.00
1500.00
1400.00
1300.00
1200.00
1100.00
1000.00
900.00
800.00
700.00
660.29
600.00
500.00
1997
1998
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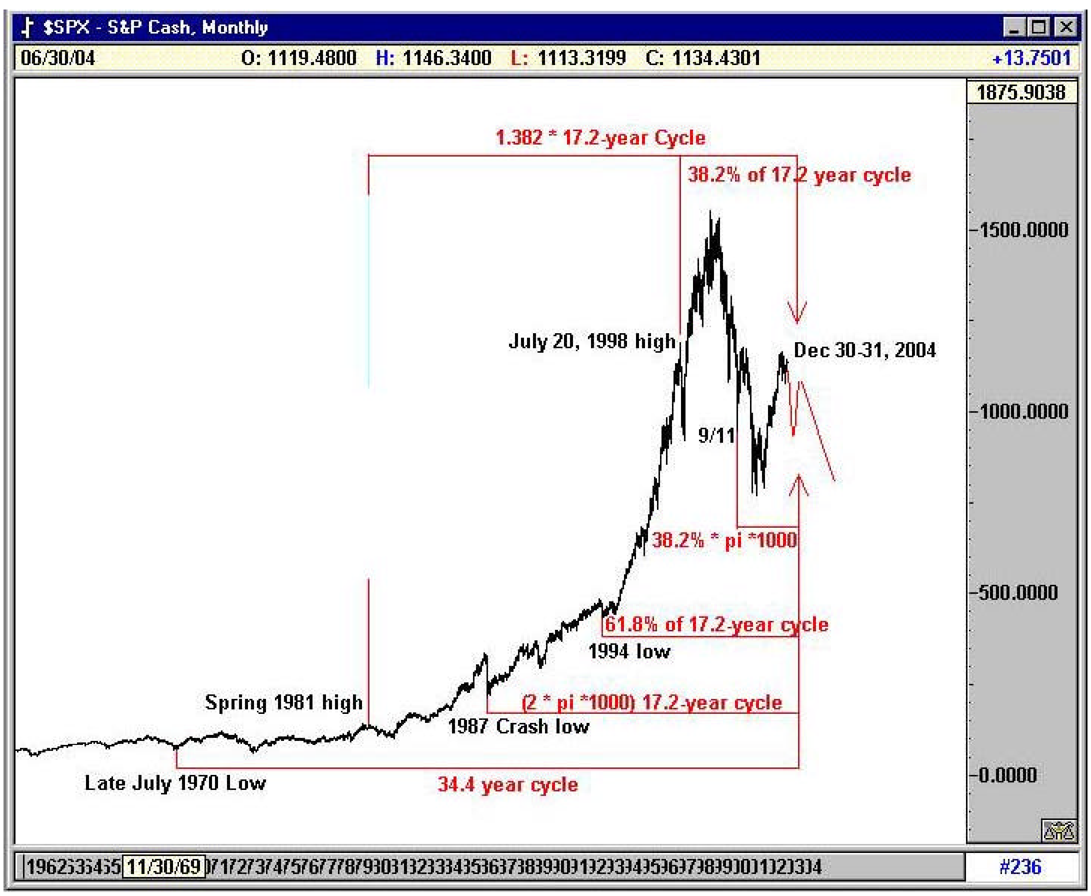
2002
2003
2004
08/31/07
#1323


$SPX - S&P Cash, Monthly
06/30/04 O: 1119.4800 H: 1146.3400 L: 1113.3199 C: 1134.4301 +13.7501
1875.9038
1.382 * 17.2-year Cycle
38.2% of 17.2 year cycle
July 20, 1998 high
Dec 30-31, 2004
9/11
38.2% * pi *1000
61.8% of 17.2-year cycle
1994 low
Spring 1981 high
(2 * pi *1000) 17.2-year cycle
1987 Crash low
Late July 1970 Low
34.4 year cycle
1500.0000
1000.0000
500.0000
0.0000
11/30/69
#236

If Mr. Kerry is indeed elected in November, and regardless of what he actually does in his administration, we believe that his presidency will likely suffer the recourse of investor anger as many of the debt build-up excesses of the Reagan, Bush Sr., Clinton, and George W. days come undone.

We have previously commented on the real estate sector and Fannie Mae's balance sheet levered at 80-1 as one particularly vulnerable spot in the underbelly of the economy. This remains very much of concern.

Few people realize the general importance of real estate within the business cycle. For those interested to read more about this, we would advise you to closely review "*Real Estate and Business Cycles: Henry George's Theory of the Trade Cycle*" by Fred E. Foldvary that may be found at www.foldvary.net/works/rebc.html. It is a masterful summary of a variety of economic theories on the interaction of government stimulus with real estate development and eventual boom-bust business cycles. It basically points out that **major booms in real estate have historically found roots in some sort of exogenous government stimulus or incentive plans, and that peaks in the real estate cycle have historically led peaks in the business cycle and eventual periods of crisis and depression.** Such examples include:

- Land grants to build a railroad network and a super-abundance of paper money issued by state controlled "wildcat" banks in the 1800's, eventually resulting in the Panic of 1873.

- The 62% increase in money supply within the U.S. during the 1920's that helped fuel the real estate boom of that decade – a boom that started to peak first in farmland and Florida land speculation in 1926, and finally in cities in 1927-1928 – well in advance of the 1929 Equity Crash.

- The Tax Reform Act of 1969 that helped turn real estate into an effective a tax shelter during early 1970's period of inflation, until interest rates started to increase, and real estate peaked in 1972 – a full year before the equity market turmoil of 1973-74.

- The decrease in interest rates in 1982 by the Fed and subsequent decline in marginal tax rates pushed through by President Reagan, which together with the liberalized real estate depreciation deductions enacted in 1981, once again helped induce real estate speculation and overbuilding that eventually saw single family housing starts and building permits peak in 1986 – a year before the 1987 Equity Crash -- and eventually led to the S&L Crisis and recession of 1990-1991.

- The excessive easy credit policies of Mr. Greenspan in 2002-2003 that helped spur a major mortgage refinancing boom and injection of liquidity into American households – but a trend that is now coming to an end with current signs of an increased interest rates and a housing market slowdown.

Certainly, in the region where we are located just outside Morristown, NJ, "For Sale" signs on houses are now everywhere and increasing. While home sales themselves have remained strong nationwide, the inventory of unsold homes is rising, with May statistics showing the inventory of unsold new homes nationwide hitting a 14-month high. Mortgage applications recently fell 6% in early June. As the table below shows, rental vacancy rates have been steadily climbing since 1996, and have recently risen for seven consecutive quarters, while rental rates have remained stagnant. The very attractiveness of real estate speculation has thus begun to get squeezed by higher land costs and building expenses, and yet lower rental incomes and higher vacancy rates.

The following table contains vacancy rate by selected unit characteristics

Unit Characteristic	1996	1997	1998	1999	2000	2001	2002	2003
All units	7.8%	7.7%	7.9%	8.1%	8.0%	8.4%	8.9%	9.8%
1 unit in structure	5.5%	5.8%	6.3%	7.2%	7.0%	7.9%	8.0%	8.4%
2 to 4 units in structure	8.6%	8.6%	8.2%	8.4%	7.7%	7.4%	8.1%	9.4%
5 units or more in structure	9.6%	9.1%	9.4%	8.9%	9.2%	9.6%	10.4%	11.4%

Source: HUD

If anyone thinks that we have not already begun a significant decline in real estate markets, please just open your eyes and look around you. The anecdotal and statistical evidence of housing over-supply and dwindling demand can be seen everywhere.

Ample signs of speculative excess also exist. As recently pointed out by Bill Fleckenstein in his daily commentary, just type "No money down mortgages" on Google, and you will come up with over 2.2 million hits. Banks are increasingly offering interest-only loans, while ARMs now account for almost a third of all new mortgages. Banks have also become very creative in circumventing a lack of credit history and impaired credit by borrowers. Bank of America and Wells Fargo are both providing "flexible credit underwriting" that includes accepting non-traditional credit references, while allowing home-buyers to obtain mortgages that require as little as a $500 down payment from their own funds.

To specifically help Hispanic home-buyers, Wells Fargo & Co now allows the incomes of a spouse and an unlimited number of aunts, uncles, and cousins to comprise up to 30% of the necessary income that is required to qualify for a loan. It will also accept as much as 30% of qualifying income to be reported as cash payments – payments that are likely impossible to verify. There is also some evidence that banks in California are even now offering mortgages to illegal immigrants. According to a recent *Business World* article, many undocumented Mexican immigrants are able to obtain the two required documents to obtain a mortgage – an Internal Revenue federal identification number and a Mexican Consular I.D. card – even while the banks and the INS pay little attention to their true legal status within the U.S.

Is it any surprise that Bank of America's mortgage lending to Hispanics rose 30.1% last year, and Wells Fargo's mortgage lending to Hispanics has more than tripled since 1997? Yet loans to immigrants have historically averaged a default rate close to a 5% – far higher than the current sub-1% on non-immigrant mortgages. Even if such lending practices help these banks look more profitable in the short-term, how such easy-credit loans will turn out in the long term certainly remains a dangerous issue.

We also recently read a story about a real estate speculator with only $50,000 in initial cash (and few other liquid resources) who parlayed himself into buying $4mm worth of rental real estate investments using ARM loans that kept his rental cash flow slightly above the mortgage financing costs. The view of the strategy was that the underlying real estate would of course always go up in value. This is how to start with nothing in America and make something. But if the financing rate on this fellow's ARMs tips just 50 basis points higher, the monthly cash flow will turn decidedly negative on the strategy. A 2% rise in interest rates will cause this fellow's mortgage payment to nearly double. This fellow has no liquid resources to support such an outcome, and is thus trying to sell his properties at present.

This is how investment demand for real estate starts to roll over. The cost of carry on property starts to fall under its rental income potential. The average non-speculating homeowner can similarly get squeezed either because of some combination of higher interest rates and/or lower income.

As an aside, we certainly look at the two charts of Bank of America and Wells Fargo shown below as potential short-sale candidates – particularly given complete looking Fibonacci fractal patterns.

Meanwhile delinquencies on all mortgages have already climbed some 7% over the past year (albeit still only around .50% of total mortgages), but notably in the sub-prime category (now 10% of total mortgages, with a high preponderance of these loans structured as ARMs), 2.13% of such mortgages began foreclosure in the fourth quarter of 2003 – an 11% jump over the third quarter of 2003, and a 25% jump over the fourth quarter of 2002. What type of happy world and economic recovery is this?

Per the article by Foldvary referred to above, the typical real estate cycle goes something like this:

1) Population growth and industrial development, often facilitated by public works and government sponsorship, creates an increase in the aggregate demand for housing and other building in excess of immediate supply.
2) Time is required for the supply of building construction to catch up. Construction adds promptly to the demand for land. Credit is attracted to construction and sales as real estate prices rise.
3) Absorption of vacant land starts a boom in vacant land for sub-division into smaller lots and speculative resale. Some people buy vacant land simply to speculate as opposed to intentions to actually build.
4) The peak of the real estate cycle is characterized by a high volume of real estate transfers and subdivision.
5) Construction eventually is completed and available housing/office space outstrips immediate demand. Rental rates fail to adjust themselves to higher land costs, rendering new building activity unprofitable. Excessive raw land values reached after the boom tend to be slow to adjust downward, with no offsetting earnings growth available to builders, and therefore contribute to a break in the building boom.
6) Rising interest rates also contribute to the slowdown, and real estate enters a "hanging" slow phase. Prices are no longer advancing. Nominal asking prices stay high, but there are now few buyers. Vacancies rise. Building declines. The sale of bare land for new development drops rapidly. In some instances, a financial panic or crash shatters real estate optimism, although real estate often does not immediately crash. Instead, it often just slowly rolls over.
7) When the real estate market finally starts to get marked down, it generally takes longer than stock market crashes since: a) there are no short sellers; b) owners tend to cling to mortgaged property with some tenacity; and c) the process of foreclosure is a slow one.
8) Eventually, mortgage costs remain fixed or go up while rents decline and vacancy rates increase. Higher interest rates, unemployment, and lower real wages further reduce demand for real estate. The low point of the cycle is characterized by high vacancies, low building rates, foreclosures, and an absence of speculation. Mortgage debt eventually must be written off by many banks as foreclosed property is resold at a deep discount to stronger new buyers.

In our opinion, the U.S. real estate market is clearly in stage 6 at present, but with an unusual amount of leverage underlying the current cycle in real estate when compared to past historical periods of excess. We would look for 2005 to mark the beginning of Stage 7, and mid-2006 to potentially bring Stage 8.

But some (particularly of the current generation) might argue that since real estate is a finite asset and the population is ever-expanding – real estate always goes up. To this argument, we would respond: "In the long term, yes." But consider the following 1833-1932 swings in the total land value of Chicago given to us within the Foldvary article:

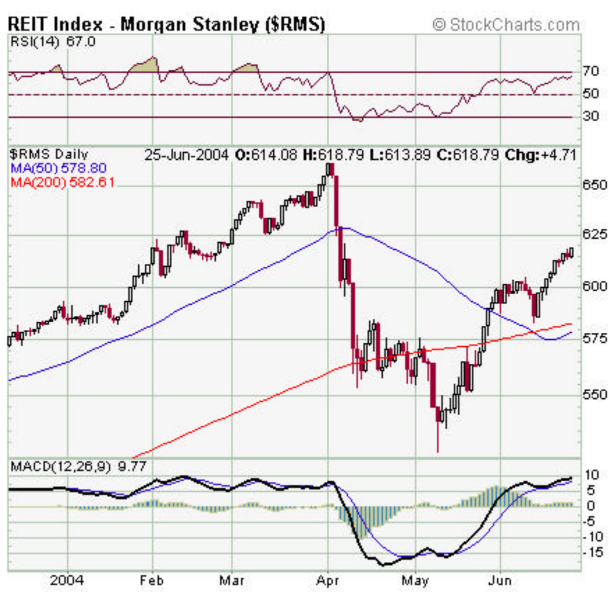
Year	Total Land Value of Chicago in Constant Dollars
1833	$160,000
1836	$10,000,000
1842	$1,200,000
1856	$125,000,000
1861	$60,000,000
1873	$575,000,000
1877	$250,000,000
1893	$1,500,000,000
1926	$5,000,000,000
1932	$2,500,000,000

Source: Real Estate and Business Cycles by, Fred E. Foldvary, 1991

Periods of 50% declines used to occur quite regularly. In the current world, has the Fed inadvertently set up the American consumer and the banking system for one of these periods depicted in red? Have we already passed the point of entropy in real estate markets where over-supply at excessive prices has been reached?

On one popular financial website, we remember reading recently some commentator's assertion that real estate markets could "never experience a 15-25% decline in a matter of days the way equity markets did during the Crash of 1987."

While such an assertion is typically true (real estate trends do tend to take longer to manifest themselves than mere days or weeks), this commentary ironically appeared just before the chart below of the Morgan Stanley AMEX REIT Index which dropped over 17% in just two weeks. This Index has recently experienced a significant 61.8% retracement bounce. Is a 76.4% retracement of the downdraft or even a 90% retracement of the downdraft possible? Sure, but we wouldn't bet on it. This market has clearly left a significant top. At some point, another nasty leg down remains in our future – just the way the July 2003 decline in T-Bonds and rally into early March 2003 eventually yielded to the April-May 2004 T-Bond "second leg" collapse (see second chart below).

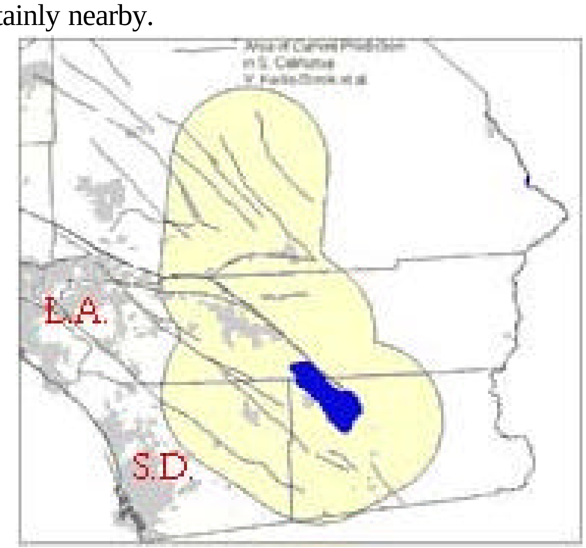


Indeed, if the current predictions of a major Southern California earthquake by September 5, 2004 being made by the Keilis-Borok team of UCLA researchers were to transpire, this could easily be a trigger for added problems in the levered real estate loan space.

It is notable that the US Geological Survey team of the U.S Department of the Interior does not dismiss these predictions as "quackery." Instead, they state:

> "The prediction method the Keilis-Borok team uses is based on identifying patterns of small earthquakes as precursors to large ones. These small earthquakes occurred last fall and the prediction window is 9 months from the end of that earthquake cluster. The work of the Keilis-Borok team is a legitimate approach to earthquake prediction research… It's notable because of the group's apparent success in predicting the magnitude 8.1 earthquake in Hokkaido, Japan in September 2003 and last December's magnitude 6.5 San Simeon quake. However, the method is unproven, and it will take much additional study, and many additional trial predictions, before it can be shown whether it works, and how well."

The area of the anticipated earthquake includes portions of the eastern Mojave Desert, Coachella Valley, Imperial Valley (San Bernardino, Riverside and Imperial Counties) and eastern San Diego County. This is not quite downtown Los Angeles. or San Diego, but it is certainly nearby.



Source: USGS

Does our bearishness on stocks and real estate necessarily make us bullish on U.S. Treasury Bonds? We likely should be, but the possibility of stagflation also looms as the U.S. government continues to "push on a string" to avoid (or at least cushion) the inevitable debt bubble burst. Bonds are over-owned, particularly by foreign holders. We thus find it hard to be excitedly bullish on an asset that has potentially large supply by a government that really could care less about diluting the ongoing inflation-adjusted value of the bonds that it issues. Meanwhile, foreign holders of this asset would love to decrease their investment in U.S. T-Bonds if they could find any politically palatable way to do so.

Over the next two years, bonds may yet rally to one more new high (as previously espoused toward a price level of 129-132 basis 30-year T-Bond futures), but it will be a stop-start affair hardly worth the risks to participate in. Selling the U.S. dollar or buying gold seem to be better risk-reward trades with less "double-sided" macro risks.

As shown below, we continue to expect the U.S dollar-yen relationship to reach at least 95.50. We also continue to expect gold to trade higher within a secular bull market.

The hoopla over *Fahrenheit 9/11* will of course pass with time. But we still find this film's appearance -- and apparent strong reception -- as an important psychological indication of how the rah-rah American spirit that emerged post the 9-11 events has starting to dissolve into renewed anger and cynicism.

Would anyone like to bet that Mr. Moore's next film in 2006 will focus on how the real estate market falls apart in this country, and the "little guy" gets screwed once again?

Send us your comments at information@Sandspring.com.

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