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To

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Subject: Morning Briefing, 04/24/2003

Sent: 24/04/2003 07:33 **Importance:** Normal

21ST CENTURY ALERT

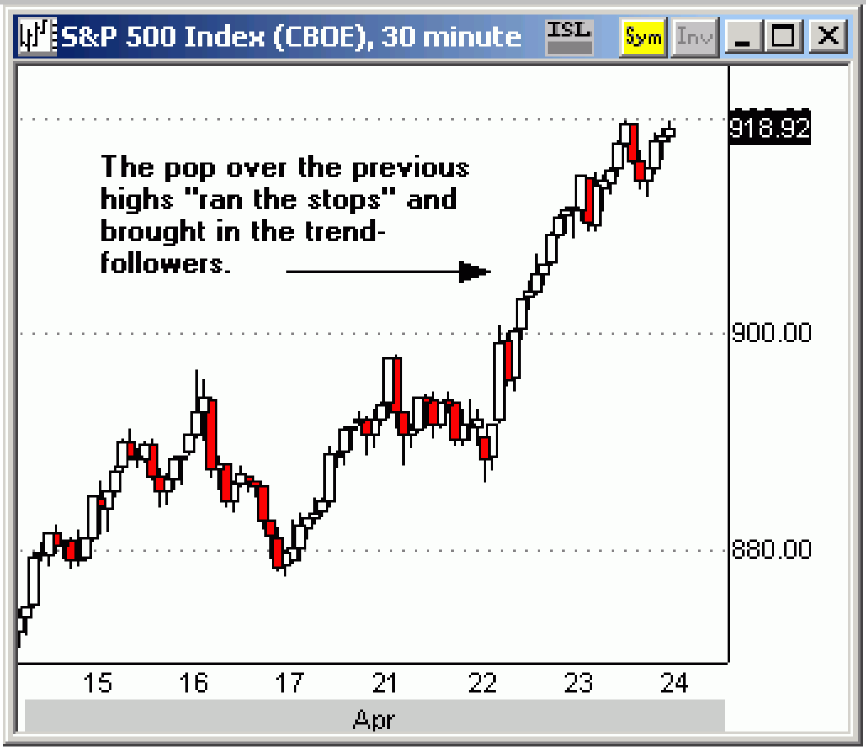
MORNING BRIEFING

THURSDAY a.m.
April 24, 2003

The Upside Party

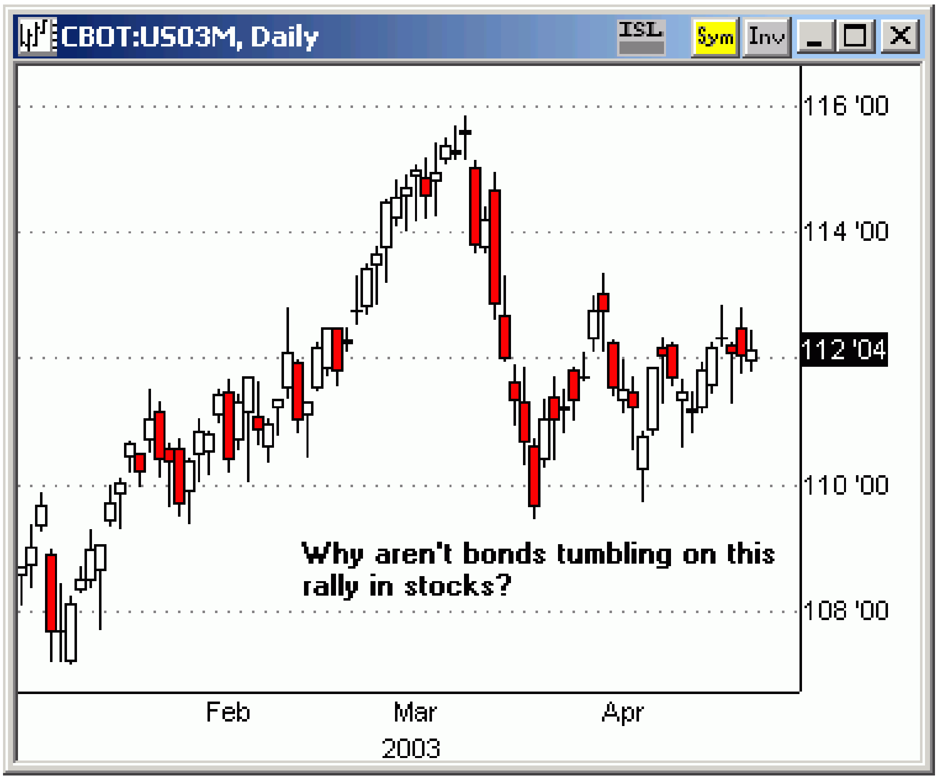
by David Nichols

Right now the big bullish dance is rocking, with the crowd jamming the day away. The bears are now sheepish wall-flowers, drifting over to the bar to nurse a consolation drink and mutter half-hearted encouragements to each other. When the SPX popped over 905, even the late-stage trend-followers got out on the floor to boogie down. It's up, up, and away.



But with the market draining out the sentiment tank, and the shorts clearing out, where's the money going to come from to keep prices going up? How long before the music stops?

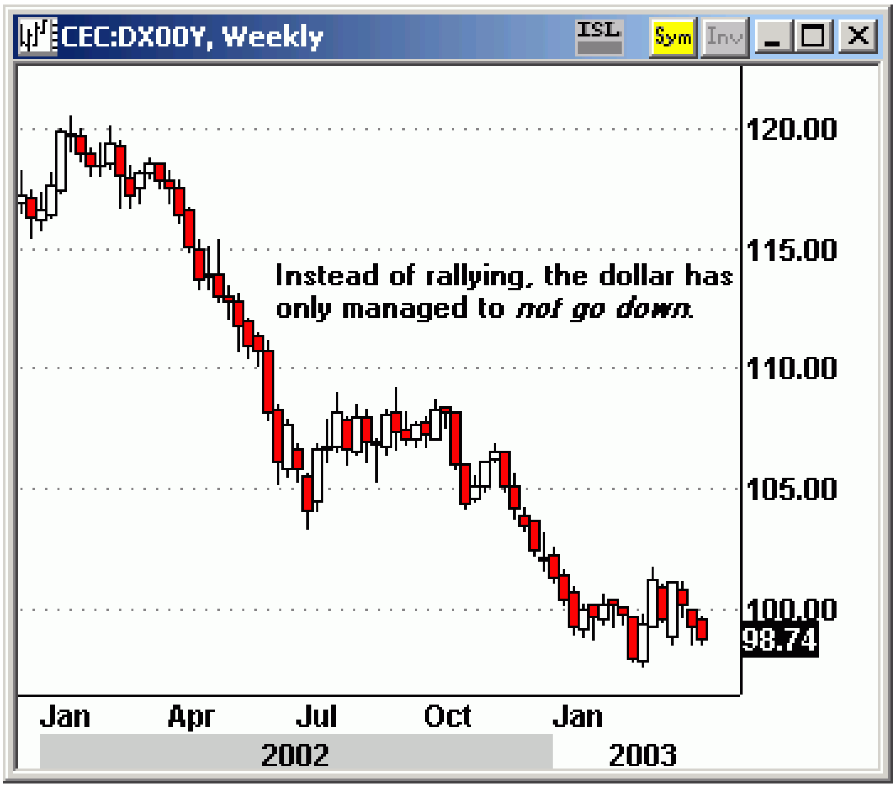
The bond market is where the real money is. Yet lately this liquidity hose for stocks has been running at just a trickle. Also in a bit of a surprise, the U.S. dollar isn't participating in the "new bull market" upside party.



Bonds have indeed dropped off their recent highs, but they're not moving down now while stocks go higher. Either it's a new paradigm, and the inverse relationship between bonds and stocks is breaking down, or bond traders just aren't ready to buy into the fashionable bull market thesis.

With our sentiment tank now only 8% full, and no discernable asset allocation out of bonds into stocks, then the rally has a major fuel crisis.

The U.S. dollar is at an interesting juncture. While U.S. stocks have everyone celebrating the return of the bull, currency traders aren't joining in.



So this could be important from a big picture standpoint, but it probably won't matter much in the short-term. As we've seen, there's no particular reason why stocks can't keep going up. It even looks like the SPX now has a date with destiny at 935, which is last quarter's high tick, hit on January 13th. It's now looking more and more like SPX 935 will end up being the "strange attractor/strange repeller" hot zone I referred to yesterday.

But it's remarkable to me that anybody could be viewing this as the start of something new and beautiful for equities. If you look at price and sentiment, the only thing that looks beautiful is the developing set-up to go short.

Now, since we're over the 40-week exponential moving average at 904 -- and still moving up -- then we've got to give a nod to some potentially bullish developments. We can't be too dogmatic. So while sentiment so far has been atrocious for the long-term bullish case, that doesn't mean things can't change.

So if -- and this is a big if -- the SPX pulls back and sentiment registers a big jump in fear, then we could be onto something. If the SPX pulls back to "home" at 876, and such a move causes the VIX to really jump higher, then we'll have to sit up and pay attention.

In other words, we've got to see how the next short-term decline phase for sentiment plays out. The indications now are that this decline phase could be a whopper to the downside, but we'll have to see what actually happens.

Yesterday I said that if you're dying to take a shot to the long side, then please keep a close eye on that 40-week exponential moving average at SPX 904. If the SPX moves under there, it could be trouble, and you won't want to hang around.

We've been giving some thought to an options strategy for this bizarrely attenuated advance phase, so I thought I'd share what we're contemplating for our options service. Keep in mind I'm just giving this as a hypothetical, and I'm in no way recommending you do such a trade if you're not very familiar with options trading. But I'm just offering this as an example of something that makes sense in the current environment, and an example of the kind of trades we can do in this service.

Let's say you'd like to take a well-defined shot to the upside, thinking that the market has a chance to just keep grinding higher. One of the great things about options is you're able to strictly define your risk, which makes them ideal for such a situation.

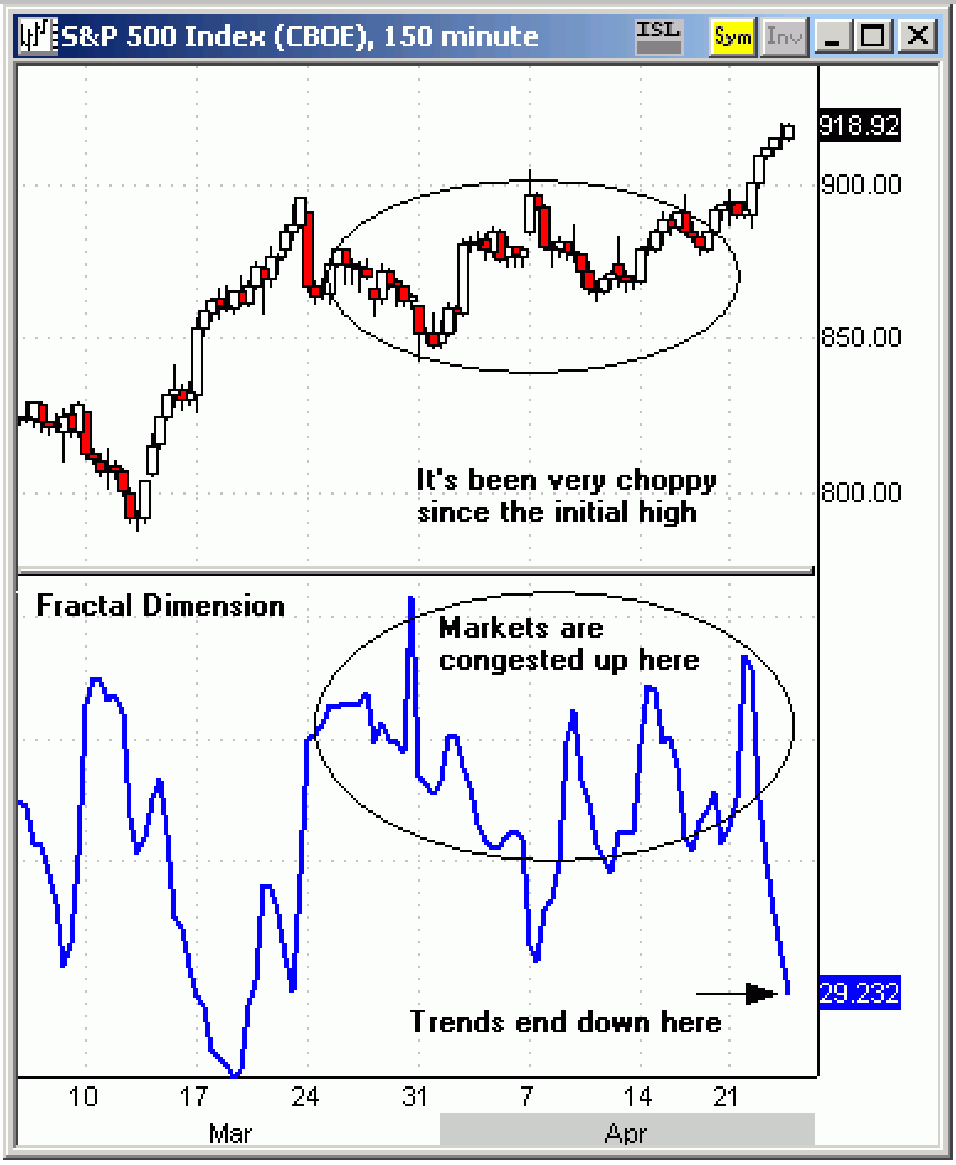
In this case, we're thinking about buying cheap out-of-the-money XEO calls (XEO are European-style options exactly equivalent to the more familiar OEX.). If the market just keeps powering higher, these will give nice gearing to any further rise.

However, let's say the rally flames out quickly, and the VIX shows a spark of fear, and the bullish majority starts heading for the exits in a mad rush. It would be a dandy strategy at that point to sell some XEO calls *underneath* the ones you own -- selling a lower strike price -- which would bring in a nice chunk of money and leave you with a "credit spread." This one move would instantly turn your bullish position into a bearish one. If the OEX then tumbles down as expected, the credit spread will rapidly decay in value and you'll get to pocket the premium (credit) you brought in. Another benefit of a credit spread is if prices just go flat you also benefit, as time decay is working in your favor.

By the way, it's best to use XEO options instead of OEX for such a credit spread, as there is no risk of assignment with European-style options, making the margin requirements less stringent.

We like this strategy because any long trade right here needs to be short-term in orientation, with a very quick escape plan ready ahead of time. Remember, the sentiment tank is only at 8%! Confirming this reading is Phil Erlanger's Buy and Sell confidence indices, which we used to have available in the Morning Briefing before our licensing deal expired. But I can pass on that Phil's "buy confidence" on both the S&P 500 and Nasdaq 100 in the short term is 0%. If ever there were warning signs about long positions, we're getting them now.

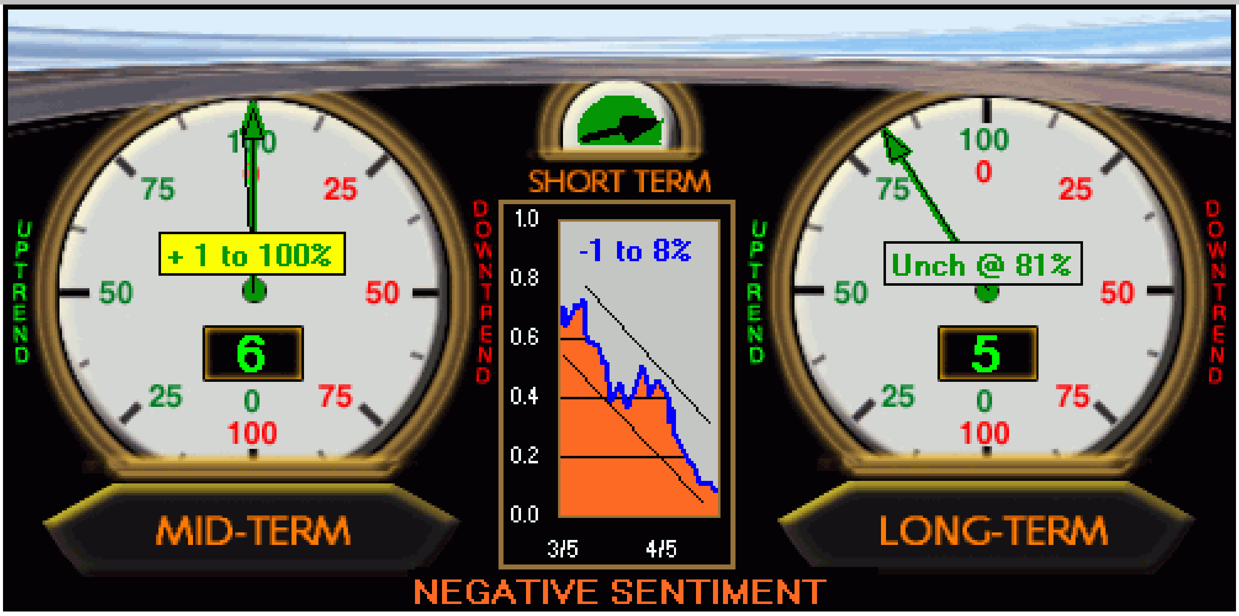
Another problem for the bullish case in the short-term is the fractal dimension of the S&P 100 (OEX) on the important 150 minute time frame. This trend is stretched about as far as they ever go, showing the markets at the very least need to pause and congest, and more likely will pull back.



But if this pause is benign, and no downside catalyst shows up to spark the fear, then the upside party can certainly continue. But as I've warned, if you're going to join the bullish party, stay close to the door, and be prepared to quickly leave that party and start dancing to a different tune. And don't drink too much, either.

Sentiment Dashboard

by Adam Oliensis



SENTIMENT TANK: The tank drained to **8% full of negative sentiment** on Wednesday. If I were driving a country road and my gas tank looked like this I'd sure want to know where the nearest filling station was. (And if my wife were with me, I'd be hearing about it!)

SHORT-TERM: The hourly gauge remains in an advance phase, but one that's now showing some signs of deterioration.

MID-TERM: The mid-term gauge **progressed 1 point to 100% in its advance phase** on Wednesday. This is the first time in the last three years that we actually have a full-on reading of 100% (no rounding, no nothing -- a clean 100%). That means that on this reckoning sentiment has reached an unprecedented level in terms of the momentum of its decay.

This also means if an intermediate top isn't very close at hand that we may indeed be changing phases in this market into a more bullish one.

Our Confidence Diffusion Index hit 6 out of a possible 7 today. Almost all our technical elements have now capitulated and turned bullish. Normally by the time this happens the market has achieved a state of being more than somewhat overbought. Gauging the quality of a selloff becomes the next interesting subject.

LONG-TERM: The weekly gauge remained **unchanged at 81% within its advance phase** on Wednesday. Our weekly CDI clicked up a point to 5.

BOTTOM LINE: Am I seduced by the bullish ambiance? You bet. I love nothing so much as a good tech rally. Brings back visions of the halcyon days of '99. All my friends thought I was a genius. I even started thinking I was one too. I don't know about you, but I sure as heck had a lot of fun that fall and early winter.

But the reality is the tank has drained from 85% down to 8% and what has price accomplished? It has run through some minor resistance levels but the SPX is more than 40 points below the neckline of the biggest Head & Shoulders this side of the Jolly Green Giant!

Could everything change? Could it be different this time? Could be. You bet. Stuff happens. Things change. But more likely this rally will run out of sentiment fuel, and pretty darn soon.

Definitions

You can find this article on the Web at:
http://www.21stcenturyalert.com/page/tcx/morningbriefing/2003-04-24/