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21ST CENTURY ALERT

MORNING BRIEFING

THURSDAY a.m.
May 8, 2003

The Pullback Will Tell the Story

by David Nichols

This market needs to pull back to let us know what it's really made of. The character of the coming correction -- and I think it's underway already, quite benignly, at least so far -- will give us a good sense of what to expect heading into the summer.

Here's a very, very rough forecast of the future path of the S&P 500 (SPX). It's not an exact forecast by any means. And did I mention that it's rough? Please don't take this literally, or examine it for anything other than what it's intended to be -- which is a general sense of what market patterns to look for going forward.

The bullish scenario is in green, with the more bearish one in red.

Even the most bullish expectations for the market involve a correction back down to at least the area of the 40-week moving average. Currently that sits at SPX 906, but it will be climbing now that prices are above it.

It would be very sweet for the bullish case for prices to come back, give a "kiss goodbye" to that important moving average, and then go merrily on their way to higher ground. If that happens, it will likely correspond with the 10-week moving average -- the green line in the chart -- crossing over the 40-week average (pink line). That would be the first time the 10-week would be above the 40-week average since the bear market began.

If this happens, and it's accompanied by a move up in the VIX towards 30 or so, then you stay bearish at your own risk. That would be a sign that the market may have actually found its footing, and we may be in for a more benign "mini-bull" that can last, well, who knows? Not 18 years, but maybe a few more decent months, or maybe even a few decent years.

But then the market will still have to overcome that nasty mega-resistance at SPX 950 to 965. But in this scenario, we'll almost certainly make a strong run at that, and will likely get over it, and least for a little while.

Now, the bearish scenario: If this pullback develops into something more than a profit-taking correction, then it could again get ugly in a hurry. This is entirely possible; indeed, it's the high-odds bet until proven otherwise.

Sentiment patterns have been very bearish for the market. Majority bullishness rules the day, with the thought that the "train-is-leaving-the-station-without-me" foremost in people's minds. The Investor's Intelligence survey just reached an astonishing 55.8% bulls. The VIX has dropped from over 40 at the March bottom to the low 20s with stronger momentum than we've seen throughout the bear market. Our sentiment tank has been in the single digits, with the market "sucking fumes" at the end of this uptrend.

So let's see how the bullish crowd survives some momentum in the opposite direction. Once the profit-taking genie comes out of the bottle, he doesn't generally go away until he's accomplished some work -- usually about a 38% retracement of the uptrend, even in a continuing bullish scenario. A shallower retracement is more bullish, a deeper one more bearish.

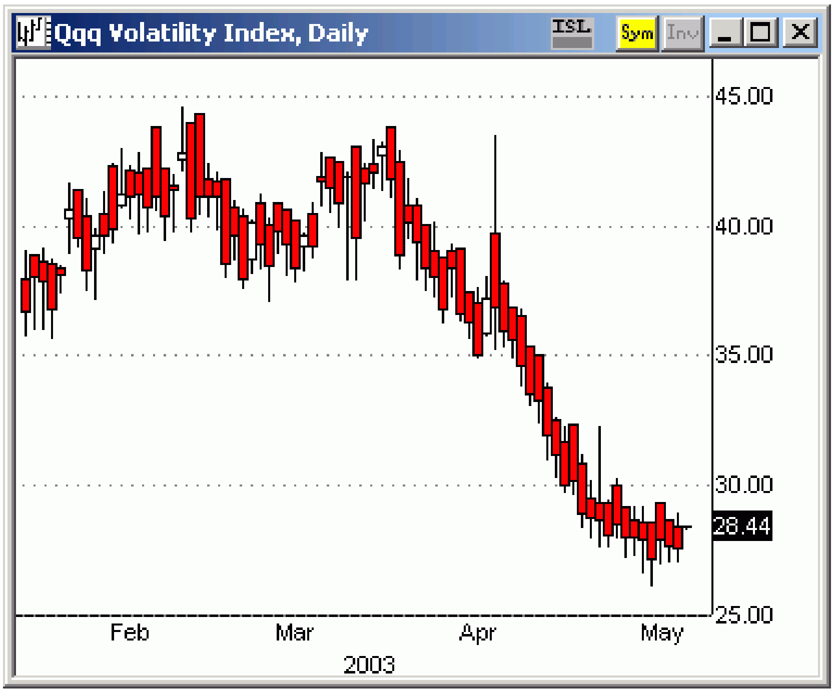
There are certainly some profits to book off this latest run, and the urge to book them has not actually been abolished. But if we start to get too far below SPX 900, then the bullish case is in doubt, and we'll have to start paying attention for signs of frailty.

The market doesn't like to reward impatience, so all those coming in late to this uptrend are now likely to feel some pressure. And all those covering shorts in a mad rush are likely to look back in disappointment how the market would have given them a chance to exit more gracefully.

We also have to understand that while the market is in this profit-taking mode, then any unexpected shocks can cause much greater damage. If people are already in a mood to sell, and negative news starts flowing, then we get downwards acceleration.

Remarkably, we're still waiting for that real "spark of fear" to show up in the VIX. Yesterday it looked like it was here at last, but by the end of the day fear was vanquished yet again, with the daily VIX candle ending up solidly red.

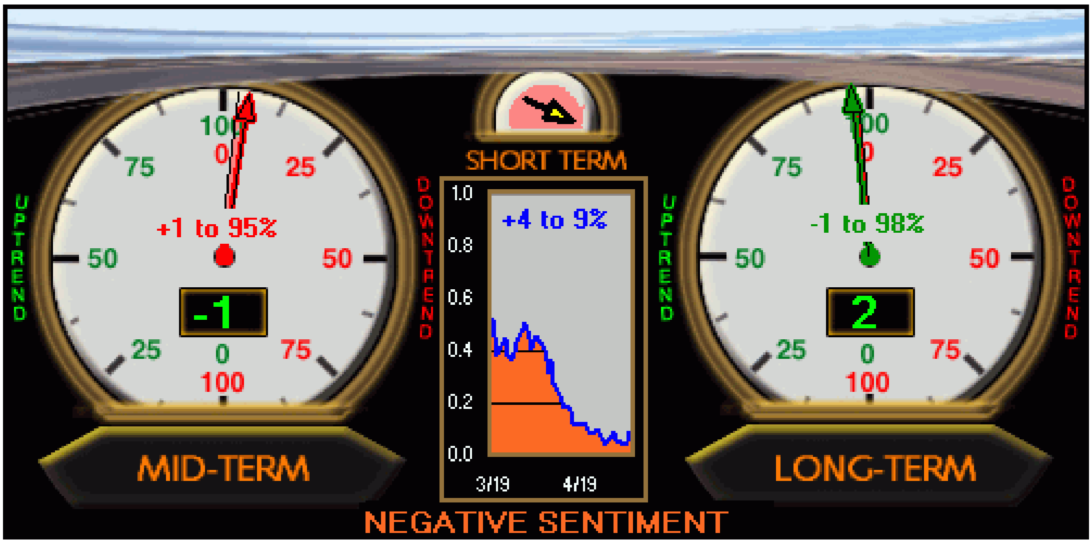
Speaking of red candles, check out the daily candles on the QQV, the VIX-equivalent implied volatility measurement on QQQ options.



That is a whole lot of red. A white candle on the QQV would be an unmistakable sign of a change in character for the market, and that long positions are going to get squeezed for a while. So we'll look for it.

Sentiment Dashboard

by Adam Oliensis



SENTIMENT TANK: The tank **filled 4 points to 9% full of negative sentiment** on Wednesday.

SHORT-TERM: The hourly gauge **moved into a decline phase** but not too convincingly as the VIX remains within its narrow range (23-24.5).

MID-TERM: The mid-term gauge **progressed 1 point to 5%** in its developing decline phase. The oscillator has now clearly crossed its trigger line. Our Confidence Diffusion Index came back toward 0 by 2 points to a bullish 1. If the CDI comes across 0 into the red (bearish) numbers with any momentum at all it will mean that we're heading into a decent mid-term decline phase.

LONG-TERM: The weekly gauge **regressed 1 point within its mature advance phase to 98%.** The CDI regressed by a point to a bullish 2. In order to roll over into a decline phase the gauge has to close on Friday below 89% (which is where it closed last Friday.)

BOTTOM LINE: The underlying bid in the market has kept both gauges up very close to their respective tops, and has kept the tank down under 10% for more than two weeks. Earnings season has brought better than expected numbers-, but those results will now dissolve into history. This market is SO ready to test down. The quality of the coming decline phase will tell us the meaning of the expiring advance phase and will begin to project whether a subsequent advance will be impulsive or reactive.

Definitions