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21ST CENTURY ALERT

MORNING BRIEFING

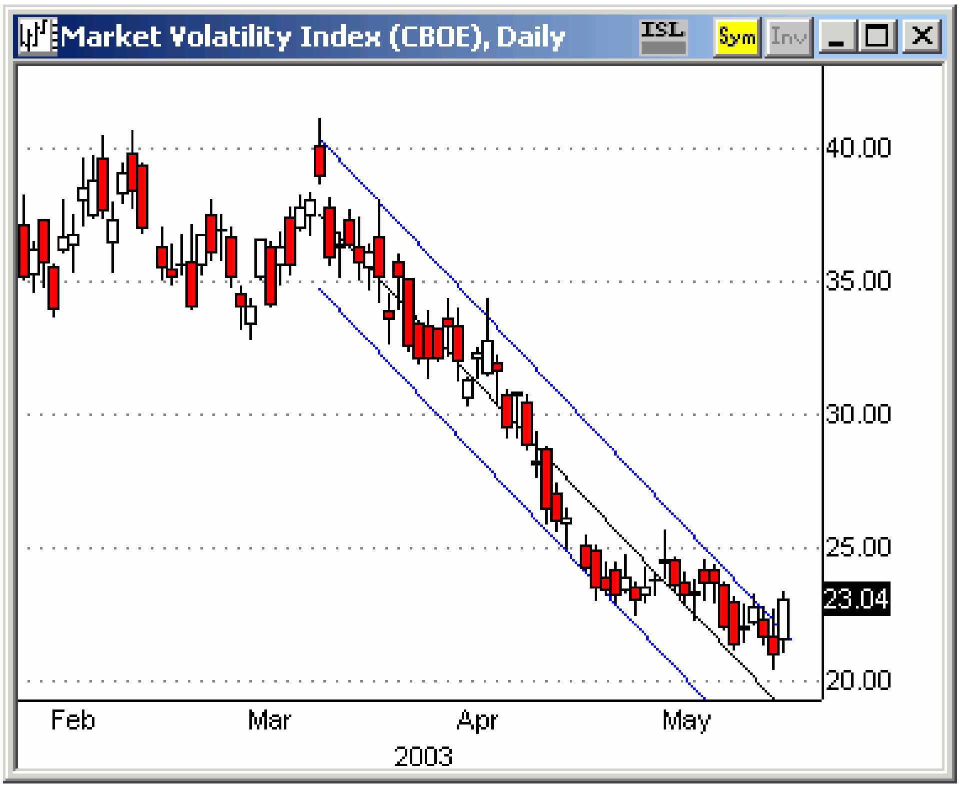
TUESDAY a.m.
May 20, 2003

Gap Down, With (Some) Fear

by David Nichols

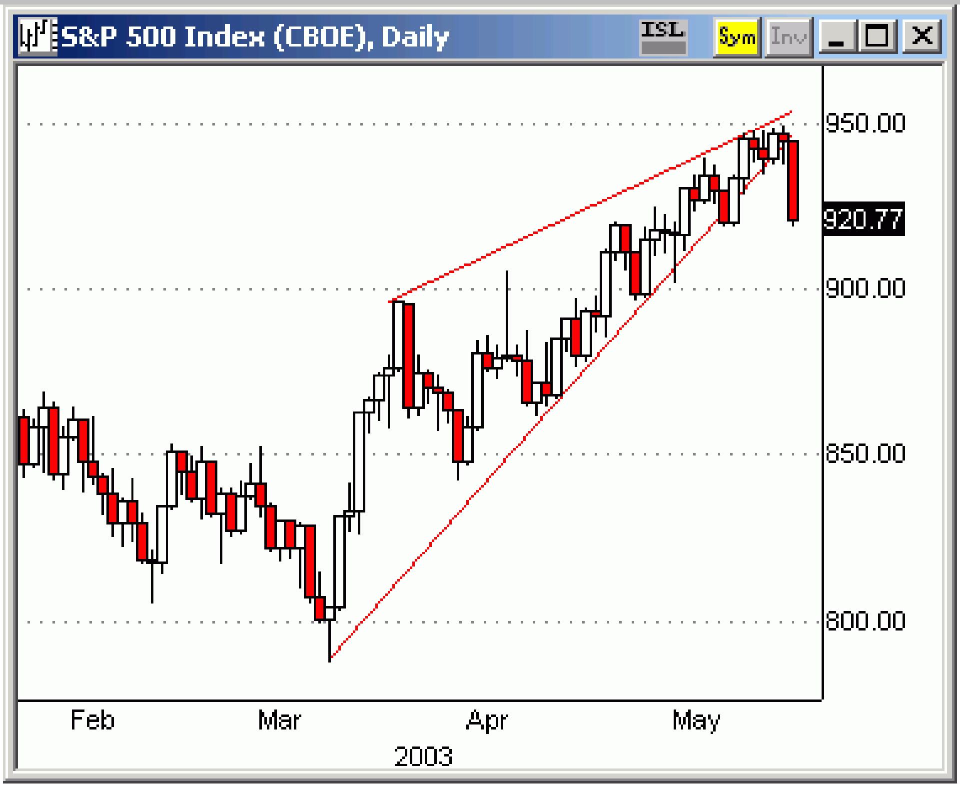
If you haven't yet heard my interview with Professor Didier Sornette, I definitely recommend you set aside some time to listen to it. It's available for everybody to hear, by clicking on the attached link. With the developing situation in the US dollar, we now have a fundamental driver lined up to potentially push the stock market into his predicted slide later this year. At the very least, it's vitally important to be aware of the possibility of a big decline still looming ahead of us.

If you watched the markets yesterday, you witnessed exactly what can happen when a bullish majority gets slammed by bad news flow.



The VIX popped out of its downtrend channel -- finally. Although it seemed like the VIX was heading down into the teens, at some point the pendulum of sentiment will swing back against the majority. Treasury Secretary Snow's weekend comments were a chaotic energy bump that dislodged the market out of its comfortable tight-range "disharmony".

Ironically, the market trades in its tightest range when there is an almost perfect *disagreement* among market participants. When buy orders and sell orders are perfectly matched, the market moves sideways in a tight congestion period. Yesterday, there was no such disharmony; there was actually a uniformity of opinion among traders and investors, with the sell orders vastly outnumbering the buy orders.

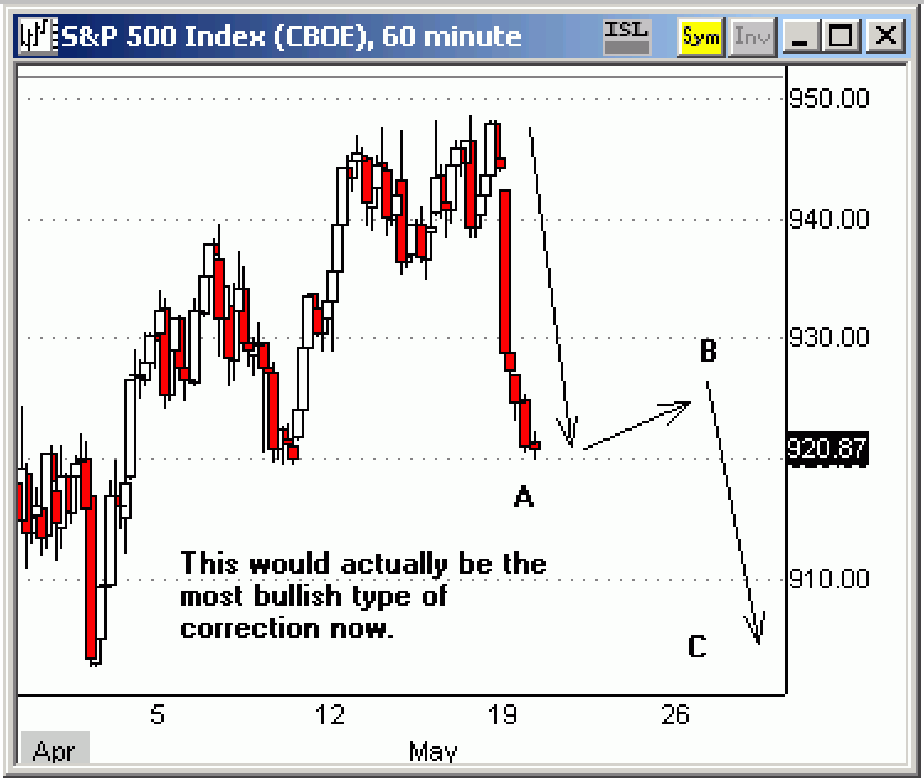


To me, this looks like the vanguard of the bullish majority abandoning their spot on the bullish side of the ship, running over to the bearish railing. But there is still a huge imbalance built up on the bullish railing. Everybody does not react at the same time, and at the same price. People require unique amounts of evidence before they'll change their market opinion. A great many will stay on that bullish railing until prices are dramatically lower, and only give up in a panic at the end. It's this lack of uniformity in decision-making that creates mid-term trends in the market.

When a super-majority is built up -- as we have now on the bullish side -- something inevitably comes along to spark up a "virus of fear", which starts to infect this super-majority one by one. In this case, it was our Treasury Secretary telling the world that it's okay to sell the US currency. Enough people remember then-Secretary James Baker's comments in 1987 to make this a scary thing. So the virus has been unleashed, and now we need to see if it turns into an epidemic among the bullish majority. Lower prices from here -- or the inability of the market to bounce back -- will stoke up a negative feedback loop that will infect the thought process of more and more bulls, dislodging them from their bullish stance, causing them to throw in market sell orders.

Of course there's no guarantee that this will turn into a selling epidemic. There never is. But the conditions are very ripe this time around -- as ripe as they've ever been in the bear market, in fact.

The rising wedge is now officially history, and true to textbook form, the break was to the downside. If you were following my advice on the "stop-and-reverse" trade, the market cascaded down through our stop at 932, and then proceeded to slide the rest of the day. If you're in that trade, there should be more downside coming. Even in the most bullish scenario for the markets, we should now see an A - B - C correction, where A equals C. That projects to below 910 on the SPX.



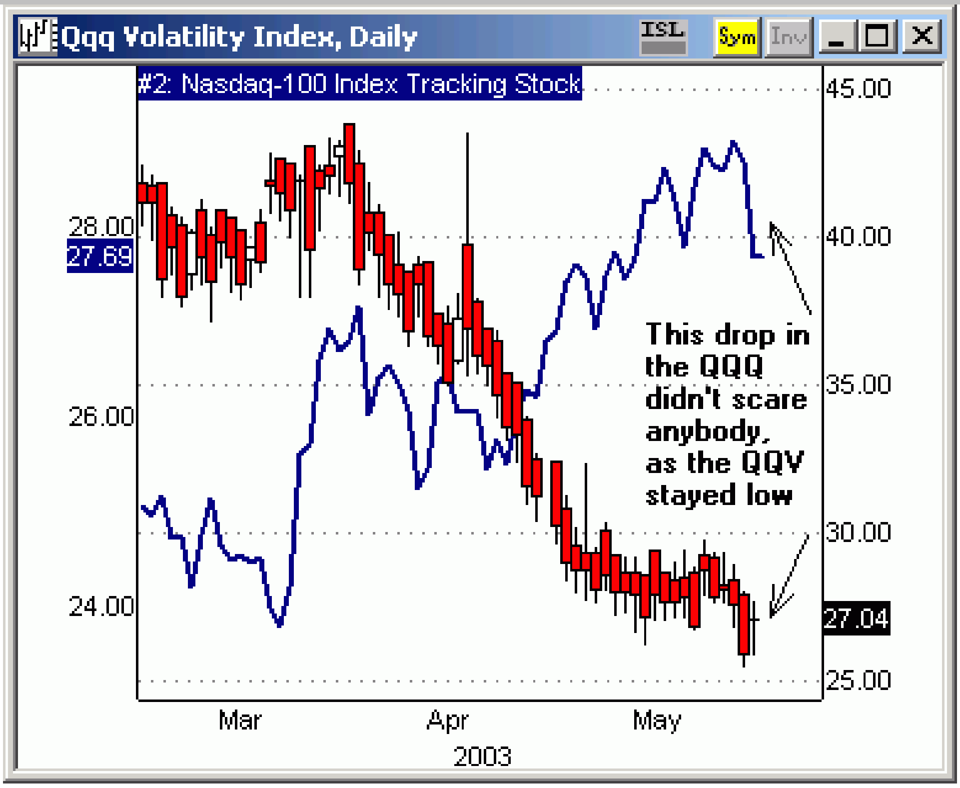
So the spark of fear is set loose, and this was the cue we were waiting for to take action in the bearish Rydex funds. Subscribers got an afternoon e-mail recommending that they put 50% of their allocated speculative capital in the Rydex Tempest Fund, symbol RYTPX.

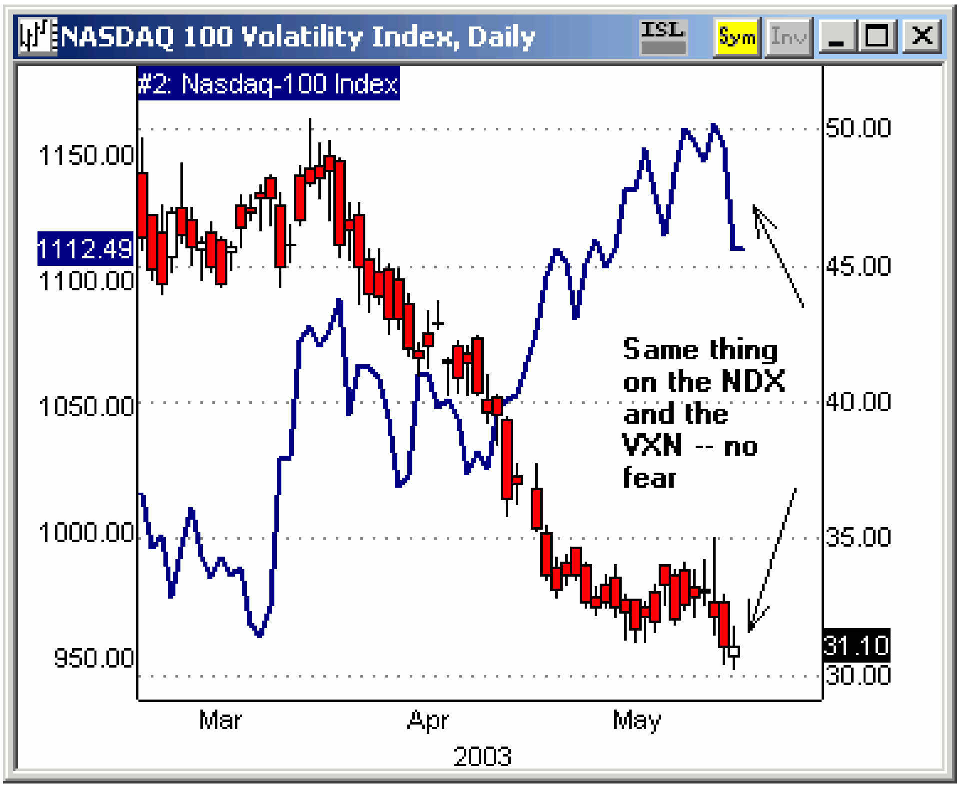
I am only recommending 50% exposure at this point, because yesterday's move down was a little bit *too much, too soon*. The market likes to find an equilibrium point after such a big move, so the next day or two should find the market bouncing back up in a tighter range. The SPX should be able to eat its way somewhat into Monday's big red candle.

The behavior of prices now will tell us a lot, in fact. If we get a further cascade down, then that will tell us it's a potentially very serious selling epidemic that's building. If we get a typical bounceback, where prices move back up into the red candle but don't totally "engulf" it -- accompanied by a drop in the VIX -- then we'll know the market is setting up to sell off hard again.

If we get a tepid move up over the next few days -- especially if it's accompanied by a drop in the VIX -- then I'll recommend putting in the other 50%. If you haven't put any money in the Rydex Funds yet, then put 50% of your allocated speculative capital into the Rydex Tempest Fund, symbol RYTPX, at the close today. The Tempest Fund is designed to go up at twice the rate the S&P 500 goes down, on a daily basis.

Now, when we go in on the other 50%, we'll be looking to go into the Rydex Venture Fund, which goes up at twice the rate the Nasdaq 100 goes down. The Nasdaq looks to be in a very precarious spot, as there was no fear exhibited yesterday in the face of big down day.



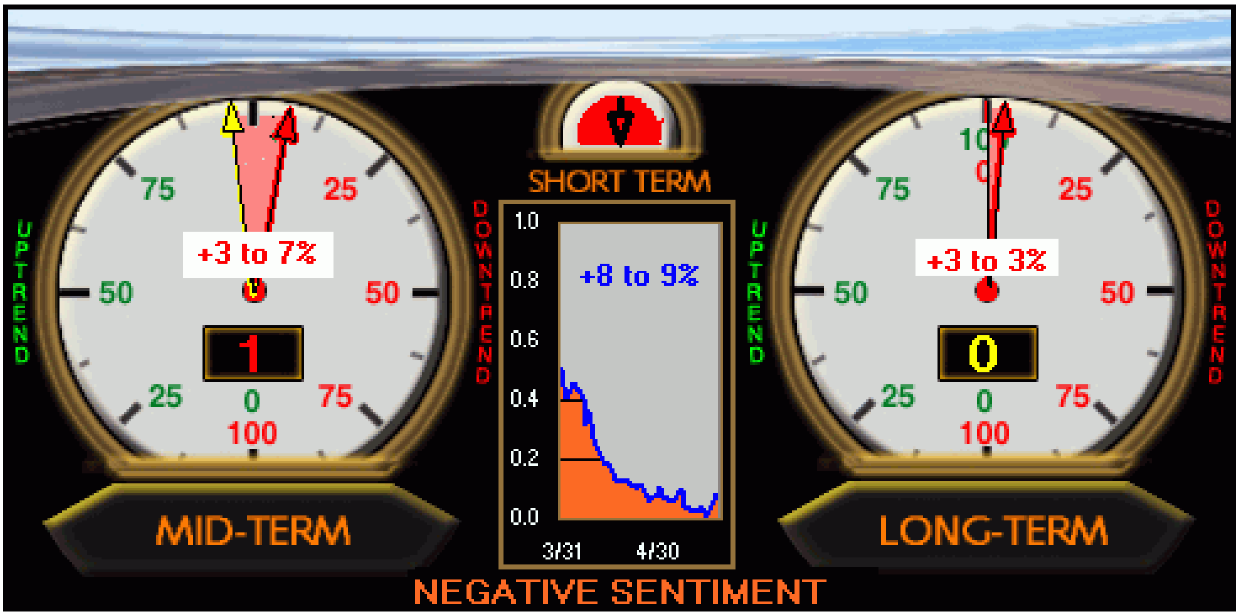


Both the QQV and the VXN -- the implied volatility measurements on QQQ and Nasdaq 100 options -- barely blipped yesterday, even though the Nasdaq 100 sold off 3.6%. That's significant, as it shows complacency in the face of adverse price movement -- a hallmark of a bear market. This is direct evidence that the brutally destructive bear market sentiment patterns are still alive and well in this market.

This also means that all those market participants who are bullish on stocks are going to require further testing of their bullish stance.

Sentiment Dashboard

by Adam Oliensis



SENTIMENT TANK: The tank, which measures the level of bearish sentiment**filled 8 points to 9% full of bearish sentiment on Monday.**

SHORT-TERM: The hourly gauge **moved into an aggressive decline phase.**

MID-TERM: The mid-term gauge, which measures the momentum of negative sentiment**progressed 3 points to 7% on the decline side.** Our Confidence Diffusion Index moved 5 points, which is a big move on the CDI, from a bullish 4 to a bearish 1. The advance in prices is now undergoing its first challenge in some time. That's what happens when we get a real spark of fear in the market.

LONG-TERM: The weekly gauge **moved from 100% in its advance phase to 3% in a new decline phase.** The weekly CDI moved to neutral at 0. The weekly gauge will not give us a definitive sell signal until the week ends. But this is where it stands intraweek.

BOTTOM LINE: This is what the beginning of a decline phase looks like. Could it get reversed? Yes. Especially in light of the recent strength of both Cumulative Volume and Breadth. So, this is unlikely to be the sort of cakewalk that decline phases have often been for short positions over the past 3 years. That said, the absolute level of the tank, the mid-term gauge, and the long-term gauge are all starting to give sell signals from extreme levels, so there is very likely to be significant downside follow-through, if not immediately then pretty darn soon.

Definitions

Money Making Book: An Investor's Guide to Options Trading

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http://www.21stcenturyalert.com/page/tcx/morningbriefing/2003-05-20/