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21ST CENTURY ALERT
MORNING BRIEFING

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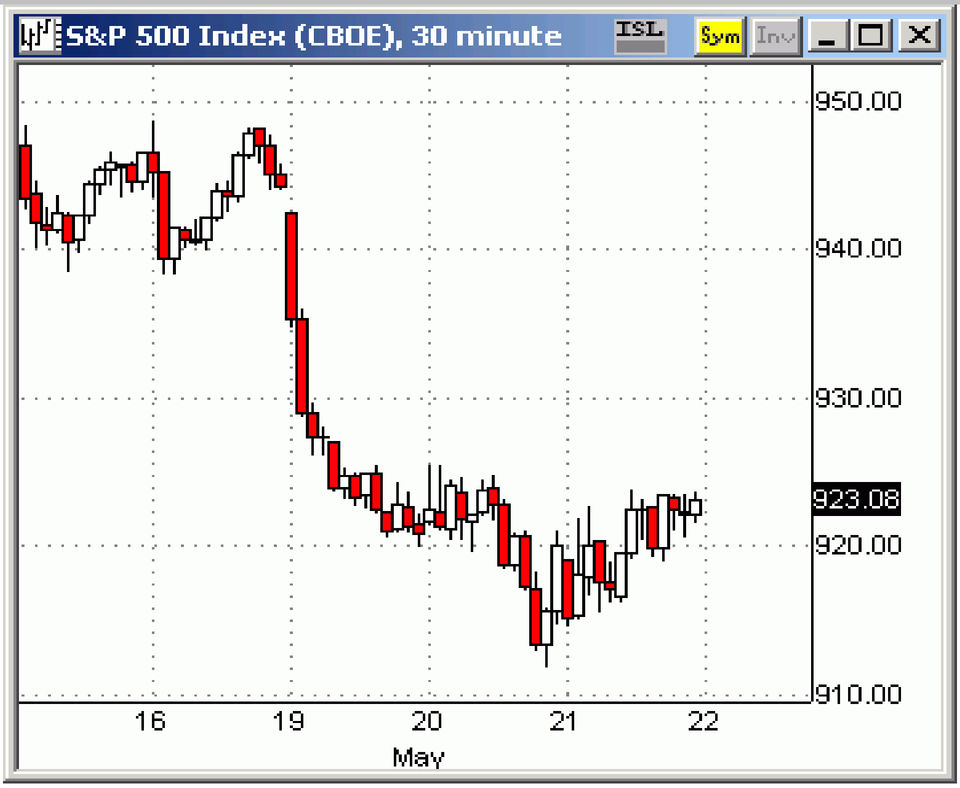
A Trading Lesson from George Soros

by David Nichols

The market didn't present much new information yesterday, as it idled around in a very tight range. That's information, too, in its own way; and really, it's not saying much for the bullish case.



Essentially this week we've had 4 hours on Monday morning where the market cascaded down. Since then, we've seen tight range gyrations with no net gain or loss. But here's the thing: a sideways consolidation of a streaky down move argues strongly in favor of a continuation down.

If the bullish forces were in gear, the markets would be eating strongly into Monday's big red down candle. They'd be showing some impulsive strength back up. This still may happen, but the time to impulsively get that job done is fading away. Absent a strong move back up and over SPX 935, the next streaky move is likely to be down, and to take the SPX down to about 900, or possibly 890.

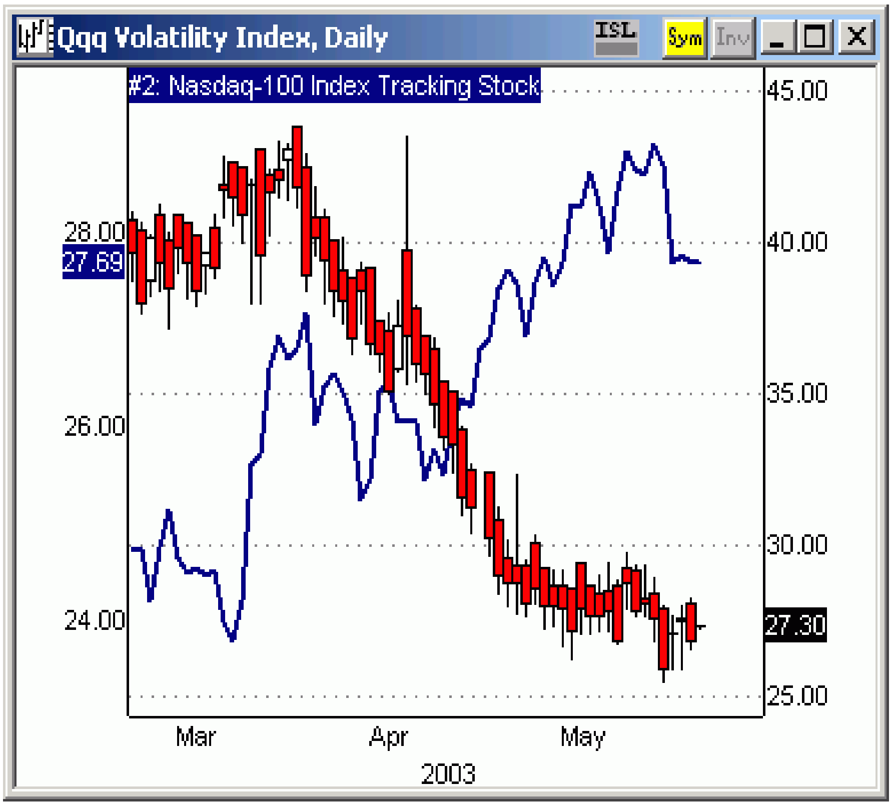
The VIX jumped up yesterday morning during Greenspan's testimony, indicating that there are some bearish bets being made, and/or some portfolio protection being sought in the options market. This little jump in bearishness seems to be one of the elements keeping the market from just tumbling down further right here.

But this is just a small and temporary burst of pessimism. In the bigger picture, market sentiment has become frothily bullish. I don't put much weight in the Investor's Intelligence numbers, but when they hit extremes, it's worth taking note. This is a survey that measures the bullishness or bearishness of market advisors. The percentage of advisors that are bullish just checked in at 56%, up from the prior week's 54.4%, with the number of bearish advisors now at 20.9%, down from 23.9%.

That's the most bullish this crowd has been in 15 years.

The situation over at the Nasdaq is pretty interesting right now, and potentially more bearish for the markets. The sentiment/price action in the QQQ is showing the same old sense of denial that the pullbacks have the potential to develop into something more significant on the downside.

The QQV is the implied volatility measurement on QQQ options -- it's the VIX on the QQQ. Even though the Nasdaq 100 has taken a hit this week, sentiment has not migrated even a little bit into bearishness. In fact, into the close yesterday, the QQV took quite a tumble itself -- showing a distinct lack of fear in this market.



When prices start to move down, and sentiment doesn't get more bearish, then the market has a big potential problem. We've seen this same sentiment pattern before every major decline in the bear market. So seeing it again now in the QQQ/NDX reinforces the idea that the crowd is far too bullish for its own good.

However, if you've spent any time studying sentiment and price action, you know that these extremes of bullish sentiment can often persist. There's no rule that says the crowd has to be punished right away. Yet if prices keep moving against the bullish majority -- and they don't care -- then the markets are definitely setting up to accelerate to the downside.

One thing we know *for sure* is that the massive bullish crowd requires testing of their bullish beliefs. That test will involve lower prices, determining their willingness to hold onto long positions in the face of adversity. The thing that we don't know for sure is whether this test is going to occur right now, or whether it can be pushed back to a later date.

I haven't yet entered the second 50% of the Rydex position because we need to see if the test is going to occur right now, and whether the "fear virus" is going to proliferate among market participants. It's off to a good start, but it hasn't really reached the stage where it grows quickly.

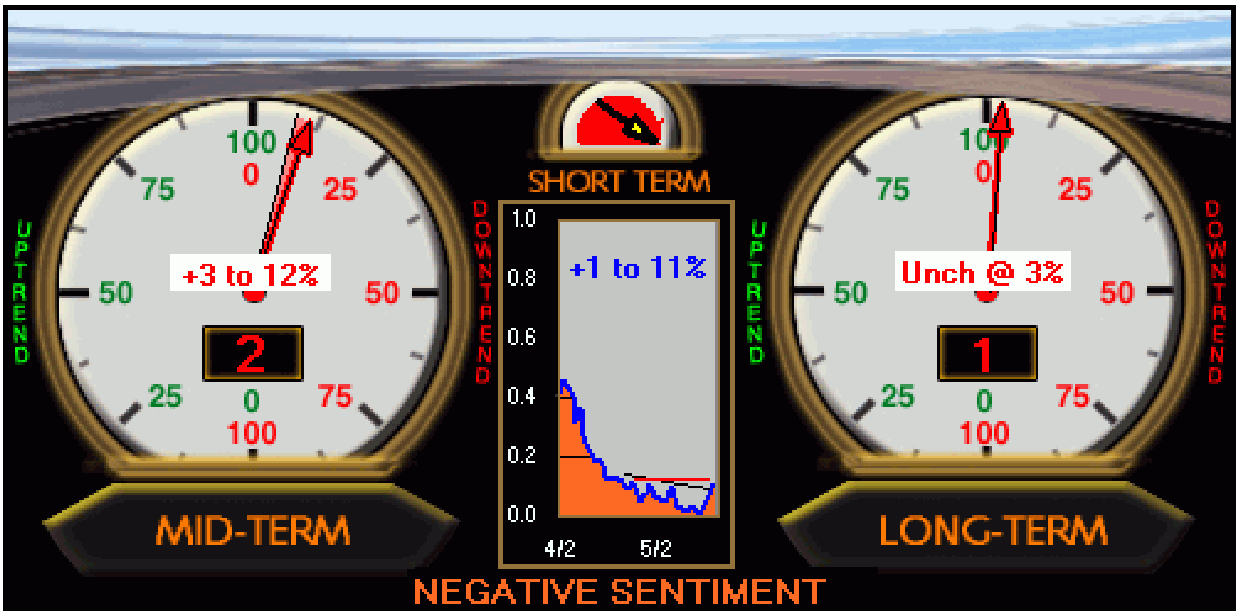
So the smart thing to do, at least in my opinion, is to stake out a position when the circumstances are right for such a selling epidemic to spark up -- as we have now -- and to *add* to that position as more evidence comes in that the big bullish crowd is on the run.

By the way, this is how George Soros got most of his $6 billion from the markets -- he would press his bets only when positions were *already going his way*. This is different than the way most people do it. Most people have the urge to "average down" when the market is moving against them. They continue to think they are right, even when the market is saying they are wrong. That's okay within reasonable limits, but I think it's a much better strategy to add more exposure to mid-term positions after you know you're right.

So a good strategy for a mid-term bearish Rydex position is to enter half on the initial short-term decline phase when the conditions are right for a reversal, and then closely watch how the ensuing short-term advance phase plays out. If the short-term advance is strong, then that is telling us something; namely, that the conditions for a bigger decline didn't spark to life. However, if it's a tepid bounce -- as it currently is -- then we'll have more confidence that the next short-term decline will carry the markets dramatically lower as the fear epidemic starts to infect more and more bullish market participants.

Sentiment Dashboard

by Adam Oliensis



SENTIMENT TANK: The tank **filled 1 point to 11% full of negative sentiment.** The tank is flirting with breaking above its recent low range around and below 10%.

SHORT-TERM: The hourly gauge **has enjoyed a solid decline phase, which may now be turning neutral, though it has not yet given a solid signal.**

MID-TERM: The mid-term gauge **progressed 3 points to 12% in its decline early decline phase.** Our Confidence Diffusion Index remained unchanged at (out of 7).

LONG-TERM: The weekly gauge **remained unchanged at 3% in its nascent decline**

phase with a CDI of 1, which is still very near neutral.

BOTTOM LINE: It would not be surprising to see an hourly advance phase kick in now. A positive bias often emerges into a holiday weekend. However the Code Orange (terror alert) may cast a pall over that notion. There is a lot of bullish sentiment floating around the financial press (viz the 2.7/1 Investors Intelligence bullish/bearish reading discussed in last night's Closing Bell) and the buy-the-dip mentality has a tendency to persist even after the technicals begin to deteriorate. It could take some time for it to really sink in that oil is back up near $30/barrel, that earnings season is over and there will be a paucity of earnings news until warning season (which is almost always tough on the market), that the economic news, while improving microscopically, is slouching toward Bethlehem (at best), and that while dollar weakness has its benefits it has its dark side as well. All of which is not to say that the market has to crash and burn, but that we would like a decent amount of creative destruction.

It's a yin/yang thing. You have to draw the bow to let the arrow fly, or as Bono sings, "if you wanna touch the sky, better learn how to kneel...on your knees, boy." The market had been very yang (aggressively up without respite) until Monday's selloff (a taste of yin). While we're probably due for a very short-term bounce to balance the one-day down, there's a larger (mid-term) yin phase (contraction, rest, darkness) that is very likely to express itself more fully in the mid-term.

Definitions

You can find this article on the Web at:
http://www.21stcenturyalert.com/page/tcx/morningbriefing/2003-05-22/