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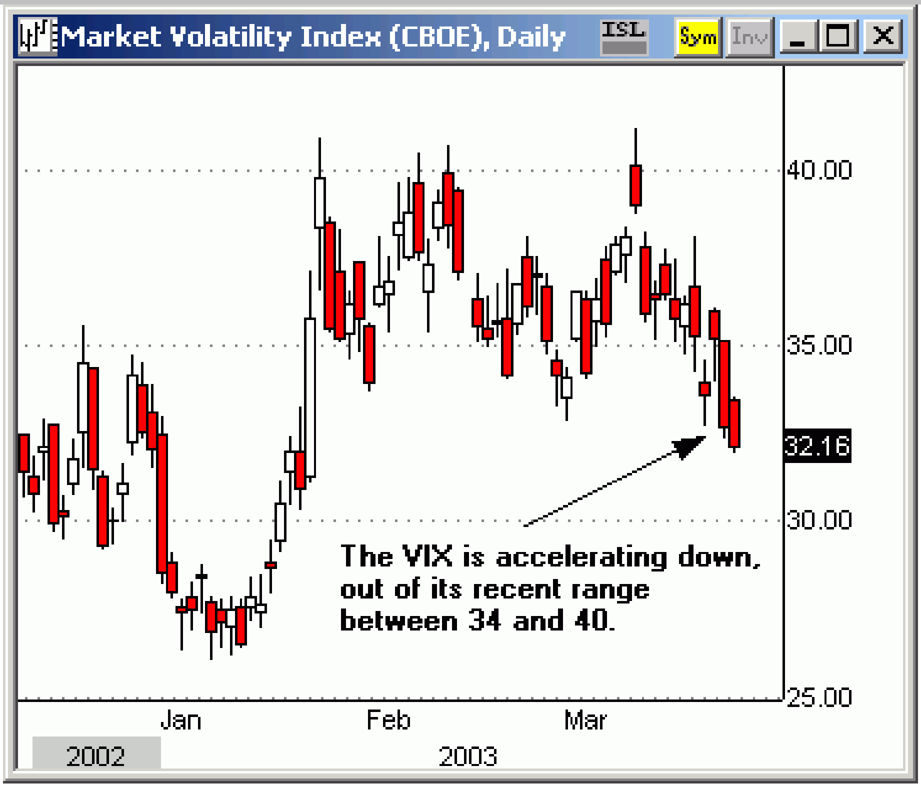
21ST CENTURY ALERT

MORNING BRIEFING

THURSDAY a.m.
March 27, 2003

Clues from the VIX

The VIX is breaking down out of its recent range in the high 30s.



This indicates less worry on the part of traders, as demand for options is waning. The market makers are lowering the price of options -- causing the VIX to fall -- to a level where they can "move some product". A falling VIX is highly correlated with a rising market.

The only problem now is we have a falling VIX, but not a rising market. It looks like everybody is buying into the notion that this is just a benign correction in a stronger uptrend.

Some people have been writing me that perhaps the VIX has lost its edge lately because it's so widely followed. At one point, years ago, I also thought this was the case. Yet subsequently I've seen the VIX continue to do the same things, over and over again. That's because when you get right down to it, people don't trust the VIX, even those who are aware of it. Each and every time, people think "this time it's different", but that never turns out to be the case.

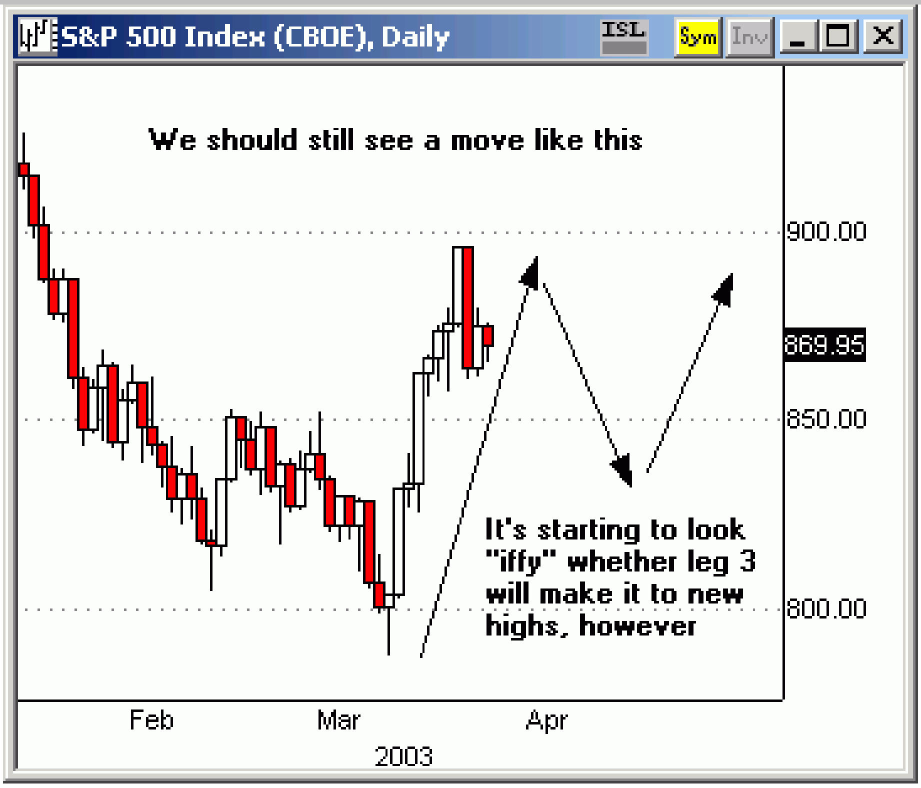
The fact is the VIX can't really lose its value, because it's based on two immutable truths: supply and demand for options; and human nature. Supply and demand is what it is -- the very foundation of markets. And we all know that human nature never changes. The same emotional cycles play out in the same ways, over and over again.

Right now we're playing out a familiar bear market sentiment cycle. The VIX is falling in the face of prices *merely not going down* . In this current case, over the last few days of congestion, the VIX has actually had a breakdown out of its range of the last two months. That can't be considered good for the long-term bullish case.

It would be much healthier if every pullback was greeted with a jump in the VIX, with traders fearing a quick collapse back to the recent lows. That's not happening.

So where does this leave us?

I'm in the camp that says this *is* merely a pullback, and the uptrend will reassert itself with at least one more thrust up. Invariably, that's how these big trending moves play out: Thrust, pause, thrust.



But the VIX is now warning that the next up leg is going to have a difficult time even making it back up to last Friday's spike high, at SPX 895. The sentiment fuel is draining out when it should be replenishing.

But there's still time to convince people there are reasons to be frightened. A break below 850 to 855 on the S&P 500 ought to scare a few bulls, and get the VIX moving up. If the market is going to pull back towards 830 -- which would still preserve a bullish overall context -- then the VIX should get moving back towards 40. If it doesn't, then there won't be much lasting oomph in any subsequent up move.

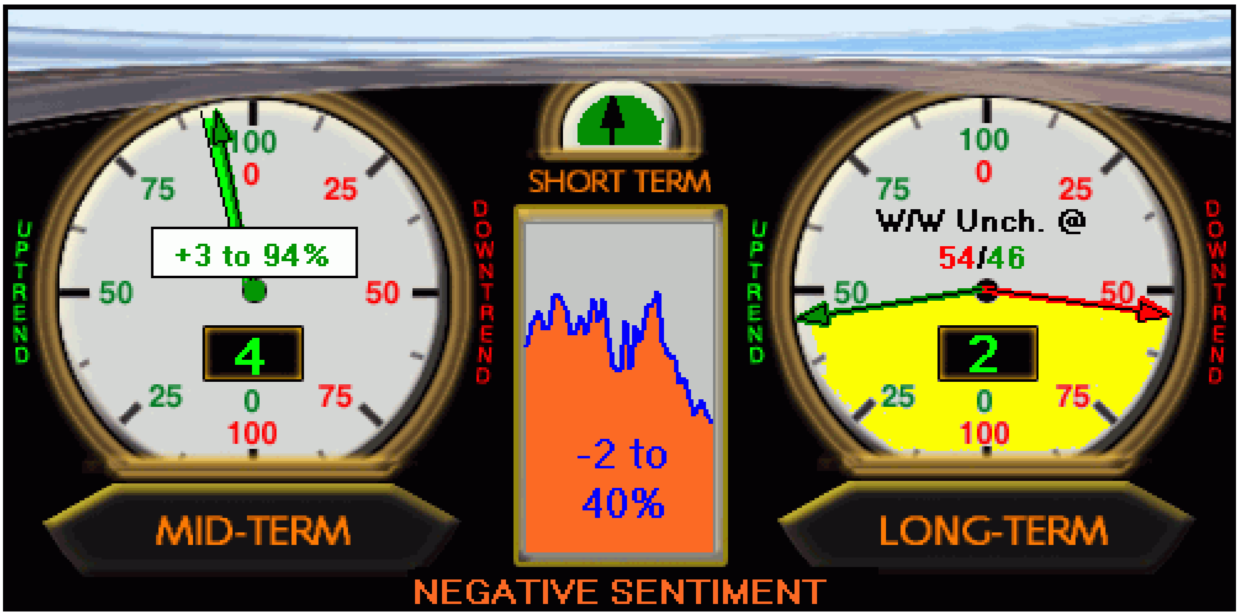
Longer-term, it's discouraging that people are so quick to jump on the bullish case. We've observed this same thing time and time again in the bear market, and the ultimate resolution ends up being a cascade to lower lows. Unless there is a massive change in investor sentiment over the next few months, then the second half of 2003 could turn out to be a very rough ride.

People have to stop calling the bottom and jumping on the bandwagon. They have to start heavily shorting every uptrend, and buying speculative puts. Instead we're still in the "train-is-leaving-the-station-without-me" mode, where the uptrends are warmly embraced. When uptrends are met with skepticism and ridicule, then we'll be building the foundation for something bigger and longer-lasting to the upside.

One final note: Thank you for the input on our service. I'm going through each and every e-mail carefully, and I'm getting some great ideas and suggestions. So keep 'em coming! If you haven't chimed in, please tell me your likes, dislikes, and wishes for the future at comments@21stcenturyalert.com.

Sentiment Dashboard

by Adam Oliensis



SENTIMENT TANK: The tank drained 2 points to "40% full" of negative sentiment on Wednesday. The VIX continues to drop as the Put/Call Ratio remained high at 0.83. The sentiment picture is sending some mixed signals. One hypothesis is that the market had, while the VIX was high, accurately predicted that there would be a lot of actual market volatility. The decline in the VIX may represent options speculators closing their positions. That would force the specialists (normally on the other side of the trade from the speculators) to buy back their options. When that happens, the implied volatility normally declines. Another factor may be that the market is now predicting that actual volatility will decline going forward.

SHORT-TERM: The hourly gauge sustained its advance phase despite the market's decline. Remember, this gauge assesses sentiment not price. Bearish sentiment has been draining as the VIX has declined. Interestingly Price has not been advancing. We may be seeing a short-term bearish divergence developing.

MID-TERM: The mid-term gauge progressed 3 points in its advance phase to 94%. There's room for another up leg in stocks, but if it doesn't come soon, this gauge will flatten out and then be ripe to roll over into a decline phase. The CDI remained at 4 out of 7.

LONG-TERM: The weekly gauge clicked into neutral from its longstanding decline phase. This gauge had been flickering around in the 50s in its decline phase, unable to commit to further downside. The CDI had gone into bullish territory and has now dragged the needle into neutral. The raw reading is now at 46%. That's the "advance phase" reading. Its inverse (54%) is what we would call the reading if it were heading down (in a decline phase). So right now the weekly gauge has the anomalous "54/46" reading. The weekly CDI is at a bullish 2 out of 7, suggesting a mild preponderance of bullish technicals on weekly sentiment charts.

Definitions

You can find this article on the Web at:
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