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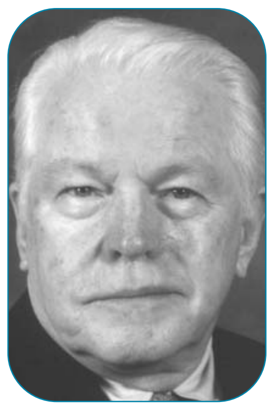
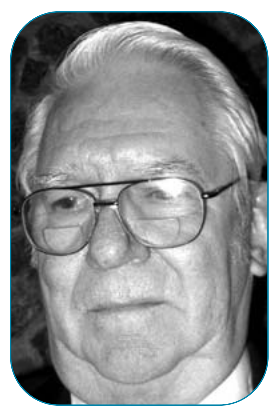
listening**in**

Technically Speaking

Six Top Analysts Address Each Other—And This #%@! Trading Range

The trading range drags on. The participants in this roundtable aren't particularly surprised. Whether bull or bear, none expects the market to break free for a while yet. Still, it wasn't hard to stir up disagreement when I placed a conference call connecting six of the sharpest technical minds extant, back on June 30. (Their names are linked to the photos in a key on page 2.) Which way will it finally break and what does it mean? Read on, and take your pick. ***KMW***





Welcome. Let's get the introductions over with first, in alphabetical order.

Dick Arms: Hi, this is Dick Arms, and I'm still out in Albuquerque, New Mexico—by choice, and still advising institutions, as I've been doing for a number of years. Still 100% a technician.

Still calculating that thing called the Arms Index?

The Arms Index, better known as TRIN, yes.

Paul, the tyranny of the alphabet puts you next.

Paul Desmond: I'm President of ***Lowry's Reports***. Lowry's is the oldest technical investment advisory firm in the country, dating back to 1938. All of our work is done on the basis of measurements of supply and demand. Most of our clients are institutional.

Gail Dudack: I come next, I guess. I'm here at **SunGard Institutional Brokerage**, a very small part of **SunGard Data Systems**, which as you know is a software company for the financial industry. I'm with the institutional broker-dealer doing what I've always done—advising institutional clients. I'm also looking at some of SunGard's software products to see if there's data within some of these systems that could be extracted or massaged to generate interesting market information that may not exist in other places. So I'm director of research products, and I also am producing the key research product right now.

Justin, it's your turn.

Justin Mamis: I'm independent nowadays, publish ***The***

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Published exclusively for clients of Weeden & Co. LP

Kathryn M. Welling
Editor and Publisher

Jean M. Galvin
Business Manager and Webmaster

Karin-Marie Fitzpatrick
Editorial Assistant

Alexander Isley Inc.
Graphic Design

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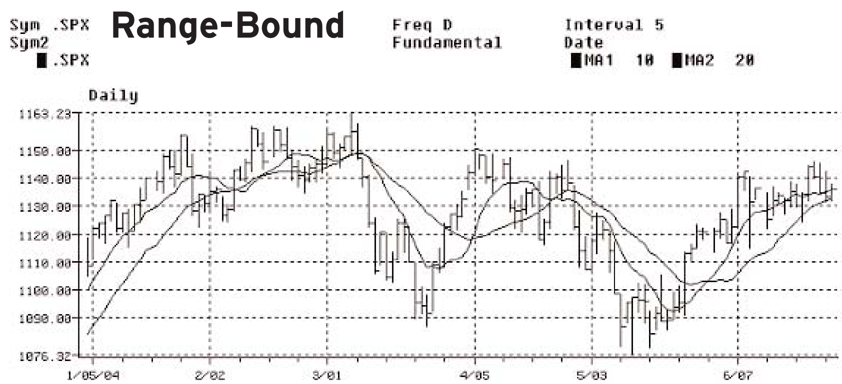
Page 1 Photo Key
Clockwise, from high noon: Desmond, Yamada, Arms, Schaeffer, Mamis, Dudack. Center: KMW

Mamis Letter and daily faxes for institutional investors. I've been doing the same kind of thing at different places for decades. I want to warn everybody that I intend to be the resident grump in all of this, or the gadfly, to make it more polite. But I'm here because I really have some concerns about what's going on in the market.



Forewarned is forearmed. Next?

Bernie Schaeffer: That would be me, Bernie Schaeffer, president of **Schaeffer's Investment Research**. We do a lot of research in the area of investor sentiment interacting with stock market technicals, and also a lot of work in options analysis and options trading–for a clientele a little different than the rest of yours'. It's largely individual investors.

You should add, too, that you just can't help yourself. You're a dyed-in-the-wool contrarian.

You bet.

Louise, you must be used to bringing up the rear where the alphabet is involved.

Louise Yamada: Absolutely. I am head of technical Research at **SalomonSmithBarney**, where I am following in the footsteps of my wonderful mentor and predecessor, **Alan Shaw**. We have two major client bases, institutional and retail, and obviously approach the markets, stocks, sectors–do all of our work–based on technical research. Lately we have been studying what has happened to volume, and I am very interested in any insights anyone can share.

Lackluster trading volumes and this persistently frustrating trading range, as well as worries about how statistical arbitrage and other variants of program trading, not to mention a derivative and ETF hedging activities, are dominating what little action there is–that's pretty much what inspired me to put this telephonic roundtable together. The market, in short, is exhibiting conflicting symptoms. You are top docs. What ails it and what is the prognosis?

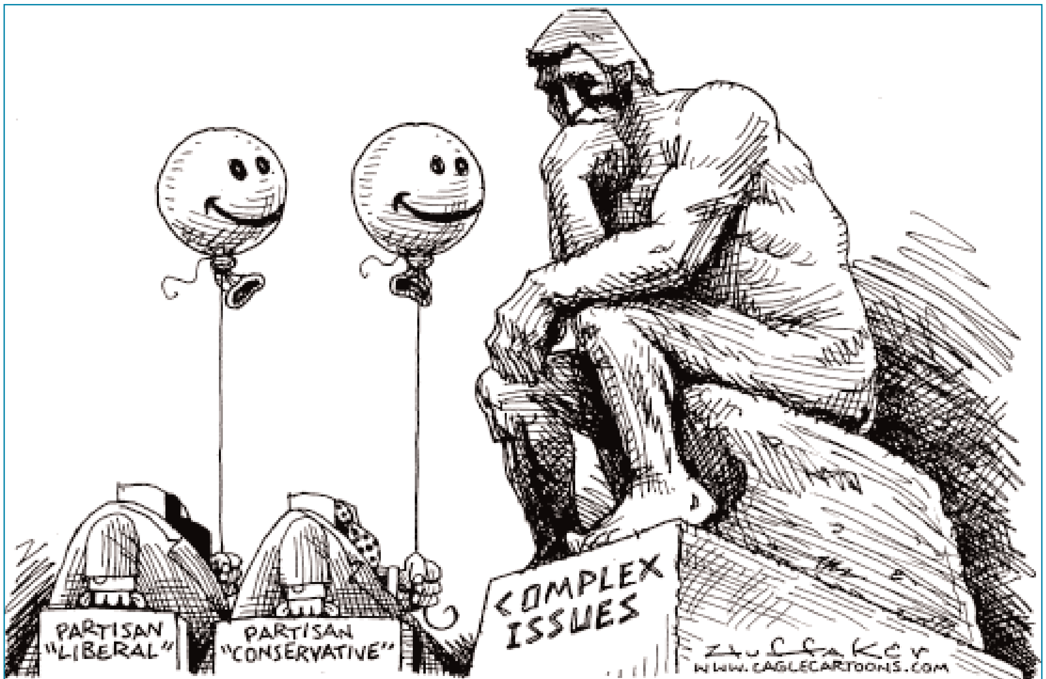
Justin Mamis: I'm a quasi-hermit; I don't really engage in dialogues very often. Therefore, when I get pent up about what I see, I sometimes express things pretty forcefully. My clients are all people who've paid attention to the market for some time–they're all gray-haired. I don't think young kids understand what I'm doing, because it's just so old-fashioned. I'm a chartist. I maintain **John Magee**'s daily charts. We keep hundreds. I am seeing failures in very many of them. As a bottoms-up analyst, I have been seeing successively lower highs. Some stocks have made two successively lower highs, and two successively lower lows–some even three. **Unisys** (UIS) is an example. There are far more deteriorating stocks than ones going up. Essentially, the indices don't want to go down, but they don't go up well, and the indices are masking deterioration in individual stocks. I've been around for generations, so I have some historical perspective. I believe this is a bear cycle. The bursting of the internet bubble ended the bull cycle. But most investors have very little direct personal experience with bear cycles. Japan took a long time to make a bottom in its bear cycle, but when it finally made one at 8,000 in the Nikkei, it did so with all of the required ingredients. Everybody hated it, finally. No one was trying to buy it, the way they had on previous dips, and it made a classic bottom. In the same way, 1974 in this market was a real give-up–to the extent that it took another eight years before people became interested in stocks again. John Magee had one indicator, and one indicator only, of a bottom–fewer than 10% of stocks with strong charts. As I go through the chart books now, as I do regularly, probably 35% or 40% are strong, so we're nowhere near a give-up bottom.

Haven't you compared this trading range to the one the market was mired in, back in '72?

There is a similarity to the essentially sideways move in 1972. I'll never forget it, because I started the ***Professional Tape Reader*** that February and I had nothing to write about as soon as I started it. That lasted until Thanksgiving, when the market exploded to the upside, leading to the Nifty Fifty peak in early '73. This is very similar in the sideways-ness and the itchiness to have a rally. Also in the emotional content of what's going on: "Everything's wonderful."

So the bulls are right? That implies we'll break out of this range to the upside.

But only very briefly. What I would read into that kind of comparison is what is likely to follow: a '73-'74 kind of broad decline, which was essentially the give-up decline of that cycle. We haven't had a give-up decline yet in the bear cycle that began when the tech bubble burst. We have no comparable experience in this market, besides '73-'74, in our lifetimes. To find others, we have to look to Japan or go back to 1929-'32. That's what bothers me. We are missing that one, final, down leg, yet everybody is wildly bullish up here at the top. The headlines and the sentiment indicators are very bullish. It's also interesting to note, amid all this fascination with Fed's rate hike, that interest rates made a low back at the end of 1972, just as the Nifty Fifty blow-off was about to start. Rates moved higher from that point until peaking amid the stock market sell-off in the second half of 1974. I'd call that a remarkable and scary similarity, and remind you of **Edson Gould**'s "three steps and a stumble" rule.



That's scarcely etched in stone—but also implies more upside before any retreat.
Only measured in months. Again, what we're talking about is that the barber is not worried about rising rates. The dentist is not worried. "They" have convinced the public that higher rates are perfectly okay–and they are, until you get to Edson Gould's third step, whenever that is. I doubt the market makes an official top until after the election, because I think we're dealing with a serious fifth wave down. The way you get a serious fifth wave down is that, no matter whom we elect, something will happen to make it clear that both parties are still in denial, don't know how to fix anything. That's where I'm coming from in a very broad sense.

Not a pleasant place, clearly.
Can I make a comment about the volume, before you push me aside?

Just take a breath and—
I'll just say this: The problem is that there is no one to sell to. That's what my clients tell me. Especially if they want to sell big pieces of stock. There are no buyers underneath. That's why volume is low.

Don't everyone else jump in at once.
Bernie Schaeffer: I want to make two quick points that might support some of what Justin was saying. From a sentiment perspective–

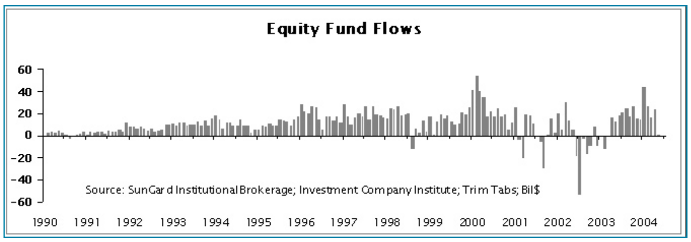
Complacency rules?
Schaeffer: Well, I am looking at something beyond the anecdotal sentiment, at an indicator that is about as over-the-top bullish as I've ever seen it. We take a 52-week moving average of the **Investors' Intelligence** data, using the net of bulls minus bears, so you're just left with the residual, so to speak. It has fluctuated in a pretty steady range over the years. If it gets above a +30% plurality, that's pretty over-the-top bullish; if it gets below -10%, that's pretty over-the-top bearish. (Which does show you that there's generally a bullish bias, because the range isn't symmetrical around zero.) My point is that over the past few months we've moved above that +30% plurality. This doesn't happen often. The last time was in '85-'86. It also occurred '71-'72-'73. (There was another spike in the late '70s, but I'm not quite sure what that was all about.) Still, it's rare. and it's not just that bullish sentiment has been strongly outweighing bearish, but that it's been doing so *persistently*. Justin also noted that people have been convinced that higher rates are not bad for the market. I love the way low rates supported the bullish case and now higher rates also support it. But the key is *real* interest rates. Not only are we behind the curve as we stand, but the Fed didn't even have the courage to take out its "measured" language in its rate hike today's announcement. So the Fed is assuring the markets that it's going to maintain its behind-the-curve status. Negative real interest rates are precisely what they intend to perpetuate, or so it seems.
I found it interesting to watch **Larry Kudlow** today on CNBC.

That's too contrarian even for me—
Justin Mamis: Boy, me too.
Schaeffer: Perversely interesting, I mean. He was so very, very concerned that the Fed might get carried away and raise rates by half a point, "just destroying the very foundation of the nation." He got what he wanted.
Justin Mamis: Let me throw this in. We are clearly a debtor nation. All I know about fundamentals is what I read in the newspapers, but all I read is about consumers being mortgaged to the hilt and so on. That's a major danger lurking out there and why higher rates pose a problem.

Which is why the Fed is being extraordinarily careful.
Gail Dudack: I would say the *good news* in this is that the Fed *does understand* that problem. We tend to have real problems when the Fed does something that brings on the bigger problem. But as I've been listening to the discussion so far, especially all the talk about the early 1970s, what's amazed me is that when you think about that period, what really crystallized it as a market top was that it was accompanied by wide recognition that inflation was a problem. Since I view the market as a big supply/demand equation, I see people taking money out of stocks and putting it into hard assets as one of the big reasons we had such a big decline in the early '70s. Gold, silver, all sorts of things. It's also very important *now*, I think, to put the market in its larger context. I'm not going to go on and on, but keep in mind that oil was a big issue back then. It's an issue now. As a strategist, I use technical, fundamental–every sort of indicator. And if investors had a better idea of the inflation rate five years from now, we'd have a much better idea of how the market is going to perform.

No doubt. But lacking that, what's your guess on what this supply/demand standoff means?
I don't think there's any doubt that the stock market in the late '90s was

a bubble, and that what we've been dealing with so far in this decade is the aftermath of a bubble. A bubble is nothing more than an extraordinarily distorted supply/demand equation, where everybody not only buys stocks, they borrow to buy stocks. Once a bubble bursts, you always have: 1) a recession; 2) stock market decline. And 3) a lack of demand for stock, because you've soaked it all up in the previous cycle. This goes directly to the low volume and the sideways pattern that Justin was talking about–low volume means there's a lack of buyers *and* sellers. No one is stepping up to the plate here. Everybody is on the sidelines. The only question is what catalyst will move the buyers or sellers? We're dealing with a slow workout process. If you noticed, when mutual fund flows were reported for May, they were practically



nonexistent(chart, above), after a very strong first quarter flows into mutual funds. Our view has been that the very strong inflows were not sustainable. Among other reasons because they had exceeded total household savings on a 12-month basis. The last time that happened was the early part of 2000. We also are seeing foreigners stop buying U.S. equities, though they're still buying bonds. So what *is* driving the market now? You have to look at where the money is, and the area that has been growing is hedge funds. Which means that the hedge funds are to a great extent determining the daily action. the weekly action, the monthly action. Hedge fund managers actually know and understand that–and realize that they're fighting each other. All in all, it has created a very strange transition for all of us, moving from a very stable, very strong bull market into a bubble in which the public was constantly acquiring stock, and then into a bear market. Now, we've had last year's rally but we're still left with this hangover from the bubble era. So far, there's nothing terribly different about what's happening in our post-bubble era than what transpired in previous ones; they typically feature a market that goes nowhere, potentially for a long time.

My question is whether volume really is low? Clearly, it's below its bubbly peak and no longer rising explosively. But the actual number of transactions is pretty healthy, on an historical basis.

Dick Arms: I just did some work looking at the average daily volume going back quite a period of time. Kate's correct. We're not running that much lower than normal. The interesting thing to me about that is that you get the highest volumes, usually, on market *lows*. Conversely, you tend to get lower average daily volumes in the area of market highs. In fact, that is something that bothers me here. The sluggish volume we're seeing is more typical of a toppy area. Which fits with my larger thesis that we've been in sideways move since the market topped in 1999–and that we could remain stuck in it for another dozen years.

Gail Dudack: That's very possible.

Dick Arms: We're very close to the top of the range, which I figure is between 7,500 and 11,000 for a number of years, but we are only four years into it so far.

Louise, you also have been examining volume–

Louise Yamada: First of all, while we can worry about it to a certain extent, we should remember that what is being perceived as low volume has been occurring in the context of a market that is up roughly 50% from its October 2002 lows. Granted, it is pretty hard to argue "volume, the weapon of the bull" here, but the market is still *up*. Our question is whether this lower volume may have something to do with something else we think we're seeing: a period of outperformance for small and mid-cap stocks. We wonder if it might not be very similar to the last structural period of out-performance for these stocks, from 1975 to '81-'83. That, of course, was during what we called the repair process of the last structural bear market. It seems to us that it also could have something to do with the lower share volume aggregates, just be by virtue of the fact that what's going up are the small and mid-cap stocks, and by definition there are fewer of those shares to trade. In any event, we do point and figure charts of all the New York Stock Exchange stocks by hand every day, capturing every intraday one-point reversal. (We find these charts especially helpful in analyzing price patterns of accumulation, distribution and periods of consolidation.) Ironically, it's this bottoms-up work of ours that has led me to a view that is the complete opposite of Justin's. We published a piece several weeks ago pointing out the large number of incredibly impressive four, five, six, seven-year consolidations that many stocks are in and lifting out of, not to mention the 15-year consolidations in a few names in the energy patch, as well as many extended uptrends visible in our charts. Yes, I said *extended* uptrends. But we see no evidence of tops. We are seeing positive charts in an enormous number of small and mid-cap names. But *not* in the large cap stocks. In fact, we do see some of the vulnerability that Justin was talking about in many of the large-caps. Still, we are incredibly impressed with the bottoms-up improvement occurring in an enormous number of smaller stocks.

So you are calling for a *rally*, then?

Our findings do not suggest that *all* stocks are breaking out–far from it. But there are clear pockets of opportunity. What impresses me is that even after the recent correction of the generous rally off of the October 2002 lows, there are surprisingly few major tops visible–and this abundance of extended but intact uptrends. Of course, they could experience volatile pullbacks and contribute to interim market weakness. But many of these extended uptrends have reconsolidated over the past few months and moved into renewed uptrends or are still consolidating and appear poised to lift again. On top of that, as I mentioned, an impressive number of stocks are breaking out or have broken through multi-year consolidations–including many cyclicals that have begun to move up over the past two years.

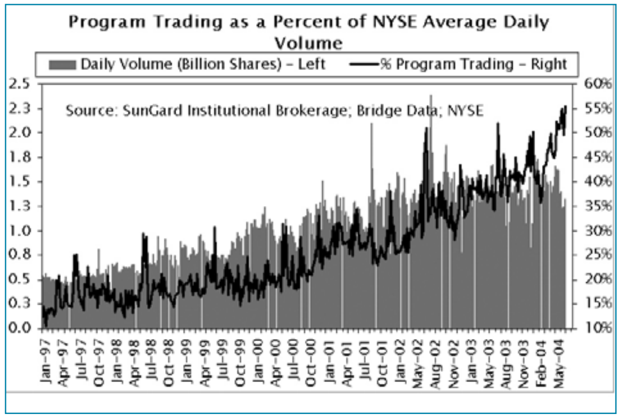
What's your take on volume trends?

We started wondering if we were missing some volume when a client mentioned that a lot of institutions are doing substantial volume off-board, trying to avoid the transparency that everybody's pushing them to accept; he suggested that a lot of volume has moved to London, and that a lot of volume is being done in the third market.

What's "a lot" ?

Good question. In London, we're not going to be able to figure it out, but some traders have suggested maybe 5%. What we did do was compare NYSE volume to reported composite volume, ex- the New York. In other words, to the volume at all of the peripheral domestic markets, Cincinnati, Pacific, etc. What we found is that those two volume streams are pretty well-correlated in terms of their rising and falling patterns, but there has been a very significant and growing difference in the spread between their volume totals, especially since September of 2002. In other words, all during the rally there was an uptrend in non-NYSE Composite volume, which was quite dramatic. But it has dropped off in the consolidation phase that we've had since April.

Hmm. Could be some institutions are demonstrating displeasure with the Big Board by taking business elsewhere. Could be ETFs and the entire alphabet soup of derivatives are draining New York volume. Or it could be because hedge funds, which Gail points out have been dominating trading, often have an affinity for rapid-fire algorithmic trading, which frequently happens off the floor. ***[See Listening In, Too with Weeden program trading desk impressarios Doug Rivelli and Michael Mook, on website]***
Just today, trying to pull some of this together, we've noticed a very strong inverse correlation between the direction of price action in the market and Spyder volume. There's an enormous increment in Spyder volume into declines, and a drying up of the Spyder volume into the rallies. I still have a lot of open questions, that I'd love to throw out.



Dick Arms: Louise, I'd love to see that study. I'm just looking at the charts, visually, but one thing that's very obvious to me is that since January, whenever we have had a down day, volume has increased, and whenever we have had an up day, volume has tended to dry up. This is a very strong tendency. We saw it, for example, last Friday [June 25], in the way volume suddenly got much heavier as the market reversed. We've seen that over and over. It means that, net-net, money is leaving the marketplace. A very bad sign. And one of the things that has made me more and more bearish over the last couple of months.
Louise Yamada: Well, another question I have, maybe because my feeble brain can't quite grasp what's happening–although even Barclay's designated ETF expert tells us there's really no way to understand how creating and redeeming ETFs affects New York Stock Exchange volume–is just that. I wish we could get a grip on ETF short interest, too. She has told us there is no way we can quantify trading volume related to short interest in the ETFs. Yet we know that a lot of funds are using ETFs to a great degree exactly because they can be shorted without an uptick. The profile we have for Spyder volume has such clear, incredible spikes into every decline that has occurred here all the way back to 1997, but with a particular increment in the declining phases from 2000 forward and at climactic bottoms. It clearly looks like climactic activity, which bothers me because it seems to be just the opposite of what Dick is describing in New York Stock Exchange volume. And yet, we're seeing these incredible spikes in the spiders, or in the ETF profile.
Bernie Schaeffer: Louise, is the implication that the reported short interest on the ETFs is not accurate?
Louise Yamada: That's a good question. But that is what we were told yesterday.
Bernie Schaeffer: One thing we do know is that it seems very big, relative to daily trading volume.
Gail Dudack: All this comes down to the fact that the structure of our industry is changing. Most of the volume no longer goes through the NYSE. ECNs have really changed the trading structure. ETFs are going to have a bigger impact on our markets than people expect. Clearly, institutions are doing a lot of portfolio hedging through ETFs. My big concern is that since the performance of so many mutual funds has not been good, the public also may simply come to choose to buy ETFs instead of putting money into mutual funds. That would potentially damage the whole fund industry. Then too, perhaps when people can buy ETFs, they don't have to think so much about buying stocks–and that could be part of what's affecting volume.

I should have mentioned this first thing; I apologize. I had told all of you I was trying to arrange for the fellows who run Weeden's program trading desk to join this conference call. That didn't work; they're flying hither and yon seeing clients. But I did get them to do a data dump into my tape recorder yesterday [See Listening In, Too]. They're in the thick of a lot of the structural changes you're all observing in the way the market works. Gail has been running a wonderful chart (below) that speaks volumes about it, showing the growing dominance of program trading, lately around 50% of all volume. But I don't know anyone who's got a handle on how much of any kind of trading activity represents any sort of "long-term" investment decision—especially on individual securities—versus how much is some sort of statistical arbitrage, or simply a casino-style bet on red or black. But it would seem more than ever.
Bernie Schaeffer: There's another kind of trading activity that is of that nature, and it contributes to these maddening trading ranges very significantly: The trades related to option premium selling. We all note that the volatility indices have been almost imploding. Essentially what is happening is that, increasingly, the favored strategy has become selling puts or selling calls against stock. Which depresses the volatility indices. It also causes the options market makers to be long a lot of premium. And essentially, bottom line, the way that translates into the cash market is, the options market makers want to be sellers on rallies and they want to be buyers on pullbacks. In other words, this trading dynamic only adds to the flatness of the landscape. What's more, since "normal" trading activity seems to be depressed, the net impact of this directionless trading dynamic is greater than it might ordinarily be. In addition, it tends to perpetuate itself by resulting in even more directionless action. Just how directionless can be seen in my chart (page 2) of the S&P this year, which shows that roughly 80% of its closing values this year have been between 1,100 and 1,150. That's plus or minus 2% off the middle there, which is excruciatingly narrow.
Dick Arms: Does that mean that if we're looking at something like the VIX, we're going to have to change our thinking as to what normal levels are?
Paul Desmond: I'm not a big fan of VIX, but I don't see where this is all leading us. First off, volume is not that dramatically off from its highs. The highs in volume were made in February, and since that time we've been in a corrective phase. And one of the basic principles of technical analysis is that you expect volume to contract during corrective periods.
Justin Mamis: Can I butt in here? Many, many of the basic individual stock charts that I keep show stocks rallying to successively lower highs on lower and lower volume every time they've tried to rally, whether their most recent peaks were in January or February. What my charts are basically saying is that these stocks are not going up, and that the volume that has been going along with their not going up is deteriorating just the way the price is.

When I look at total NYSE, Nasdaq and composite volume statistics, they're not off by much.
Mamis: But I'm dealing with clients who deal with individual stocks.
There aren't many of those left.
[Laughter]
Mamis: Well, I'm making a living. Seriously, what is a **Legg Mason** to do?

What does a **Fidelity** do? These people have to own big portfolios of stocks, and at this juncture they're being told to be fully invested.

Paul Desmond: Let's go back and look at this from a different perspective. Let's look at the S&P 500 *on an unweighted basis.* We run an unweighted index of the S&P 500's component stocks. It made a new, all-time high just in the last week.

Louise Yamada: That's another way of seeing the strength in small and mid-cap stocks.

Paul Desmond: We also run an unweighted index of all domestic common stocks listed on the New York Stock Exchange. It's within 1% of a new all-time high. Our operating companies-only advance/decline (we simply take out all of the preferreds and closed ends and bond funds listed on the New York Stock Exchange) also made a new, all-time high just last week.

Mamis: And if you take the REITs and the foreign stocks out, it makes an even bigger high.

Paul Desmond: Yes, that's right, we've done that too. When we look at our sector work, seven of our 10 major sectors are positive, three of them are negative. Five sectors are at new, all-time highs. None are at new, all-time lows, or anywhere near it. On an industry group basis, we're showing 29 out of 50 industry groups at, or very close to new, all-time highs. Granted, when you look at this market from a broad standpoint, in other words, if you focus on the Standard & Poor 500 or the Dow Jones Industrial Average, which are essentially the big-cap indexes, you see a market that doesn't seem to be able to recover from what people perceive as a previous bear market. But if you look at it from the standpoint of sectors, industry groups, the small-cap and mid-cap stocks, you see a bull market in place. I don't know how you can possibly call new, all-time highs in the S&P 500 stocks a bear market. That to me is the absolute definition of a bull market. And, we just don't see any evidence in our work at this point of a serious contraction in demand. Our buying power index is at the best levels it's been at in 11 months. Meanwhile, the amount of selling going on here is very interesting: Selling keeps contracting . You have to ask: "Why is it that somebody wouldn't sell if they had the opportunity?" We've certainly had plenty of bad news, and yet investors continue to just move to the sidelines, saying: "I don't want to sell my stocks at these levels." I can only assume that they don't want to sell them at these levels because they expect them to go higher. So I just don't see any of this bearishness, once you move away from these big-cap indexes.

Louise Yamada: That is what we're seeing, too. One of the things to keep in mind, in terms of the small and mid-cap leadership out there, is that while they dominate the averages, there are actually very few large cap stocks in the major indices. I mean, more than 50% of the components of the S&P 500 are small and mid-cap stocks. That's why Paul's work is showing a new high in the unweighted index. The same goes for the NYSE. We've only got about 280 large-cap stocks on the entire Big Board. It's important to recognize that the majority of stocks are small and mid-cap. And from our bottoms-up perspective and Paul's work, they look very positive.

Does it strike anybody that you're describing the opposite of the market's situation at the bubble peak?

Louise Yamada: Yes.

Paul Desmond: Actually, what everybody now talks about as the bear market that began when the bubble popped, is a fascinating period from a technical standpoint. The NASDAQ Index, from its top in 2000, dropped 70%. No question, it appears that was a bubble that burst. But the New York Stock Exchange Index, subsequently dropped 35%. That's no burst bubble. It may be a cyclical bear market, but it's no burst bubble. But if you look at the Lowry Unweighted Index, which is nothing more than all domestic common stocks listed on the NYSE on an unweighted basis, it was in a bull market over that stretch. It was rising over 2000 and 2001 to a high made in May 2002. So at the same time that you had a disaster going on in the NASDAQ index, you had a stealth bull market going on in mid-cap and small-cap stocks. So to talk about this 2000-2002 period as the aftermath of a bubble, it has to be done on a selective basis. You can't talk about the NYSE Index as being a broken bubble. You can't talk about the mid-cap and small cap stocks as a broken bubble. You can only talk about the NASDAQ as a broken bubble. Therefore, any conclusions that you come to, as far as whether stocks can get back to new highs, or whether they'll remain in a trading range for a long time, only really apply to the NASDAQ index. It's a very important distinction that has to be made–and that probably could not be made in the aftermath of '29. It certainly was not the pattern during '73-'74. I just don't think you can make direct comparisons. This particular bear market was a really unique set of circumstances.

Bernie Schaeffer: Paul, aren't you just carving the S&P into a small and mid-cap piece that has been very strong and a mostly NASDAQ mega-cap piece that's been relatively weak? Isn't what you're left with when you put them together an S&P that's somewhere in between. So my question still is, assuming that we're focusing on the S&P at least for the sake of making comparisons to the past, where is the S&P headed? I mean, you can always slice and dice.

Paul Desmond: I don't think it matters, Bernie. It really comes down to a case of saying: "Look, our job as technicians or as portfolio managers is to make money for our clients." And the way you make money in this market–especially in this market, but also in most market environments –is by not concentrating on the averages, because the average is a level of mediocrity. What we want to focus on all the time is what's running *at the front* of those 500 stocks. All we're saying is, the weighted indexes mean very little to a portfolio manager. Unweighted indexes mean a great deal to them; that's the way they build their portfolios.

That's the way it *should* be done. But that was certainly *not* the dominant method of managing portfolios as this century began.

Paul Desmond: I understand. But this is really a case of a portfolio manager asking himself whether he's following some guideline that may or may not be right, or following the strength of the market?" Right now, the strength of the market is all over the place. All I'm saying is that the 500 stocks in the S&P, as an unweighted group, were at an all-time high last week.

Justin Mamis: How come, then, the number of reported new highs is not exceeding previous peaks?

Paul Desmond: Well, a big part of the reason is that 53% of all the listings on the NYSE aren't common stocks and many of those are interest-sensitive. In a period when bonds have been very weak, that has totally distorted the new highs list.

Justin Mamis: No, I'm talking about using the common stock only list. Statistically speaking, on that, we had only 103 new highs yesterday, far below their peak of 287 new highs on April 2. That's the problem.

Paul Desmond: No, it's not a problem. If you go back–

Justin Mamis: Well, it's a problem if you're trying to own stocks that go up to new highs.

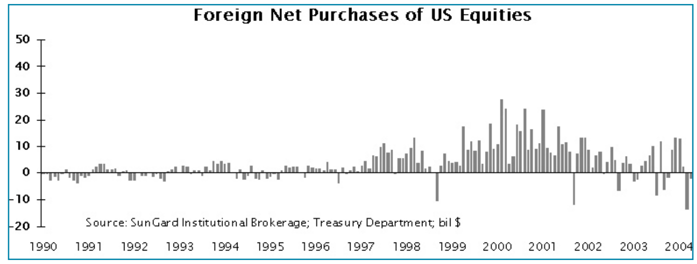
Paul Desmond: If you'd look at the history of the pattern of new highs and new lows, you'd see that it just isn't important where they are at this point. In other words, the point at which new highs not reaching a peak becomes important is when the averages are making a new high, and new highs are not making a new high. But we currently have the S&P 500 Index not making new highs, and the number of stocks making new highs is also below its peak. So from an historical standpoint, that indicator is acting the way it's supposed to. How the new high list is supposed to act relative to the operating companies- only index, is something that we don't know at this point. But I can tell you that the num-

bers are dramatically distorted.
Justin Mamis: I understand that adjustments still need to made to the index. Still, I am looking at these statistics and saying, "Boy, here's this cumulative breadth line making higher highs, and yet the number of new highs is not."
Louise Yamada: Well, the number of new highs can have a lag time of up to a year before you have any problem in the measured index.
Justin Mamis: But when we *do* have that–and remember, I'm a forecaster here–we get a negative, divergent signal that has *always* been meaningful.
Paul Desmond: The "divergence" you're pointing out has existed for only two months–but both the S&P 500 Index and the number of new highs are below their previous highs. My point is that there won't be a true negative divergence unless and until the S&P 500 Index moves to new rally highs, and new highs does not go to a new peak.

Gail, let me ask you to jump in here. You've published reams on bubbles. Isn't it fairly typical that whatever market is at the epicenter of the bubble is inflated—then deflated—the most? In '29, that was the Dow, because it had the sexy stocks like RCA and the automakers. In the late '60s and early '70s, it was I guess the S&P that was dominated by the Nifty Fifty. This time around, it was the Nasdaq Index.
Gail Dudack: Yes. And there are almost always pockets of opportunity. But just to pull some things together, people are fixated on this trading range and volume is relatively flat because there's a lot of indecision. What I'd describe as a general lack of the sort of demand that can support a long, enduring, broadbased bull cycle. I just don't see that happening in the foreseeable future. There was a huge bubble, particularly in the NASDAQ, and it seems very possible to me that the bear market in those stocks has not really been completed yet. We've had a nice respite rally and maybe we're in a transition period in which the stocks that lead the bubble really aren't going anywhere. But there is life–as Louise and Paul have been pointing out–in other parts of the market. But the mid and small-cap stocks don't drive the major indices–

And all-too-many portfolios are still heavily weighted to mimic those indices.
Louise Yamada: We're in the process of seeing capitalization weights shift, but it's going to take *time* for some of today's small and mid-caps to grow their capitalizations to the point that they'll affect the market indices. Likewise, it'll take time before some of today's big-cap names see their capitalizations shrink. A lot of funds have to be transitioned.

Sure, Xerox didn't go from mega cap to small cap overnight.
Gail Dudack: Yes, when you think about where money is now, you can't get very excited about the chart patterns of a **Dell** (DELL) or a **Microsoft** (MSFT). There's still a lot of money invested there by a lot of big-cap money managers, more because they *have to* than they necessarily want to.
Bernie Schaeffer: We had a classic rebound rally in the NASDAQ, of course. It pretty much doubled off its bottom, then that was it. And that's not a very positive technical sign. The Dells, the **Cisco**s, the Microsofts, and the **Oracle**s are not very exciting. I'm quite concerned about them. They still have pretty decent capitalizations, in terms of influencing the S&P 500, and they are pretty much bellwethers, as far as investor psychology goes. And they still enjoy something of a life of their own; they still get more Street and media attention than they perhaps deserve, based on their current capitalizations; they still have tremendous followings. Still have 30-35 analysts covering them.
Gail Dudack: Right, and they're owned kind of defensively. I think that a lot of the PMs feel they have to be there, because they do represent a lot of the S&P's market cap. In effect, *not* to own them is making a huge decision that many people aren't comfortable with. But the transition is already is underway. They aren't acting like growth stocks anymore. I still see that every time



we get any kind of good economic news, these stocks move–because people are starting to treat them as cyclical stocks, which is what they are. And everytime we get not-so-good economic news, they fall back. Yet they continue to anchor so many portfolios. Which is why this area of the market is quite vulnerable, whereas others parts are where you want to focus your buying. I don't know how this impacts volume or breadth statistics, but it clearly this is a market that's changing in a lot of different ways.
Paul Desmond: We do a completely separate analysis of the NASDAQ, and there we see a considerably different pattern than on the NYSE. On the NASDAQ, we're seeing what Justin is talking about: stocks making successive lower tops. All of the different NASDAQ advance/decline lines that we follow–for the top 100 NASDAQ stocks, for the top 500, and for what we call the NASDAQ 4,000, are all showing patterns of successively lower tops. So, back to the idea of the broken bubble, I agree with Gail that it's entirely possible that the NASDAQ could remain very sluggish, if not in an honest to goodness bear market, even while the NYSE goes to new highs.

But not the big caps?
Paul Desmond: There's a strong possibility that what's happening here is like the old magic trick: Watch what my left hand is doing while I hit you with my right. All of the institutions are focused on the biggest of the big cap stocks and that's not where the action is. All the rest of the issues are moving up to new highs, and they're eventually going to drag the S&P 500 up kicking and screaming, but today's very large cap stocks will continue to drag until then.

An army led by the rank and file doesn't often get far. Isn't what you're really talking about new highs in the headline averages *after* today's generals are busted to privates?
Paul Desmond: And in the meantime, the action is in the mid-caps and small cap stocks. That's where investors have to be if they're going to profit in what appears to be a sideways moving market, but is not.

This is probably over-dramatic, but could we be watching the death throes of indexation? Perhaps indexing in all its official and "closet" manifestations crossed a tipping point amid the bubble, where no one was left to buy.
Gail Dudack: I don't think that can happen until we end the era of sponsor-domination of the investment process. You know, the sponsors, under the thrall of the Russells and all the rest of the consulting groups basically redesigned the the investment community during the long bull market of the '80s and '90s.

You mean we *still* have to first shoot all the consultants?
Gail Dudack: Right. They've pigeonholed all the money managers into certain styles, to which they are benchmarked, and to which they now must adhere–and outperform.
But if any underlying theme has emerged from this discussion, it is that adhering to those benchmarks virtually assures underperformance.
Gail Dudack: What I struggle with is whether, in practical terms, that just gives way to a world in which the average investor gives up on (bench-

marked) mutual funds and shifts into ETFs?
Justin Mamis: The average investor is not interested in ETFs. The average investor I talk to is writing options.
Gail Dudack: Wow.

That's not an average investor. Those are the folks Bernie was talking about, collecting premiums.
Louise Yamada: We are seeing an enormous amount of ETF demand from the retail sector.
Paul Desmond: Absolutely. I really believe that open-end mutual funds, so popular in the '70s, '80s and '90s, are dinosaurs that don't recognize yet that their era is over. They will largely be replaced over the next 20 or 25 years by ETFs.

I know the race is on to create every flavor of ETF imaginable, but for now at least only a few attract most of the trading volume—and they're as handicapped in the performance game as any index mutual fund—because they ape those same capitalization-weighted indexes.
Gail Dudack: We have to keep in mind the reason that mutual funds are at risk right now of losing market share to ETFs. It's because of how the industry has changed. When I got into this business, money managers could actually *hold cash* if they didn't like the stock market. They could buy almost any stock if they thought it was going to do better than the market. I can't name one mutual fund money manager who can do that today. We really have to end the tyranny of the style box and allow professional money managers to actually professionally run money. I don't think they can, anymore.
Paul Desmond: The problem is the way the funds run money; it's their unwillingness to move off of the once-a-day pricing; it's the fees that they charge for making exchanges—
Bernie Schaeffer: Not to mention that the best and brightest fund managers are going to hedge funds.
Justin Mamis: If I get my '73-'74-type final wave down, it'll eliminate all of these questions. It will eliminate the consultants and the open-end mutual funds and the ETFs—
Bernie Schaeffer: Paul, you see ETFs growing mostly at the expense of mutual funds, not equities trading?
Paul Desmond: Yes, an ETF is just an advanced form of mutual fund, with all-day pricing, without penalties for exchanges. It's easy to employ leverage with an ETF, instead of nearly impossible with a mutual. You can't short an open-end mutual fund, but you can short an ETF—and without an uptick. It's just a better product.
Bernie Schaeffer: Isn't a big part of the ETF pitch that you don't have to pick stocks, just sectors?
Paul Desmond: Investors do have a tendency to make the most mistakes at the lowest level of the investment decision chain. Get the market direction right, and even sectors, but then pick the wrong stocks. So by eliminating that one decision, I think you'd substantially improve their overall returns.
Bernie Schaeffer: They haven't exactly proved adept at trading sector funds.
Paul Desmond: No, but sector ETFs are relatively new. Two years ago, if you tried to find research on when to buy or sell an ETF, there was nothing. Now, there's some analysis out there, but still relatively little considering the growth in the ETFs themselves.
Justin Mamis: Judging from the client portfolios I've seen, institutions are using ETFs as tools to flesh out portfolios, use up available cash so they'll be fully invested, even if they haven't the vaguest idea which stocks to buy in a particular sector. They're tools.
Paul Desmond: That's a great approach. We're in a learning process, and people will get more adept at using ETFs as time goes on.

Okay, to sum up, the market's next move is—
Gail Dudack: The question most everybody still struggles with is, was last year's 50% gain in the indices the start of the new bull market or a rally in a bear market?
Paul Desmond: Again, it was not a 50% gain, except when you look at a capitalization-weighted index.

Which is how investors generally keep score.
Gail Dudack: Yes, don't forget that a capitalization-weighted index tells you an awful about whether people made money or not, which is important.
Bernie Schaeffer: Paul, you suggested that the strong small and mid-caps would drag the cap-weighted S&P higher. But I'd say it's more likely that the big-caps drag it down.
Paul Desmond: Well, there's a good chance that the tech sector, it will not make new highs, and it could stay in a negative pattern for quite some time. Historically, when people get badly burned, they don't go back to those same stocks for years.
Gail Dudack: Yet that's exactly what the did, in 2003. That's what bothered me about the October 2002 low; that the leadership off of it was tech stocks. Now, there are good stocks and bad, as we've said, but trading has been so slow that the last few months feel like years.
[Laughter]
Louise Yamada: We've looked at old charts, Gail, of the aftermath of '29 and '74, and the stocks that lead those bubbles didn't simply fall down and die. They often had a substantial "dead cat" bounce before a second collapse that often took many years to consolidate and repair.
Gail Dudack: So couldn't we still be in a transition phase? The rally, which was led by tech stocks, now seems to have come to an end. And maybe the tech stocks are yet to finish what we call in sentiment terms, the disgust phase? Meanwhile, simultaneously, a new bull market is emerging, but in a different area.
Louise Yamada: That's just like what happened in the late '70s and early '80s. There was an incredible bull market in small and mid-cap stocks, yet the Dow and the S&P couldn't make new highs until 1982.
Gail Dudack: Right. It's a numbers game. You can buy an awful lot of small cap stocks when you sell just a few large cap stocks. That can really drive the smaller caps—but is that a long-term, sustainable trend, or do you have to bring new buyers into the equation?
Paul Desmond: I don't think anything is a long, sustainable trend.
[Laughter]

Let's end on that cheery note. Thanks much, all.

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