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INSIDE

Listening In
The Lowry's Report Proprietor Sees More Upside In Small- and Mid-Caps, Albeit *Not* For Former Tech Bubble Stocks
PAGE 1

Talk Back
Egg-Faced!
PAGE 8

Listening In, Too
Bernie Schaeffer: Complacency, Premium Selling Are Strangling Market Action
News Bite
Canada's Contrarian Techie
Guest Perspectives
Paul Montgomery: *National Geographic* Cover Story Spells End Of Oil Run
Ron Griess Cycle Quiz
Acute Observations
ALL ON WEBSITE

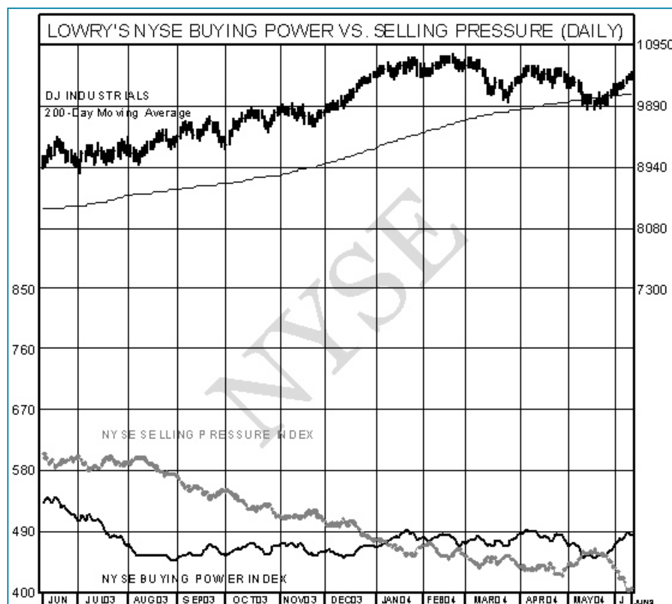
RESEARCH DISCLOSURES PAGE 8

listening**in**

Lowry's Paul Desmond

Rally Lacks Buying Enthusiasm, Volume, But No Top In Sight

Neither the venerable ***Lowry Reports****, which he publishes from North Palm Beach, nor* ***Paul Desmond*** *himself need introduction in professional circles. Mention either name and the impression is the same, rock-solid technical research and insight. So naturally, when I called Paul last week, that's what I got.*
KMW



Talk about summer doldrums. Some days, it feels like the stock market is never going to break out of this trading range, Paul—and it's still early June.

Yet Monday [6/7]was a 90% upside day on the New York, which throws an interesting twist into our analysis of the market here–

Even though that 90% upside day occurred on practically no volume?

That's the whole problem. It was on very low volume. And that makes me think–when you have 90% upside days occurring without being preceded by a series of 90% downside days, they tend to be blow-offs. What we have been getting here since the May bottom is this entire recovery rally occurring *on diminishing volume*. And that really concerns us. Makes us feel that the correction that started in the first quarter may not be over yet.

So this sputtering rally is just a head fake?

Well, yes it's *possible*. There are a couple of things that are interesting about it. From the March 2003 bottom, all the way into the first quarter of 2004, we didn't have *any* corrections to speak of.

Nothing that measured even 5%–

That's right. We didn't get even a 5% correction until March 2004. And even that one was just nominally 5%. So I keep comparing this situation to what *should* be the market's pattern. It *should* have a pattern that is a two-steps-forward, one-step-back kind of thing, so that it can keep rekindling itself as it moves forward. It's almost as though the comparison you could make is that if we were to stay up for three days without any sleep, we'd then have a bigger collapse. In other words, if the market does go up without a correction for an extended period, then when the correction does come, it tends to be deeper and longer than normal. That may be what is going on here.

But this correction certainly hasn't been deeper than one might expect–

Not *yet*. But that may be coming. Actually, I don't

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Kathryn M. Welling
Editor and Publisher

Jean M. Galvin
Business Manager and Webmaster
Karin-Marie Fitzpatrick
Editorial Assistant
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think it will end up being too terribly deep, but I think it could very well be protracted. The reason I say that is that our **Lowry's Selling Pressure Index**, which is merely a measure of the amount of selling going on in the market, is at new multi-year lows. It is at its lowest level in about five years. So there is no real desire to sell–

But there's not a lot of desire to buy, either–
That's it. And that's what concerns us. What we've seen as the market has tried to recover here, as I said, is that it has done so with diminishing upside volume. And upside volume is really a very strong measure of investor confidence.

How so?
It simply says how much risk investors are willing to take. How much money are they willing to take out of their pockets and put at risk in the market? What we've been seeing here, as the rally has been taking place, is that they've been willing to risk less and less money, all the time. That suggests to us that we probably are not going to be able to break through to new rally highs on this particular attempt–and that we may need to repeat this process. Typically, these kinds of stalled markets that can't seem to attract enough selling to drive them lower and can't seem to attract enough buying to drive them higher, either, complete themselves with some kind of sharp decline that drives prices down to new lows, temporarily, and scares the dickens out of everybody. Then, you can start–

The bargain-hunting.
That's right. It shakes out the weak holders of stock and creates some bargains that people can get excited about again. I think that until we can see that sort of bottom occur, the only other thing that could occur to move this market up out of its trading range would be for some very fundamental factor to change. You know, like we come up with a solution to the oil crisis. A new scientific discovery in magnetics or something like that.

Or like peace breaking out in the Mideast...
Wouldn't that be wonderful? But nothing even remotely like that seems likely to happen.

So we are stuck with a range-bound market as a diversion?
Well, the question is, how else are we going to revitalize the buying enthusiasm? Part of the answer is that a certain amount of *time* has to go by. People have to see the economy continue to show some signs of improvement. Perhaps this Iraqi thing has to be sorted out a little bit better than it is. And perhaps prices have to go a little bit lower than they are now in order to shake out the weak holders and create some bargains. But at the same time, we *don't* see any of the classic signs of a major market top. And that is what makes us feel that, ultimately, this market has substantially farther to go on the upside. All we have done this year is take the normal 5%, 6%, 7%, 8% corrections that *ought* to have been occurring all during 2003 and early 2004, and we've put them all together in one spot.

Producing this drawn-out correction and trading range?
Right. But at the same time, when we came down to the bottom in 2003 (we felt that March 2003 was a better buying opportunity than October, 2002), we had four indicators that we watch closely all telling us how deeply oversold the market was, how close we were to a market bottom. There was no doubt, in March of 2003, that all four of those indicators were saying "this is a major cyclical market bottom."

"Cyclical" as distinguished from what?
Well, what I mean when I say cyclical is that historically, the rally that has followed after these types of things have occurred has lasted for two-to-three years. In our 70-year history at Lowry's, there was probably only one cyclical bull market that lasted less than two years in length. Almost all of them lasted two to three years, typically three. Only sometimes, when they have started late in the overall cycle, have they been as short as two years long. But even today, we are only a little more than a year into this thing. So we are thinking that we have months–eight months and perhaps as many as 18 months–to go on the upside.

So which of your indicators were so definitive in telling you a new bull cycle was starting in March of last year?
Well, the ones we always watch to tell us about these things. We watch the spread between our Buying Power and Selling Pressure gauges, which should get very wide at a major bottom. At major bottoms, demand is very, very weak and supply is dominating the market–and that's what happened in March 2003. Selling Pressure got down recently to its lowest level in eight years, reducing the odds of a severe decline. But Buying Power hasn't been able to rise above its early April high of 493. The next one we've been watching is our average power-rating index, which is a complex relative strength measurement for 900 key stocks. It is more or less an expanded version of the S&P 500. It got down to its lowest level in 10 years in March of 2003. Then we looked at our short-term buying power index. It pretty much vacillates between the high 100s and below 60, where we consider it to be oversold. A lot of our institutional clients who have followed it over the years have said that, "When it gets down below the 60s, that's when I want to start accumulating stocks." That's kind of a rough approach, though, so we take it a little bit further, saying that for it to be a valid indicator, it has to get down below 60 and then it has to reverse upward by at least 6 points to indicate that it has truly made a reversal. Well, that's what it did, in March of 2003, and it hit its lowest level since 1974 as well. Then, the fourth indicator

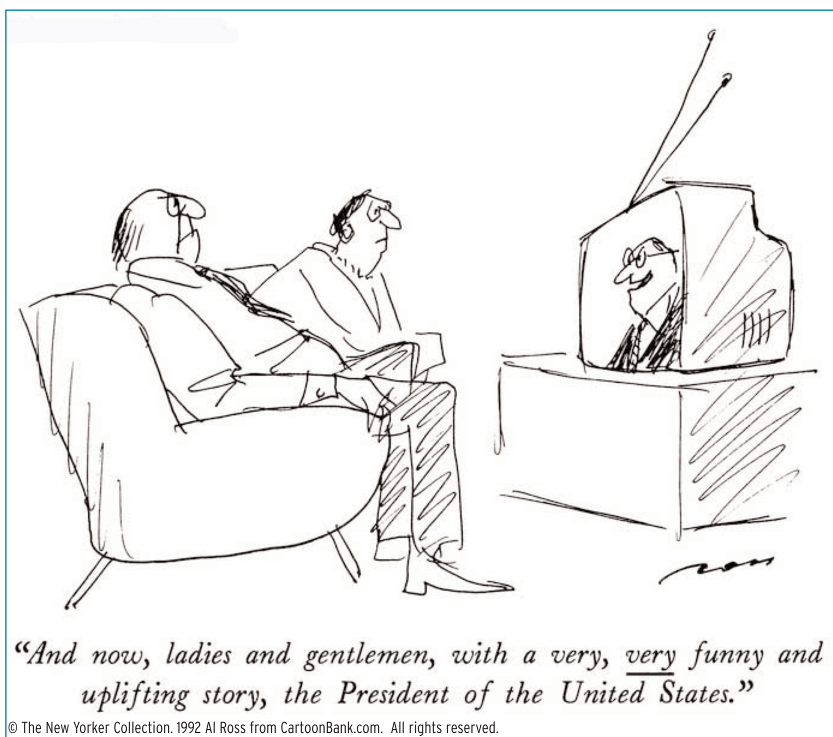
we track is the 90% day pattern. We had had two 90% downside days, preceding the March 2003 low. One in late January and the other one, about March 14. Then we had the reversal on March 17, with the 90% upside day. So those four indicators were all aligned. We keep those four on a separate chart that simply says where we are in terms of a major market top or a major market bottom. And those four indicators are particularly good at identifying major market bottoms. The bottom line is that they said we were at a real market bottom in March of 2003. And the market bottoms that we have seen in the past that have been marked by these four indicators reaching these levels produced subsequent uptrends that typically has lasted two or three years.

And that's enough to give you hope of breaking out of this range to the upside?

Yes, but then we go on to watch on a day-to-day basis, as we go forward and look to see any indications of something going wrong. But so far, the only thing that has gone wrong here is that investor demand has been unusually weak. Market breadth still looks good. The percentage of stocks above their 10-week and 30-week moving averages still looks good. So there is strong buying enthusiasm; there is nothing selective about this initial move. We are seeing good things in net upside volume to net downside volume. In other words, in the ratio of upside volume to downside is very positive. It is just that there is not enough total volume. That is what has really been shrinking. And it has been shrinking on both the buy side and the sell side. But at this point we don't really see any signs of a new market top.

Hasn't the number of new highs really dropped off of late?

New highs have dropped off, but it's still too early for that to really be a significant warning. They usually make their top about six to nine months in advance of the market–and often as much as 12 months in advance of a major market top. Right now we're at six months since the new highs topped, but there's still a possibility that within the next three months they can turn around and make new highs again. So it's a little bit too early to say conclusively that this specific indicator isn't bullish–and even if it that were the case, it would be the only one that we had that would be standing out there all by itself. And what we should typically see is a *series* of warning signs. For example, one of the most common warning signs is to see market breadth start to diminish. The advance/decline line usually rolls over and starts to decline about four to six months *before* a major market top–and in this case, we really haven't seen that at all. The drop we've had in the advance/decline line has come right along with the top in the market averages. But if this were signaling a major top, what we should see is a divergence where the market averages are going to new highs and the advance/decline line is dropping for four to six months while the rally is still taking place. We're not seeing that at all yet. Now, one of the things that I think is coming up that is going to be interesting is that the advance/decline line–as most people watch it–has been very, very badly distorted by the NYSE listing a whole lot of issues that are really not common stocks.



"And now, ladies and gentlemen, with a very, very funny and uplifting story, the President of the United States."

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Which is why you've put together what you call your operating companies only A/D gauge?

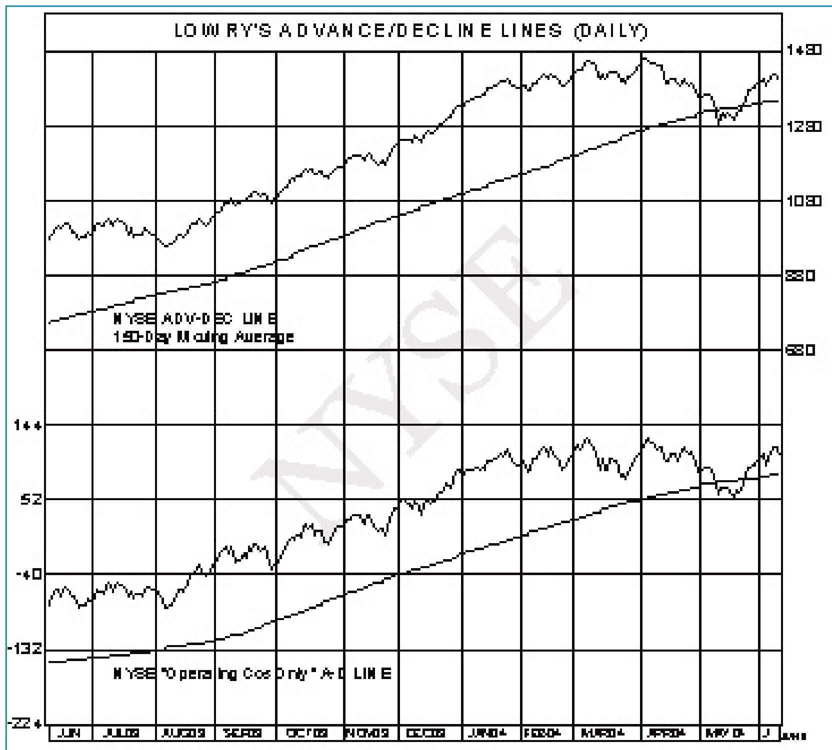
Yes, the statistic now is that 53% of all stocks listed on the NYSE are *not* domestic common stocks.

Incredible. Over half.

That's right. So they need to change the name to the New York Stock and Bond and ADR Exchange or at least they ought to start publishing separate numbers. That's really what we do. We decided that if the stock exchange is not going to publish them, then we'll publish them for our clients. So we just break out domestic common stocks versus non-domestic common stocks, in the statistics. It has not made a great deal of difference, up to this point, but if interest rates start climbing again and bonds go down, then all of a sudden the ordinary NYSE advance/decline line is going to have a very, very negative bias because of all these interest-sensitive stocks and all the interest-sensitive actual bond funds that are listed on the NYSE. So this interest-sensitivity in the A/D line is going to create a picture for most of us that's going to look very, very negative and may tend to scare people out of the market prematurely.

Isn't it pretty well-advertised?

Yes, but the advance/decline line has been badly distorted at some very significant points in the past and investors really got trapped badly because of it, despite warnings. And they could do the same thing



this time. In the past, bonds were very strong when the stock market was dull and so the bonds gave the advance/decline line a very positive bias, causing people to jump in during the bear market on a couple of occasions and trapping them. This time, we may get just the opposite, where bonds are weak. So if stocks get dull, the bonds will dominate the advance/decline line and make it look like it's really a weak market. People will bail out because of it and be left out on the sidelines as the market continues to go higher. So we're watching that closely and comparing it to our own operating companies only advance/decline line. It made a new high in early April, so it was actually making new highs after most of the market indexes had already turned down.

It's also bounced back a lot, right?
Yes, it has recovered 66% of its losses, so it wouldn't take much more to push it back up towards the highs. The thing that we're concerned about again is that for the market to really break through convincingly to new highs, we'd like to see some expansion in volume. It's going to be very difficult to break through the resistance levels above here with the volume drying up. There's just less enthusiasm about buying stocks now than there was the last time we were making these rally highs.

What sense do you get of what's doing the most to dampen enthusiasm at this point?
I don't know. To some extent my answer would be that's why we've taken a technical approach rather than a fundamental approach to market analysis, because there are so many things you can possibly blame it on—but it really doesn't make any difference.

It doesn't?
No. That's just the way it is. Buying enthusiasm is drying up and I don't know why. It could be Iraq, it could be the economy, it could be interest rates, it could be all kinds of things.

Could structural issues in the trading environment even be getting in the way? I know you've been following the growth of ETFs closely. Are they draining too much activity?
That doesn't seem to be any problem. We've looked at the amount of volume that's gone into the ETFs as a separate function. Their growth has been terrific and it's going to continue that way, but at this point it doesn't fully explain this loss of buying enthusiasm. So I don't know what does. To some extent, a number of analysts feel that it's because we're still suffering the after-effects of the bear market, in that fewer investors are willing to go back in—and there maybe some substance to that. In our analytical work, for instance, the Nasdaq looks dramatically weaker than the NYSE does. And there have been some studies done by analysts like **Ian McAvity** and **Walt Deemer**, suggesting that once a bubble breaks, the next rally after that is generally relatively short-lived. The interesting thing though, is that I think that Ian kind of threw everything into the pot in his study and said, "Everything went through the bubble." Yet, when you go back and actually look at the statistics, it just doesn't lay out the way he describes it. It really wasn't that everything was in one big bubble all at once. For example, the NASDAQ index during the bear market was ravaged by 70%, but the NYSE index was off less than half of that—around 32%. A 32% decline is really not a bubble breaking, we've seen that magnitude of a drop on a variety of occasions before. It has happened in regular bear markets, not just in burst bubbles. Meanwhile. the American Stock Exchange during the bear market was almost in a trading range, it really didn't go far in either direction and—

Considering what is traded on the American, I'm not sure where it fits in.
But if you go through and look at the major price indexes, you'll see a whole variety of different patterns, not just one pattern. Everything did not go up together in the bubble, or burst at the same time.

Isn't that often the case? The market in which the mania is centered sucks up all the attention, and then craters—while others suffer varying degrees of collateral damage? The Nifty Fifty got creamed when that bubble popped, but there were other sectors that didn't fare nearly as badly, weren't there?
Yes, to the same extent. When the Nasdaq was down 70% during '73-'73, the Dow Jones Industrial Average sank 50%, so you always have some degree of difference, with the Nasdaq being down more sharply because it's more volatile, because of its

newer and riskier companies, and so on. But the interesting thing is that during the 2000-2003 bear market in the Nasdaq, there was actually a bull market going on in mid-cap and small-cap stocks. We could see that through an index that we follow, called the **Lowry Unweighted Index.** It was making new all-time highs in May of 2002. So even as the Nasdaq was losing 70%, this unweighted index of all domestic common stocks listed on the NYSE was actually in a *bull* market, not a bear market. My point is that if you're going to apply this idea of what happens after a bubble burst, I think the only place it can be applied is to the Nasdaq, I don't think it applies to much of anything else other than the Nasdaq.

The thing is that a lot of the mid-cap and small-cap stocks, particularly any of them with a value bent, already had gone through horrendous bear markets before the bubble burst.

That's exactly right and they were in a bull market up to 1998. At that time we kept talking in our reports about what we were calling a stealth bull market in mid- and small-cap stocks. But clients would call up and say, "I don't know what in the world you're talking about. I don't see any bull market here."

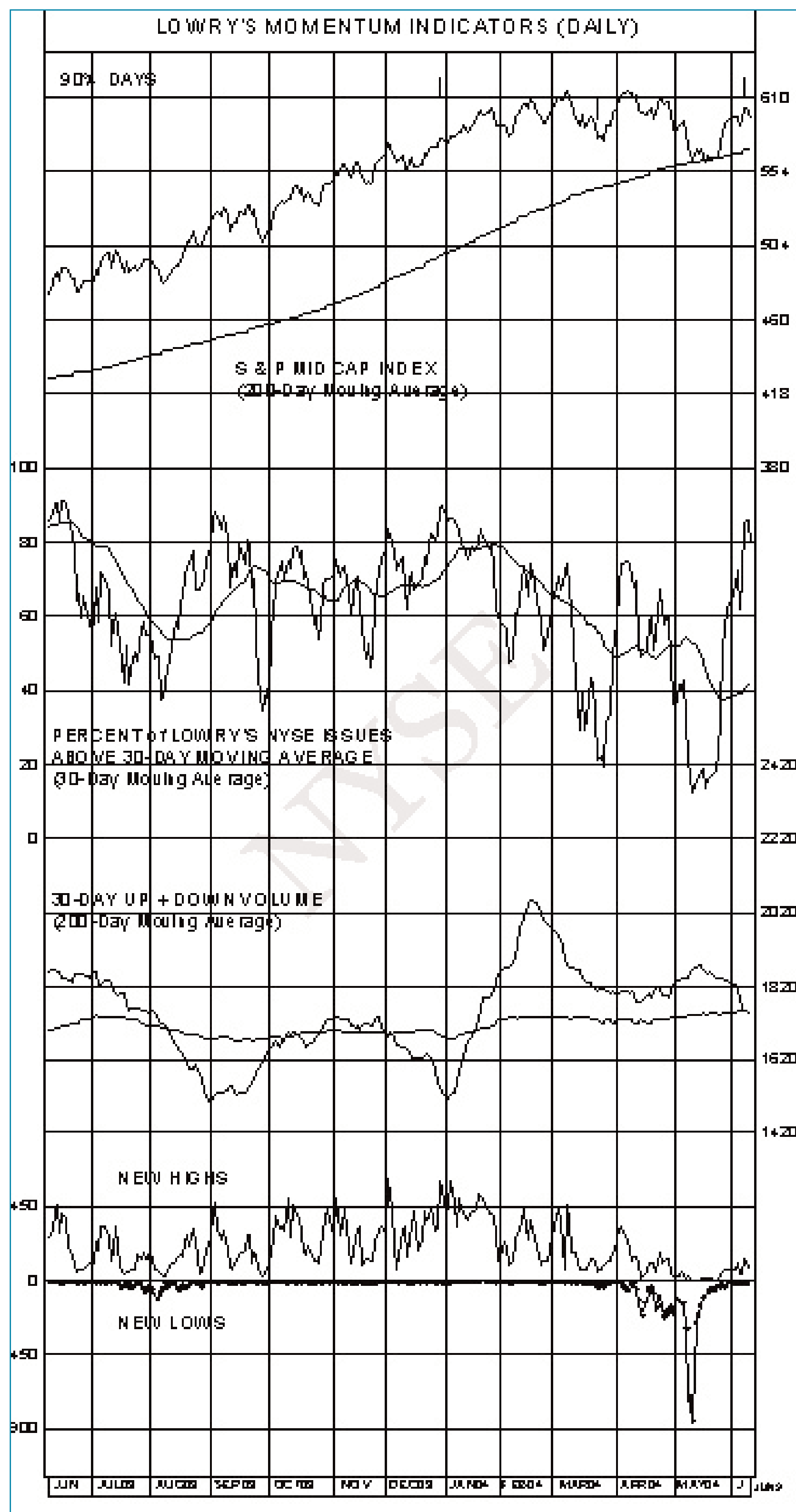
Because they were all overweighted elsewhere–

Well, that's true. But not only that, there's no place that you could go, there's no newspaper that you can pick up and turn a page to and see a chart of mid-cap and small-cap stocks. They show you the Dow, they show you the S&P. If anything else, they show you the S&P mid-cap index, which is not a particularly good index. But generally you just see the Dow, S&P and the Nasdaq, that's all.

You're implying that investors would see a different picture, if they looked at something like your unweighted index?

Yes. A lot of people have said that we're still in a bear market and one of the things that they point to as evidence is that the S&P 500 index hasn't recouped many of its bear market losses. In fact, it has recovered only about half of what it lost. But we also track an unweighted index of the Standard & Poors 500 component stocks–which hit a new all-time high in April. Our **Lowry's Unweighted Index** that we also track is very similar. It contains almost the same issues, not quite, but almost the same issues as the NYSE index. Our unweighted index was making new all-time highs from August of last year to April of this year. It was at all-time highs when the conventional NYSE index, because of its weighting, was still considerably below its all-time high. So a lot of the argument over whether this is a bull market or a bear market is based on whether you use a weighted index or an unweighted index. There are a lot of gauges, like the S&P 500 and the NYSE index, that would have made new all- time highs in April–except for the fact that they're weighted. So there have been a relatively small number of stocks that have made over-sized contributions to the malaise. The last time I looked at the specific issues, there were something like 24 issues that, if you took them out of the index or you just took the weighting off, would change the whole composition of the index–and push it to new all-time highs. To me, that says that this is still a bull market.

It would more generally be perceived that way,



if people were looking at those indicators, instead of listening to happy talk TV.

I think these circumstances *ought* to open up an interesting debate as to whether we should be looking at weighted indexes or unweighted indexes. After all, weighting doesn't do anything for a portfolio manager except make it almost impossible for him to be able to match the indexes' performance. Portfolio managers run their portfolios based upon unweighted indexes and it would seem they would be better off looking at an unweighted index. So we simply show both kinds of indexes in our reports so that you can see where the strengths and weaknesses are coming from.

You're right—but of course, you're talking about turning the whole structure of the investment management and consulting businesses upside down.

Exactly, but the difference is this: in looking at the two indexes alongside of each other, what they are saying is that if you are selective in your purchases you can do much better. Yet there are a lot of money managers charged with trying to beat or at least keep up with the S&P 500—who try to do that by mostly buying the S&P 500.

Yes, by aping it.

Which tends to guarantee that they're going to underperform it. If they were simply to take the position of saying, "We can see by looking at these two indexes that there's a bunch of the biggest of the big-cap stocks that are underperforming, so if we simply don't put those in our portfolios and concentrate on those issues that are performing well, we can outperform the S&P 500 by a substantial margin," they would actually do it. I just went to an investment management conference in California. I was sitting in the audience after speaking myself, when a fellow got up and did a presentation using our work. He said, "We are running these portfolios where we take an index like the S&P 500 and we simply go through and look at the 500 issues one at a time. We look for strong buying enthusiasm in those issues. Those are the ones we want to buy. The ones that have weak buying enthusiasm in them, we simply leave them out of our portfolios." His performance has been essentially double what it would have been, if he had invested in the whole index. So I think this is going to be something investors will have to reckon with more and more. The problem was that we couldn't see these kinds of differences before. But now that we're separating out the weighted from the unweighted, it helps to be able to distinguish where the strength is and where the weakness is in the market.

No small thing, in these treacherous times.

It really isn't. The rally started more than a year ago, now, and so based on past experience, the one thing we probably know for sure is that as this rally continues, it's going to become increasingly selective. So what portfolio managers really should be doing is going through their holdings, saying, "How can I narrow my portfolio?" They have to know that broad diversification is going to work against them from this point on rather than helping them.

Yet, many are so afraid of selecting the wrong stocks, that they persist in diversifying themselves into mediocrity.

You're getting back to turning the whole business upside down again. But mediocrity is exactly the result. History shows that markets grow more selective as they grow older. The general perception that most people have is that the last half of a market advance is not as dynamic as the first half. And that is generally true, if you look at it on the basis of all stocks traded. But it's not true at all if you look at it on the basis of identifying those stocks that are performing well. In other words, you have to use relative strength to separate out the wheat from the chaff. If you only invested in the stocks showing stronger accumulation and if you left out those stocks that are not interesting to investors, your performance during the latter half of a market advance would actually be greater than during the first half. And you'd have to deal with smaller numbers of stocks. There are many ways investors can now put that sort of strategy to work. This is where, ETFs, for example, can come into play. If small stocks are running, but a portfolio manager doesn't feel comfortable owning the small-caps, he can buy an ETF that represents small stocks and still have liquidity.

True, but at some point the liquidity of the underlying securities has to become a factor. Someone has to buy and sell those to create ETF shares.

Yes, but I think that over a period of time we're going to find that the ETFs take on a life of their own. What's going to happen will be almost like what happens with the mutual funds today, where a substantial amount of the trading in the mutual fund shares never hits the portfolio at all. It's a case of matching buys with sell orders, so the portfolio manager never sees the money at all. It is all done at the brokerage level or at the clearing level. And I imagine that the ETFs are going to do precisely the same thing. There's going to be a lot more trading in ETFs than could ever be invested in the actual stocks, but it's all going to be just matched trades.

That makes ETFs sound like they'll generate a lot of short-term noise.

There will be enough short-term ETF trading to satisfy liquidity needs. But that doesn't mean that everybody has to trade them short-term. While short-term traders will become an important part of creating liquidity in ETF shares, that liquidity doesn't necessarily have to flow back to the underlying issues. We're going to find out—they're still such new creatures—but we saw something like this happen in the mutual fund industry. All that an ETF is, after all, is an advanced form of a mutual fund. Initially, when all this trading and short-term trading in mutual fund started taking place, everybody was saying, "This is going to be terrible for the long-term holders of mutual funds." But the brokerage firms and the transfer agents kept insisting that the short-term trading wouldn't have to affect the portfolio managers at all. "They don't even have to know what's going on; there could be double the volume in the fund shares as in what is actually in the portfolio and it wouldn't affect the portfolio manager at all." Something like 70% of the trades in mutual funds are matched outside of the mutual funds, and the same thing will happen with ETFs.

Even though there has been an incredible proliferation of ETFs, the trading activity is still heavily concentrated in the very biggest. The Leuthold Group's Eric Bjorgen recently published a very enlightening special study on them that showed that quite dramatically.

I saw some statistics a while ago about **Barclays Bank**'s ETF efforts. They showed that they own something like 80% of all of the ETFs, but that only 15% of those 80% are actually profitable for the bank. Just the few big ones are producing all the volume. But it is early in their life cycle. I remember that the same thing was true with mutual funds. When the mutual funds started to come to life again, particularly after the '74 bottom, they were a very hard sell. They traditionally had always been considered to be primarily buy-and-hold type of investments. And yet people had just lost so much money in them during '73-'74, that the surviving mutual funds were basically desperate to stem any further outflow of their capital. I remember that we at Lowry's were heavily involved at that time in telling a

number of mutual funds, "You know, there's another way to stem the outflow of capital, and that's to talk to your investors about changing from one type of portfolio to another so they don't have to leave your funds." We particularly started talking to Oppenheimer. The man who was its chairman at the time just loved the idea of saying don't just take your money out of Oppenheimer, move it over to an Oppenheimer bond fund or move it over to one of its money market funds or move it over to something else.

So you bare no little responsibility for kindling the fund industry's asset-capture bonfire?
Yes. Everybody started doing that and all of a sudden, mutual funds took on a whole new kind of life. The funds could still be sold as buy and hold kinds of investments, but people could also change their portfolios as conditions changed. That changed the whole nature of the business–and for a while a lot of people were scared to death that it was going to have a terribly detrimental effect. But it never did.

I think the jury is still out on that one—
Even today, after all the scandals and despite all of the talk about "market timing" (which had nothing really to do with market timing) that unfortunately has emerged from Eliot Spitzer's office, the sorts of new requirements and new penalties for short-term trading that are being talked about wouldn't have any real effect on the management of fund portfolios at all.

Well, what gets regulated is usually the last thing that needs to be. It's one of Murphy's Laws. All we really know is that new regulations will somehow produces unintended consequences that contribute mightily to the next fiasco.
I really think that what we're probably witnessing is the very slow dissolution of the open-end mutual fund concept.

Goodbye, mutual fund industry? That's some statement.
Ultimately, we have found a new, better product. As more players get into it–and everybody is rushing into these ETFs now–

Careful, you're about to lose your bona fides as a contrarian.
Well, there is just so much excitement about them–but there are so many people trying to launch new ones that we're going to go through something of a shakeout. Ultimately, particularly from an institutional standpoint, people are going to recognize that it's just a smart way to manage money. If you go back through performance histories, particularly of technically oriented money managers, you tend to find that the vast majority of their mistakes are made at the individual stock level. In other words, they'll get the general pattern of the market's action correct and then they'll go into various sectors and even get the sectors correct. When they drill down further and get into industry groups, they may even get those correct. But when they get to the individual stocks, they select the wrong issues–and so can completely miss out on a trend. What that means is that if they could just take that one decision out of the process, their performance would probably increase dramatically. And that is clearly part of the attraction of ETFs to portfolio managers.

Hmmm, "one-decision" stocks were tried in an earlier era...
Well, look at it from another standpoint. There are a lot of good market technicians, for instance, who are never going to be able to pick out the right biotech stocks, if they have to get down into the fundamental analysis of the companies and their compounds. It's pretty hard to sort those things out, unless you are intimately involved with what's going on inside the companies. So for many technicians, the development of trading vehicles like ETFs is a godsend.

That's what they're supposed to have all sorts of technical indicators to tell them from the way the stocks trade, isn't it?
Well, our Lowry's indicators are still showing a tremendous amount of strength in the small-cap and mid-cap stocks.

Shouldn't those smallfries be pretty well exhausted by the time we've gotten to this stage of the rally off of the March 2003 bottom?
Not really. When you go back through the history of previous major advances and you look at the leadership, you generally don't see it changing dramatically during the middle of the uptrend. Usually, the leadership in an uptrend identifies itself relatively early on–then it continues to lead all the way to the top. Which is why I really think we're going to see continued strength in the small-cap and mid-cap stocks. I just don't see anything to interrupt that. What is fascinating about that is that our analysis today also says that the Nasdaq market is significantly weaker than the New York–

Yet it is where you find lots of small and mid-caps. But the Nasdaq isn't monolithic any more than the NYSE is. Isn't your stuff really saying that the stocks that were at ground zero, so to speak, of the bubble, will continue to be weak—the tech maniacs and the ones heavily weighted in the indexes. But that there are lots of other stocks, particularly in the small and mid-cap sectors, that could do all right?
Yes, as I was saying, Ian's study and Walt's study may be absolutely right about the aftermath of bubbles, but you can't expect the consequences to apply to all stocks equally. They have to fall most heavily on the ones at the center of the mania. And that's substantially different than saying that everything has got to go through the same wrenching readjustments. I just don't see evidence to support that taking place at this point. I do see it for the Nasdaq itself–and especially for the tech stocks on the Nasdaq, but I don't see it for the New York Exchange. I don't see it for the small caps. I don't see it in the mid caps.

Didn't I see something in one of your latest weeklies about the Nasdaq computer stocks doing better than most other sectors of that market?
They have been. The Nasdaq computer index is one of the few that hasn't fallen below its March low. But actual gains in that index have also been very sparse and inconsistent. Anytime you get a little rally after a sell-off, it seems like the initial burst of buying is coming primarily from hedge funds–where all they're looking for is volatility and for something that's been discounted already. So they come rushing back into the computer stocks, but only for short-term trades. They are not looking for long-term investments.

Sure, they want to buy anything that might be supercharged.
They're buying the pop, right. So what we've seen in the rally attempt from the March 2004 low, for instance, was an initial very strong burst of buying enthusiasm. But it just gave out after a couple of weeks, and the volume started to dry up. That was one of the first real clues that something was wrong in March and April 2004. And I think that's probably what we're going to see here again: An initial burst of buying enthusiasm from the traders but then the re-emergence of questioning whether long-term investors are going to be willing to step in here and accumulate stocks.

So seeing some real follow-through will become crucial?
If they're going to do it, we ought to see it strongly in the volume numbers. That's the thing that's really missing. The rally has gathered in the traders but now we need to see if we can attract the long-term investors. They are the ones who will carry this thing to new highs. But so far I don't think they're there. This 90% upside day that we had Monday came out of the blue. It was not preceded by any 90% downside

days and it occurred after a 6% or 7% correction. History says that these isolated 90% upside days are much more typically blow-offs than they are signs of new buying enthusiasm.

Couldn't it also have been just a "Win one for the Gipper rally?"

Anything is possible, I suppose. But the last time we had an isolated 90% upside day was in late December of 2003. That was a little early, but it was not long after that the markets started to go into this trading range. So that 90% upside day was an indication that you were getting somewhere near a top. Nonetheless, this thing might be followed with some further gains. We haven't had any sell signals. So we are *not* saying everybody should sell this rally. But we are saying that it should be watched very closely because, if the volume is drying up as it tries to break through to new highs, the chances are that this rally is not going to be sustained. The underlying question here is did the decline to the March lows produce the kind of bargains that would attract sustained demand? And the answer is no. So now the question is did the May bottom, which in the case of the S&P 500 was another 0.7% lower than it was in March, enough to produce sustained buying interest? We're going to see, but the evidence is saying probably not.

Even with profits rebounding strongly, you really have to torture the numbers to get P/Es to fit any reasonable definition of a bargain.

What we really need, I think, would be the sort of 10%-12% correction you get after most market advances. A 10% correction would not be at all that unusual, historically. And that may be necessary in order to bring the buyers back in. Get them excited. If that were to happen, the valuation indicators, like the price/earnings ratio, would all of a sudden be at the most attractive levels they have seen in quite some time. The P/E ratio on the S&P 500 right now is at its lowest level since 2003, which could get people interested, if the economy keeps improving and if prices were knocked down a little bit more. That could produce the same kind of buying enthusiasm that we had coming off the March 2003 bottom–which would produce a nice finishing rally that would take us up to the top of this bull market.

We can only hope–

The evidence supports it at this point. We don't have any signs of a top. We had signs back at the March low that this was the beginning of a move that should last two to three years. So far, all of the evidence continues to support that assumption. But we still don't have any significant signs of a market top. All we have to do is get through a correction to regain that enthusiasm. Nothing is really different here than what we've seen in bull market patterns of the past. And if we're stuck in this fragile correction here for a while, well, we'll just be building a bigger and more beautiful base for later–

Thanks, Paul.

talkback

EGG-FACED

I may not be as erudite as Mr. **James Paulsen,** but I've never seen yields rise *and* bond prices rise.

Michael Farrell
David L. Babson & Co.
MFarrell@DLBABSON.com
June 3, 2004

***KMW** responds: As I have unhappily had occasion to confess before, I hate eggs, but here I stand, egg-faced. It was my bleary-eyed editing, and not Jim Paulsen's erudition that failed. As the eagle-eyed Mr. Farrell points out, the interchange reproduced (with correction) below, which practically began our recent (w@w 5/28/04) interview was marred by the slovenly substitution of the word "bond" when "stock" should have appeared. I am mortified.*

The bond market has been one of the big worries each way–

The stock market has had no shortage of things to worry about- Iraq, oil and China, to name just a few-but the biggest worry for investors has been rising interest rates. Which most believe will inevitably lead to stock price declines.

You disagree?

There clearly was a strong negative correlation between stock prices and interest rates from the late 1960s through the late 1990s-in other words, throughout most investors' active lifetimes. However, since 1998, more often than not, there has been a positive correlation between bond yields and stock prices, when yields have risen, so have **STOCK** prices, and vice versa. This is not the first time this "delinking" has occurred. A positive correlation between stock prices and bond yields was common back in the 1950 and 1960s, when stocks rarely rose without the accompaniment of rising treasury yields.

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