Longboat Global Advisors

CROSSCURRENTS

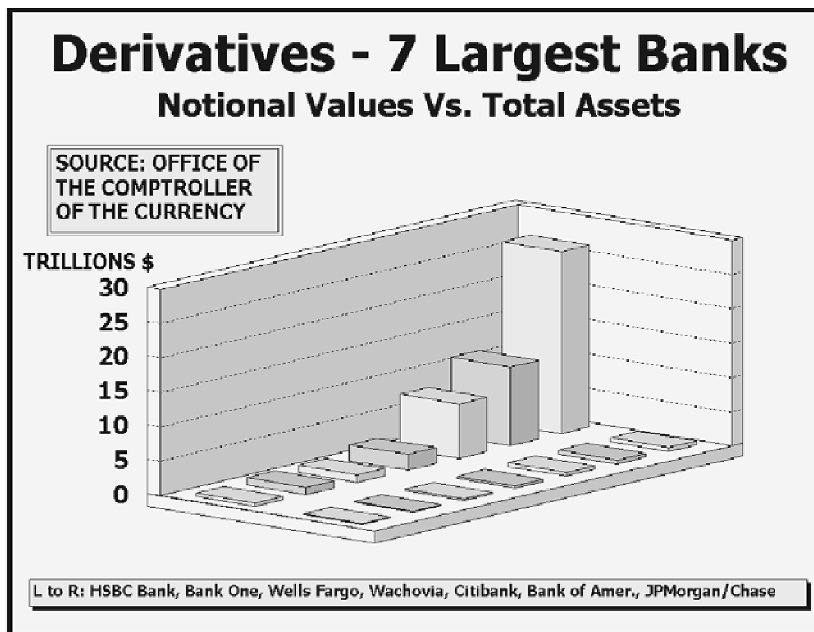
U.S. STOCK MARKET OUTLOOK for MARCH 10, 2003

DJIA 7740 - SPX 828 - NASDAQ 1305

JPMORGAN/CHASE DERIVATIVE CREDIT EXPOSURE IS NOW 6.2 TIMES THEIR RISK BASED CAPITAL. CASH LEVELS AT THREE LARGEST MUTUALS FALL FROM 2.48% IN DECEMBER TO 2.25% IN JANUARY. "CLOSET INDEXING" ADDING TO THE OVERALL EFFECTS OF INDEXING AND WILL PROLONG THE BEAR MARKET. **- NEXT ISSUE - MARCH 24, 2003 -**

Weapons Of Mass Destruction

If you haven't done so already, read the Warren Buffett piece on derivatives in this month's Fortune. Those of you who have been with us for any length of time know just how vehement we have been on the dangers of derivatives for several years, covering the subject both here and in our internet features. Mr. Buffett claims that derivatives are "financial weapons of mass destruction." We believe they are aimed right at the heart of the capitalist system. Buffett's perspective adds plenty of ammunition to the arguments that systemic risks have risen to intolerable levels. A more complete look at derivatives will be a focus of a Pictures of a Stock Market Mania update due to be published by March 15th at www.cross-currents.net /charts.htm. Do not miss it. However, we could not resist scooping ourselves to show our front page chart now. This chart clearly illustrates how the total assets of the seven largest derivatives players match up against the total notional values of their derivatives contracts. For several years, we have been unable to comprehend how this chart implies anything but monstrous risk to the financial system in its entirety. All financial contracts carry some inherent risk and in the case of derivatives, although risk is typically transferred elsewhere, the risk remains very much within the system. Risk is inviolable and cannot be removed from any closed system. Portfolio insurance proved this beyond any shadow of a doubt in 1987, taking us to the brink of a total financial collapse. And if you doubt that Long Term Capital Management was a threat to the entire financial system, picture the need for the nation's largest banks and brokers to meet at the Federal Reserve's office in New York at the "invitation" of the NY Fed President Bill McDonough in October 1998. A similar meeting was never held before nor has been held thereafter. But nothing much has really changed. In the case of JPMorgan/Chase, credit exposure is now equal to 6.2 times their risk based capital. Long Term Capital Management was leveraged far greater in 1998 when it imploded but we can no longer take comfort from academics who insisted it couldn't happen. That it did happen means it WILL happen again. Notional values covered by derivative contracts are two-thirds higher than they were in October 1998. Perhaps the odds are even greater now for another derivative event. We were able to avoid a total collapse in 1987 and in 1998. We may not be as lucky next time.



The most stunning news from the ICI February 27th report on mutual funds was not that money continued to be withdrawn from equity mutuals but that the cash-to-assets ratio of stock funds continued to fall to 4.4%, close enough to the 3.9% record lows of December 1972 to question just what the blazes are fund managers smoking? Or is there another explanation to consider? (to next page)➔

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The record December 1972 cash ratio low came right at a major price peak for stocks that was not exceeded for an entire decade and in fact, since that time, the cash ratio has only been lower than now in December 1999 and March 2000, right at the blowoff peak for stock prices in the mania. At this juncture, prices are down substantially and have continued to decline. In the past, when prices declined, managers grew fearful and cash rose. Not now. Absolute cash levels remain on a declining path and are now back to where they were in March 1997, providing less ammunition for any possibility of a renewed bull market. It was one thing back then when folks were just becoming excited about the prospects for tech stocks, the internet and were imbued with the confidence imparted by pie-in-the-sky analyst reports and CEO misrepresentations of income. It is quite another thing now. The actual cash pile may be just as high but the attitudes of investors are not; instead, their attitudes are far removed from the same naive stance as before. The same cannot be said of the nation's fund managers, who are clearly still as high as a kite and dancing to the tune of the long term mantra, "buy and hold." In fact, the nation's three largest stock mutual funds continue to show bravery bordering on insanity, although one of the funds has the excuse of being legally blind, therefore they cannot see the forest nor the trees. We're speaking of the Vanguard Index fund, all $66.8 billion of it, and the zero cash position the fund carries as a result of their franchise to be permanently and fully invested however horrible the prospects might be for stocks. Second largest is the $54.7 billion Fidelity Magellan, who have pared their meager 4.4% cash position in December to a mere 3.5% at the end of January. The third largest fund is American Funds' Washington Mutual, now $53 billion in assets, of which only 3.8% is represented by cash. The three funds account for better than one of every sixteen dollars in stock mutuals and have a collective cash-to-assets ratio of 2.25%, down from 2.48% last month. How cash levels this low are supposed to drive a new bull market or even a substantial short term rally is way beyond our ability to fantasize. It would appear reality is still a vast distance away from those who run OPM and quite obviously, they will continue to dance to the tune of the long term mantra until they drop. Of course, fund managers are tied tightly into the fabric of Wall Street's dream weavers, a/k/a strategists. For the umpteenth week in a row, said strategists are stuck at 68.7% allocations for stocks and only 6.8% for cash. The stock allocation is still very close to record highs and portrays extreme bullishness in the face of the continuing deterioration in prices. The attitudes of fund managers and strategists have been weapons of mass destruction in their own right, and are at least partially responsible for the loss of $7 trillion from investors' portfolios. How can cash levels still be so low after all this damage?! How can strategists maintain their bullish views after all this time on the downside?! It is patently obvious that neither group can or will admit fault or error. Both are firmly committed to their stance until the long term finally bails them out.

Additionally, we must now face the inescapable evidence that the largest mutuals are rapidly turning into index funds themselves. Consider that the ten largest positions of the Fidelity Magellan fund are comprised of eight of the actual top ten market capitalization issues. Only IBM (9th in market cap) and Johnson & Johnson (7th) are not in Fidelity's top ten, instead replaced by Bank America and Viacom, both of which still have hefty market caps. Clearly, the lion's share of Magellan's assets closely resemble the market cap progression of a plain vanilla index fund. As well, Magellan and other large funds like Washington Mutual seem to be gravitating closer and closer to a zero cash position. Given the environment of lower prices, this is antithetical to the behavior of the past, where cash was always raised as prices moved lower. Can it be that the larger funds like Magellan & Washington Mutual are so frantic in their need to compete with indexers that they are purposely cutting cash positions so as not to be left at the gate when stocks "finally" take off? We believe they are, and unfortunately, this new policy bodes further ills for investors. History's perfect example of the importance of a huge cash-to-assets ratio is the 13% level achieved the last time the US was about to invade Iraq. When things went well, the pent up demand was able to fuel a new bull market. The extremely low cash-to-assets ratio available today will only be able to fuel a bear market rally - even if things go well. The very savvy Kate Welling recently confided to your Editor that, "something, eventually, will have to blow the fund industry out of closet indexing - which is infinitely larger than the official sort - and break the faith in their fully invested religion before the logjam is broken.... unfortunately, right now, it looks like what it will be is many, many months of redemptions that force them to sell because they certainly have no meaningful cash reserves.... has no one learned anything from history?" Fund managers and strategists have clearly learned nothing and are determined to continue to act as weapons of mass distraction, and will continue to mislead the public into believing in the long term mantra, no matter how long it takes for prices to come back.

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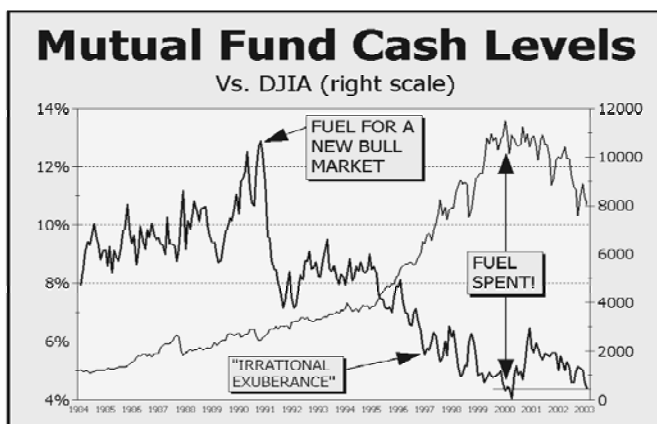

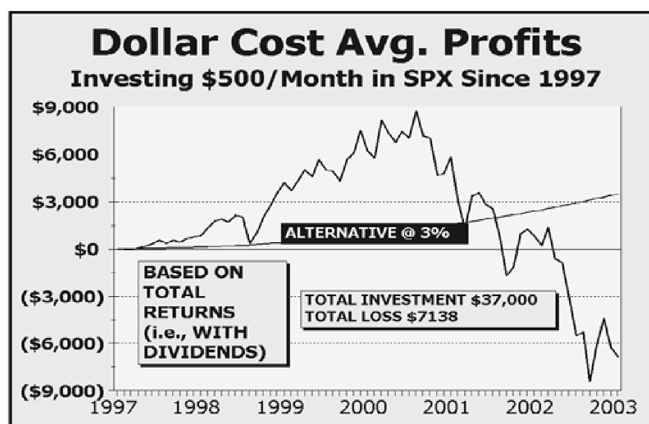

These die-hard bull strategists and fund managers will continue to point to trillions in money market funds as if the money markets had only and always been temporary way stations before an inevitable investment in stocks. But nothing could be further from the truth, especially now that the bubble has burst. After losing $7 trillion from the highs, investors are now likely to keep remaining trillions where they cannot be harmed, in the very same money market funds. Despite the assumptions of strategists and fund managers, history has shown the public to be generally risk averse. The mania was a once in a lifetime aberration that will take many years to heal. Nevertheless, the industry insists upon trotting out the long term mantra at every opportunity, the sure fire sure thing solution to all ills - buy and hold. To back up the proposition, the industry devised Dollar Cost Averaging, a simple system of investing in which if prices go down, you buy more shares. If prices rise, you buy less shares. In theory, quite elegant but since the system requires that you are always buying shares, you are theoretically NEVER selling shares and an investor will always eventually be subject to the vagaries of market timing anyway. When an investor finally needs the money, it just might conceivably be at the worst possible time. The mathematical "magic" of Dollar Cost Averaging is an illusion! (right chart, page two) Through February 2003, DCA investors lost $7138 of a total investment of $37,000, as they wound up purchasing stocks at prices that were the result of mass insanity. Indeed, it is somewhat ironic that the "indisputable logic" of DCA turned out to be one of the engines that drove the mania to its extreme, obliterating the flawed "logic" in its entirety.

Somehow, sentiment seems to have become a difficult argument now as bulls hang their hats on shorter term measures such as Put/Call ratios and the Rydex ratio, ratios that are meaningless in the long term. As we showed in our last issue, the Rydex ratio is particularly flawed as it governs a very small piece of the overall pie, too small to be of any value. At the peak in March 2000, Rydex bull and sector assets came to roughly 80% but bear assets have not ranged higher than 42% in recent weeks and are now only 37%. Although the ratio certainly shows pessimism, the emotion portrayed is not particularly strong. Although some analysts now point to the American Association of Individual Investors weekly readings as further proof of excessive pessimism, we have always viewed this indicator as highly volatile and not terribly useful since much of its history is taken from the greatest bull market of all time. However, given a secular bear market in progress and the possibility that stocks as a percentage of household assets will eventually decline substantially from here, this measure could conceivably show bearish extremes for years! However, the Investors Intelligence numbers issued by Chartcraft have been around for a very long time and our colleague Peter Eliades (www.stockmarketcycles.com) has as great a grasp of their importance as anyone we know. Peter recently put forth a bevy of facts about the past, all of which imply that sentiment here will have to turn a lot uglier before we may assume a bottom is close at hand. Peter notes the May 1970 bottom was preceded by 27 or 28 weeks in which there were more bears than bulls. Also, the bottom in October 1974, when there were 27 consecutive weeks of considerably more bears than bulls. Then March 1978, when 17 of the prior 20 weeks registered more bears than bulls. Then August 1982, when 34 or the prior 35 weeks registered more bears than bulls, and considerably so in most weeks. Then late 1984, 19 consecutive weeks of bears proliferating over bulls. Then late 1990 and early 1991, there were 26 consecutive weeks of more bears than bulls. And then Peter relates, "....in 1994-1995, the last major bottom prior to the market's excursion into bubble mania, there were 46 consecutive weeks of more bears than bulls." Almost a year! Even during the brief LTCM episode in October 1998, there were seven consecutive weeks of bear proliferation. And now? In the last 227 weeks, only nine have seen bears more in evidence than bulls. And when the bears growled, they have not growled loudly or for more than a few weeks. Even after all the damage in recent weeks, the bear view simply receives way too little respect.

" The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear..... Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts.... "[they] are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."
- Warren Buffett, BRK Annual Report

According to David Evans' article on Bloomberg last week, the SEC said the agency was concerned about corporate filings with incomplete information that obscured pension losses. Carol Stacey, the chief accountant of the SEC's division of corporation finance warned, "There was a general lack of informative transparent disclosure," in the more than 500 annual reports that were reviewed for 2001. CSFB and UBS Warburg back up the SEC and say that S&P 500 companies lost more than $200 billion in the past two years in pension investments without clearly disclosing those losses. Meanwhile, corporations are maintaining "expected rates of returns" that continue to guarantee the illusion of profits. Yet, CSFB found that aggregate earnings for the S&P 500 would have been 69% lower than actually reported in 2001! And now, after three years of disastrous results, Caterpillar, Lockheed and Verizon all lowered expectations but only by one-third of a percent to an average of 8.7%. Thus, even if their actual pension investments lose value this year, all three companies will still report profits from those pensions! How can shareholders or the public adequately gauge earnings? THEY CANNOT. As well, since companies are not addressing these issues now, they will be forced to deal with them later by cutbacks in spending and hiring and will have to come up with the money for retirees somehow, perhaps by borrowing or by contributing Treasury shares, which will dilute shares already outstanding. The pension story threatens to explode and could conceivably become a weapon of mass destruction for corporate earnings, with consequences that may be felt for years to come.

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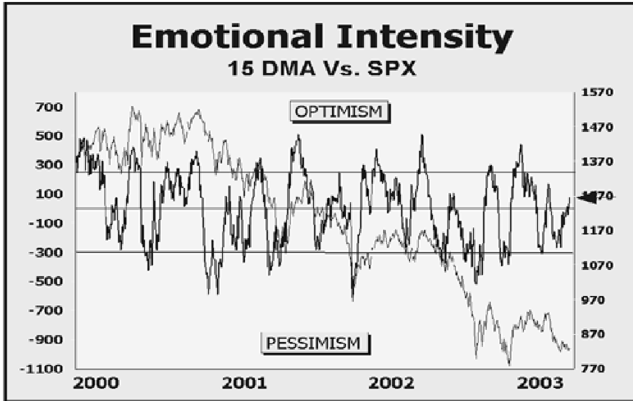

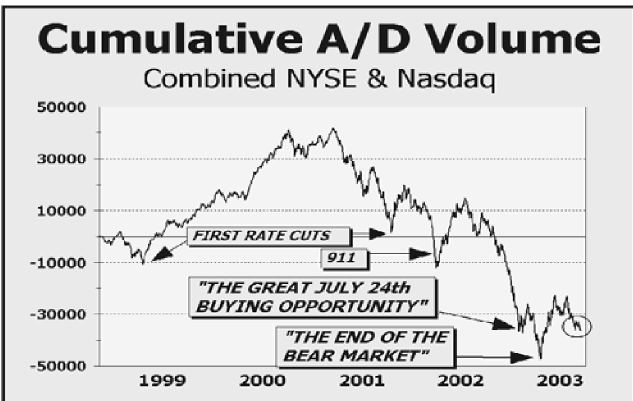

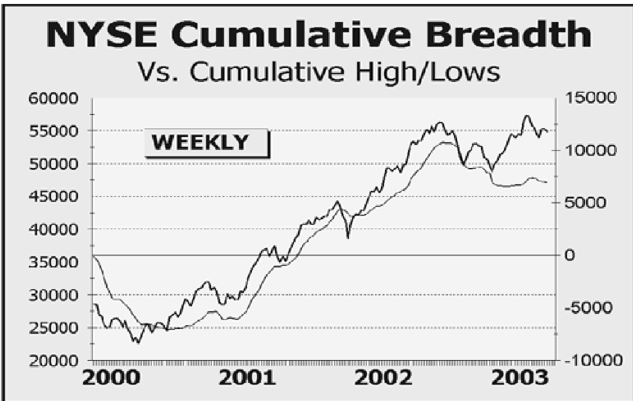

Our measures of Emotional Intensity display a disturbing amount of complacency in the face of the market's further price decline. While not outright bearish, we would have expected the opposite tack in the last two weeks. As well, a tightening of the ranges in our indicators means a large move is probably waiting in the wings. Without a pickup in pessimism, it's hard to see how the move can be up.

Cumulative A/D volume for the combined U.S. markets is on the cusp of breaking below a recent low and if it does, will increase the odds for a test of the October low. As it now stands, the odds are already in favor of the bears as rallies do not seem to be able to generate any power for long. Given the low volume stagnation currently on both exchanges, it is no wonder.

Another important divergence? Weekly highs and lows on the NYSE clearly imply that even in the rally phase, the NYSE's advance from the October lows was just a "reflex" rally and not a brave new world. More evidence that seems to be pointing towards the bears.

The headline of our February 28, 2000 issue read, "Nasdaq Index may be facing a crash." Our Two Weeks Ahead feature began, "We believe we are very, very close to a significant reversal of Nasdaq's fortunes, possible even a Nasdaq crash." We offered a under-3000 target for Nasdaq, "possibly as soon as mid-April," an astounding forecast with the time and price targets only six weeks away! In this business, one is never supposed to offer price and time targets together, in order to hedge against being wrong, but we did. Nasdaq was trading at 4590. The top came in two weeks later. By April 17th, Nasdaq traded as low as 3227. The collapse of Nasdaq was a defining moment that should have proved to all that a veritable stock market mania had driven prices. But on this, the third anniversary of the mania peak, we are astonished that the subject is still so ignored and never broached in polite company. Meanwhile, Germany trades at a seven year low. Japan trades at a 20 year low. And here at home, corporate malfeasance continues to gnaw at the future as companies design assumptions about their pensions to show earnings that are mere illusions. But since individual stocks are apparently no longer good enough to invest in anyway, who cares? The bankers and exchanges create new index products as fast as hens lay eggs and mutual funds move closer and closer to indexing their assets, destroying what remains of pricing efficiencies for individual stocks. And as the year progresses, program trading captures 37% of all NYSE volume, and no one can understand why the public isn't coming back in?! It's a bear market and likely to be the worst of this century. Shame on the financial industry for allowing it to happen. Shame on the financial industry for allowing it to continue.

☑☑☑☑☑

THANKS TO:

KATE WELLING

www.welling.weeden.com

FOR COVERAGE OF OUR COMMENTARY

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- Rationales & Targets -

Although time still appears to be running out for the bears before a rally gets underway, let's not get too optimistic just yet. Two months of derioration have found no accelerant for the bears, which would typically connote a faltering rationale. However, much of the intermittent rallies in this phase have been pitifully brief and are apparently catalyzed only by the bears themselves as they seek to cover at the slightest hint of bullish news. Is this bullish? Or would bullish be when bears pressed their downside bets at each hint of distress? Given the latter circumstance would expose the bulls to the max and might generate something approaching climactic volume, we believe the evidence is that capitulation is far, far away. Bears do not want to press the bet. Bulls do not want to buy. Meanwhile, the current phase of consolidation & deterioration has coiled our volatility indicators and we now expect a decent sized move to commence shortly. Given that these indicators never show the likely direction, we must determine direction from other factors, like time, which says the bears have already had control for long enough. However, the bears have not yet lost control and an awful lot can happen in a few days. Given the backdrop of a savage bear market, we do think any rally will not look better for the bulls on the upside than the recent colnsolidation & deterioration looked for bears on the downside. It may be that the volatility spring continues to coil as the bulls make a little hay until late in April. All told, we see vastly increased short term risk for BOTH sides. This is already a very tough trading environment and the prospect of it getting worse for the next several weeks is a signal to temporarily withdraw to the sidelines. Since others see this prospect as well, it is no wonder that our volatility indicators are coiling as liquidity suffers. All told, you pay us to make hard choices so we'll allow that downside odds still prevail at this point. We would use a penetration of our resistance levels outlined at right to change this view for the short term. The overt reliance pinned on the Bradley Astro indicator by many traders probably means we should look for at least a short term reversal from whatever trend predominates this Friday or next Monday as said traders grasp at every straw in the wind. *- AMN*

SHORT TERM RANGES:
DOW 7197-8869 (at 32% of range) = NEARING CRITICAL TEST
SPX 768-935 (at 36% of range) = NEARING CRITICAL TEST
NASDAQ 1109-1467 (at 55% of range) = EXPECT TO UNDERPERFORM!
(at 55%, a perfect example of the "move to conservatism" in the QQQs!)

INTERMEDIATE TARGETS:
DOW 6400 - SPX - 680 - NASDAQ 1000

TradeStation Chart Analysis - BBH(D) Weekly [AMEX] Biotech Holdrs Tr Dep Receipt
BBH(D) - Weekly AMEX C=89.65 +1.25 +1.41% O=87.90 H=90.00 L=87.80 V=976400
Note low was made in July, not October.
Two biggest volume days were on the upside.
Shares have refused to decline recently.
Volume() 3674400.00
Created with TradeStation

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The Psychology of the Market

Strategists: Extremely Optimistic
Newsletter Writers: Neutral
Public: Complacent
Mutual Funds: Extremely Optimistic
Rydex Rato: Pessimistic
Put/Call Ratios: Neutral
CONTRARIAN OUTLOOK: BEARISH

Support & Resistance

Initial Short Term Resistance:
Dow 8076 - SPX 852 - Nasdaq 1353
Important Short Term Resistance:
Dow 8869 - SPX 935 - Nasdaq 1467
Initial Short Term Supports:
Dow 7562 - SPX 806 - Nasdaq 1261
Very Important Short Term Supports:
Dow 7197 - SPX 768 - Nasdaq 1109

Long on market rally - BBH - $89.65
Amex Biotech Holders Trust

We're interested in the BBH only if the market can break above short term resistance at SPX 852.92. We're also not interested in paying more than $94. We have no desire to make any moves on the long side now but will let the market tell us by rallying. If it does, the BBH appears poised to rally well beyond its own resistance and potential is likely to extend to the $110 level. We'll stop 5% lower if executed.

Stop out the IYW-$31.99 Feb 3 short @ $32.45 above $33.00. Volume has dried up and the position is not declining as expected. Our other outstanding ideas at this time are SWH-$26.20 (Jan.21 short @ $28.50) stop above $27.35 and XAU-$67.44 (Mar.7 long @ $68.00 per our comments in the Feb. 24th issue) stop under $64.95.