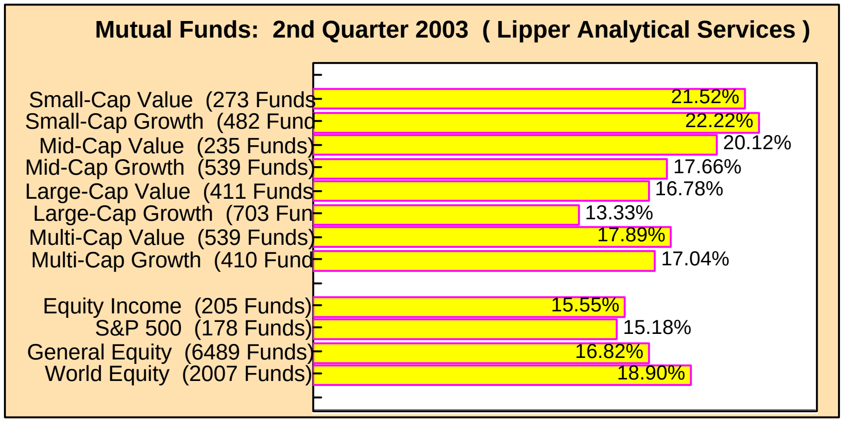
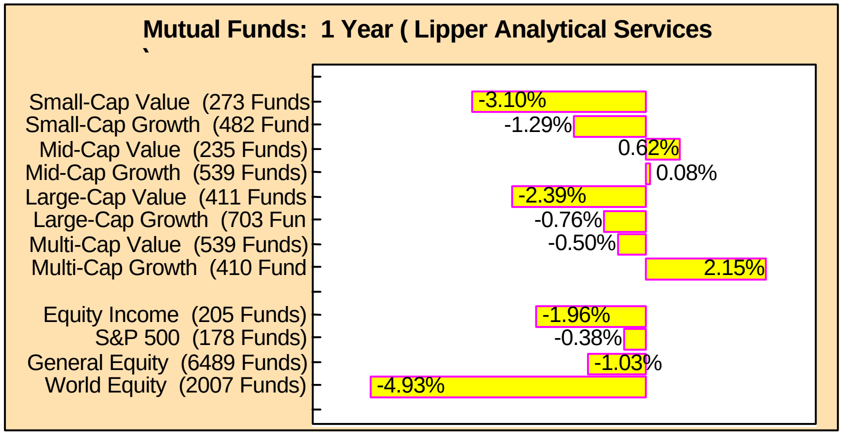
Niemann Capital Management, Inc.

Second Quarter 2003 Review

Survivor!

While I've never seen the series, my bet is these "reality shows" have nothing on our experience in the markets over the past three years. Ranging from the heat of dot.com excitement to the cold depths of nine-eleven despair, investors left standing by the end of this ordeal have survived the trial of a lifetime. Thankfully, relief blew in on the warm spring breezes of Q2. Very strong quarterly returns across the board (see "Mutual Funds: 2nd Quarter 2003" from Lipper) evidence a sea of change in market psychology. As is typically the case, investors with the perseverance and discipline to stick with the plan are there to reap the benefits. Those who bailed out get left with the challenge of figuring out how, and when, to get back in.





Also typical is that those parts of the market that suffered the most in the bear's final plunge; small to mid-cap value/growth, and international equities - have enjoyed the strongest recovery. The NASDAQ was hardest hit by the bear overall, losing over 75% (!) of its value. So naturally it's the best performer after the turn – and up over 25% this year. On the flip side, the Dow Jones Industrial Average fell the least through the bear, and sure enough, it lags the recovery. Large cap growth was the under-performing general equity class at +13.33%.

Strong as the 2nd quarter was, stocks in general have not yet recovered the losses suffered during the final leg down to the October 2002 lows. The 1-year view from Lipper shows most classes of stock mutual funds remain in the red year over year. As we discussed in our Q4 2002 *Review*, that final plunge was the most destructive phase of the bear, taking everything down with it. The fact that stocks have recovered so much so fast is notable in itself.

Another Bull Trap, or the End of the Great Bear Market?

The good news is this rally looks real. The economic backdrop is good, with both Fed and fiscal policy constructive. But the superior investor must rely on the message of the market to confirm or deny expectations. So more important to us at this stage must be the "price action" of the market itself. The recent breakout over 950 in the S&P 500 is notable and encouraging. Let's use this *Review* to explore a chart of the S&P over the past couple of years to see why. This exercise will also serve to give you some insight into how we construct our "bigger picture" market view. We'll use a weekly chart of the index for this purpose.

Fully a year into the bear, stock prices had been moving lower for several weeks when the terrorists struck their blow on Sept. 11, 2001. Shares plunged 10% when our markets resumed trading a week later. Fear ruled the day. Fortunately, out-sized price moves caused by external events usually run their course quickly, and this time proved no exception. Note the level at which buyers overcame sellers, and turned the tide on the decline. The S&P briefly punched through 950 (1) before reversing into a 6-month rally phase, moving higher into early 2002. But all was for naught. When the bulls failed to push the market above 1180 for the second time (2) in April, the bears came back in force. Over the next few weeks the bulls failed on each opportunity to hold the line: the spring lows at 1080, the November 2001 low (3), and the post-attack lows of the previous September. The bears took full control.

Markets plunged 25% and more before finding their "internal low" (4) in July 2002. The internal low is that point of maximum selling pressure (and investor fear), with the greatest number of shares under attack. I'll bet it was around this time where you were most afraid – wondering what was happening in the world to cause our market to go down so hard. I know it was for me. There were 917 new 12-month lows on the "reversal day" of July 24 and NYSE volume peaked at over 2.7 billion shares as investors bailed out at any price. Pros call this price action a "selling climax".

This day also marked the first "reversal" of a potential bottoming complex. Generally speaking, a reversal is where a security has a wide range of movement from high to low and closes at the opposite extreme of the previous trend direction. The greater the volume accompanying this price action, the more important it becomes. When you think about the dynamics of price for a moment, you'll understand how reversals relate to trend exhaustion. This market will undergo three full upside reversals (4, 6, 8) through its 9-month bottoming phase.

A sharp rally unfolded into August, as share prices vaulted through the vacuum of exhausted sellers. This rally attempt was halted abruptly, hitting a wall of supply at 950 (5). What had proven to be support in 2001 was now resistance as buyers looked to cut their losses or get out even. The bears were back and stock prices moved down quickly to their July lows, a vicious 20% decline. Here is where the picture begins to brighten.

As the S&P broke through to a “lower-low” (6) in October, it was clear the bears were running out of ammunition. 1.8 billion shares were traded on the day of the low, significantly down from July, and the number of stocks making new price lows shrank by a third to 604. Downside momentum was on the wane. Breaking the lows, but unable to go lower, the S&P 500 reversed to the upside for a second time. This new rally attempt lasted a few more weeks, but failed once again at 950 (7). By this point the 950 level in the S&P 500 has taken on considerable significance.

Failure by the bulls to move the market above 950, added to the uncertainty of pending war in Iraq, proved enough to send share prices back towards their lows. For the third time the bears lost the argument at 800. The S&P briefly dipped below this level (8) only to reverse higher on March 12, 2003. 319 new lows were recorded that day, about half of October’s count. The trading range was clear: 950 on the upside and 800 on the down. The key to the next intermediate trend would be a solid break of either of those levels.

Fortunately, the bulls took command. After being turned back at 950 for a week, the market broke through to the upside at the end of May (9). 581 new 12-month highs were registered on June 6. Sporting its first “higher-low, higher-high” sequence since March 2000, Mr. Market is suggesting the first bear of the new millennium might have drawn to a close.

The Message of the Market.

The fundamental backdrop is good! We enjoy historically low interest rates, even after moving higher recently. In fact the up-tick in rates is another bullish confirmation for stocks: the bond market is anticipating stronger economic growth ahead. Earnings expectations have been hammered down too much, typical of the first phase of a bull. Most companies are beating their numbers this quarter. Some are even beginning to lift their forward view. Fiscal policy is just starting to kick in as tax cuts and new policies take effect. This should act like a booster to earnings later this year. And remember, our economy is growing despite the debilitating drag of $30 crude. Every dollar in the price of a barrel of crude oil is worth about ½% of GDP. Should oil prices drop back to the mid $20’s, as they should when Iraq begins to export, look out!

Add to this the recent breakout above S&P 950 and the evidence is mounting of a change in the big picture. Price seems to be falling in step with improving fundamentals. But even if this is a new bull, beware; it comes complete with its own set of warts. Investors will continue to be obsessed by excessive valuations, a protracted endgame in Iraq, unemployment, the threat of terror, and budget deficits – just to name a few. These potential land mines will keep many afraid and out of the market.

Then what has really changed, you ask? Stocks continue to advance, even on bad news! The market has begun to climb this wall of worry.

Thank you for your continued confidence,

Don Niemann
President, CIO
Niemann Capital Management, Inc