



The ETF Authority

The ETF Authority for Monday, June 23rd, 2003

Volume 2, Issue #25

Published weekly on Sunday evening, [The ETF Authority](#) is a short-term trading newsletter that can help you profit from some of the most heavily-traded securities on the market -- exchange-traded funds (ETFs).

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We urge all readers to print out this newsletter each week for maximum benefit...

(1.) MARKET SUMMARY

Please see our special educational section below on divergences and our NEW regular feature -- "ETF Spotlight." In it, we'll feature a different ETF each week and will give you a better idea of how you can profit from that ETF in the coming months. We will start our analysis this week with the Nasdaq-100 Trust (QQQ) -- the most heavily traded U.S. stock.

Last week saw stocks move mostly sideways. After surging on Monday, most stocks took it on the chin through the middle of the week. Friday saw a mixed performance, with some of the recently beaten down sectors managing minor recoveries. In the end, nine of 19 equity-linked ETFs that we track for this newsletter finished in negative territory on the week. Incredibly, the second-worst-performing fund was the 20+ Year Lehman U.S. Govt. Bond iShares (TLT, \$93.75), which sank -3.5%.

Our Model ETF Portfolio, which is geared more toward longer-term traders, performed nicely thanks to our substantial short position in the Nasdaq Biotech iShares (IBB, \$67.77). This ETF was by far the worst performer last week, tumbling -7.30%. Our short position here propelled our Model ETF Portfolio to a +2.55% gain on the week, which compares favorably with the S&P 500's +0.75% move higher and the -0.1% loss recorded by the S&P 500 SPDR (SPY, \$99.44).

Our recommendation to short the Energy SPDR (XLE, \$24.45) proved to be in the right direction, but unfortunately XLE did not move high enough to hit our target entry price. The fund fell -1.96% last week, ranking it near the bottom of the pack.

THE WEEK IN REVIEW

There is still little sign that the stock market is ready to roll over. While I remain bearish long-term, the recent trading, as exemplified by last week's action, represents a trading range or correction from a very strong run. My biggest concern is that we have recently seen very high volume with little in the way of price movement. The work of Richard Schabacker, the father of technical analysis, warned that this was a sign of distribution -- smart money allegedly selling to the public.

I do not yet have a sell signal, so I will operate under the assumption that recent equity price action is part of a minor correction. Meanwhile, the bond market got hit hard last week, as the economic data were mixed with some upward surprises. Furthermore, concern crept in that stocks could explode higher, and that the Fed could be at the end of its easing rope.

We clearly are at a short-term danger point. After surging on the stronger-than-expected Empire State Index, stocks could not get out of their own way when the Philly Fed Index rose as expected (although it was less than what the rumors said it might be).

ECONOMIC ANALYSIS

The data remain mixed. The relatively unimportant Empire (New York) State Index, which came out last Monday, was much stronger than expected. This provided a convenient excuse to hammer Friday's shorts. Housing starts also rose nicely, though if the recent interest rate increase holds, then that sector could weaken quickly.

Consumer prices fell, but core prices, which exclude food and energy, increased by +0.3%. This got the bond market more than a little concerned, as the Fed has been operating under the assumption that the greater risk is to deflation rather than inflation. The main culprit in the increase was housing. Home prices have been rising as interest rates have fallen. Beyond that, the inflation data were benign.

A Washington Post article turned the bond market around on Thursday, as it implied that the Fed would cut rates by 50 basis points. Industrial production data, which saw only a +0.1% increase in May, certainly gives no great reason to believe that the economy is on a positive track. The Philadelphia Fed Index came in a bit above early expectations, but even though it jumped to 4.0 from -4.8 in May, rumor of a jump to as high as 25.0, in the end, led to a substantially weaker stock market.

Next week sees three important data items. Consumer confidence, due at 10AM on Tuesday, is forecast to slip a bit from its recent 83.8 reading (which was a surprise on the downside when it came out). Durable goods orders are expected to have risen about +1.0% in May from April's -2.3% drop. Given the decent ISM (Institute for Supply Management, which tracks both manufacturing and service sector data) numbers last month, I suspect the risk is to a slightly higher result. GDP (Gross Domestic Product) is also due out, but as the final revision to Q2, the data should be largely ignored.

The main event next week will be the Fed's rate decision, which is due on Wednesday. This is the Fed's semi-annual two-day meeting. Last week saw huge swings in sentiment between a 25 basis point (1/4%) and a 50 basis point (1/2%) cut in the Fed Funds rate from its current 1.25% level. The Fed fund futures put the probability of a 50 basis point cut at 52%. The futures have not been wrong in a couple of years, but I honestly (despite the newspaper article) do not expect the Fed to lower interest rates by a full 50 basis points this time around. Equity investors are likely to be disappointed

by anything other than a 50 basis point cut, so that should be enough cause a brief market correction. However, it will not be enough to put a top on this market.

WHERE DO WE GO FROM HERE?

I show risk of a turn in the stock market for this week starting on Thursday, June 26th. Various incarnations of the Bradley Model (astrologically based) also forecast a turn this week or next. Additionally, a well-regarded neural net has a turn scheduled for this week or next.

Of course, the consolidation that we've been seeing over the past week or two muddles the exact meaning of the upcoming turn. If prices turn higher early in the week, and especially if most averages move to new highs, then I would assume that the upcoming turn would be to lower prices. However, if prices remain in a sideways to lower pattern, then I would have to assume that the trend to higher prices will continue.

Where do I think the market is headed? Well, a number of key sectors remain overbought (the technology-heavy Nasdaq 100 Trust (QQQ), for example, has gained more than +24% year to date) and the summer is usually a bad time of the year for stocks. And given the valuation levels we're at right now, there is far more downside risk in the market than upside risk.

I am not convinced that stocks will experience a full-fledged collapse, but a deeper correction is likely. Overall, I expect a 5-10% fall for the broad market, and possibly more for the Nasdaq. I suspect the Nasdaq has seen its peak for now, although the S&P and Dow might make a small new high by Thursday. Look for lower prices into month-end or even into July. But, I doubt that we've seen the end of this bull move. A more likely topping timeframe is mid-August to early September.

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(2.) WEEKLY ETF PERFORMANCE

Below you'll find a table of weekly performance data for all ETFs that I track for this newsletter...

<u>Name (Ticker Symbol)</u>	<u>Open</u>	<u>High</u>	<u>Low</u>	<u>Last</u>	<u>Change</u>	<u>% Change</u>
<u>Major Indices</u>						
Dow Diamonds (DIA)	91.98	93.95	91.80	91.84	0.26	0.3%
S&P 500 SPDR (SPY)	99.96	102.17	99.42	99.44	-0.12	-0.1%
Nasdaq-100 Index (QQQ)	30.17	31.24	30.00	30.38	0.42	1.4%
Russell 2000 iShares (IWM)	90.20	91.84	89.25	89.27	-0.37	-0.4%
S&P 400 Mid-Cap (MDY)	89.15	90.49	88.32	88.40	-0.21	-0.2%

International Indices

Japan Webs (EWJ)	7.17	7.34	7.15	7.31	0.12	1.7%
Canada Webs (EWC)	12.00	12.19	11.75	11.80	-0.08	-0.7%

Fixed Income Indices

1-3 Year Lehman U.S. Govt. Bond iShares (SHY)	82.93	82.94	82.71	82.80	-0.15	-0.2%
7-10 Year Lehman U.S. Govt. Bond iShares (IEF)	90.80	90.80	88.85	89.12	-1.51	-1.7%
20+ Year Lehman U.S. Govt. Bond iShares (TLT)	97.50	97.66	93.03	93.75	-3.43	-3.5%
iShares GS \$ InvesTopTM Corporate Bond Fund	117.90	117.96	115.15	115.25	-2.23	-1.9%

Other Equity Index Based ETFs

Russell 1000 Value (IWD)	52.00	52.80	51.40	51.67	0.19	0.4%
Russell 2000 Growth (IWO)	47.92	49.15	47.55	47.89	0.13	0.3%

Sector-based ETFs

Biotech HOLDR (BBH)	128.30	132.30	123.26	125.89	-1.36	-1.1%
Nasdaq Biotech iShares (IBB)	74.20	75.36	66.35	67.77	-5.34	-7.3%
Energy SPDR (XLE)	25.00	25.00	24.39	24.45	-0.49	-2.0%
Financial SPDR (XLF)	25.45	26.25	24.98	25.05	-0.29	-1.1%
Oil Service HOLDR (OIH)	63.15	63.15	60.35	61.72	-1.63	-2.6%
Pharmaceutical HOLDR (PPH)	80.95	85.99	80.95	83.80	3.58	4.5%
Retail HOLDR (RTH)	81.10	82.85	80.75	81.10	0.61	0.8%
Semiconductor HOLDR (SMH)	28.65	30.04	28.20	28.90	0.40	1.4%
Software HOLDR (SWH)	33.00	33.79	32.48	32.79	0.40	1.2%
Technology SPDR (XLK)	17.19	17.90	17.05	17.52	0.52	3.1%

(3.) ETF RELATIVE STRENGTH MONITOR

(Note: If you're a first-time reader or you are otherwise unfamiliar with our proprietary **ETF Relative Strength Monitor**, then please [click here](#) for a brief description.)

A couple of weeks back I tried to buy the Pharmaceutical HOLDRs (PPH, \$83.80), but missed the execution by a small amount. After trailing the markets for months, PPH has moved to the top of our rankings, gaining +4.46% last week (remember -- a reading of "23" means the fund has the highest relative strength out of all the funds we track for this newsletter). My ranking is heavily weighted to recent performance, and with a +10.73% gain over the past four weeks, PPH ranks highly there as well (the Biotech funds had shown much better numbers until the past couple of weeks). PPH actually treaded water before that, and sits towards the middle of the pack over the past 13 weeks, with a +10.34% gain.

The move by PPH to the top of the rankings may herald a shift in market thinking toward defensive issues. The sharp losses seen in the Nasdaq Biotech iShares (IBB, \$67.77) last week may also be a

warning of impending trouble. However, the tech sector remains strong, so there is no clear shift out of high-risk issues. Also, the Energy SPDR (XLE, \$24.45) is still bringing up the rear, which I would not typically expect in a bear market. That said, if deflation (a period of declining prices) takes hold in the U.S., then XLE might not act very well, as oil prices would likely tumble.

Not a single one of the funds we track for this newsletter is showing a loss over the past 13 weeks. The worst performer has been the Dow Diamonds (DIA, \$91.84), which is ahead +7.88% during that time and is in the middle of our relative strength rankings.

Meanwhile, fixed-income issues moved back to hold four of the bottom six positions in our rankings. All were losers, with the 20+ Year Lehman U.S. Govt. Bond iShares (TLT, \$93.75) losses only exceeded by IBB. Even the 1-3 Year Lehman U.S. Govt. Bond iShares (SHY, \$82.80) edged lower.

Here is this week's *ETF Relative Strength Monitor*...

<u>Name (Ticker Symbol)</u>	<u>1-week return</u>	<u>4-week return</u>	<u>13-week return</u>	<u>ETF Relative Strength Rank</u>	<u>Change from Last Week</u>	<u>4-week Average Rank</u>
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Major Indices

Dow Diamonds (DIA)	0.28%	6.51%	7.88%	12	-6	11.50
S&P 500 SPDR (SPY)	-0.12%	6.06%	10.90%	11	-1	10.50
Nasdaq-100 Index (QQQ)	1.40%	8.10%	11.79%	19	15	12.25
Russell 2000 iShares (IWM)	-0.41%	7.04%	19.39%	14	0	16.75
S&P 400 Mid-Cap (MDY)	-0.24%	6.01%	14.14%	10	-8	13.50

International Indices

Japan Webs (EWJ)	1.67%	7.50%	8.94%	19	-3	14.00
Canada Webs (EWC)	-0.67%	4.52%	17.53%	9	-7	13.75

Fixed Income Indices

1-3 Year Lehman U.S. Govt. Bond iShares (SHY)	-0.18%	0.17%	0.95%	6	3	3.25
7-10 Year Lehman U.S. Govt. Bond iShares (IEF)	-1.67%	-0.09%	5.38%	4	-7	5.25
20+ Year Lehman U.S. Govt. Bond iShares (TLT)	-3.53%	-2.19%	8.95%	1	-17	7.00
iShares GS \$ InvesTopTM Corporate Bond Fund (LQD)	-1.90%	-0.24%	7.07%	2	-12	5.75

Other Equity Index Based ETFs

Russell 1000 Value (IWD)	0.37%	5.66%	12.99%	13	4	11.25
Russell 2000 Growth (IWO)	0.27%	7.86%	19.90%	18	10	15.50

Sector-based ETFs

Biotech HOLDR (BBH)	-1.07%	9.28%	32.25%	15	-8	20.00
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Nasdaq Biotech iShares (IBB)	-7.30%	6.41%	29.95%	7	-14	18.50
Energy SPDR (XLE)	-1.96%	1.37%	9.25%	5	-12	9.75
Financial SPDR (XLF)	-1.14%	6.10%	13.25%	8	-4	12.75
Oil Service HOLDR (OIH)	-2.57%	-2.77%	11.59%	2	-8	7.50
Pharmaceutical HOLDR (PPH)	4.46%	10.73%	10.34%	23	16	11.50
Retail HOLDR (RTH)	0.76%	6.92%	9.30%	15	10	10.50
Semiconductor HOLDR (SMH)	1.40%	6.56%	9.64%	17	16	14.25
Software HOLDR (SWH)	1.23%	9.85%	18.76%	21	15	16.25
Technology SPDR (XLK)	3.06%	8.55%	12.81%	22	20	10.75

(4.) MODEL ETF PORTFOLIO

	S&P 500	Model Portfolio
Last Week	+0.75%	+2.55%
Since Inception	+5.59%	+6.50%

Our second consecutive week of outperformance has propelled our Model ETF Portfolio ahead of the S&P 500. ***Our portfolio has now gained +6.50% in one month's time. We've achieved this performance during a time when the S&P has risen substantially, even though we have had more than one short position and a partially hedged long.*** IBB, for example, tumbled -7.30% last week and has fallen -9.55% since we sold it a bit more than a week ago.

As you may recall, we had a core long position in the Dow Diamonds (DIA, \$91.84), but had sold June 88 calls against the position. We were called on that trade last week. This gave us a +1.9% total return for the period, which unfortunately is less than we would have achieved with an unhedged position.

I am prepared to increase our short positions again, if the market warrants it. However, at this moment, I do not have a clear signal for a major drop. For the time being, I need to give the larger bullish trend the benefit of the doubt. With IBB showing potential down to \$65.56 to \$63.27, I am loath to close the position. However, if prices continue lower this week, then I will take profits on the trade since the pattern, despite the weekly reversal, still looks like a classic fourth-wave correction (which means a higher high is still due).



This week's instructions are:

- Buy back 50 shares (1/2 position) of IBB on a fall to or below \$65.56.
- Maintain IBB stops at \$79.10.
- Buy 100 shares 20+ Year U.S. Govt. Bond iShares (TLT, \$93.75) at the open on Monday. Set a stop at \$92.40. (For a further discussion of this trade, please see our "[Trade of the Week](#)" below.)
- Buy 100 shares S&P 500 SPDR (SPY, \$99.44) at the open on Monday to reinstate a core long position. If the market rallies into Wednesday or Thursday, then I will probably issue a flash to exit and move to cash, bonds and short positions only.

Performance Since Inception

ETF Name	Sym	Shares	Entered	Entry Price	Begin Value	Current Price	Current Value	Div	Chg	%Chg
Nasdaq Biotech iShares	IBB	-100	12-Jun	\$74.88	-\$7,488	\$67.77	-\$6,777	\$0	\$711	9.50%
Money Market							\$28,072	\$6		
Portfolio Totals			19-May		\$20,000		\$21,295	\$6	\$1,301	6.50%

S&P 500 Index	SPX	21	19-May	944.30	\$20,000	995.73	\$21,089	\$28	\$1,117	5.59%
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Weekly Performance

ETF Name	Sym	Shares	Entered	Entry Price	Begin Value	Current Price	Current Value	Div	Chg	%Chg
Dow Diamonds	DIA	100	19-May	\$91.58	\$9,158	\$88.00	\$8,800	\$0	-\$358	-3.91%
Nasdaq Biotech iShares	IBB	-100	12-Jun	\$73.11	-\$7,311	\$67.77	-\$6,777	\$0	\$534	7.30%

DIA June 88 call	DAVFJ	-1	26-May	\$3.50	-\$350	\$0.00	\$0	\$350	100%	
Money Market					\$19,272		\$19,272	\$4		
Portfolio Totals			19-May		\$20,769		\$21,295	\$4	\$530	2.55%

S&P 500 Index	SPX	21	9-Jun	988.61	\$20,938	995.73	\$21,089	\$7	\$157	0.75%
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Positions Closed Last Week

	<u>Sym</u>	<u>Shares</u>	<u>Entered</u>	<u>Entry Price</u>	<u>Begin Value</u>	<u>Current Price</u>	<u>Current Value</u>	<u>Div</u>	<u>Chg</u>	<u>%Chg</u>
Dow Diamonds	DIA	100	19-May	\$86.99	\$8,699	\$88.00	\$8,800	\$0	\$101	1.16%
DIA June 88 call	DAVFJ	-1	26-May	\$0.65	-\$65.00	\$0.00	\$0	\$0	\$65.00	100%

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(5.) TRADE OF THE WEEK

BUY 100 SHARES 20+ YEAR LEHMAN U.S. GOVT. BOND ISHARES (TLT, \$93.75) AT THE OPEN ON MONDAY

The bond market got annihilated last week, but the pattern still calls for one more new high. This trade will likely take a couple of weeks to develop, but you should also receive a dividend in that time. For the bond market, we are definitely oversold and the 0-2 trendline is still holding (and is where my stop level comes from). My only concern is that yields have already hit near record lows and that there is a momentum divergence (*you can read all about divergences in our "Special Educational Section" below*) where I have placed the label for wave-3. Optimal counts usually have a momentum confirmation. However, if stocks weaken to start the week, then I might close this position early, if the gains in TLT look corrective. But if stocks enter a correction, as I expect, then with the Fed seen cutting rates, the bond market will rally (even if they go less than 50 basis points).



You should buy TLT this week because:

- TLT is short-term oversold.
- Elliott Wave counts suggest one more leg higher.
- Stock market expected to turn lower.
- Fed expected to ease again.

RECOMMENDATION:

BUY 100 SHARES TLT AT THE OPEN ON MONDAY

TARGET: \$97.67

STOP: \$92.40

Assuming a purchase at \$93.75 (Friday's closing price) and sale at \$97.67, you would make \$392 from this trade, or +4.2%.

(6.) CONTINUED GUIDANCE ON PREVIOUS TRADES

SELL SHORT 300 SHARES OF THE ENERGY SPDR (XLE, \$24.45) ON A BOUNCE

DATE RECOMMENDED: 06/16/2003

DATE ENTERED: **CANCELLED**

Although XLE was one of the worst performing funds last week, it did not rally high enough to hit our entry target. If stocks turn lower next week, then there will be far more profitable shorts to enter into. Meanwhile, if the market accelerates higher, then I will jump on an oversold and reversing sector. Therefore, please cancel this recommendation.

(7.) ETF SPOTLIGHT

Starting with this week's report, I will provide summary information for each of the ETFs that we follow for this [ETF Authority](#) newsletter. My goal will be to better familiarize you with each ETF that we follow and to give you an idea of where I think each fund is headed in the coming months. I will also offer this information for important new ETF offerings as they become available in the future, so please stay tuned for that analysis.

I hope you find this information useful in the course of your trading!

NASDAQ-100 TRUST (QQQ)

Affectionately known as the "Q's" or "Cubes" due to its unusual ticker symbol (which consists of three "Q's"), the Nasdaq-100 Trust is probably the best-known Exchange Traded Fund (ETF) in existence. QQQ has been around since March 1999, and is now the most heavily traded stock in the United States. Although its average daily volume is near 72 million shares, that figure is down substantially from more than 80 million in 2002. And, the monetary value of shares traded is down even more when you consider that QQQ once traded as high as \$120.50!

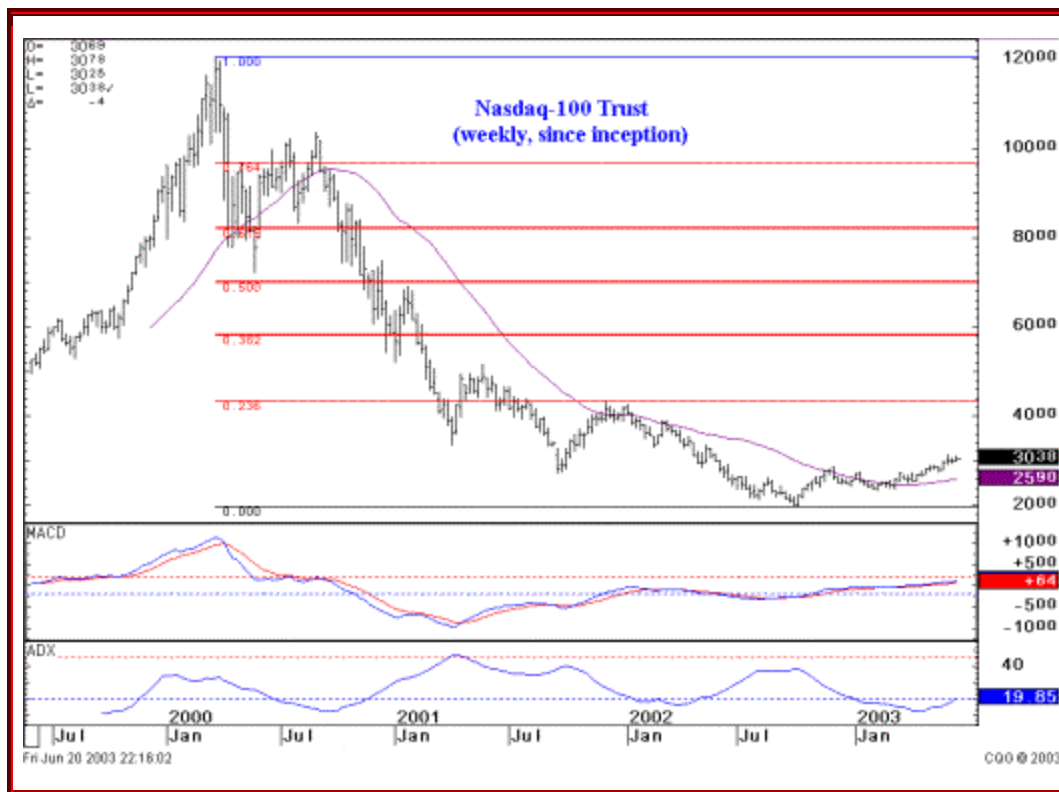
The Nasdaq-100 Trust ETF tracks the Nasdaq-100 Trust Index, which consists of 100 of the largest companies traded on the Nasdaq stock exchange. The largest holding in the fund is Microsoft Corp. (MSFT, \$26.33), which made up more than 11% of the fund's value as of March 31, 2003. The fund's five largest holdings accounted for greater than 29% of QQQ's value at that time.

Because QQQ's value is based on the Nasdaq market, which is technology heavy, the fund trades very much like a portfolio of technology issues. However, in late 2002 the Nasdaq altered some of the members of the trust, making it less reliant on technology issues. Even so, it remains strongly correlated with the technology sector. Its volatility has declined somewhat, however, as its average daily price range is more than 1% below where it was in 2002.

This ETF is so liquid that, if you use a direct access broker and trade through the [ECNs](#) (Electronic Communications Networks), it is not at all uncommon for the fund to have a higher bid price on one ECN than its offer on another. This is known as a "[crossed market](#)." The S&P 500 SPDR (SPY, \$99.44) also trades crossed on a regular basis.

QQQ is fairly volatile. It is a favorite of daytraders, both because of its excellent liquidity as well as its fairly wide daily trading range. While it may pale in comparison to individual stocks, its average daily range of more than 2%, and its deep market means that daytraders can easily enter and exit trades with minimal [slippage](#).

[The ETF Authority](#) seeks steady weekly returns for its readers. We do not make daytrading recommendations. However, as you can see from the chart below, QQQ has certainly trended well over the years. It is ahead by more than +20% year to date, despite falling more than -3% from its high set on June 6, 2003.



QQQ is far more volatile than its more staid cousins -- the Dow Diamonds (DIA, \$91.84) and the S&P 500 SPDRs (SPY, \$99.44). It makes an excellent choice if you're looking to raise the risk profile of your portfolio.

AN IN-DEPTH LOOK AT THE NUMBERS

Nasdaq-100 Trust (QQQ)

Type: Broad market index (Nasdaq-100)
Similar funds: Technology SPDR (XLK)
 Software HOLDR (SWH)
 Semiconductor HOLDR (SMH)
Options?: Yes, liquid

Performance Data

YTD High:	\$31.47	6/6/03	Annualized return since:	
YTD Low:	\$23.32	2/13/03	One-year	14.51%
YTD Return:	24.33%	As of close 6/20/2003	Three-year	-32.30%
			Five-year	N/A
Dividends:	None		Life of fund	-11.50%

Correlation Data*	(1/1/02-5/31/03)	Holdings	(as of 3/31/2003)
Dow Jones Industrials	80.1%	Microsoft Corp (MSFT)	11.34%
S&P 500	85.5%	Intel Corp (INTC)	4.74%
Nasdaq Composite	96.7%	Amgen Inc (AMGN)	4.41%
Nasdaq-100	97.9%	QUALCOMM (QCOM)	4.36%
		Cisco Systems (CSCO)	4.19%
XLK	95.1%	Comcast Corp (CMCSK)	3.45%
SMH	90.7%	Dell Computer (DELL)	3.30%
SWH	90.4%	Oracle (ORCL)	3.03%
		E-Bay (EBAY)	2.50%
		Maxim Integrated Prod (MXIM)	2.08%

Average Daily Volume

May-03	72,652,776
2003 YTD	71,831,610
2002	88,978,836

Average Daily Price Range

May-03	2.1%
2003 YTD	2.6%
2002	3.7%

* - Correlation measures how closely the two items track each other

HOW TO MAKE MONEY IN QQQ THIS YEAR

The current situation is guardedly positive. The trend indicators show that we are in the middle stages of a bear market rally (more or less a miniature bull market). While a correction is more than overdue, and losses of another 10% from mid-June levels seem possible, with the 40-week moving average still increasing and MACD (weekly) in a clear buy signal, there is little reason to expect a return of the bear market quite yet.

However, my long-term outlook remains negative for QQQ and the U.S. stock market in general. QQQ will likely hit substantial resistance in the low- to middle-\$30s and new lows are possible in the year ahead. Prices may rise, in general, until mid-August 2003, but I expect the bear market to resume at that time.

For the time being, we are likely in a short-term corrective swing lower, but unless losses accelerate, I would use these dips to build longs for the first half of the summer at least.

(8.) SPECIAL EDUCATIONAL BONUS

Regular readers of this report often see me mention that a trend looks tired as evidenced by a momentum divergence. In this week's recommended purchase of TLT, I expressed some concern due to the fact that the recent high occurred with a divergence.

WHAT IS A DIVERGENCE?

A divergence occurs when two or more items: indices, prices, momentum, etc..., fail to confirm one another. In Dow Theory, you start to worry about a rally if the Industrials make a new high, but the Transports do not. Another form of divergence might be a new price high, but on lower volume.

When I refer to divergence, I usually mean that although prices made a new high (low), momentum did not also manage a new high (low).

WHAT ABOUT MOMENTUM?

Of course, you need to understand momentum. Momentum is simply the speed with which prices are rising or falling. One common measure of price momentum is the Relative Strength Index (RSI), developed by Welles Wilder. A simple measure of momentum would be a rolling rate of change going back 14 days. I usually use RSI since it is bounded by zero and 100.

WHAT IS THE DIVERGENCE SHOWING ME?

Funny you should ask. I will use a recent example to highlight what I am talking about. Look at the chart of the Software HOLDR (SWH, \$32.79) (see below). It shows prices from late-2001 until the current time period. Note how SWH made a fairly substantial new low in October 2002, but how momentum, as measured by RSI, did not even come close to its prior nadir. This means that although prices fell to a new low, in the last leg down, the sellers were not as aggressive as they were the first time down. This *can* be an early warning sign of a reversal in the trend. Note also that there is currently a very tiny divergence on the chart. SWH made a new closing high, but momentum is below where it stood two weeks ago.



SO, IS THIS THE HOLY GRAIL?

If it were, then I'd at least ask you to extend your subscription before I sent it to you! The truth of the matter is that no technical indicator works every time. Look again at the SWH chart. Prices made three new weekly closing lows before turning higher, and the losses were substantial. A momentum divergence is merely a warning. You still need to get real trend-changing action before acting, but divergences should certainly get your antennae up!

You can avoid trouble by not trying to anticipate the change in trend. Also, I have often found that if you draw a trendline against the supposed divergence, and if that trendline breaks, then there is a good chance that momentum will ultimately confirm, thus removing your signal.

Also, it's worth noting that divergences can last a very long time. The S&P 500's momentum peak occurred in June 1996 at 670.63, yet the index topped at 1552.87 nearly five years later!

Thanks again for reading this week's issue, and good trading in the week ahead!



A handwritten signature in blue ink that reads "Steve W. Poser".

Steven Poser

Editor

[The ETF Authority](#)

New York, NY

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