



The ETF Authority

The ETF Authority for Monday, July 7th, 2003

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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

The stock market edged higher in a generally strong performance this past week. Only the two energy-related ETFs, plus the Pharmaceutical HOLDR (PPH, \$81.42), lost ground. Our trade of the week was to short PPH, but unfortunately, this ETF did not rise enough for us to get our short trade executed.

Did the Bradley Model Work?

You may recall that I mentioned an astrologically-based model, developed by the late Donald Bradley, recently. It is known as the Bradley Model. This model forecast a turning point in the U.S. stock market for last Wednesday, July 2nd. While prices did reach a short-term high on that day, we missed the mid-June peak by greater than 1%. However, it was a good short-term test and may represent at least a short-term turning point.

The Technicals

Stocks briefly traded above the key short-term 20-day moving average on Wednesday, but closed below it on Thursday. Volume has not been as strong in the recent rally as it had been when equities peaked in mid-June. These are two minor negatives. However, I do not have any sign that we are in anything more than a consolidation or a correction in the midst of an intermediate-term uptrend. And,

any move on high volume above the 995 level for the S&P 500 would suggest that equity prices are likely to move back to, and probably past, their highs for the year.

Seasonal Patterns

The stock market has tended to act fairly well, at least for the first part of July. The summer months -- or in actuality, the period from May through October -- are usually negative. However, we always see brief market rallies in that time span, and this July has been no exception to that general rule. Last year the market surged at the end of the month. If prices rally into options expiration (July 18th), then I would start worrying about a larger fall beginning at that time. For now, however, there is no sign of major trouble.

The Bottom Line

The trend is your friend. The medium-term trend is up. The short-term trend is sideways. With prices in the middle of the range in place since mid-June, large bets do not make sense here. However, I would be willing to chase the market higher on a move above 995 on the S&P 500, and would sell if prices accelerate lower on strong volume below last week's lows. I lean slightly to the latter idea, which is why I am going to keep my sell recommendation on the Pharmaceutical HOLDR active. PPH has been the worst-performing equity-related ETF on my radar screen over the past 13 weeks.

THE WEEK IN REVIEW

The holiday-shortened week (the markets were closed on Friday, July 4th in observance of the Independence Day holiday in the U.S.) was not without some fireworks. Stocks fell into the morning of Tuesday, July 1st, and then catapulted higher, surging nearly +3% from their lows at one point by the close on Thursday. News was sparse, though the economic data were mixed and corporate announcements seemed to be mostly positive. More and more analysts seem to be getting bullish, and sentiment is clearly very positive right now. This raises the risks for those investors looking to initiate new long positions, at least in the short term (please see our [educational section](#) on sentiment below). However, economists are starting to raise their growth forecasts for the U.S. economy. If this becomes a trend, then it is likely to alter the public's thinking (even though I am confident they will be proven wrong). If that thinking takes hold, then any losses now will be limited, and new market highs would be likely in the very near term. However, as I've mentioned numerous times in recent issues, I ultimately expect the market to reverse course and head down to new lows later this summer.

ECONOMIC ANALYSIS

The economic data last week were mixed, at best. In fact, given the data, the stock market had an excellent time of it. Vehicle sales rose more than expected with the help of improved incentives. The Chicago Purchasing Managers Report, which measures manufacturing activity in the Midwest, was stronger than forecast. However, the National version, known as the ISM (Institute for Supply Management), came in below expectations. The market was expecting a move above 50, which signifies expansion in manufacturing, but it fell short at 49.8 -- a fractional improvement when compared with May's 49.4 result.

The monthly payroll report came out weaker than expected as well. Non-farm payrolls tumbled 30,000 -- well below expectations for a flat to slightly down result. The unemployment rate jumped as well, reaching 6.4%. About the only positive was the jump in temporary workers, which may be a precursor to future hiring.

The ISM did release a bit of good news. Services (things like restaurants and consultants) data improved, reaching an index level of 60.6 from 54.5. That shows strong expansion.

Next week will be an extremely quiet one on the economic front. Weekly unemployment claims, as always, are due out on Thursday. They remained at disturbingly high levels last week (430,000). Producer prices (in essence, prices that manufacturers pay, as opposed to what you and I pay) will be released on Friday. The forecast is for a gain of +0.2%, with prices excluding food and energy seen increasing +0.1%. In other words, inflation is still a non-factor.

WHERE DO WE GO FROM HERE?

Many market pundits are looking for the market to continue to consolidate in the weeks ahead. However, I doubt the market has seen its highs quite yet. While a fast drop would have me exit long positions in our "[Model ETF Portfolio](#)", I would not be aggressively short unless volume really picks up. In the end, I expect the market to trend higher this week. A move above 995 for the S&P 500 would likely mean a new high within a week. A drop beneath last week's 962.10 low would probably signal a test at least back down to the old bear market down trendline, which is now in the 930's.

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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)	90.37	91.68	88.85	90.70	0.83	0.9%
S&P 500 SPDR (SPY)	98.22	99.80	96.43	98.74	1.08	1.1%
Nasdaq-100 Index (QQQ)	30.16	31.10	29.26	30.58	0.75	2.5%
Russell 2000 iShares (IWM)	89.69	91.75	87.75	90.96	1.78	2.0%
S&P 400 Mid-Cap (MDY)	88.64	89.80	86.75	89.11	1.03	1.2%
<u>International Indices</u>						
Japan Webs (EWJ)	7.28	7.85	7.24	7.75	0.51	7.0%
Canada Webs (EWC)	11.60	11.98	11.59	11.91	0.31	2.7%
<u>Fixed Income Indices</u>						
1-3 Year Lehman U.S. Govt. Bond iShares (SHY)	82.59	82.72	82.51	82.56	-0.08	-0.1%
7-10 Year Lehman U.S. Govt. Bond iShares (IEF)	88.23	88.55	87.49	87.55	-0.69	-0.8%
20+ Year Lehman U.S. Govt. Bond iShares (TLT)	91.92	92.52	90.60	90.60	-1.47	-1.6%
iShares GS \$ InvesTopTM Corporate Bond Fund	114.50	114.63	112.87	113.05	-1.05	-0.9%

Other Equity Index Based ETFs

Russell 1000 Value (IWD)	51.12	51.73	50.01	51.28	0.73	1.4%
Russell 2000 Growth (IWO)	48.35	49.19	46.70	48.67	0.89	1.9%

Sector-based ETFs

Biotech HOLDR (BBH)	124.50	126.58	120.40	125.15	0.95	0.8%
Nasdaq Biotech iShares (IBB)	67.61	69.19	65.10	68.40	0.56	0.8%
Energy SPDR (XLE)	24.30	24.33	23.68	23.96	-0.24	-1.0%
Financial SPDR (XLF)	24.65	25.21	24.29	25.03	0.39	1.6%
Oil Service HOLDR (OIH)	61.15	61.35	58.85	60.15	-0.60	-1.0%
Pharmaceutical HOLDR (PPH)	81.92	82.23	79.44	81.42	-0.01	0.0%
Retail HOLDR (RTH)	81.50	82.20	79.85	81.45	0.67	0.8%
Semiconductor HOLDR (SMH)	28.85	29.79	27.65	29.24	0.89	3.1%
Software HOLDR (SWH)	32.25	32.88	31.03	32.22	0.37	1.2%
Technology SPDR (XLK)	17.22	17.74	16.77	17.46	0.34	2.0%

(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.)

If there's one consistent story recently, it has been the incredibly poor performance of the oil patch. The Oil Service HOLDR (OIH, \$60.15) has the lowest relative strength rating of any non-bond-market ETF we follow, and its -4.57% loss over the past four weeks is worse than any on our list with the exception of the Nasdaq Biotech iShares (IBB, \$68.40). The difference between these two funds, of course, is that IBB has gained +28.96% over the past 13 weeks, which ranks it tops on our list, while OIH has gained just +10.21%, which ranks it near the bottom of our tracked funds. With OIH nearing important support, it may be time to think about picking up a bit of this ETF.

The technology sector rallied nicely last week (excluding software, that is). Semiconductor HOLDERS (SMH, \$29.24) jumped +3.10%, ranking this fund number two on our hit parade. Also rising more than +2.00% were the Canada WEBS (EWC, \$11.91), which rallied +2.67%, and the Japan WEBS (EWJ, \$7.75), which rocketed +7.04%. (You can view our analysis of EWJ in our "[ETF Spotlight](#)" section below.)

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)	0.92%	-0.19%	9.49%	8	-1	11.75
S&P 500 SPDR (SPY)	1.11%	-0.52%	11.92%	10	-3	11.50
Nasdaq-100 Index (QQQ)	2.51%	1.49%	17.39%	22	17	12.50
Russell 2000 iShares (IWM)	2.00%	0.62%	22.04%	21	-2	18.00
S&P 400 Mid-Cap (MDY)	1.17%	0.52%	16.33%	16	-3	15.25

International Indices

Japan Webs (EWJ)	7.04%	9.62%	19.23%	23	5	20.25
Canada Webs (EWC)	2.67%	0.17%	19.70%	18	3	14.25

Fixed Income Indices

1-3 Year Lehman U.S. Govt. Bond iShares (SHY)	-0.10%	-0.16%	0.32%	6	-10	7.75
7-10 Year Lehman U.S. Govt. Bond iShares (IEF)	-0.78%	-1.79%	2.34%	5	-7	8.00
20+ Year Lehman U.S. Govt. Bond iShares (TLT)	-1.60%	-3.76%	4.08%	1	0	5.25
iShares GS \$ InvesTopTM Corporate Bond Fund (LQD)	-0.92%	-2.16%	3.26%	4	-4	7.00

Other Equity Index Based ETFs

Russell 1000 Value (IWD)	1.44%	-0.91%	14.34%	14	10	10.00
Russell 2000 Growth (IWO)	1.86%	0.87%	22.59%	18	-4	16.50

Sector-based ETFs

Biotech HOLDR (BBH)	0.76%	-0.63%	28.76%	9	-8	16.00
Nasdaq Biotech iShares (IBB)	0.83%	-6.20%	28.96%	7	-14	13.75
Energy SPDR (XLE)	-0.99%	-3.27%	7.01%	3	-8	9.00
Financial SPDR (XLF)	1.58%	-1.53%	13.82%	14	0	12.00
Oil Service HOLDR (OIH)	-0.99%	-4.57%	10.21%	2	-1	4.25
Pharmaceutical HOLDR (PPH)	-0.01%	2.00%	6.08%	10	1	12.00
Retail HOLDR (RTH)	0.83%	0.46%	10.22%	12	-8	13.00
Semiconductor HOLDR (SMH)	3.10%	-4.13%	19.88%	17	15	9.25
Software HOLDR (SWH)	1.16%	-1.59%	21.31%	13	7	11.50
Technology SPDR (XLK)	1.99%	1.51%	17.34%	18	11	11.75

(4.) MODEL ETF PORTFOLIO

S&P 500 Model Portfolio

Last Week	+1.00%	+0.34%
Since Inception	+4.59%	+5.79%

The stock market beat us last week, as the sharp drop on Tuesday morning forced us out of half of the long position we held in the S&P 500 SPDR (SPY, \$98.74). We managed to buy IBB at a fairly low level however, when we reversed at the open on Monday. That was quite a good move. For next week, I am going to buy 100 shares of OIH if it dips a bit more. In addition, I'm going to short 700 shares of EWJ.

This week's instructions are:

- Keep the stop loss on IBB at \$64.65.
- Buy 100 shares of OIH at \$58.50. Place at stop at \$56.20.
- Sell short 700 shares of EWJ at the open on Monday, July 7th, but do not sell at any price lower than \$7.50. You can short on a rally above \$7.50 during the day. Place stops at \$8.10.

MODEL ETF PORTFOLIO

PERFORMANCE SINCE INCEPTION

ETF Name	Sym	Shares	Entered	Entry Price	Begin Value	Current Price	Current Value	Div	Chg	%Chg
S&P 500 SPDR	SPY	50	23-Jun	\$99.45	\$4,973	\$98.74	\$4,937	\$0	-\$36	-0.71%
Nasdaq Biotech iShares	IBB	50	19-Jun	\$67.61	\$3,381	\$68.40	\$3,420	\$0	\$40	1.17%
Money Market Deposit					\$9,768		\$12,794	\$7		
Portfolio Totals			19-May		\$20,000		\$21,151	\$7	\$1,158	5.79%

S&P 500 Index	SPX	21	19-May	944.30	\$20,000	985.70	\$20,877	\$40	\$917	4.59%
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WEEKLY PERFORMANCE

ETF Name	Sym	Shares	Entered	Entry Price	Begin Value	Current Price	Current Value	Div	Chg	%Chg
S&P 500 SPDR	SPY	50	23-Jun	\$97.66	\$4,883	\$98.74	\$4,937	\$0	\$54	1.11%
Nasdaq Biotech iShares	IBB	50	19-Jun	\$67.61	\$3,381	\$68.40	\$3,420	\$0	\$40	1.17%
Money Market Deposit					\$8,745		\$12,794	\$2		
Portfolio Totals			20-Jun		\$21,081		\$21,151	\$2	\$72	0.34%

S&P 500 Index	SPX	21	20-Jun	976.22	\$20,676	985.70	\$20,877	\$7	\$207	1.00%
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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>
Nasdaq Biotech iShares	IBB	-50	12-Jun	\$74.88	-\$3,744	\$67.61	-\$3,381	\$0	\$364	9.71%
S&P 500 SPDR	SPY	50	23-Jun	\$99.45	\$4,973	\$96.96	\$4,848	\$0	-\$125	-2.50%

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(5.) TRADE OF THE WEEK

SELL SHORT 500 SHARES JAPAN iSHARES MSCI WEBS (EWJ, \$7.75)

We have analyzed EWJ in several other sections of today's newsletter, including our "[Model ETF Portfolio](#)" section above, as well as our "[ETF Spotlight](#)" section below. However, here is a quick summary of why I'd like to short EWJ at this juncture:

- The fund is hugely overbought, with small divergence in stochastics.
- When it comes to Elliott Wave theory, the fund has completed five waves from its lows. This is even clearer in the Nikkei-225 Index itself.
- The Average Directional Index (ADX) is extended. (See our educational supplement in our June 16th issue for more information on this technical indicator.)
- Rejected at neckline.

RECOMMENDATION:

SELL SHORT 500 SHARES OF EWJ AT THE OPEN ON MONDAY, JULY 7TH, LIMIT \$7.50. YOU MAY SHORT IT ON A MOVE BACK ABOVE \$7.50.

TARGET: \$7.20

STOP: \$8.10

Assuming a sale at Thursday's \$7.75 close and a purchase at our \$7.20 target, you would make \$275 from this trade, or +7.1%.

(6.) CONTINUED GUIDANCE ON PREVIOUS TRADES

SELL SHORT 100 SHARES PHARMACEUTICAL HOLDR (PPH, \$81.42) ON A BOUNCE, AND AT THE SAME TIME BUY 20 SHARES OF ELI LILLY (LLY, \$69.27)

(See revision below)

PPH remains a weak performer, as it lost ground last week. I wouldn't be surprised to see the fund bounce slightly higher from these levels, but I still wish to short it. **However, LLY gained ground last week and is near a breakout. I doubt that it will be able to gain traction above its \$71.40 high, and after a surge it is possible, there would be substantial downside risk the re. Therefore, limit purchases of LLY and buy only if LLY can be had for less than \$71.12.**



RECOMMENDATION:

**SELL SHORT 100 SHARES OF PPH AT \$83.78, LIMIT \$84.15.
BUY 20 SHARES OF LLY AT THE SAME TIME (MEANING WHEN THE PPH SHORT IS EXECUTED) AT THE PREVAILING MARKET PRICE, BUT ONLY IF LLY IS AT OR BELOW \$71.12. IF LLY IS ABOVE THAT PRICE, THEN DO NOT BUY IT, EVEN IF IT LATER FALLS BELOW \$71.12.**

TARGET (PPH): \$79.18

STOP (PPH): \$86.00

Assuming a sale at \$83.78, and ignoring the effect from LLY, you will make \$460 from this trade, or +5.5%.

(7.) ETF SPOTLIGHT

We initiated this new section of the newsletter a few weeks ago, and since then I have told you all about the QQQs and the Biotech iShares (IBB). Another extremely popular fund is the iShares MSCI Japan Fund (EWJ). Because this fund owns stocks domiciled in Japan, there's a lot to learn here, so let's get started!

ISHARES MORGAN STANLEY CAPITAL INTERNATIONAL (MSCI) JAPAN FUND (EWJ)

Morgan Stanley's product line of international stock market indices – MSCI -- is well known among professional portfolio managers. In fact, the MSCI Japan Index is used by many as the benchmark against which they measure their performance. Morgan Stanley spends a lot of time perfecting the way they calculate their indices, which has allowed MSCI to take the lead in the indexing field from the Nikkei-225 Index and the TOPIX-150 Index in Japan. MSCI is broader (includes more stocks), so it is more representative of the overall Japanese stock market.

There are many important things you should know about EWJ. First of all, it is more expensive to trade in Japan than it is in the United States. Because of this, the expense ratio of the fund is much higher than that of most other ETFs. This means that the value of the fund will underperform the actual index by a greater amount than many other ETFs will. However, keep in mind that we are still talking about a difference of less than 1% per year.



Before you trade EWJ, you'll also want to understand a number of other key facts. Take a look at the two charts above. The chart on the LEFT is that of EWJ. Meanwhile, the chart on the RIGHT is of the

Nikkei-225 Index. Although they are quite similar, you'll notice a number of substantial differences between the two charts. There are three reasons why these two indices do not correlate perfectly:

1. They represent different stocks.
2. There are no expenses taken out of the Nikkei-225, but EWJ includes a 0.84% expense ratio.
3. The chart of the Nikkei-225 Index does not include the impact of the U.S. dollar exchange rate against the yen, but the chart for EWJ does.

We've already discussed the first two differences, but let's think about the third for a moment. If you own Japanese stocks, do you think it is good or bad for you for the U.S. dollar to be strong?

If you said bad, then you are correct. Why?

Imagine you buy 100 shares of Sony stock. Make believe, for a moment, that Sony's shares sell for 100 yen each. That means it will cost you 10,000 yen to buy those shares (100 times 100 is 10,000). Now, also make believe that you can buy 100 yen for \$1.00. That is the same thing as saying the U.S. dollar -- Japanese Yen exchange rate is 100. So, if you can buy 100 yen for a dollar, then it will cost you \$100 to buy your 100 shares of Sony (10,000 yen divided by 100 equals \$100).

Now, imagine that Sony's stock jumps 10% to 110 yen per share. That means that the stock is worth 11,000 yen. Pretty cool, huh? But wait a minute. Also consider what happens if everybody decides that the U.S. economy is going to do a lot better than the Japanese economy, and that the U.S. Treasury Secretary just said he wants to see the U.S. dollar go up in value. In this scenario, the exchange rate between the dollar and the yen might change substantially. In our example, let's say that you can now purchase 115 yen for one dollar.

If this were to take place, then when you convert your Sony shares back to dollars, you will get just \$1.00 for every 115 yen you now hold. In other words, you will get back $11,000/115$, or just \$95.65. What this means is that even though Sony's stock climbed +10%, you still lost -3.35% on your investment!

Of course, it can work the other way as well. If the dollar weakened to, say, 90 yen per dollar, then your same 100 shares would now be worth \$122.22, which would equate to a +22.22% gain.

What does all of this mean to you as an investor? Well, first of all, it means that if you decide to look at a chart of the Nikkei-225, you shouldn't expect it to look the same as a chart of EWJ. It also means that before you invest in EWJ, you need to do your analysis on that fund, on the Japanese stock market overall, and on the dollar/yen exchange rate. (As luck would have it, I do all of this for you in this weekly newsletter!)

A few additional notes. You may have noticed that many of the stocks shown as belonging to EWJ trade on the New York Stock Exchange. These are shares that represent the shares traded in Japan (American Depositary Receipts) in most cases, and they are directly affected by the exchange rates as well. You cannot get around the dollar's shifting value versus the yen.

Also, note that some of the companies are not widely traded in the United States (Tokyo Electric Power is one such firm). Although it makes up a sizable portion of the fund, it is only available via the Pink Sheets (many brokers don't even trade these illiquid stocks). The shares rarely ever trade in the U.S., and you might not be able to buy or sell odd lots either.

EWJ is also unique for another reason. Because the fund is really based on what happens in Japan, you have the rare opportunity to enter and exit trades based on trading that already occurred. You can do so by shifting your buy and sell points prior to the opening of the U.S. markets. If you are completely wrong in your assessment of EWJ and have not entered into a trade, then you will not get blindsided here, since you'll have a pretty good idea of where the stock will open. The flipside is that the real activity in EWJ essentially occurs while you are most likely fast asleep. Unless you want to trade the futures markets at night in another country, you will not be able to get into or out of a position in EWJ while the real action is happening.

iShares Morgan Stanley Capital International (MSCI) Japan (EWJ)

Type: International (Broad stock market index)

Similar funds: TOPIX-150 (ITF)

iShares MSCI Pacific ex-Japan (EPP)

Options?: Yes, liquid

Performance Data

YTD High:	\$7.85	7/2/03	Annualized return since:	
YTD Low:	\$6.19	4/28/03	One year ago	-8.07%
YTD Return:	4.60%	As of 7/4/03	Three years ago	-20.09%
Dividends:	None		Five years ago	-4.60%
			Life of fund	-9.48%

Correlation Data*

(1/1/02-6/30/03)

Dow Jones Industrials	61.1%
S&P 500	61.4%
Nasdaq Composite	60.2%
Nasdaq-100	59.5%
ITF (TOPIX-150)	75.8% *
EPP (Pacific ex-Japan)	52.4% **

* - correlation affected by illiquidity of ITF

** - EPP only available since 7/15/02

Holdings*

(as of 3/31/2003)

Toyota Motor Corp (TM)	4.92%
NTT DoCoMo Inc (DCM)	3.26%
Sony Corp (SNE)	2.92%
Takeda Chemical Ind. (TDCHF)	2.88%
Canon Inc. (CAJ)	2.69%
Tokyo Elec. Power (TKECF)	2.21%
Honda Motor Corp (HMC)	1.97%
Nomura Holdings (NMR)	1.88%
Matsushita Elec. Ind. (MC)	1.76%
Nippon Tel.&Tel (NTT)	1.66%

* - These are all U.S. versions of Japanese shares. Ticker symbols with five characters are traded on pink sheets.

Average Daily Volume

Jun-03 3,559,481

Average Daily Price Range*

Jun-03 1.5%

2003 YTD	1,967,204	2003 YTD	1.6%
2002	1,205,361	2002	2.1%

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

* Includes prior day's close (true range)

HOW TO MAKE MONEY IN EWJ THIS YEAR

Japanese stocks have actually performed quite well since they bottomed back in April. In fact, there is a decent chance that the Nikkei-225 has finally ended its more than 13-year long bear market! In the short-term, however, I feel that Japanese stocks may have reached a near-term peak. Additionally, the U.S. dollar appears set to rally as well. That means that EWJ's value could be hurt by a combination of two factors: lower Japanese stock prices and a stronger U.S. dollar. Unless you're interested in shorting the shares, I'd suggest you steer clear of EWJ right now.

Looking at the longer-term picture, however, EWJ could make for a decent addition to your portfolio, as it will help you diversify your holdings. After all, the fund is not as closely correlated with U.S. stocks as most other funds would be. This could lower the volatility of your overall portfolio returns. Additionally, in the long run I expect Japanese shares to outperform U.S. shares. (Remember, I do not think that U.S. stocks have bottomed, while their Japanese brethren may have.)

The biggest problem right now is that the dollar might also make gains against the yen. Although that does not seem to make a whole lot of sense if you think that Japanese shares will outperform U.S. stocks, currency rates are not just affected by the stock market (in fact, despite what you might read elsewhere, equity markets are probably a very small part of what causes a currency's value to change). Although the Nikkei-225 chart appears to have bottomed, EWJ does show some risk of making a new low. Therefore, I'd suggest you steer clear of the fund for now, unless you wish to hedge the dollar.



Hedge the dollar?!? That is only for people who know a whole lot about exchange rates. But with a bit of sophisticated trading, you could own the stocks in Japan, but you could also place a bet on the U.S. dollar gaining versus the yen. This would be complicated, risky and expensive to do, and you probably couldn't do it with a stockbroker either.

Bottom line: Initiate long positions in EWJ later this year, but wait for the fund to dip 10-15% below current levels. If you must trade it now, then short it.

(8.) WEEKLY EDUCATIONAL BONUS -- WHAT'S ALL THIS SENTIMENT AND EXPECTATIONS STUFF YOU'RE ALWAYS TALKING ABOUT?

Technical analysts love to lean against the crowd. It is a built-in reaction and an interesting psychological phenomenon. I am rarely comfortable if too many people agree with me. At the same time, it is incredibly difficult to make a trade when you are all alone. This is exactly what sentiment is all about.

Every trend is comprised of a period where only the lucky few are in on it (some call this the "smart money"). For example, at the lows in October 2002, almost everybody was writing about how the rally was a mere bear market bounce. I still believe the rally is, but it is a huge one, and it is probably not over yet. Finding buyers then, or even at the March 2003 bottom, would have been tough to do.

The next step in a trend takes place when the so-called "technical traders" jump on the bandwagon. The whole world has not yet caught on, but volume starts to pick up. If you're in the early stages of a bullish rally, then the market (or the particular stock) is making higher highs and higher lows. The opposite is true if the trend is down. Prices will actually start to move higher (in a rally) more quickly -- meaning that momentum is on the rise. Soon after, the "crowd" kicks in. It is not a bad thing to be on the same side of the crowd at this point. The move is not over yet.

The final part of the run sees everybody jumping in feet first, and not even looking. Look at all the sellers after September 11, 2001, or at the bottoms in October 2002 and March 2003. Or even better, the buyers at the March 2000 top. Usually, you have almost everybody playing from the same side, be it long or short. People are fully invested and there's nobody left to buy (in a bull market) or to sell (in a bear market). This is when contrarians -- those that like to trade against the crowd -- make their money.

The above description, by the way, is largely a partial explanation of Dow Theory. If you are interested in Dow Theory, then pick up [*Technical Analysis of Stock Trends*](#) by Edwards and Magee. (You can purchase this book at a discount by visiting our HTML newsletter version on the web and clicking on the link provided.)

So, how does one measure sentiment? There are many ways. I will discuss a few of these below.

Surveys and Polls: There are surveys everywhere you look that ask investors, traders, analysts and portfolio managers what they think about some investment or other. The ones that measure portfolio managers' bullish or bearish leanings are best known. CNBC talks about them all the time. I take part a short-term oriented one that is published by the former head of Knight-Ridder's Chicago bureau. Some come out weekly, some monthly, some even daily (I am not so sure daily sentiment indications are terribly meaningful).

In order to really use the data generated by a particular survey, you first need to understand that survey and to know the levels at which its extremes have typically foreshadowed changes in market trends. Also, you must keep up on the survey itself. Some surveys gain and lose participants frequently, which can make comparisons to previous time periods useless. Some are very short-term oriented, while others are longer-term in nature.

Regardless of how the survey is constructed, the idea remains the same: Most of the time the data will tell you little. However, at historic extremes the survey might accurately forecast an imminent trend reversal. I would never suggest making a trade based exclusively on one of these polls, but it is a piece of evidence worth considering.

Asset Allocation: What is Wall Street telling you? If most major brokerage houses are recommending that you allocate 70% of your portfolio to common stocks, then that is usually a sell signal. If they are at 50%, then it is often a buy signal. Richard Bernstein at Merrill Lynch tracks that information, but you can probably find out what most big brokerage firms are recommending for free on their web sites. The idea is that most companies rarely push the stock market portion of a portfolio above 70-80%, or below 50%. For those big-picture bears, the asset allocators have been near 70% throughout much of the bear market. We will most likely not have a final bottom until nobody cares anymore and allocations fall down near 50% again.

Options Volatility: If you've been reading this newsletter for awhile, then you've seen me talk about the S&P 500 VIX (Volatility Index) and the similar Nasdaq-100 VXN. These measure the implied volatility of at-the-money options on these indices (see <http://www.investorwords.com> for definitions of these terms). Typically, very high volatility can signal a bottom in the stock market, while low volatility may warn of an impending top. However, volatility can be seasonal. It gets low in the summer months, so you must always be aware of those patterns.

Note also that the underlying indices can change. For example, the Nasdaq-100 removed a slew of technology sector stocks last year. The changes have made that index less volatile due to its more docile make-up. Therefore, one would expect lower volatility in general from that volatility index.

Newsletter Writers Bull/Bear Levels: Several prominent publications that track the percentage of newsletter writers that are bullish or bearish. Unfortunately, newsletters come and go, and I am not convinced that these types of indices make a good sentiment indicator. However, if all newsletter writers (or nearly all) are bullish or bearish, then I would stand up and take notice. Hopefully, this one will not be with everybody else!

Rydex Fund Ratios: Rydex has bull and bear funds as well as bond market funds. Tracking how much money is in each of these funds has, in the past, provided good short-term to medium-term buy and sell signals. However, I've heard some talk on Wall Street recently that hedge funds have been using the Rydex Funds as hedging vehicles, which has altered the nature of this method.

Mutual Fund Cash Flows: Trimtabs and others publish, with a delay, how much money is flowing into and out of stock, bond and money market funds. Losses of momentum or extreme inflows/outflows may precede a major change in trend.

Mutual Fund Cash Levels: These data are reported with a delay. However, if a bond fund is 100% in bonds, then unless new money flows into the fund, it will not have any more money to allocate to bonds. Since funds represent a large portion of market activity, if cash levels are very low, then there is probably very little room for the market to post further gains. If cash levels are high, then

portfolio managers are being conservative and are probably under-invested. Any rally will force managers into making major purchases as they attempt to "catch up" to their benchmarks.

In summary: Sentiment indicators are supposed to help you determine what the crowd thinks. When you're in the middle of a trend, the crowd is usually correct. However, they get on board late and leave late. Sentiment indicators can help you identify what the crowd is thinking. I would rarely ever trade just based on a sentiment signal, but when coupled with other technical signposts, you can often make a lot of money if you understand how to use them.

If you want to read about manias and sentiment, then I suggest Charles Mackay's classic: [*Extraordinary Popular Delusions and the Madness of Crowds*](#). (You can purchase this book today by visiting our HTML newsletter version on the web and clicking on the link provided.)

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



A handwritten signature in blue ink that reads "Steven Poser".

Steven Poser

Editor

[*The ETF Authority*](#)

New York, NY

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