

## In terms of Behavioural Technical Analysis, where are financial markets in the cycle and where are they going?

**Extremes of sentiment coincide with all the important turning points** - A week ago I was concluding my last 2-day workshop - The Chart Seminar - on BTA for the year. It always ends with a comprehensive review of markets, in which delegates participate, using objective technical/behavioural criteria. Here is a brief summary, in terms of what we have just seen and where markets are likely to go over the next few months. In September, we witnessed nothing less than extreme panic, evidenced by plunging stock markets, following what had already been substantial declines, and soaring bond prices due to the "flight to quality". FM208's front page headline on 26th September was, "Global stock markets have seldom been more oversold". To boost confidence and ensure sufficient liquidity, central banks responded with another round of aggressive interest rate cuts, similar to what we have seen near the bottom of all other bear markets for stocks. Share indices reached their bear market lows on 21st September, while long-dated government bond yields fell until early November on deflation fears. Accordingly, prices for these instruments became as overbought as stocks were oversold, and have subsequently plunged from those heights. The main fear following terrorist attacks on 11th September, expressed by everyone, was that there would be additional atrocities perpetrated against the US and/or its allies, plunging the global economy into deeper recession. However, without confirming evidence, investors are not going to base their strategy for very long on the possible repetition of an event that has only occurred once before, albeit recently, within US mainland borders. Consequently the pendulum for crowd sentiment

began its journey away from extreme pessimism in mid-September, with stock markets rising first on short covering and then new demand as investors switched away from cash and bonds, while some of that excess liquidity sloshing around also found its way into shares. Initially, hardly anyone believed that the September lows would hold. Today, people are hopeful about economic prospects for 2002 and a majority now believes that the bear market is over. Consensus optimism can only increase with each new recovery high for stock market indices, and this soon feeds through to consumer and eventually corporate spending. Very few people now mention the unthinkable - another terrorist attack of consequence, despite security alerts from the US Government. For investors, as we have been reminded in the last few days, the current fear is being out of rising stock markets. However at this stage of a recovery and less than 3 months from the lows, confidence is ephemeral. As cash levels are reduced and more stocks approach a breakeven level for investors who rode out the decline, supply and demand will become more evenly balanced. We can already see this in the somewhat more choppy and ranging activity for many stock market indices, although less so with the influential S&P 500 shown here. The yearend rally will be followed by a more sober reappraisal. The Middle East remains a dangerous, troubled region. Corporate profits for 4Q 2001, while mostly discounted, will be a reminder that all is not well for the global economy. When stock market indices break their sequence of rising reaction lows (currently 1125 for the S&P), at least a one-third retracement of the recovery should follow. Nevertheless I believe this will be no worse than a base extension during which the lows will hold, although Japanese indices could be an exception, before investors resume discounting a US-led economic recovery. This should become clearly apparent from 2Q 2002's data, judging from the stock market's lead of approximately 6 months. Corporate profits should be quite strong in 3Q and 4Q next year, helped by this year's right offs. However by that time investors may be worrying about rising short-term interest rates, which eventually end bull markets. In conclusion, I believe the initial stock market recovery is in its final stages and that a significant pullback will occur in 1Q, possibly commencing before yearend. Thereafter somewhat higher levels are probable, in line with a U-shaped economic recovery, likely to be moderate in the US, mild in Europe and negligible in Japan. Government long-dated bonds will stage a partial recovery as equities consolidate, with fixed interest yields resuming their bear market as stock markets rally further. The yen should weaken significantly.

Best regards - David Fuller

S&P 500 Index: 1170 (Daily)



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Fullermoney a division of Stockcube Research Limited Suite 1.21 Plaza 535 Kings Road London SW10 0SZ UK

Website: [www.fullermoney.com](http://www.fullermoney.com) Email: [research@chartanalysts.com](mailto:research@chartanalysts.com) Tel: +44 (0) 20 7351 5751 Fax: +44 (0) 20 7352 3185 Single Issue Price £3

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