

This stock market rally is in response to the most technically oversold condition since October 1987 and December 1974.

Panic selling is always followed by a rebound -

In FM208's leading article, I mentioned that the rally commencing on 24th September was in response to one of the most oversold conditions that I have seen during 36 years of monitoring stock markets. I can only recall two occasions when shares were more technically oversold - October 1987 and December 1974. Moreover the 2000/01 bear market, which started earlier for some indices, has been the worst since 1973/74. Following the downward leg commencing last May and culminating in a climactic acceleration from late August through 21st September, I would normally conclude without hesitation that share indices had reached a low of at least medium-term significance. This could still be the case but unfortunately investors have to contend with a dangerous wildcard, which few have previously seen - the possibility of another devastating attack by terrorists. Were this to occur in the US or Europe, the psychological and therefore economic implications would be dire, instantly outweighing all other factors.

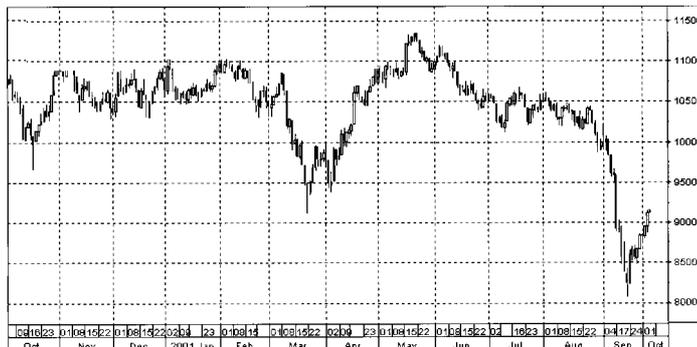
Oversold rallies usually occur in two stages - Declines culminating in a spike are often followed by a strong rebound, as we have seen recently. Once the initial rally is checked by overhead supply, a partial to full retracement follows as we last saw in April. If investors then see that support is being encountered near or above the low, a second-stage rebound usually occurs. The current rally is rapidly correcting a short-term oversold condition and approaching initial resistance from the March to mid-August lows. A likely trigger will be commencement of the counter-terrorist military offensive. However, stock markets would respond favourably to a successful campaign, especially if there are no further attacks on the West.

Monetary stimulus versus valuations - Alan Greenspan's additional pump priming since the attacks on 11th September has been massive, including another 100 basis points off the Federal Funds Rate, which he has lowered 400 points in nine steps so far this year. Other central banks are also reflating and more rate cuts are likely. This

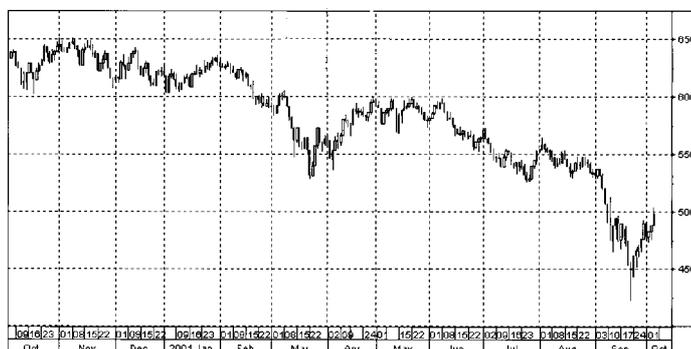
can only be bullish for stock markets, assuming further terrorist attacks of consequence are prevented. Previously, such concerted action has coincided with the end of bearish trends for share indices. This time, there will probably be less upside potential because valuations in the US remain historically high. Long-term charts for the DJIA and S&P 500 reflect this problem, showing extensive overhead supply and unfulfilled downside scope. Therefore upside potential is probably limited to some strong rallies within the overall downtrends. While valuations are lower in other countries, few stock markets uncouple from Wall Street's main trend. It is unlikely to be different this time because whatever happens in the fight against terrorism, the extent of monetary and now fiscal stimulus in the US should enable the American economy to recover before Euroland or Japan.

Best regards - David Fuller

Dow Jones Industrial Average : 9150 (Daily)



UK FTSE 100 Index : 4989 (Daily)



Charts supplied by Bloomberg

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