



Vision Clients: 2002 In Review

General Market Conditions

The stock indices in the second half of 2002 have been unusually volatile. I cannot remember a four or five month period with more price gaps on the exchange openings, as well as gaps that remain "unfilled" for days. These are classic signs of volatile markets. Combined with these volatile conditions, the markets worked themselves into several vicious ranges. The combination of these two made the second half of 2002 the most difficult trading period I have experienced in the stock index futures. Might this increased volatility point to a potential bottoming of the stock market? I'll do my best to answer that question a bit later in this review.

Our Performance

As I stated above, the second half of 2002 has been an extremely difficult trading environment for traders. Looking at our performance for Vision clients, we had one very difficult month, September, during this period. We made five Nasdaq futures trades for client accounts, four of which were losing trades. We were stopped out of these losing trades within three ticks of the extreme of each move, three times on unexpected news. [The largest loss came after an unexpected announcement by Iraq that they would comply with UN demands, which came right after the market closed.] The market remained just quiet enough for us to continue to get signaled into trades and the unexpected news just kept stopping us out of our positions. Despite four out five losing trades, our strict adherence to prudent money management limited our losses to only 6.68 percent, which was further reduced by profitable months in October and November.

This is unusual for our Nasdaq model. One of the strengths of this system is that we are out of the markets for a good portion of any month. That generally limits our exposure to such "news shocks." Our model waits for a specific pattern, a "quiet state," and then enters the market as it moves out of this pattern. We have found this pattern to be extremely reliable.

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We were profitable in both October and November, though we would have liked to see a few more signals. The recent frequent price gaps on the exchange openings limited our trading opportunities, but not taking signals if price gaps through them on the opening are an important part of our money management strategy. As I asked above, might this increased volatility and unusual number of gaps point to a potential long-term trend change in the stock market?

The 2003 Stocks Indices: A Preview

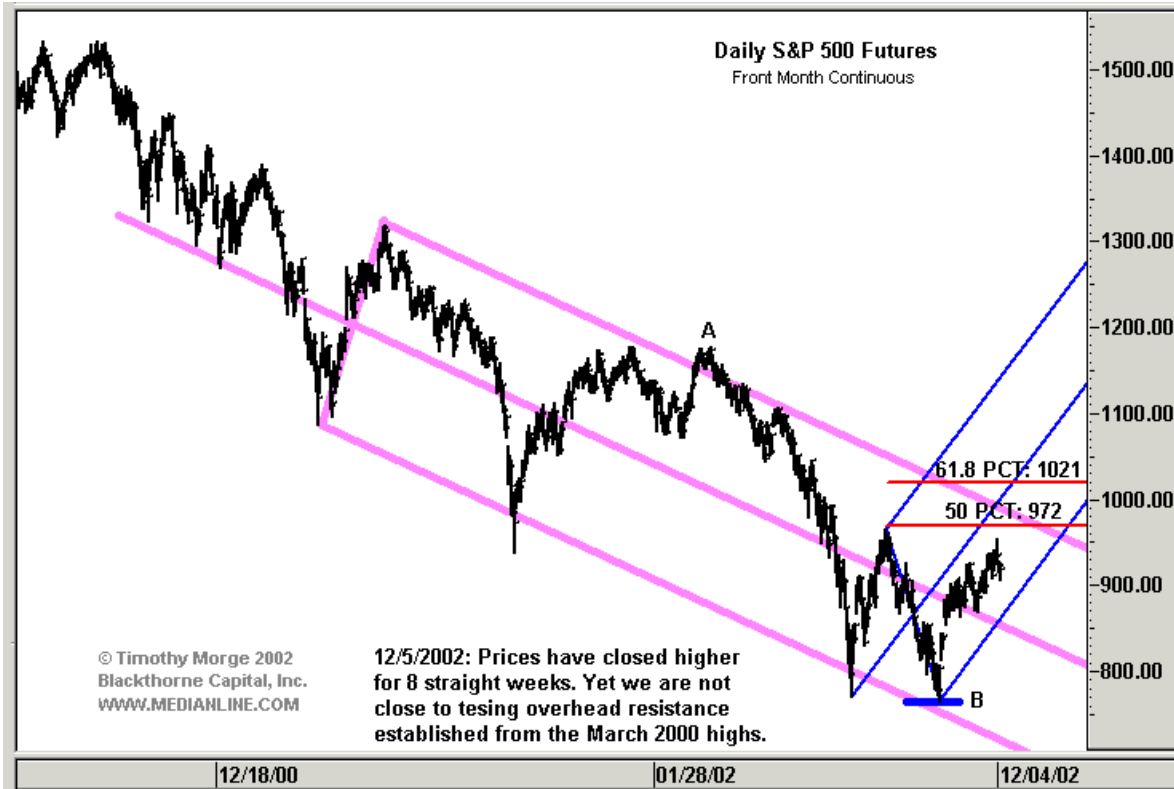
As I write this review, stocks have just finished their eighth winning week in a row. By the sound of that statement, you'd think that all vestiges of the down trend have passed and the path of least resistance would be up, up up!

I looked carefully at long-term charts of both the Nasdaq 100 and S&P 500 futures for this review. The two charts, presented with a brief analysis of each, are not walking the same path and that may say quite a bit for the next three to six months.

S&P 500 Futures: Still In A Down Trend?

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Let's begin with the S&P 500 Futures. It's a broader representation of the markets. As we near the end of the year, the question, "Is this an eight week rally in a down trend or has a new up trend started?" keeps appearing in the typical news columns. Obviously the answer depends on the timeframe you are discussing, because for eight weeks, index prices kept closing higher. Many would consider that a trend. But did this recent eight-week run up negate the down trend that dates back to the March 2000 highs?

In my charting toolbox, I use tools that were honed and developed by the master chartists from the period of the 1930's to 1950's, a time I've referred to as the "Golden Era of Technical Analysis." In many ways, computers and computer screen charting packages have set back the art of charting at least 100 years. These days, its easy to find a charting package that will draw all sorts of esoteric indicators and moving averages with little or no knowledge of the underlying principles involved in the correct use of these tools. Rather than focus on computer generated indicators, I tend to use "bigger picture" charting tools that were developed by and for traders that charted by hand drawing their charts.

What do these tools tell me about the state of the current S&P 500 market? Although there has been a strong multi-week rally off the mid-October lows, no damage has been

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done to the multi-year down trend. The most important criteria of a trend change, for me, is the penetration of the P 0-4 Line, a simple trend line drawn from the high of March 2000 to the fourth major pivot, in this case a high pivot marked "A" on the above chart. Right now, the P 0-4 Line is just above 1025 on the S&P 500 chart. Until we breach that area, price remains in a major down trend.

Secondary evidence adds further credence: The 61.8 percent retracement from the P 4 pivot at 1177 and the October low of 767 ½ is 1020 ½. This retracement level is confluent with the P 0-4 Line level of 1025 and will make this area particularly important and difficult to breach.

And one last measure of a long-term trend: When charting long-term swings, a good test of trend is simply the "two swing" test. This test simply says that in a long-term down trend, the down trend is intact until price makes highs higher than the two prior major swing highs. In this case, price would have to rally past the last swing high of 966, as well as the minor swing high preceding that at 1108—although a more convincing show of strength would be a break of the two major swing highs, 966 and 1177.

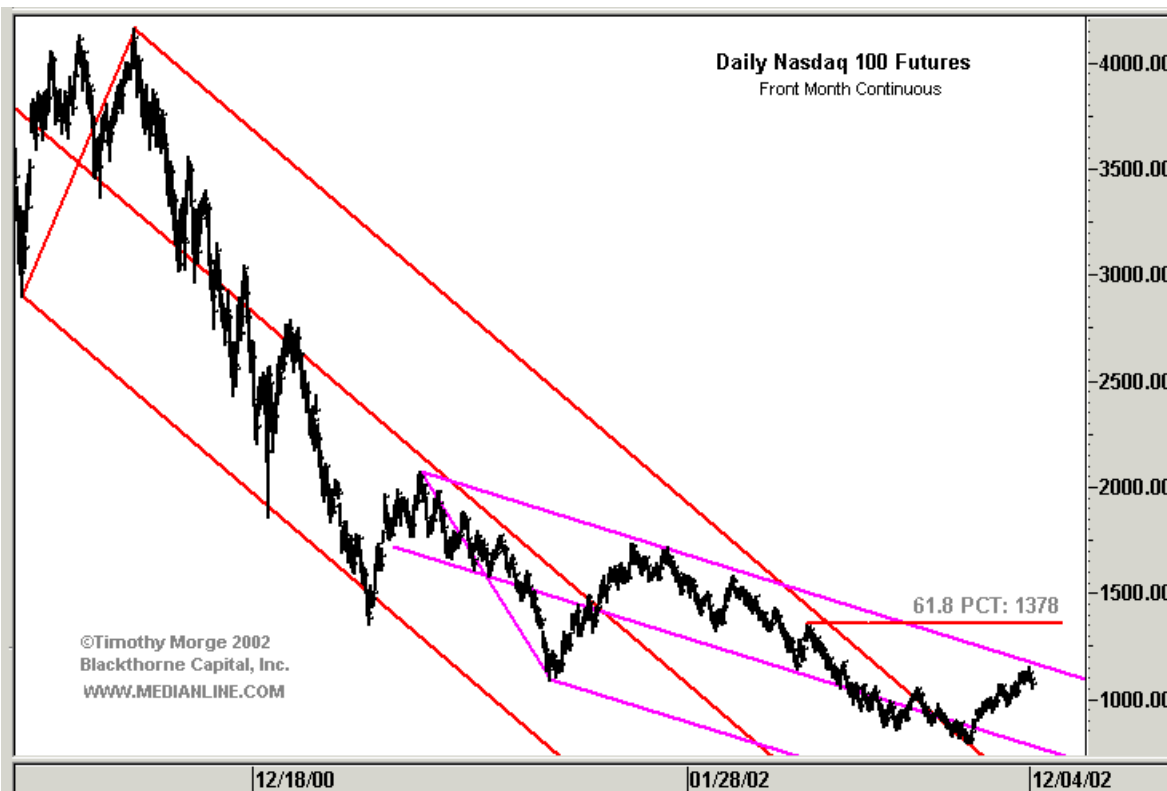
Summary: The S&P 500 futures remain in a long-term down trend. There is near-term resistance at 966, but the real key will be if price can rally above the key 1025.

Nasdaq 100 Futures: Going To Zero?

The Nasdaq market has fallen so far, so fast, it's difficult to draw a long-term chart without running out of paper! The European NASDAQ Exchange equivalent actually closed its doors this summer. Is that where the Nasdaq 100 futures are headed?

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In the case of the Nasdaq 100 futures, the steepness of the decline set up a “horizontal creep.” Like the S&P 500 futures, prices haven’t staged enough of a rally, in terms of retracement levels, for the down trend to be declared over. The speed of the sell off has moderated and that alone allowed the P 0-4 Line to be penetrated. In the strictest sense of the word, the down trend from the March 2000 highs has ended. It ended before the recent eight-week rally.

Are the Nasdaq 100 futures now in a long-term up trend? In my opinion, the Nasdaq futures are now forming a gentle bottom. I don’t think this process has ended. In fact, I would not classify the Nasdaq futures as being in an up trend. The severity of the sell off changed decidedly over the past four months. Again, that is more a symptom of how far this market came in two years: From above 4800 to below 800 in just over two years! For me, the down trend will be ended when either the S&P 500 futures signal a change in trend or when the Nasdaq futures break above the swing high at of 1354 and the 61.8 percent retracement at 1378.

Summary: The Nasdaq 100 futures are consolidating after a severe down trend. I believe they are in the beginning of a bottoming formation.

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2003: First Half Prediction

The S&P 500 and Nasdaq 100 futures markets are in two different phases of down trends. I still think the S&P futures may revisit their recent lows or even make new lows for the move before they begin to build a long-term bottom. But the general bottoming formation building in the Nasdaq futures leads me to keep my eye on the signs in both markets that would signal an end of the long-term down trend. If further rallies develop, keep your eyes on the levels I've set out in each market for signs of trend changes. But until those levels are breached, the long-term down trends remain intact.

As the markets return to more "normal" conditions, I believe we will see market conditions that will allow us to take advantage of the quiet periods and return to the performance we expect. We remain confident that our strategies are sound and, over the long run we believe, combined with our strict adherence to prudent money management, we will not disappoint your expectations!



Tim Morge
Blackthorne Capital, Inc.

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