

July 17, 2003

## Charting the Market

The stock market has just recorded one of the strongest quarters on record, yet we still hear the doomsayers wailing that the bear market of the past three years is very much alive and ready to extract more blood from us. On the other hand, a few brave souls are predicting that the US economy and securities markets are spring-loaded and ready to accelerate at a pace none of us can imagine today. As usual, the majority of investors are somewhere in the middle, hoping for the best, yet remembering that over the past three years the bear's mighty claws have crushed their hopes time and again.

As we said in our April letter, "The Case for Optimism," we are in the camp of those who believe that the bear has been slain and that there are many signs a new bull market may be at hand. The list of problems facing our nation and our economy is still long, but in our judgement, progress is being made in most areas, and we believe the stock market's rally may be signaling that better news is coming.

In pivotal times like these, when opinions become so varied and firmly held, we like to step back from the numbing flow of statistics and news to simply review the charts that show us how stock market prices have moved over the longer term. Stock charts are not always entirely clear or convincing, but they do help us cut through the fog of one opinion versus the next and show us two important pieces of the picture: where we have been and where we are now. Where a stock has been over a certain period of time does not assure where it is going in the future, but how it has acted at key levels can give us clues as to its relative vitality.

We stated in our April letter and again in our June special report that the fundamentals of the economy and corporate America are improving. If this is true, we should expect stock prices to be advancing to reflect the improving fundamentals well before much good news appears in the headlines. After such a long sell-off in stocks, we believe an advance that is sustainable will have the following characteristics:

1. The move will come after the market has made a clearly identifiable low, or "bottom."
2. Most major industry sectors will be moving higher with the market.
3. All sectors will show evidence that their downward trends are being broken by moving above important, long-term moving averages.

The most important question as to whether or not we have entered a new bull market is answered by points 2 and 3. These are issues of the stock market's "breadth." Any hot stock market that does not have broad participation should be viewed with caution. Studying the charts for each of the major industry sectors enables us to answer the breadth question, as well as to gauge the power and sustainability of the current rally. Let's start our analysis of the current stock rally by looking first at the Standard & Poors 500 Index. If we do not have bull market characteristics here, there is not much sense in looking further.

### Chart 1

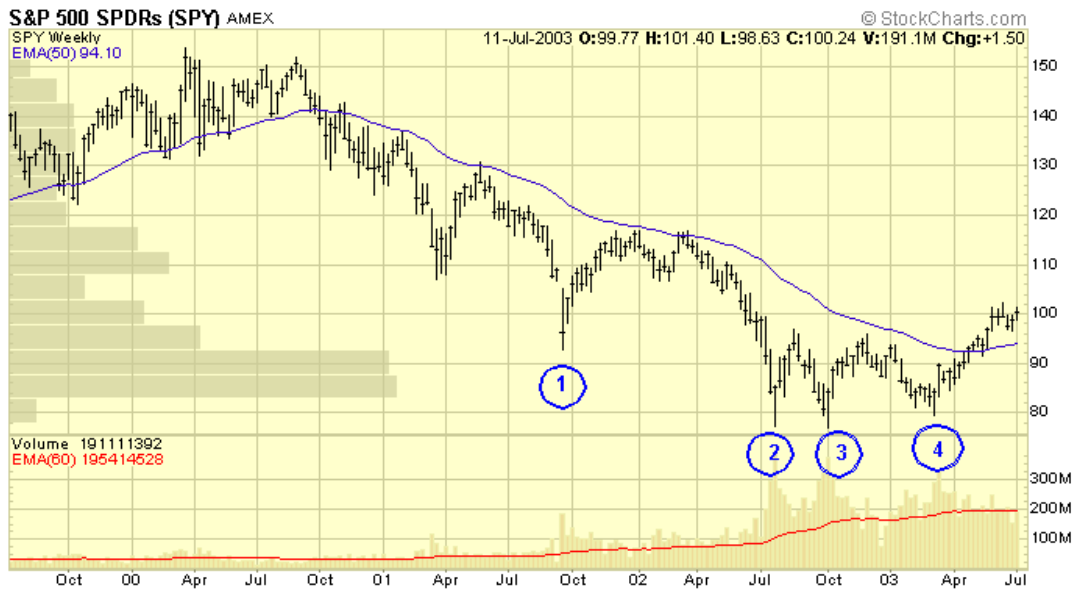


Chart 1 plots the price movement of the S&P 500 Index by using a widely traded index fund (symbol: SPY). To gain some perspective, let's identify the elements of the chart that we will be evaluating. The black, jagged bars that run from the top left across the width of the chart are the weekly price ranges for the S&P over the last four years. The smooth, blue line running through the bars is the 200-day moving average for those same prices. The numbered circles near the bottom right of the chart are the multiple bottoms the S&P has formed since September 11, 2001 (point #1). The shaded stripes on the far-left side of the chart show the number of shares that have changed hands over the last four years at each \$5 increment. Each of these elements tells a different part of the story, and hopefully, taken together can offer us a sense of how the story may unfold from here.

#### Analyzing and Scoring the S&P 500

The S&P has formed a classic multiple bottom. The points numbered 2, 3, and 4 show that the S&P turned higher three times at almost the same level. **This triple bottom is a convincing sign that the S&P, which represents about 75% of the market capitalization of all stocks, has bottomed.** In addition, the bottoms were all made at times of great uncertainty in the market. Point 2 happened just prior to the government's required sign-off on all financial statements by CEOs and CFOs, which prompted fears that a herd of Enrons and Worldcoms would be uncovered. Point 3 came after the disappointing 2002 third quarter corporate earnings season when fears of a double-dip recession were widespread. The last low, Point 4, occurred just prior to the Iraq war when our disputes with France and Germany were flaring up. The sharp downward spikes are clear indications of panic selling. The chart shows that, in each case, when panic selling took hold, as shown by the surge in volume, buyers came in and quickly pushed stocks higher. The strong recoveries are equally clear signs of very large buyers absorbing all the stock anybody wanted to sell. Investment club money or day trader money cannot turn a market in this way. This is very big, very knowledgeable money. **History shows us few market bottoms with more classic details than the one that occurred over the last twelve months in the S&P Index.**

The smooth, blue line is the 200-day moving average. The 200-day moving average is widely considered a primary trend indicator. Note that since October of 2000 numerous rallies failed precisely when the market rose to meet the 200-day moving average. Each time this happened, the market was revealing that the downtrend had not yet come to its end. The recent piercing of the line, however, is a strong argument that stocks may be headed even higher. In addition, for the first time in three years, the 200-day moving average has curled up, another good sign.

Finally, the shaded stripes on the left are indicating that very large volumes of stock were bought and sold in the \$85 to \$95 range. The fact that the S&P has moved above these huge spikes in volume argues that there is very little overhead volume (potential sellers) to contend with. With most of the stock that was in "weak hands" having been driven to the sidelines, the path of least resistance for the S&P should now be up. This is because the "strong hands" who were the big buyers at the bottom are not quick buck artists likely to sell anytime soon.

Let's score each of Chart 1's elements on a three point scale, with three being the most favorable. We rate the triple bottom at a 3; the solid piercing of the 200-day moving average also gets a 3; as does the strong move through heavy volume. The S&P 500 in our simple scoring summary would get a perfect score. Everything about its recent action is suggestive that it is doing the right thing at the right time, which should mean the index is headed higher.

### In Search of Breadth

If we stopped after analyzing the S&P, we would be joining with the spring-loaded crowds, who are calling for a sharp upward move in economic activity and stock prices. However, as we said earlier, at this stage in the market, breadth is the key. We need to see that the strong action exhibited by the S&P 500 has been driven by similar actions among its major sectors.

Table 1 scores the charts of the nine sectors of the economy that make up the stocks in the S&P 500 on the same basis as we just scored the whole index. This table will help us identify and analyze significant points of convergence or divergence.

**Table 1**

### Breadth Analysis of S&P 500

<b>Sector</b>	<b>Bottom</b>	<b>200-Day Moving Average</b>	<b>Overhead Volume</b>	<b>Relative Strength vs. S&amp;P</b>	<b>Total</b>
<b>Consumer Discretionary</b>	2	3	3	3	11
<b>Technology</b>	3	3	2	3	11
<b>Health-Care</b>	3	3	3	2	11
<b>Financials</b>	3	3	3	2	11
<b>Utilities</b>	2	2	2	2	8
<b>Industrials</b>	1	2	3	1	7
<b>Energy</b>	3	2	1	1	7
<b>Materials</b>	3	2	1	1	7
<b>Consumer Non- Discretionary</b>	1	2	1	1	5
Average					8.7

Column 5, Relative Strength vs. S&P, measures how each sector is performing compared to the overall market. This indicator is key for us to understand which sectors are running ahead of the market and which are lagging. In this column, a score of 3 means the sector outperformed the S&P Index over the past six months, 2 means similar performance, and 1 indicates under performance. The table shows the current distribution is fairly normal, with two superior performers, three comparable performers, and four under performers. This means that five of the nine sectors are performing as well as or better than the S&P, which we said earlier was showing classic early stage bull market qualities. This is a 56% ratio, an acceptable breadth score for an early stage bull

market. Significantly, all of the sectors have pierced their 200-day moving averages. This also shows solid breadth. No sector should be left behind if the economy is convincingly turning higher.

### **Convergences and Divergences**

Even though the market passes our basic test for breadth, it is still necessary to take another step before we can declare that the current upswing in the S&P 500 is operating on all cylinders. We can now look for the convergences and divergences we mentioned earlier. A convergence is where industry sectors that have led significant bull markets in the past are once again taking the lead. A divergence is strength or weakness inconsistent with historic patterns.

Finding **Consumer Non-Discretionary**, or as it was formerly known, Consumer Staples, at the bottom of our list is not surprising. These companies sell products, like food, household and personal products, and soft drinks, which are consumed every day. These companies are not as sensitive to economic cycles as most companies and have fared much better than the average stock in the recent bear market.

**Consumer Discretionary** landing on top of the list is also not surprising. Indeed, it would be a big warning signal if this were not the case. This sector includes companies that produce products that have a life-span longer than a year such as, housing, furniture, automobiles, and most retail stores. These products are often financed, which means consumers typically delay these purchases when the economy is weakening. With this sector leading the pack, it is a clear signal that investors believe consumers will have increasing confidence in their job security and their ability to handle additional debt in the months ahead.

**Technology's** high ranking is also typical of early stage bull market action. Indeed, since the bear market can largely be laid at the feet of the Tech stocks, their recent uptick is the strongest evidence that the worst may be over, and that corporate America may be awakening from its multi-year hibernation. But, these convergences, or things we would expect, bring us headlong into a divergence, or something we would not expect at this stage in a market rally.

Chart 2, below, shows that the **Industrial** sector, a manufacturing-oriented industry, is performing below average. If investors believed that an economic upturn was imminent, we would expect the Industrial sector to be one of the top perform

**Chart 2**



Corporate America has been shedding jobs and inventory for the last two to three years. Companies in the Industrial sector sell machinery and supplies used by other companies to build new plants or expand production. As corporations have delayed adding new capacity, it has put a strain on the

sales for companies in the Industrial sector. We need a turnaround in this area before we can confidently proclaim a bull market. Let's take a closer look at the Industrial sector's chart to see if we can pry any more positive points from it.

This is not a bad looking chart, but it is not nearly as well formed as that of the S&P 500 Index. On the positive side, the industrials do look like they have bottomed, and they have popped above their 200-day moving average. However, a key difference between the Industrials and many of the other sectors is its relatively unimpressive, bottoming formation. The Industrials have made a kind of sliding bottom, as indicated by the broken, red line on the chart. Additionally, they still have a lot of overhead volume to work through at slightly higher prices. The biggest negative, however, is the Industrials very weak relative strength as shown by the downward sloping green line at the bottom of the chart. Companies that comprise this sector are among the most important in the United States: General Electric, United Technologies, Honeywell, Caterpillar, 3M, Boeing, and Northrop Grumman.

While the price action of the Industrial sector is certainly positive, we don't see any additional points we can give it, and that presents a problem. If the Industrials are not a full contributor in the current upturn, the economy is still putting a lot of responsibility on the consumer, who has carried the load for the last three years. The Industrials are very large manufacturing companies with huge payrolls and unless these stocks are at least moving with the pack, we question how far the economy and stocks can go. The Industrials have bottomed and turned higher, and these are very good signs, but before we can officially dub the current market as having entered into a true bull market phase, we need to see some heavy lifting from the Industrials.

There is another divergence that brings us some good news from a sector that we will watch closely. The market almost always turns higher while the **Financials** are still suffering from the hangover of loan losses that a weak economy inevitably creates. At this time in a normal stock market cycle, it is surprising to see the Financial sector riding near the top. The Financial sector running near the top of the list is a strong counterbalance to the Industrials lagging behind. Indeed, the Financials have held up remarkably well throughout the last three years, even in the face of the 2001 recession. We think this is a result of their very strong financial condition heading into the economic slowdown, and the shallow nature of the downturn.

Bank loan loss ratios, which would have normally worsened dramatically in a recession, have stayed well below the levels of prior recessions, and the fall in interest rates has led to a bonanza in mortgage loans. For this reason, we believe banks will be much more willing and able to finance business loans when demand for them picks up. They are the one sector that might even benefit from rising, long-term interest rates, which most assuredly will come if the economy picks up. The Federal Reserve has made it clear they are not going to push short rates higher at the first sign of an improved economy. This means banks could continue to have a very cheap source of funds while long-term interest rates move higher, making each of their new loans potentially more profitable.

**Chart 3**



The Financials are exhibiting just an excellent chart pattern with no signs of budding weakness. In fact, they would receive a perfect score if they succeed in moving through the big volume spike at about the current price. The bottom was classic, the movement through the 200 day moving average was powerful, and the Financials are outpacing the S&P Index. Should the Financials work their way through the current heavy volume, we would not be surprised to see them as much as 20% higher by the end of the year.

### **The Chart Room**

If the Industrial sector continues to lag, all is not lost. The other sectors could well make solid gains and push the overall stock market higher. However, unless we get participation from the Industrials, we suspect that the duration and strength of the current rally will be diminished.

We would like nothing more than to tell you a new, long-term bull market is underway, but for the moment, we can only say that the indications are very promising. As we have drilled deeper in our breadth analysis, we find that everything checks out except for the Industrials. History and logic tell us it is unlikely that the market will begin a new, sustainable bull phase without that sector participating as one of the leaders. We believe this will eventually happen, but until it does, we will continue to keep a cautious eye on the charts.

Blessings,

Greg Donaldson

Mike Hull