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Getting Healthy Again

May 12, 2003

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After a long bout with the flu, doesn't it feel great when you finally wake up one morning and realize that you aren't sick anymore? □ Don't you want to bounce up out of bed, do a little dance and get back to a normal life? □ In a way that's what the market is doing right now. □ Think of the last month or so as a little dance celebrating the fact that the market has kicked the latest flu bug (i.e. Iraq). □ Now the real question is: ok - the market has bounced up and done a little dance, but can it get back to "normal"? □ And by the way, what is "normal" these days?

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Frankly I'm not sure anyone on the planet knows what "normal" is anymore. □ The bears' answer is to short every rally in the hope that the market can return to its normal pattern of disappointment and losses. □ On the other hand, even the most bullish analysts would agree that the bubble days of 1999 aren't likely to be considered "normal" again any time soon. □ So - while we can't be sure exactly what "normal" will look like in the next year, I can say that the market is looking healthier with each passing week. □

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Some Cheese with That?

You may recall that I have gone on record (it was really more like whining) that the market's rally off the bottom lacked the type of momentum, or thrust, that generally accompanies strong advances. □ Well, somebody needs to get me some cheese to accompany that wine, because the market has come through with the goods. □ Stocks are rallying, volume is solid, breadth is excellent, there is a wall of worry to climb (earnings and the economy), leadership is becoming evident

(techs and financials) and yes, fans, we've got some momentum on our hands.□

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State of the Market Buy Signal

One of our main focuses is the market "environment".□We believe the key to successful investing is to keep accounts "in-tune" with the environment at all times.□The most important point to be made about the stock market right now is that the environment has changed – for the better.□As a case in point, we received a rare, long term, "State of the Market" buy signal last Monday.□

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One of the best ways to determine the overall health of the market is to count up the number of stocks that are "technically healthy".□Try not to let your eyes glaze over as I define "technically healthy"... first, we identify our universe as the 1500 largest stocks.□Next, we look at the number of stocks that are above their trend lines over the past 10 weeks.□

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If one-half of the stocks in the universe are "technically healthy" then you could say the market is neutral.□When 70% - 75% of the stocks are in a positive technical position, you could call it a healthy market.□But when 90% of all stocks are "healthy", history tells us you've got a strong market going.□The real key is the 90% level doesn't get hit very often and it has a remarkable history of signaling positive (dare I say, bullish) markets.

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Just in case you think I'm making up that last part, let's look back and see when this signal has occurred in the past.□The last one was on February 6, 1991 after Gulf War I.□The one before that was just after the Crash of '87 on January 7, 1988.□Then there was one in early 1985 and another in September of 1982.□So, in the last 21 years there have been just 5 signals of an extraordinarily healthy market.□(I know that sounds really positive, but don't worry; I'll try and rain on the parade later.)

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What can we expect from this signal?□Since 1970 the signal has occurred on just 10 occasions.□One month later the S&P 500 was up 8 times for an average gain of 2.7%.□(Not exactly exciting - but hang in there, it gets better.)□After three

months the market was up 10 out of 10 times with an average rise of 7.9%. The signal was also perfect six months and one year later - and the average gains were 12.7% and 18.4% respectively. None of these signals called the bottom of any bear markets (they were all late). The key is that they all signaled the beginning of a bull market. And believe it or not - Yes, I did say "Bull Market"

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There are bulls and then there are BULLS!

For me anyway, the question now becomes - does this signal give us the green light for a new Bull Market? The answers are yes, and no, and will require a little qualification. First, there are two types of Bull Markets: Cyclical and Secular (think "little bull" and "BIG BULL"). A secular Bull generally lasts for many years and begins with low valuations for stocks. (Do you remember 1982?) Thus, in short, in the early stages of a secular Bull there is a compelling reason to buy stocks which lasts for a long period of time. On the other hand, a cyclical bull is more of your "garden variety" move higher - where we see gains of at least 20% and the move lasts for three months or more.

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While I don't believe that we have entered a new secular (i.e. long term) bull market, it is pretty obvious that we are in the midst of some sort of a "cyclical bull". The S&P 500 is 21.7% off its Bear Market low set last October, and 18% higher than the recent Gulf War II depths. So, by definition this should be considered a cyclical bull move. (FYI, The index still needs a gain of more than 61% from here to get back to where it stood on 3/31/00.)

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According to Ned Davis Research, the median (half above, half below) cyclical bull market has seen a gain of 51% from the low. But before you run out and mortgage the house to buy stocks, understand the move is at best almost one-half over already and the market is bumping into "overhead resistance". Other technical concerns include the fact that the market is overbought and sentiment is a little too happy these days. And on the fundamental front, the "hope" for improvements in the economy and corporate earnings, which are being priced into stocks right now, needs to turn into a "reality" at some point.

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All Clear?

In other words, the move off the low will likely qualify as a cyclical bull. Unfortunately however, the run so far has simply moved the market from the low end of an established range to the high end. In order for things to get really interesting, the market needs to break above 950 on the S&P with authority, and then hold above that level. The good news is that the Russell 2000 and the NASDAQ Composite have already breached their equivalent levels and are moving higher. So at this stage we have to give the market the benefit of the doubt. Yet at the same time, we have to keep in mind that the move can be considered “mature” in terms of sentiment and overbought levels. Is this an “all clear” environment? Not by a long shot...but it is getting healthier all the time.

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Beating the Market...

Step 1: Identify the “Big Picture” Environment (To Determine Your Exposure to Market Risk)

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*The first step in successful investing is to identify the market’s environment in terms of risk versus reward. The goal is to **first determine the level of exposure to market risk that is appropriate for the current conditions.** In other words, in positive market environments you want to be more fully invested and give the market “the benefit of doubt” during short term declines. However, when Bear Markets or high risk conditions are present, it makes more sense to take less risk and maintain a more defensive posture.*

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The indicators presented below in The Big Picture section are intended to provide indications of the market’s momentum, trend, fundamentals, sentiment, and valuation - and are designed for an investment timeframe of 3 to 6 months. The range for the “Score” of our indicators is 0-10 with 10 being the highest score.

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Step 2: Security Selection (Focus on the Market’s Leaders)

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Leading Industries and Top Ranked Stocks

Once we have “separated the wheat from the chaff” by identifying the leading sectors of the market, we dig deeper to find leadership in terms of the strongest industry groups and individual companies. □ Our analysis of the 100 industry groups includes industry specific models, the relative strength and momentum of each industry, and an emphasis on the earnings strength of the companies within each industry. Finally, we then identify the leading companies within each group (the top 2%) in terms of performance and earnings strength. □

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The week’s top Industry Groups and the Highest Ranked Stocks within each group:

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State of Your 401(k)

Once a month we update our strategies for our long-term retirement plan model in terms of Asset Allocation, Fund type, and Exposure to Market Risk. □ The model is designed to be a guide for Long-Term Investment plans such as IRAs and 401(k).

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As always, we wish you safe, happy, and successful week. □ Please do not hesitate to contact us with questions, comments or ideas.

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