

PHASES & CYCLES®

**DESPITE A DIFFICULT START, IT SHOULD BE
A GOOD YEAR FOR THE RIGHT STOCKS.**

INTRODUCTORY SUMMARY: Two weeks into the New Year and the bulls are already giving up, bracing for the worst in 2008. But should they? Since early December, we have anticipated that the markets will stage a test of the late-November lows. This is happening now.

Technical and cyclical indicators suggest that such a test should be successful, followed by a calming period and a **new bull cycle**. Initial direction should come from US stocks, but mid- and long-term leadership remains centered in the Toronto market, especially in Energy and Gold stocks.

MARKETS NOW: In our early December Market Comment we outlined the probability that a “double bottom” was developing; we suggested that it would be healthy if the late-November lows were tested successfully since this would provide a good foundation for a sustained advance in 2008. Indeed, the markets staged such a test in mid-December, which was followed by a brief rally and another period of weakness into the New Year.

While Toronto has been holding strong, New York had a very rough entry into the New Year. This shouldn't come as a surprise. The never-ending fusillade of fear- mongering and almost daily episodes of the sub-prime saga in the media has finally taken a toll on US investors. They entered the New Year with only one resolution: SELL! As a result, the DJIA and the S&P 500 declined below their November lows. The decline seems to be drastic and volatile but that is usual for most corrections/bear markets as they play out the tail end of a correction phase.

The setback in Toronto differed from the one in New York. The S&P/TSX composite, supported by Energy and Golds, managed to lock in three consecutive, slightly higher bottoms in November, December and

early-January. These lows, if sustained, should also provide a strong base for the anticipated rally in 2008.

This positive view of the markets is supported by the cyclical outlook. The intermediate-term cycle has bottomed and should exert upward pressure until mid-March. As usual, the pressure is strongest at the beginning of the cycle, which is why it is imperative that the market reacts to it in the near future.

The latest sentiment readings show that the recent sell-off and the continued media lament over the state of the economy has finally sent the bulls to the exit doors en masse. According to the latest results from the American Association of Individual Investors (AAII), there are only 19.6% bulls left in the market. At the same time, the bears (at 58.9%) have nearly reached celebrity status. In fact, these numbers show that investors' expectations of the markets reached cataclysmic proportions, usually the harbinger of a final capitulation.

Technical signals are also pointing to the probability of a major reversal. The markets are extremely oversold and divergences have occurred in many of these indicators. The only negative is that all major indices remain below their 50- and 200-day moving averages, which, if sustained, could cause more damage. However, any rally from here should correct this problem.

In summary, the bulls are in disarray, technicals are improving, and cycles are pointing to the upside— the right ingredients for a new bull market. At a time like this, it is worth remembering the old saying: “When the time is ripe to buy, you are least likely to want to.”

THE MARKETS IN 2008:

The first indication that 2008 could be a difficult year came from the “first five days of January” index, which has an impressive record of projecting the performance of the S&P 500 for the year ahead. Whenever the S&P 500 rises during the first five days of trading, there is a strong tendency (about 85% since 1950) for the markets to rise, and vice versa.

Like last year, this “early warning” index waved a red flag, since all the major indices declined in the first five days of trading. The full assessment of this message, however, should wait until the end of the month when the readings of an even more accurate indicator, the January barometer, will be available.

Unlike the troubling readings of the “first five days of January,” the “decennial index” suggests a strong year for stocks. As the table on page three illustrates the decennial pattern of years ending in “8” have the second best record of the decade (years ending in “5” are the best, ones ending in “9” are third). The odds for a bullish year increase even more when major turmoil occurs in the previous year (1977, 1987 or 1997).

Our research suggests that 2008 will be a **bullish** but **difficult** year:

Bullish:

- Because the recent (July-November) correction/bear market completed the 2002-07 cycle and a new cycle has begun.
- Because years ending in “8” (i.e. 2008) have the second best record of the decade.
- Because sentiment is bearish: Based on the “Stocks above their 10-week moving average” indicator, the markets are as over-sold now as they were in October 2002.

While results from the first days of trading and from the review of historical patterns are inconclusive, let’s turn our attention to stocks.

Multi-year breakdowns in the Banks and major breakouts in Energy and Golds had a crucial impact on the markets in 2007. These crosscurrents will continue to set the tone for the markets in 2008, most likely with different outcomes for Toronto and New York.

The sectors with the strongest up-side potentials (Energy, Metals and Golds) should be able to neutralize sluggish Banks and therefore put the S&P/TSX composite in the plus column for the year. At the same time, the US market, over-weighted by struggling Financials, may find 2008 a challenging year.

2008 may well become a year in which individual stock selection may become more important than index selection.

Difficult (in Canada):

- Because the weight of the positive Energy Sector is about the same as the weight of the sluggish Banks, neutralizing the upside potential and leaving only the Materials, Golds and Utilities to drive the Index higher.
- Because stock selection will be vital.
- Because Investors will probably be reluctant to discard Banks to skew their portfolio towards Energy and Materials (especially Golds) and therefore under-perform.

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THE DECENNIAL (10-YEAR) STOCK MARKET CYCLE

Edson Gould published a report on the yearly performance of the S&P 500 Index from 1885 to 1985. Mr. Gould passed away soon thereafter, but we have updated the data from 1986 to date.

As the enclosed table indicates, in the 12 occurrences since 1885, the years ending in 5 have NEVER shown a loss. The accumulated gain for year 5 is astonishing 288%, which means that \$1,000 invested on January 1st, 1885 and held until December 31st of the same year and reinvested on each year ending in 5 held for that year would have grown to \$12,609.18.

Year 5 is the only year that has an unbroken record (although years ending in 8 are also impressive).

Obviously, an exception could occur at anytime, but this is an amazing record. We are looking forward to see how 2005 will unfold.

The 10-Year Stock Market Cycle Annual Percent Change in Standard & Poor's Composite Index in the past 125 Years

Year of Decade	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th
1881–1890	—	—	—	—	20	9	-7	-2	3	-14
1891–1900	18	1	-20	-3	1	-2	13	19	7	14
1901–1910	16	1	-19	25	16	3	-33	37	14	-12
1911–1920	1	3	-14	-9	32	3	-31	16	13	-24
1921–1930	7	20	-3	19	23	5	26	36	-15	-29
1931–1940	-47	-18	48	-2	39	28	-34	13	0	-12
1941–1950	-15	6	21	14	33	-10	-2	-2	11	20
1951–1960	15	7	-3	39	23	4	-13	33	11	-4
1961–1970	27	-13	18	13	9	-11	17	12	-14	-1
1971–1980	10	12	-19	-32	32	18	-10	2	11	26
1981–1990	-7	13	18	1	26	16	0	8	28	-8
1991–2000	28	4	7	-1	34	20	31	27	20	-9
2001–2010	-13	-23	26	9	3	14	4			
Sum of change	40%	13%	60%	73%	291%	97%	-39%	199%	89%	-53%
No. of Up yrs	8	9	6	7	13	10	5	10	9	3
No. of Down yrs	4	3	6	5	0	3	7	2	2	9

** Data from 1885 to 1985 by Edson Gould; from 1986 to date by Ron Meisels

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