

MARKET COMMENT

(S&P/TSX – 12467; S&P – 1412; DJI – 12416; NASDAQ – 2443)

A WEAKNESS TO MID-FEBRUARY SHOULD GIVE WAY TO A STRONG RALLY.

For our 2007 forecast, please see page 2.

INTRODUCTORY SUMMARY: We can now say; welcome to the 2002-2007 bull market. And what a market it's been! Since its inception in October 2002 this stubborn and decisive bull has been pushing the North American markets higher despite political turmoil and negative publicity. Fortunately, throughout this time we have stayed in tune with the bullish trend, avoiding the trap of "outguessing" its demise. Instead, we have focused on the technical health of the market which, despite showing some signs of aging, still demonstrates a relatively wholesome picture for now.

MARKETS NOW: In our previous Market Comment we indicated that New York was in need of a short-term pause. The premier objective for a correction was to eliminate the troubling discrepancy between the major US indices and their 200-day moving averages. A slow start in 2007 indicates that we were right, and that the US market has begun the correction.

While New York has been searching for a direction, Toronto had a very rough entrance into the New Year. This shouldn't come as a surprise. The S&P/TSX Composite has also become overbought in the short term and in order to prolong its phenomenal run it needed a

rejuvenating pullback, which arrived in the first days of January. The setback seems to be drastic and volatile but that's the way most corrections play out late in a cycle. At the same time, they are usually followed by an equally forceful rally. Watch for the area between the 50- and 200-day moving averages for the conclusion of this pullback (see pages 3 and 4).

The correction should help the market to alleviate recent excesses. The 39-week cycle, well beyond its mid-point, should exert more pressure between now and the next cycle low in late February.

Sentiment readings are also supportive of a correction. The latest data from Investors Intelligence show that the percentage of bullish investment advisers stayed high at 55.3% while the number of bears remained at 21.3%. Such numbers suggest that investors got a little bit too cosy with the market. These tendencies, however, by no means indicate the end of the bull market as the main harbingers of the demise – greed and euphoria - are not yet apparent.

Sentiment readings at the beginning of 2007 suggest more short-term weakness, but the great finale of this bull market is still ahead of us.

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THE MARKETS IN 2006: One year ago, under the flood of bearish reports, we suggested that readers should not give up on this bull but continue focusing on the Metals, Energy and Golds. Throughout the year we stressed the strength of the bull market and its ability to “surprise to the upside.” Indeed, 2006 was a year of plenty. Every bull could find something, but clearly, Toronto was the place to be in 2006.

THE MARKETS FOR 2007: A hint of what the New Year would bring comes from the “first five days of January” index which has a very impressive record of projecting the performance of the S&P 500 for the year ahead. If the S&P 500 rises during the first five days of trading, there is a very strong tendency (about 85% since 1950) for the markets to rise, and vice-versa.

Unlike last year, the “early warning” index raised a red flag as of yesterday, since the S&P 500 *declined* during the first five days of trading. To confirm this signal we await the January barometer results which take into account the whole month of January. Here the accuracy rate is even more impressive with only five major errors since 1950 and a 91.1% success ratio.

In tune with the bearish readings of the “first five days of January” is the “decennial index” for years ending in “7.” Only four of the thirteen “seventh year” since 1880 were winners. While weighing in these data it is important to emphasize that this bull market has entered its fifth year and this is where the underlying risk awaits.

So how about 2007? For the first time since early 2003, we have multiple answers. We see three possible scenarios:

Scenario 1 suggests that the correction is now complete and that this bull market is once again ready to “surprise on the upside”. Both New York

The greatest risk for 2007 is associated with the “time factor” as the current up-cycle enters its fifth year. Therefore,

and Toronto resume their rallies without taking time for a break. This kind of vertical explosion would get the markets into a corner, as in 1987.

Scenario 2 – After spending the first month-and-a-half in a sizable correction and bringing out the bears once more, Toronto and New York rally to new highs well into the second quarter of the year, engaging all the sceptics and creating a perfect storm of euphoria and greed to bring the 2002-2007 bull market to a glorious end.

Scenario 3 – The market completed its 4-year cycle by a very short bear market (just as in 1966 - 40 years ago!!) when it declined 8% from March to July (13% for Toronto from April to June) and it is already in a new bull market. Support for this theory is the above mentioned event 40 years ago, the strength of the rally to December and the leadership of the Financials.

Despite the popularity of the second scenario (the so-called “Nike” or “V” market) we prefer this outcome, but with a non-popular ending. Whereas everyone is looking for a up move till the end of 2007, our cycle work suggests that problems could begin in mid-2007, near the end of the second quarter.

Whichever way the market decides to go, we expect one thing to be common to all three scenarios: the markets will not all top at the same time. New York should be the first one to submit to a bearish reality, about two to three months before Toronto. Investors north of the border should therefore enjoy the usual extension of the bull market.

Despite a rough start in 2007, the main technical structure of the bull market remains intact. All major indices are trading above their rising 200-day moving averages and their major trend lines.

investors should stay focused on late-cycle sectors, at the same time protecting the gains with tight stop-orders.

THE TORONTO COMPOSITE INDEX



When the S&P/TSX Composite closed at 13,021 on December 14th, it reached our Point & Figure target of 13,000. Since then the index has started a well-deserved correction which aims to eliminate the overbought condition created by the rally from the early October lows.

The decline has already reached the top of the very strong 12,200-12,500 support zone where it should find some relief. This is also an area just between the 50- and 200-day moving averages. Finally, both a rising 200-

day moving average and the lower line of the up-trending channel going back to mid-2004 is in the proximity of 12,000, which should be the maximum extent of the correction in mid-February.

Use the current weakness to focus on the sectors which usually complete the bullish cycle: Materials, Golds, Paper Stocks and Consumer Discretionary.

THE S&P 500 INDEX



In our last Market Comment we made the case for a correction, we argued that for the longer-term health of this bull market the S&P 500 needs to pull back as soon as possible. Indeed, during the second half of December, the index showed numerous signs of short-term exhaustion.

The S&P 500 has already broken below the July-December trendline and is now sitting at its 50-day moving average. A one-third retracement could bring the index back to the

1350 level, the space between the 50-day and 200-day moving averages.

The ongoing correction is the only alternative for the S&P 500 to stay healthy for the near future. The pullback should provide investors with an opportunity to accumulate the leaders of the next rally.