

North American Marketletter

MARKET COMMENT

(S&P/TSX – 12910; S&P – 1413; DJI – 12317; NASDAQ – 2432)

DESPITE A POTENTIAL CORRECTION, THIS BULL SHOULD STILL BE WITH US AT THE BEGINNING OF 2007.

In our initial Market Comment of January 2006, we posed three possible scenarios for the year. The first possibility – which we rejected -- was a quick end to the bull market, followed by a short bear decline into a projected 4-year cycle low later in the year. The second option was a more prolonged bull market, with the peak occurring in the second half of 2006.

Our third possibility was our “contrary opinion” scenario. It was based on our repeated observation that the underlying strength of the market was such that the bull would stay in control for much longer than most expected. We suggested that we might be on the verge of a *5-year bull/bear cycle* (which has occurred several times in market history), with the bull refusing to die until 2007.

As we near the end of 2006, our “contrary opinion” scenario is the winner. This is not a surprise since it always pays to go against the majority. 2006 has been a very positive year, with a good rally in the first few months, a mid-year corrective period, followed by an even stronger upsurge as the year draws to a close.

The strength and persistence of the current rally since the June-July lows of 2006 has both “good news” and “bad news” elements, depending on market participants’ overall view of the bull/bear picture. There are more than a few analysts who now contend that we had a *stealth bear* in mid-year, and that the current rally is the lift-off for a new multi-year bull market. The appearance in recent months of more favorable media commentary about the markets’ prospects is one sign that for some, the wall of worry is crumbling and there are blue skies ahead.

The alternative view – which we share – is that the bull market dating from October 2002 is still in force, and that the bear has yet to appear. For the past few months, a long-in-the-tooth bull achieved a remarkable and sustained rally, easily overcoming seasonal fall weakness, without the public stampede of bullish enthusiasm that typically accompanies the end of a bull market.

Should we be pleased, or is this cause for worry as we approach the end of the year? As we detail on page 2, the markets are full of technical cross-currents and accompanying risks, but there is – as yet – no convincing case to be made that the bull market has reached its end. While markets on both sides of the border look strong on the surface – to the point of being short-term overbought -- we are beginning to see once again some de-coupling of the Toronto market from the major U.S. market indices. Most importantly for the shorter-term outlook, the U.S. markets are showing signs of short-term internal technical deterioration. *At this stage in the bull market, any sign of technical weakness must be watched closely – the consequences of major technical failure after over four years of bullish action are potentially much greater than if the bull was much younger.*

A short-term correction is due -- indeed overdue – and would be the best indication that the bull market will persist into at least early 2007, if not longer. Given its history, the chances are good that there will be further “upside surprises.” But, at the same time, market participants should recognize that the bull market is definitely in its later innings, and adjust their portfolios accordingly, in sectors that still demonstrate strength.

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During the last month, North American markets have continued to move upwards, with periods of selling appearing somewhat more frequently than earlier in the current rally. The technical picture has, however, started to shift as the rally extends.

The sentiment picture is losing its bullish hue. The Investors Intelligence weekly figures (a contrary indicator) currently show the percentage of bullish market advisers at to nearly 60% and the bears down in the low 20s. Both figures are near their extremes for this bull market. In addition, the percentage of NYSE stocks above their 10 week moving averages is about 80% -- this figure peaked in late October and has declined since then, even as the market has rallied further. This indicates that fewer stocks are participating in the upside move.

The current 39-week cycle is well beyond its mid-point, and is “right-translating” – this indicates the strength of the current advance, but it also suggests that there is a strong likelihood of some market weakness between now and the projected cycle low in late February 2007.

While the cycle picture points to some forthcoming weakness, an even greater immediate concern is the significant negative divergence in internal momentum indicators (such as MACD) for the major market indices. This is particularly pronounced in the U.S. markets, where the divergence has been developing for the past month. One of two outcomes will occur – either the markets will correct shortly and “work off” the divergence, or they will continue to rally and probably create an even greater divergence. The healthier outcome for the longevity of the bull market is for the correction to occur sooner rather than later.

A related risk is the possible “blow-off” phase, if the markets accelerate their

current rallies. We rate this risk as small, but it cannot be completely discounted. This would indicate upside exhaustion, with the possibility of a rapid tumble, calling a quick halt to the bull market.

What is more likely is that the bull market, as it ends, will engage in a more prolonged topping period, with New York leading and Toronto following. The longer-term indicators that we have cited in previous Market Comments – e.g., major bull market trendlines, and 200-day moving averages – require sustained bouts of selling before they would turn into negative territory and confirm that the bull market has ended. Those indicators are, for the moment, holding up well.

The technical picture outlined above will be played out against a backdrop of bullish and bearish forces over the winter months. Year-end tax selling and January profit-taking will be pitted against year-end bargain-hunting and a new RRSP contribution season. And lurking in the background are rumours of an adjustment to the Canadian income trust tax ruling.

At this point in its life, the underlying long-term risk for this extended bull market is simple – it is that of the *time* factor. Price resistance in the major market indices has been vanquished, but this bull market is gradually approaching its resistance point in terms of duration. It is likely that this point will be reached sometime next year.

The technical picture suggests that this bull market has at least one more corrective phase before it ends. We believe such a correction will occur soon. Declines in major market indices below their respective 50-day moving averages are possible. Following a corrective period, the bull market should launch its final significant advance in 2007.

THE TORONTO COMPOSITE INDEX



Of the four major market indices reviewed on these pages, the S&P/TSX Composite Index looks the strongest technically by far. In mid-November, the Toronto market looked a little hesitant below the key 12,500 resistance level, with some signs of weakening internal momentum. But the index fought through this internal weakness and has broken through – and stayed above – the resistance, setting new all-time highs. Our next identifiable Point and Figure target of 13,000 is close at hand..

The current strength of the Toronto market can be seen by the fact that at the close of last week it was over 600 points (more than 5%) above its 50-day moving average. The market is overbought, but there is room in the short-term for it to go higher. The percentage of Toronto stocks above their 10-week moving averages is about 67%

(lower than mid-summer readings), and about 64% of stocks are above their 30-week moving averages – in both cases, the figures have room to go higher before a severe overbought status would be reached.

Near-term support rests at the trend line that can be drawn from the October 4th low (currently at about 12,700), and the 12,500 level acts as a further support for any short-term decline. Internal momentum figures do not indicate any important negative divergences, but the sheer strength of the recent momentum peak does call into question whether the S&P/TSX Composite Index needs a brief rest.

The Toronto market continues to perform well. Any pullback should continue to be treated as buying opportunity in strong sectors.

THE S&P 500 INDEX



We published a Point and Figure target of 1425 for the S&P 500 – last week the index came within less than 7 points of this target. The question of the moment is whether the S&P 500 can still hit this target without first going through a corrective period.

There is a good argument to be made for a correction. The S&P 500 has rallied about 200 points, or about 16%, from its May-June double-bottom (A-B). Then, starting in mid-October (C), the index moved *above* the upper part of the trend-channel (see solid line) that joins intermediate-term peaks (and which has been in force since the beginning of 2004). This indicates acceleration of the prevailing trend to the upside. In addition, the recent action has stretched internal momentum figures to extreme readings.

Most worrying is the peak in internal momentum (e.g., as measured by the MACD indicator) that occurred in late-October (D), followed by a lower peak in late-November, and further indications that the index may be forming a third and even lower peak in December. This pattern has occurred as the index has pushed ever higher, creating a 6-week period of growing

negative divergence in internal momentum. From this type of pattern, markets have a good probability of entering a corrective period.

If a pullback does occur, it will be healthy for the bull's prospects. The trend line drawn under the July-December rally (see dashed line) rests at about 1390 and the major trend line referred to above is about 20 points lower – both of these levels should provide good support. In addition, the rising 50-day moving average (50dMA) rests at about 1380. Given the strength of the rally and the extent of the negative divergence, it would not be surprising if this 1370-90 zone is broken on the downside in order to resolve the current technical weakness. A one-third retracement of the rally could, for example, bring the index back to the 1350 level, about mid-way between the 50-day and 200-day moving averages.

We expect – and would prefer for the longer-term health of this bull market – to see the S&P 500 pull back as soon as possible from current levels and take a rest. A correction should be contained above the 200-day moving average, forming the basis for another push to new bull market highs.

THE DOW JONES INDUSTRIALS



Like the S&P 500, the recent rally of the Dow Industrials has resulted in a move above the major trend line that has defined the upper boundary of the bull market (see solid line). Dow Industrials is also afflicted with the same negative internal momentum divergences as is seen in the S&P 500. The Dow has also registered an extremely high overbought reading in late-October (the highest for the index in this bull market) which looks increasingly as a significant intermediate-term peak in internal momentum.

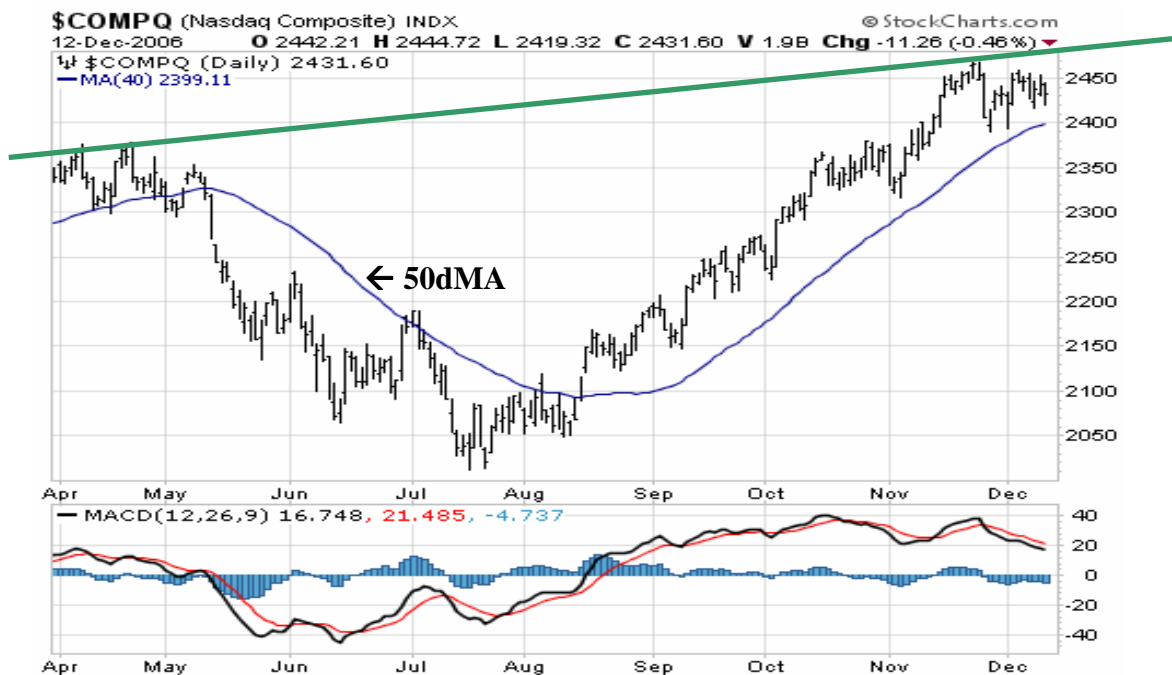
One month ago the Market Comment suggested that the Dow Industrials were in need of a healthy pause/pullback. A quick decline in the latter part of November was followed immediately by a rally back towards previous highs, setting up a potential short-term “double-top.” The

deterioration of internal momentum, and at the same time, the persistent failure of the Dow Transports to confirm the recent highs, makes the current picture look even more technically problematic over the near-term.

The Dow Industrials desperately need a pause. The major initial support for any pullback is the 11,900 level. A one-third correction of the July-December rally would target about 11,770, and a one-half retracement would bring the Dow Industrials back to their rising 200-day moving average in the 11,500s.

The Dow Industrials need to pull back quickly from current levels to correct recent excesses. Assuming this pull back is well-contained, the major trend remains up and the Dow should be able to rally back above its November highs.

NASDAQ COMPOSITE INDEX



The NASDAQ's action over the past few months has been impressive, but we remain skeptical of the underlying strength of this index. The rally since mid-summer is showing the same signs of fading that are to be seen in the S&P 500 and the Dow Industrials.

In mid-November the NASDAQ hit a peak around 2470. This peak was right below the two-year trendline that joins three other peaks the index made since the beginning of 2005. This is a level of significant upside resistance. If the NASDAQ is able to exceed this peak then it will indicate further possibilities to rally higher.

Given the negative divergence in internal momentum, we believe the NASDAQ's next important move will be a pull back from here. The 50-day moving average offers near-term support at about 2400, but since NASDAQ corrections tend to be sharp, a one-third correction of the recent rally towards the 2300 zone seems possible.

Our overall view of the NASDAQ remains that its bullish possibilities are significantly constrained. As we said one month ago, the entire current bull market for the NASDAQ may merely be a one-third recovery of the massive 2000-2002 decline. This interpretation holds unless the NASDAQ exceeds 2525.

The NASDAQ's action of the past year and a half also suggests what is referred to technically as a "broadening top", with higher highs accompanied by lower lows. This pattern is visible from July 2005. Resolution of this formation typically is on the downside, in this case below the July 2006 low of 2013.

The NASDAQ is over-extended. For nimble traders it has profitable possibilities, but for longer-term investors the risks at this late stage of the bull market substantially exceeds any rewards.