

## MARKET COMMENT

(S&P/TSX - 11640; S&P - 1270; DJI - 11205; NASDAQ - 2196)

**THE EXPECTED “PAUSE FOR FRESH AIR” HAS ARRIVED.  
BUT THIS BULL HAS NOT LEFT THE MARKETS YET.**

The headline in our last Market Comment at the beginning of May was “let’s pause for fresh air.” As North American markets continued to rally strongly through the late winter and early spring, we commented frequently on the lack of bullish enthusiasm. Then, just as the warmer weather arrived, so did a renewed sense of popular bullishness and optimism. First quarter earnings generally exceeded expectations. Four-figure targets for gold bullion were mentioned. A wave of mergers and acquisitions in the Materials sector was forecast.

We were sufficiently concerned two weeks ago by the decline of market skepticism and the “throwing in of the towel” by some bears that we issued a cautionary note, warning of the possibility of short-term weakness. We forecast that May could be a flat or negative month, especially for the sectors that have led the bull market in Toronto.

The market action late last week confirms that a significant period of profit-taking has arrived. What’s behind the selling? After many months of rallying, the markets were technically overextended. The major indices in Toronto and the U.S. (S&P 500) were at the top of their major trend channels, so a decline was very likely. Good profits were there for the taking, especially with rising interest rates. Public confidence was growing – not “irrational exuberance” and euphoria – but a sense that the advance that had been in place since last October was sustainable and had more immediate upside. In addition, in anticipation of option expiry this Friday, some participants were likely adjusting their positions.

Page 2 of this report goes into further details concerning the technical position of the markets. But at a time of increased nervousness for the bulls, let’s remind ourselves of two features of the larger picture. First, the 9-month cycle is well advanced and is overdue for its “declining” phase. Second, at the recent tops in the major indices, there were no major “blow-off” moves to the upside, nor were there major internal momentum divergences. Conclusion: this is a minor top in an ongoing bull market.

One possible scenario for the next few weeks is a continuation of last week’s sell-off, followed by some choppy and sluggish action for at least the rest of May. Pessimism should grow about the future prospects of the market. Different sectors of the market should reach their bottoms at different times, and then gradually take-off to the upside in sequence. In Toronto, for example, we might see the Energy sector – which has been under selling pressure for some weeks – bottom and turn upwards before the Golds.

**For the next few weeks, North American markets will likely be under more intense pressure than at any time since last October. After a six-month rally, the bullish “wall of worry” needs some re-building. A few panic days should do the job and the stage will then be set for the early “summer surprise” in the form of a substantial rally.**

**David Tippin  
Ron Meisels**

Have the advocates of “sell in May and go away” finally been proven correct? Our weekend “Thought for the day” indicated that this popular refrain is not very applicable in bull markets. In fact, selling in May and staying out of the markets until September during the bull years of 2003, 2004 and 2005 missed good advances in both the Canadian and U.S. markets. The following table shows the percentage and point gains in these markets from the low of the first trading day in May, to the high point in September.

	S&P/TSX Composite Index	S&P 500
2003	1128 points 17.3%	137 points 15.2%
2004	428 points 3.5%	25 points 2.3%
2005	1788 points 19.1%	88 points 7.6%

As we said in the weekend “Thought for the day”, the “sell in May” advocates may have a short period of “we were right”. But as the summer progresses and the bull market continues, many of those who sold out will be looking to re-enter the market – at considerably higher prices.

The 9-month cycle that began last October has been good for the North American markets. This cycle has “right-translated”, meaning that its mid-cycle peak has shifted to the right, or later in time. The markets have been positive for a good two-thirds of this cycle, indicating their underlying strength. The next low in this cycle is due in the first half of June, and this should coincide with the exhaustion of the current liquidation phase.

We said on the first page that public enthusiasm was growing for the markets. The sentiment of professional investment advisers – as measured by Investors Intelligence -- has also remained bullish, but less so than previously. The percentage of these advisers in the bear camp is up to 26.8%, and if selling persists in the markets for a few weeks, we should see this percentage grow. That will be an indicator that pessimism is gaining an audience – and for contrarians, this will be a sign that the selling is coming to an end.

The bottom line for this bull market remains unaltered. The major North American market indices are all above their rising 200-day moving averages, and their major bull market trend lines. None of the indices has completed a pattern of prolonged internal distribution that would indicate a turn in the major market tide that has been in effect since October 2002. The history of this bull market has been its continual capacity to “surprise on the upside”, against a largely skeptical and disbelieving investment public.

**There may be a short-lived “swoon in June”, but “buying for July” and a summer rally should be a rewarding strategy. Our approach is to watch for signs of over-extended selling in the bull market leaders such as Energy, Materials and Golds – and use these occasions in the weeks ahead as buying opportunities. Our upside targets for the S&P 500 (1360) and the S&P/TSX Composite Index (14,000) remain achievable during the next upturn.**

# THE TORONTO COMPOSITE INDEX

(S&P/TSX – 11641)

(Daily chart with 50- and 200-day moving averages)



The bull market in Toronto was three years old in October 2005, and by historical standards was entering the “aging bull” category. So what did the S&P/TSX Composite Index do at that point? From mid-October until mid-April the index rose another 2350 points, or 23%. The aging bull became a *raging bull*.

After six months of vigorous rallying, Toronto needed a rest. We are not at all perturbed by the recent declines – a pause here is very healthy. From October to April, the S&P/TSX Composite Index moved in a well-defined upward channel, and has, since mid-November, held above the rising 50-day moving average.

The strong rally means that the Toronto market has considerable room to retreat without damaging the overall bullish picture. The index moved below its 50-day moving average last week, and the period of time it will spend below this moving average will be useful to mobilize strength for the next upward move.

A one-third retracement of the October-April rally would bring the S&P/TSX Composite Index back to about 11,700 – in other words, somewhere in the zone between the 50-day moving average and the 200-day moving average. This seems a likely scenario. If the retracement were to be one-half of the previous rally, the target would be about 11,300, which is where the 200-day moving average currently rests.

**The Toronto market is going through a period of profit-taking in the overbought Sectors. Volatility will likely increase in the short-term as some portfolios are re-positioned. This is normal bull market behaviour. Expect the selling to exhaust itself and the buyers to return to the bull market leaders in Energy, Materials and Golds. Our objective for the S&P/TSX Composite Index remains 14,000.**

# THE S&P 500 INDEX

(S&P 500 – 1270)

(Daily chart with 50- and 200-day moving averages)



For the past two months our Market Comment has observed that the S&P 500 is taking a slow and meandering path to new recovery highs. The action has been choppy, with upside and downside moves of a few weeks duration, all within an upward bias.

The move from mid-April to a new high at 1327 (early May) pushed the S&P 500 right up against the resistance offered by the upper trend line (see dashed line). The index's reaction to meeting resistance has been a quick sell-off. This latest decline very likely indicates that the "up" portion of the 9-month cycle in the S&P 500 has ended, and that we should now expect a period of pause into a cycle low.

In terms of support zones, the overall picture for the S&P 500 is the following:

- First support is near the March lows; next at the February lows (see horizontal lines)
- The rising 200-day moving average is just below 1260
- The lower trend line of the major trading channel is at about 1230

From October 2005 to May 2006, the S&P 500 rose about 160 points, or about 13.6%. During that time, the index dipped slightly below its rising 50-day moving average on several occasions.

Sustained pausing action will probably cause the 50-day moving average to flatten out and probably roll over for a time. It would be healthy in the longer-term for the S&P 500 to spend some time *below* its 50-day moving average. Targets for corrections:

- A one-third correction of the October–May rally would target 1275
- A one-half correction of the previous rally would target about 1250

**We expect that the S&P 500 will spend the next few weeks in a pausing/corrective mode. There are several support zones that should contain any serious price damage. Following the end of the correction, look for a good summer rally to new highs for this bull market.**

# THE DOW JONES INDUSTRIALS

(DJI – 11205)

(Daily chart with 50- and 200-day moving averages)



When the Market Comment last analyzed the Dow Industrials – in late March – the index was in the 11,200 zone. We were bullish on the Industrials at that time, and expected the index to move higher following some further pausing action.

As forecast, the Dow Industrials pulled back to just below its rising 50-day moving average in April. From that point – just above 11,000 – it’s been “all systems go” on the upside, with both the Industrials and the Dow Transports reaching new highs for the 2002-2006 bull market. Last week, the Dow Industrials came very close – less one per cent -- to exceed its all-time of 11,750. The media started paying more attention to what has been the “long lost” index of this bull market.

The over 600 point rally of the past few weeks resulted in the Dow Industrials becoming very overbought. It is no surprise that the Dow started to sell off late last week from this overbought condition.

Initial support for the Dow Industrials exists in the 11,200-11,300 zone, and major bull market support in the 10,800-10,900 region (where the rising 200-day moving average and the major 2002-06 bull market up trend line rest).

**The Dow Industrials’ recent action was a typical “running out of steam” move. Some corrective action is needed, probably as much in terms of time as in price. Subsequent rallies should at least challenge the all-time high of 11,750.**

# NASDAQ COMPOSITE INDEX

(NASDAQ – 2196)

(Daily chart with 50- and 200-day moving averages)



The last time we looked at the NASDAQ, in early April, the index had just reached a new recovery high for this bull market. We said at the time that “the key point to watch in April is the quality of the ensuing action, particularly whether the NASDAQ moves quickly beyond the 2350 level, or decides to consolidate its recent rally as the S&P 500 has done.”

Immediately after that new high, the NASDAQ retreated to its rising 50-day moving average, found support and then made another quick thrust to the 2370 area. This rally was on weaker internal momentum than the previous high, setting up a negative internal divergence. Since then, the NASDAQ has been in retreat – which was made very visible by the sell-off late last week.

The decline since mid-April has now taken the NASDAQ well below its 50-day moving

average, and now below its rising 200-day moving average. Near-term support is indicated at the major bull market up trend line in the low 2200s.

The NASDAQ had a very good 7-month rally from October to April. It is now time for a pause. Provided that the index remains above the 2190 level – its low point in January 2006(see dashed line) -- the overall bullish position of the NASDAQ is intact. A sustained move below 2190 would signal that the bull market for the NASDAQ has ended.

**The NASDAQ is oversold, and needs some further consolidation. The 2500 is still possible, but it must not move below 2190-2200 to stay healthy.**

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