



North American Marketletter

MARKET COMMENT

(S&P/TSX - 12365; S&P - 1399; DJI - 12305; NASDAQ - 2449)

A CORRECTIVE PERIOD IS ON THE HORIZON, BUT THE BULLS REMAIN IN CHARGE OF THE MARKETS.

The North American bull market is now *50 months old*. New highs are being made in many major market indices. But just how long can this party last?

Part of the answer to this question lies in understanding market psychology. As bull markets move into their final stages, it becomes more and more important to analyze the sentiment of market participants – ranging from pessimism and fear at one extreme, to optimism, over-confidence and euphoria at the other extreme. Indeed, one definition of a mature bull market is that it presents opportunities for participants to be both pessimistic (as in, worry that the bull is going to end, or has already ended) and optimistic (as in, eagerness to be involved in the next rally). The market action of the past few months illustrates these principles very well.

Let's go back to the May-June correction. Two months of sharp decline shattered the nerves of many market participants. After all, hadn't the bull survived for far too long since 2002? And wasn't there a 4-year cycle low due in October 2006? And hadn't so many market analysts declared that "sell in May and go away" was the correct strategy? (And in mid-June, they looked right!). Gloom was widespread.

Of course, in the midst of growing pessimism, the bull once again took charge in mid-June. By September, the U.S. the media was on the "new high for the Dow Industrials" watch – with every squiggle of the Dow pored over in anticipation,

while skeptics gleefully pointed out how few of the Dow stocks were performing positively (and therefore the bull was bound to fail). All this attention for an index that had been ignored for years! But as the Dow Industrials exceeded previous highs, the skeptics were overwhelmed by a new and more positive sentiment – maybe, just maybe, these big caps have some staying power. And on the Canadian side, the Toronto market did hiccup in September, but quickly recovered. And there was no October massacre.

What, then, is the current status of North American markets? As we show on page 2, the technical evidence is that bull market is still in force, and there are few long-term signs that the bulls have been completely exhausted. Bullish eagerness is not yet outright greed and excess, of which we should see signs when the bull nears its end.

At the same time, after several months of rallying, these markets need a rest – there are, as the next page shows, some technical cracks appearing. A pause at this point would be healthy.

The market skeptics continue to be disappointed. The bull market needs another short-term rest, but it has yet to finish its work. There are more new highs to come in both Toronto and New York.

Over four years and counting. And there's still ample technical evidence that this bull market has some life remaining in it:

- Major market indices have rallied strongly for months, during a seasonal period when technical weakness has often appeared
- Long-term moving averages continue to point upwards
- Higher Point and Figure targets for the S&P 500 and the S&P/TSX Composite remain visible
- Bullish sentiment is not yet at the extreme levels that one would expect to see at the end of a bull market.

But there are also some technical concerns.

(1) The current 39-week cycle has either reached its top, or is very near to it. The down portion of this cycle will act as a drag on any attempts at market advances over the next few months. (2) Negative divergences in internal momentum are appearing in some of the major market indices. (3) The new high/new low ratio on the NYSE has reached an extreme of 89%, and is unlikely to go higher in the intermediate term. (4) The Investors Intelligence weekly figures show that the percentage of bearish market advisers is down to 22%, and the percentage of bulls has risen to 56%. In addition, the percentage of New York stocks above their 10-week moving average is at 78% and the percentage above their 30-week moving average is at 81%.

In Toronto, the extent of the overbought condition is smaller – reflecting the September/early October weakness – with the comparable percentages being 50% (30-week) and 56% (10-week). These figures

indicate some intermediate-term enthusiasm that could give way to some weakness over the next few weeks as some stocks pull back to their 50-day moving averages.

The recent tax announcement affecting Canadian income trusts provides another useful illustration of late bull market psychology. Money poured out of the income trust sector, but did not leave the market entirely; it was put to work in other sectors such as the big banks. The Toronto market absorbed the one-day hit, then resumed its advance -- bad news is handled well in bull markets (as an aside, the Australian market, also resource-heavy, made new highs recently – Toronto would very likely have done the same if not for the income trust tax).

The North American bull market is approaching its end-game, but it is not there yet. The 4-year cycle has been delayed, but it has not been repealed – there will be a bear market at some point. But as our Market Comment has said repeatedly for the past couple of years, the major mistake investors have made is to doubt the power and longevity of this bull – this means there is still a risk of selling too soon. If historical patterns hold, New York will top out first and lead Toronto downwards. But at the moment, the New York market is not indicating that it has peaked.

Any pullbacks over the next few weeks should be treated as last-chance buying opportunities in bullish-looking sectors, as well as the Energy, Metals and Golds.

THE TORONTO COMPOSITE INDEX



From its June 2006 low (A), the S&P/TSX Composite Index rallied strongly for over two months – but without exceeding its all-time high made in April. At the end of its rally in early September, the Toronto market developed a small negative divergence in internal momentum. This was enough to precipitate a sharp decline into a low on October 4 (B). At that point, the Toronto market’s position looked very similar to how it appeared at the June low – the index was under its 200-day moving average, but that average was still rising.

The rally over the past few weeks has carried the S&P/TSX Composite back towards its all-time high. But once again, there are signs of weakening internal momentum – a declining number of new highs, a smaller number of stocks above their 50-day moving averages -- which suggest that a pause may be in order.

The move in the Toronto market from the June low to November is best viewed as a

single somewhat choppy up leg, punctuated by several minor corrections. The rally has moved the index above both its 50-day and 200-day moving averages, both of which sit just slightly under 12,000. These should provide good support for any pullback.

While an immediate move above 12,500 cannot be discounted – which would quickly be followed by a challenge of our initial target of 13,000 – the internal momentum problems suggest that the Toronto market may retest the low 12,000s/high 11,000s. The major 2002-2006 bull market trend line rests at about 11,500, so there is ample room for the bull to take a short break.

The Toronto market’s performance of late has been impressive, given the unexpected income trust tax pressures, and weakness in the driving forces of the bull market (Energy, Metals and Golds). Any short-term weakness should be followed by a renewed push past the April all-time high.

THE S&P 500 INDEX



Our Market Comment has maintained its correctly bullish view of the S&P 500 as it rose towards our Point and Figure objective of 1425, despite the worry and skepticism of so many market participants

Following a textbook-perfect double-bottom with the second low occurring on a positive internal momentum divergence (A-B), the S&P 500 index has risen over 13%. This powerful move has stretched the index well above its 200-day moving average (just under 1300) and above the long-term bull market trend channel.

From mid-September to late-October the S&P 500 was more and more in overbought territory. That condition has been alleviated somewhat by a small decline at the end of last month. However, the subsequent

attempt to rally has set off warning signals in internal momentum (which is diverging negatively), and has triggered a short-term MACD warning signal (see circle).

The likely outcome of this technical condition is that the S&P 500 will have a resting period, and probably give back a small portion of recent gains. A one-third pull back would bring the index back to just below its rising 50-day moving average (now at 1350). The 200-day moving average (now at 1300) is in the vicinity of a 50% correction.

The S&P 500's technical position remains strong but it deserves a short rest. The 1425 target is still clearly visible.

THE DOW JONES INDUSTRIALS



When we looked at the Dow Industrials in September, we noted that the long-term trend line (then at about 10,600) needed to hold in order for a bullish interpretation to remain valid. The Industrials succeeded in making a double-bottom in the 10,600-700 area in June and July (A-B), and since then it's been all systems go on the upside for the index – at the close of last week the Dow had risen by over 14%.

The key features of the Dow Industrials' current technical position are:

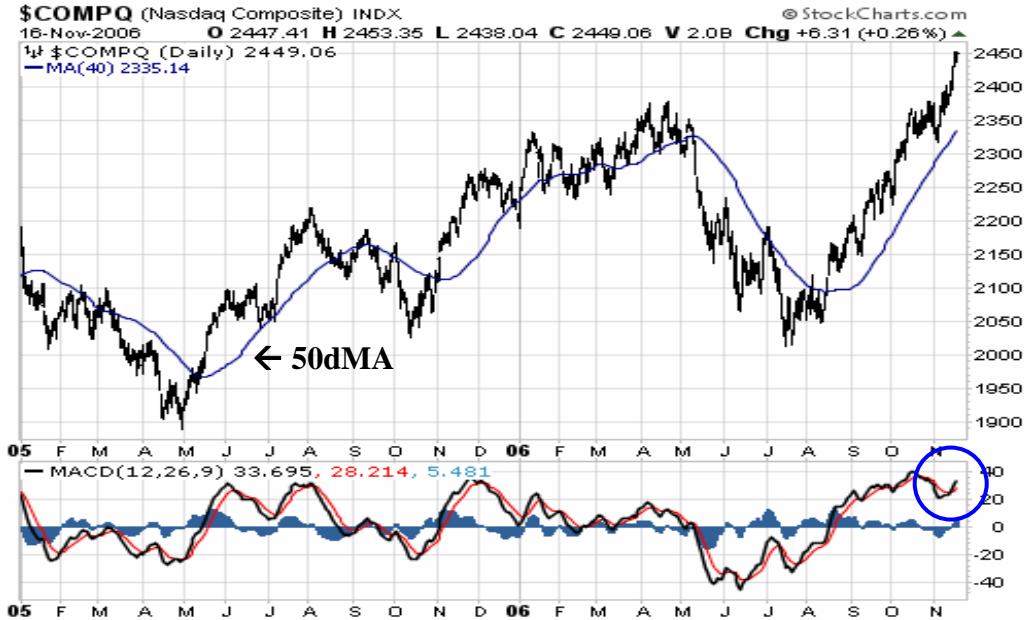
- Frequent new highs, with the index breaking above a major long-term trend channel that extends back to 2004
- Extremely positive internal momentum achieved in late October, followed by a lower reading – this is a negative divergence (see circle)
- The Dow is far above its 200-day moving average
- The Dow Transports have not confirmed the new high in the Industrials

After a more than 1500 point rally over the past four months, the Dow Industrials is extended, have an eroding internal momentum, and are due for a healthy pause.

At a minimum, any pullback that occurs can expect to reach the 11,800-900 area, which is the zone occupied by the rising 50-day moving average. A one-third correction would take the Dow slightly below these levels, while a 50% retracement would target the low 11,400s. The 200-day moving average is just above 11,300 and the major long-term bull market trend line rests at about 11,000. There are, in other words, several support zones and points that would have to be violated before the bull market in the Dow Industrials could be questioned.

The healthiest development for the Dow Industrials in the next few weeks would be a pause/pullback to rest from the upside heroics of the past few months. If the bull market is still in force, any pullback should be followed by a move to another new all-time high. The Dow Transports bear close watching to see if they confirm any new high in the Industrials.

NASDAQ COMPOSITE INDEX



The last time we looked at the NASDAQ we were quite confident that the bull market in the index had been completed, and that any rally attempt would meet with renewed selling pressure as the bearish forces took hold.

The NASDAQ has surprised us with its vigour. From its low in July, the NASDAQ has climbed over 18%, to reach, and then to slightly exceed, its April 2006 peak. The index now sits well above its 200-day moving average.

How is the recent action best interpreted? One point of view would be that the advance since mid-July is just a bear market rally that is heading to fulfill the 1/3 correction target of the whole 2000-2002 decline from 5133 to 1220, i.e. to 2524. An alternative point of view is that the bull market for the NASDAQ is still in force and that further new highs will be achieved as the S&P 500 continues upwards. We believe that the former is more probable.

Currently, the NASDAQ is showing significant signs of a negative internal momentum divergence (see circle). After several months of rally, this should result in a pullback over the near-term. A one-third retracement would target about 2265 (just below the 50-day moving average); a one-half pullback would be about 2200 (just below the 200-day moving average). The major bull market trendline is at about 2100.

Expect a short-term decline in the NASDAQ, back into the trading range and towards the 200-day moving average. Any subsequent rallies should be approached cautiously, unless there is a significant expansion in volume if and when the index exceeds 2400.

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