

## MARKET COMMENT

**THIS CURRENT PERIOD OF WEAKNESS HAS MORE ROOM TO RUN.  
BUT A VERY CONSEQUENTIAL "SPRING RALLY" SHOULD FOLLOW.**

**March 21, 2007**

At long last, the expected correction in North American markets is underway. It has been an extended wait as the markets have slowly pushed higher, but we have been calling for a pause in the up trend as a necessary ingredient in preserving the longevity of, what is admittedly, an aging bull market. We have also said in previous Market Comments that any corrective period should be the prelude to an important rally as spring approaches.

The correction that began in late February was, on the surface, triggered by bad news – in this case a sell-off in China. As the decline gained momentum in early March, the media "bad news bears" quickly came out of the woodwork, loudly proclaiming that sub-prime mortgage market concerns were going to put the bull down for the count once and for all. The attention given to negative news is typical in this type of correction, seeking to tie market behaviour to specific events, trends or concerns. But it masks what the Market Comment has been highlighting for a number of months prior to the appearance of the negative news – the gradual deterioration of the internal structure of the bull market, with the emerging technical weakness being the best forecaster of the decline that is now occurring. On page 2 we recapitulate the significant technical and investor sentiment trends of the past several months and assess the market's current position in more detail, and suggest two possible scenarios for this late stage bull market in the months ahead.

How long will this current period of market weakness continue? In this bull market, corrective periods that followed extended up trends have tended to last for a number of weeks, and sometimes up to two months. If this tendency holds, then much of the month of March should be corrective. The initial swift drop from the February highs was the first down leg, which could be followed with an attempt at recovery, but the lows of the first down leg could be tested before the correction ends.

What next? We think the next up move in North American markets – likely a "spring rally" -- will be the one that truly "tells the tale" for most of 2007. It will either reconfirm that the bull market has some time left on its clock – which would be indicated by good volume, broadly-based moves to significant (not marginal) new bull market highs in the major indices, or the rally will sputter and limp to an end somewhere near existing index highs – which would suggest that the bull market is very near its expiry date.

**A "buying opportunity" in selected sectors should emerge in the weeks ahead. But it must be treated with caution, and viewed – unless new evidence emerges – as a rally of limited duration and potential.**

**Ron Meisels**

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## North American Marketletter

By some measures, the 2002-2007 bull market continues to thrive. As the bull approached its fourth anniversary last October it was able to launch yet another strong rally through early 2007. The major bull market up trend lines remained intact and indices remained above their 200-day moving averages. Corrections, including the present one thus far, have been well-contained.

Below the surface, as we have stressed in recent Market Comments, the technical condition of the markets is not quite as rosy. An internal high on the S&P 500 index, as measured by momentum indicators, has probably occurred last October in the middle of the most recent rally. In Toronto, this internal momentum peaked later, in December. North American markets continued to move higher after these momentum peaks, and created negative divergences between price and momentum.

Advisory sentiment continues to display strong comfort level with the persistence of a bull market. The Investors Intelligence data show a slow increase in the number of bearish advisers and an equally slow decrease in the number of bulls as the markets correct, but the overall dominance of bullish advisers remains. We also note that Mark Hulbert's mid-March review of the five best-performing long-term investment newsletters revealed that all were bullish.

Among investors, the picture remains mixed. We have observed in previous Market Comments that we have yet to see the levels of widespread public greed and euphoria that frequently occur at major market tops. But excesses have appeared in selected sectors over the past year – recall how gold was projected to be an easy journey to new all-time highs, and \$100 barrel oil? Might it be that one of the “foolers” at the end of this bull market will be the absence of widespread public optimism?

Putting all this together, the picture that emerges is of an aging bull market that is increasingly characterized by negative divergences, deterioration in the number of stocks participating in the major up trend, and a sense of complacency (of professional advisers)

or neutrality (by the investing public). We should not forget the negative tendencies that the seventh year of the decade has shown historically (Please see reprint of this on Page 7, in case it was overlooked in our last issue). We are also concerned about the lack of significantly higher Point and Figure targets in major indices – our S&P 500 target of 1,425 has already been hit, and the S&P/TSX Composite Index projects to a modest new high at 14,000. New higher targets could, of course, emerge in the weeks ahead, but they are not visible at the moment.

A bull market does not change to a bear market overnight. Typically, there is a period of transition – which can range from a matter of weeks to many months – during which stocks are being distributed from stronger hands to weaker hands. The evidence is by no means conclusive that this process has started, but the mixed technical picture following four-plus years of bull market action suggests that the signs of transition must be watched closely. The market's condition also suggests two possibilities for the months ahead:

1. The next rally will re-test bull market highs in New York, and modestly exceed recent highs in Toronto, probably fueled in the latter case by renewed strength in sectors such as the Metals and Golds.
2. The next rally will be weak, not exceed recent highs, and will be followed by a significant test of the support offered by the 200-day moving averages of the major market indices, as well as the major bull market up trend lines. If these tests fail, it will be further evidence that we are well into a transition from bull to bear.

**Investors with shorter-term time horizons should participate in the projected spring rally with close stops. Longer-term investors should exercise caution. We expect that a future Market Comment will be headlined “the bull is dead, long live the bear” – but it is not yet ready to see the light of day. We await the results of the next rally.**

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## THE TORONTO COMPOSITE INDEX



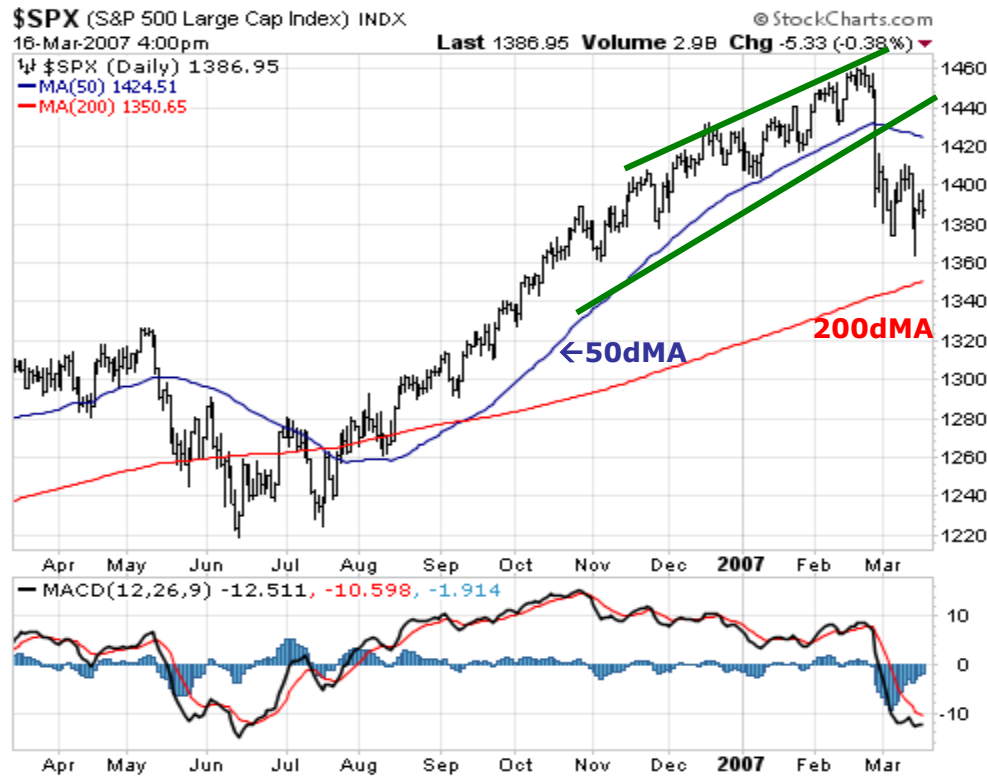
Twice thus far in the month of March the corrective phase in the S&P/TSX Composite Index has found support in the 12,650 area. This is about a one-third correction of the June 2006-February 2007 rally. We forecasted initial support approximately in this area in previous Market Comments. The index is currently below its gradually flattening 50-day moving average, but remains well above the still rising 200-day moving average, currently at about 12,250. This is also the area that would be reached if the correction retraces one-half of the previous rally. There is strong support at about 12,400 to 12,500 – the zone where the early January decline was halted.

The Toronto market is currently oversold, but has started to form a small positive internal momentum divergence. This might indicate

some further rally attempts over the short term. However, the 12,650 zone is likely to come under renewed pressure before the current decline ends.

**We expect that the S&P/TSX Composite Index will fluctuate for some time above and below the 13,000 level until the correction ends. The 12,400-500 zone should contain the balance of the correction, unless there is a panic decline. The Point and Figure target of 14,000 can still be achieved by a spring rally in this bull market.**

## THE S&P 500 INDEX



At the beginning of February our Market Comment observed that “the S&P 500’s price pattern, while still rising, has settled into a rising wedge pattern, which has negative implications” (see lines). Each rally to new bull market highs was weaker than the previous one, so each new price peak in the S&P 500 made the index look like it is slowly “rolling over.” In late February the dam gave way and the index tumbled rapidly out of the rising wedge pattern. The subsequent negative action has seen the S&P 500 probe the 1,360 area, and has turned the 50-day moving average downwards for the first time since last summer. This latter event in itself shows the technical significance of the current decline.

As of the end of last week, the S&P 500 retraced over one-third of the July-February rally. A one-half retracement would take the

index down to its 200-day moving average at around 1,350. Sooner or later, as we observed previously, this moving average will be seriously tested.

The S&P 500 is still working off its major negative internal momentum divergence, but has temporarily moved in to oversold territory. Although we may see some short-term backing and filling around current levels, we expect that the low of February 14 at 1,364 will be re-tested before the current decline runs its course.

**The S&P 500 should stabilize above its rising 200-day moving average. The initial obstacle in any subsequent rally attempt will be the resistance caused by the declining 50-day moving average.**

## THE DOW JONES INDUSTRIALS



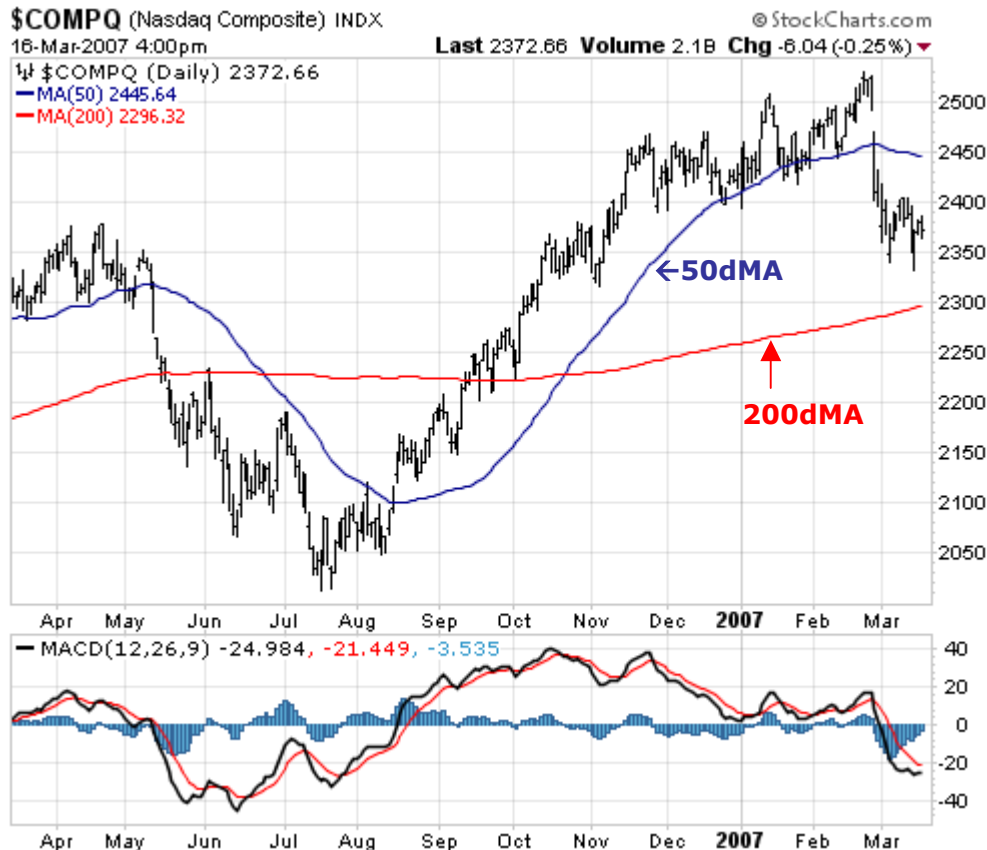
When we looked at the Dow Industrials at the beginning of February, we declared that the index was in "pre-correction" mode. The Dow was over-extended, momentum was weakening significantly, and the price pattern was forming a potentially bearish wedge shape (see lines).

The Dow Industrials held up until the second half of February but the decline has been swift since then. The retracement was about one-third (700 points) of the July-February advance. Initial support was found near 12,000, at the trend line formed by the early 2004 – 2006 tops (not shown). This trend line, which was broken

on the upside by the late 2006 rally, is now a case of "resistance becomes support". Further support is provided by the rising 200-day moving average in the 11,800 area, which is near the 50% retracement level.

**The Dow is oversold short-term and could bounce higher, but the 12,000-12,100 zone is likely to be re-tested before the decline ends. The 12,500 zone will act as significant resistance for any rally attempt.**

## NASDAQ COMPOSITE INDEX



Our recent Market Comment suggested that the NASDAQ would correct in February. Although the index took its time, eventually its internal technical weakness did the expected job and the decline took hold.

The NASDAQ has thus far re-traced about one-third of its previous rally and has attempted to stabilize between its 50-day and 200-day moving averages. The 200-day moving average also offers support at just above the 50% retracement level.

**While the NASDAQ may attempt to mark time at current levels, we think another down leg is in the cards prior to the end of this corrective period. The NASDAQ may be the first of the major indices to test its 200-day moving average. There is strong overhead resistance in the 2,450-2,500 zone. The NASDAQ is very likely to have already topped out in this bull market.**

## THE SEVEN YEAR “ITCH”

**The seventh year of the decade has an unblemished record of providing bad news and bad surprises (data based on the Dow Jones Industrial Index or equivalent).**

We have examined the market’s performance since 1887 and as the table below illustrates, there has not been even one year since 1887 that did not contain a serious (and sometimes disastrous) sell-off.

To be fair, in many of the years mentioned below, the markets had recovered by the end of the year, but almost all the years mentioned below had either a multi-percentage decline or an out and out crash.

On the positive side (if there is one), please note that in eight of the twelve instances the decline only started in the second half of the year.

YEAR	DURATION	DECLINE
<b>1887</b>	<b>May to October</b>	<b>-14%</b>
<b>*1897</b>	<b>September to October</b>	<b>-20%</b>
<b>1907</b>	<b>January to November</b>	<b>-45%</b>
<b>1917</b>	<b>June to December</b>	<b>-33%</b>
<b>1927</b>	<b>October</b>	<b>-11%</b>
<b>1937</b>	<b>August to November</b>	<b>-40%</b>
<b>*1947</b>	<b>February to May</b>	<b>-9%</b>
<b>1957</b>	<b>July to October</b>	<b>-19%</b>
<b>*1967</b>	<b>September to November</b>	<b>-10%</b>
<b>1977</b>	<b>January to December</b>	<b>-18%</b>
<b>1987</b>	<b>October</b>	<b>-20%</b>
<b>1997</b>	<b>August to October</b>	<b>-16%</b>
<b>2007</b>	<b>? to ?</b>	<b>?%</b>

In the three years illustrated with an asterisk the bear market ended in the preceding year (the year ending in 6) and the decline in the 7th year was mainly a correction against the ongoing uptrend.

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