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North American Marketletter

MARKET COMMENT

(S&P/TSX – 13034; S&P – 1438; DJI – 12622; NASDAQ – 2464)

A CORRECTION IS URGENTLY NEEDED TO KEEP THIS BULL MARKET IN GOOD HEALTH.

As the surprising – no surprise to us– rally in the North American markets during the latter half of 2006 extended itself, the Market Comment started to wave some technical warning flags. We have called for a correction to occur before the markets got too far ahead of themselves – deeming it a very healthy and necessary development

But the markets seem insistent to rise further. The last few months of 2006 saw minor pullbacks within an overall rising trend. Each pullback has been treated as a buying opportunity, pushing prices up again, sometimes to new bull market highs. As a result, North American markets are now in the seventh month of an up trend with little rest – and all of this is occurring in the fifth year of a bull market. This is an impressive performance for an aging bull.

Meanwhile, the technical warning flags have turned into some significant intermediate-term technical weaknesses. Balanced against these technical worries is the overall longer-term posture of the markets, with the rising trend remaining intact. These plusses and minuses are detailed on page 2. But what remains to be discussed, spanning the technical positives and negatives, is the age of the bull market.

This "time" factor is growing in importance as the bull market continues. Our operating assumption remains that this bull market started in October 2002 and that a bear market will follow at some point. If this premise remains correct, then this bull market presents us with a growing, and increasingly concerning, contradiction. Time is running out for the bull in the longer-term, and time is running out for a healthy correction to occur in the intermediate-term. <u>The longer the correction is delayed, the less time there will likely be for a significant rally afterwards</u>. And if a multi-week correction does not occur soon then the possibility that this bull market will eventually end with a disorderly "bang" and not a more orderly "whimper" is very likely going to increase.

By the way, for the more statistically oriented: The "5-day indicator" – which suggests that there is a strong relationship between the status of the first five days of trading on the S&P500 and the rest of the year – is negative for 2007. The so-called "January Barometer" -- as the first month goes, so does the balance of the year – is positive, while the "Superbowl indicator" (we already know) is going to give a buy signal. Take your pick.

The odds are that North American markets will succumb soon to the growing technical weakness, and will correct in the month of February. This correction will set up the markets for yet another buying opportunity – which will likely be one of the best, and very possibly the last, such opportunity for 2007.

Ron Meisels

PAC-07-021; MKT-158; February 1, 2007

Even after over four years of generally positive action, this bull market continues to show many positive aspects. Major market indices remain well above their rising 200-day moving averages – indeed, the gap between this long-term average and each index is as large as it has been in the life of the bull market. It will take a sustained period of negative action to turn the long-term averages downwards. Major bull market trend lines are intact. Selling squalls have been limited and generally well-contained in recent months. There are still plenty of buyers willing to step in when the markets dip. The leadership of the markets continues to rotate – witness for example the response in Toronto during the last few months where the financial and communications sectors stepped in to take over leadership from the materials, energy and golds.

The problems, though, are growing in number. In our mid-December Market Comment we called attention to the "right-translation" of the current 39-week cycle, which is projected to bottom in February. Most of this cycle has been occupied by the up trend, with the markets refusing to correct significantly, so any weakness into the cycle low in the next few weeks may be in the form of a sharp downward move.

Internal momentum, as measured by such indicators as MACD, continues to gradually deteriorate as the markets remain at elevated levels. The divergence is multi-month, with as yet no definite outcome. This negative divergence between price and momentum usually gets resolved by price giving way. Compounding the momentum problems, the number of NYSE or TSE stocks at new 52-week highs was significantly less at the end of January in comparison to early December – another divergence.

Sentiment remains mixed. There is enthusiasm for stocks, but evidence of a greedy stampede by the public is sparse. The Investors Intelligence weekly figures (a contrary indicator) show that the percentage of bullish market advisers has declined from a high near 60%, to a current reading of 52.7%, but the percentage of bears remains very low (20.9%), near levels where market turns can be expected. The percentage of NYSE stocks above their 40-week moving averages is at a very high 78%, but the corresponding figure for stocks above their 10-week moving averages is 63%, well down from the 85% levels of last November. This latter statistic is an indication of declining momentum, as fewer stocks are participating in this extended rally.

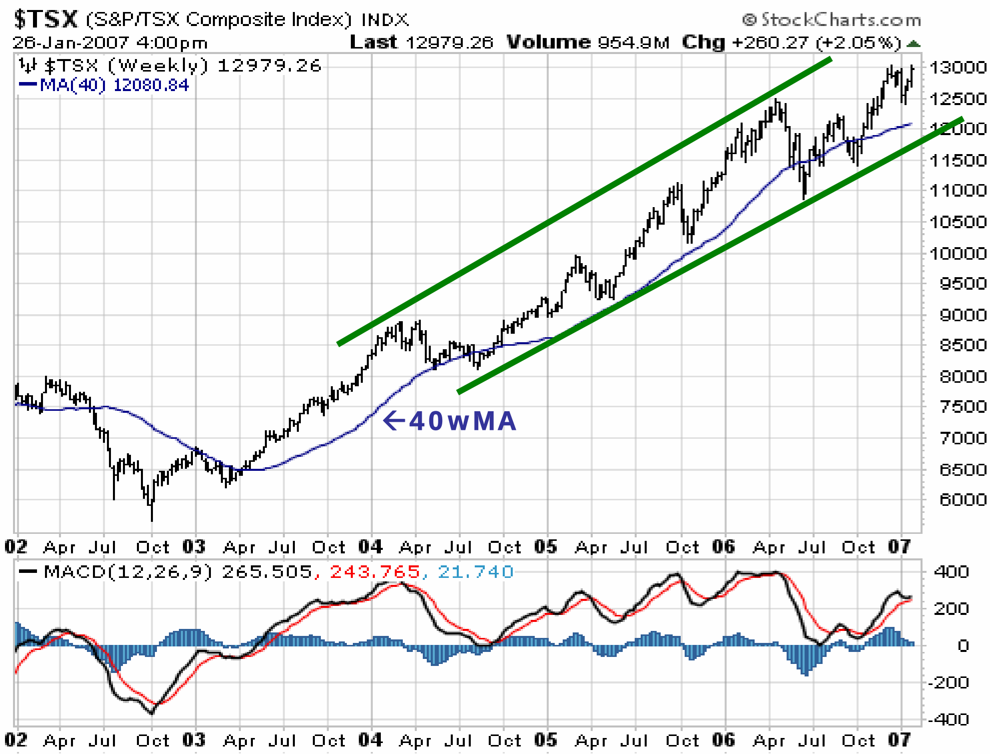
The analysis of the major market indices in Toronto and New York which appears on the next pages makes the case that an intermediate-term correction is due. But what if North American markets refuse to correct in the next several weeks, and continue to move upwards? What is the implication for the health and durability of the bull market?

Our answer to this question has two parts.

- **First**, the refusal to have a meaningful correction that would work off overbought conditions as well as decrease the current gaps between market indexes and their 40-week moving averages means that the markets are slowly backing themselves into a corner – running out of "bull market time", and increasing the possibility of an eventual abrupt end to the bull market.
- **Second**, a renewed rally from current levels could mean that the Market Comment has underestimated this bull's strength and its ability to shrug off technical uncertainties. But a renewed sprint to new highs would also increase the "blow-off' possibilities – after a four-plus year bull market any "parabolic rise to the top" would very likely be followed by a climactic and sharp reversal, with an exit door crowded by sellers.

We continue to rate a "blow-off top" as a low probability. A correction into the 39-week cycle low is more likely, followed by what may be the "last rally of the 2002-2007 bull market." When making investment decisions over the next few months, all market participants must keep in mind two questions: "how much life does this bull market have left in it"; and "how much higher can this bull market go?"

THE TORONTO COMPOSITE INDEX



Our last Market Comment suggested a 13,000 target for the S&P/TSX Composite Index. From a low in early October, the Toronto market hit this level in December, pulled back, and then repeated it in January.

The action over the last six weeks seems to be pointing to an intermediate-term top, which we have been expecting.

- **First**, the overall cyclical picture suggests that a corrective phase is due.
- **Second**, the S&P/TSX Composite Index's January high was made on significantly weaker internal momentum figures than the December high – a negative divergence. Coming after such a strong rally in the fall of 2006, this negative divergence is significant.
- **Third**, the number of new 52-week highs on the Toronto market is declining with each high in the index.

Putting these factors together, it is likely that the Toronto market made an intermediate-term internal top on December 15 (a "reversal-day" with a higher opening and a lower close), and its subsequent action has been corrective. The first down leg of the correction into early January took the index below its 10-week moving average, but was not strong or long-lasting enough to turn that average downwards. It is likely that any second corrective phase from current levels will push the 10-week moving average downwards, with the index re-testing its low of January 10.

Any corrective action in the next few weeks should encounter good initial support at the 12,700 level, and stronger support at the 12,400 level.

The Toronto market should have a pause over the next few weeks. The correction should end somewhere below the 10-week moving average, but above the 40-week moving average. With a Point and Figure target of 14,000 still to be achieved, a February low will be a buying opportunity.

THE S&P 500 INDEX

In October 2006 the S&P 500 index moved above the major rising trend channel that has confined much of the bull market action since 2004 (see solid lines). At that time, this breakout looked like an acceleration of the bull trend. However, the subsequent behaviour of the S&P 500 has called this into doubt – the action of the last few months has been filled with signs of growing technical weakness, not technical strength.

The October 2006 breakout was quickly followed by a peak in internal momentum, and the negative divergence between the index and momentum indicators has continued to grow ever since. The S&P 500's price pattern, while still rising, has also settled into a "rising wedge" pattern which has negative implications after many months of rallying. As each rally to new highs is weaker than the previous one, so each new price peak makes the index look like it is slowly "rolling over." However, the S&P 500 has been able to achieve and marginally exceed our Point and Figure target of 1425.

Where to from here? The S&P 500 seems poised for a decline which would be healthy for a late-stage bull. A one-third retracement of the advance that started last summer would bring the S&P 500 back to the 1375 level, which is also roughly where the upper trend channel line rests. The 200-day moving average is still rising, and offers further support around 1330.

The S&P 500 has stayed resolutely above its 10-week moving average for many months. We expect that any correction will bring the index down below this moving average (currently at about 1410) and into the high - 1300s.

THE DOW JONES INDUSTRIALS

The Dow Industrials are in the seventh month of an advance dating from July of 2006 (A). When we last looked at this index in December we declared that the Dow was overextended and in desperate need of a pause in order to renew its technical strength.

Six weeks further on, the Dow is even more stretched technically. The Dow Industrials' internal momentum peaked in October, and has gradually declined since then even as the index continues to make new highs. The Dow Transports continue to refuse to confirm the new highs in the Industrials.

The Dow Industrials remain in a "pre-correction" mode. A one-third retracement of the July-January rally would see the index back to about 12,000. The rising 40-week moving average currently rests near 11,700 and this would provide further support for any decline.

We expect that the Dow Industrials will not be able to withstand the current technical weakness, and that a correction will occur soon which will take the index below its 10-week moving average and into the lower 12,000s.

NASDAQ COMPOSITE INDEX

After a strong and surprising rally from mid-2006 (A), the NASDAQ appears to have run out of gas in the near-term and is headed for a fall.

The NASDAQ has re-traced about one-third of the 2000-2002 bear market. It reached the 2,500 level, but here the rally has stalled. The index has run into two obstacles. The first is the upper trend line of the channel which dates from late 2004 (see upper solid line). The second is the declining internal momentum that has accompanied the tight 2,400 – 2,500 trading range since November.

A break below 2,400 could signal at least a one-third retracement of the July-January rally – this would target about 2,350. There is further support at the 40-week moving average in the 2,275 zone.

With an extended rally that looks exhausted, the risks in the NASDAQ seem to be far in excess of the potential rewards over the next few months. Anticipate that the NASDAQ will correct in February.