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THE OPPORTUNITY FOR A SIGNIFICANT RECOVERY RALLY HAS PASSED. THE RE-TEST OF THE NOVEMBER 21ST 'LINE IN THE SAND' MUST SUCCEED; OTHERWISE THE BEARS WILL DRIVE THE MARKETS SUBSTANTIALLY LOWER.

What we said. In Market Comment #203, published in mid-January, we noted that the North American markets had positioned themselves for a possible upside rally in the fourth quarter of 2008. The combination of highly visible lows in momentum, price and the 39-week cycle presented a technically favourable picture. But we also raised a major caution: "If this confluence of positive technical factors cannot continue to support prices above the November 21st lows then it's 'look out below' for the markets. In other words, the market indices drew a 'line in the sand' in November, daring the bears to cross it".

Current market status. North American markets have performed poorly since November 21, 2008. Some individual stocks and sectors have had periods of strength, but overall most stocks and the major market indices have struggled to reach and stay above their 50-day moving averages. The so-called 'rally' has been distinctly unimpressive, with limited participation. Indeed, following the initial snap back from November 21st, the best period of market advance coincided with the low-volume holiday period at the end of December. On balance, 2009 has been very negative for most markets.

As the North American market indices deteriorated, everyone was watching for the re-test of the Nov. 21st lows. The Dow Industrials led the way and appears to have failed the test last week. At the same time, at the close of last week, the other indices had yet to complete the re-test.

There are two reasons why the significance of this period of re-testing cannot be underestimated. **First**, it is not only a measure of whether the current bear market lows will provide support (as measured by the S&P 500), but it is also a re-test of the 2002 bear market lows. **Second**, a significant move below the November lows will create a multi-month ceiling of overhead resistance that any future rally effort will have to overcome.

The symmetrical triangles in the major market indices. A negative feature of the recent action in the major market indices is the appearance of distinct 'symmetrical triangle' formations. These triangles are marked on each of the charts on the following pages. Each triangle was broken to the downside last week. This is bearish. These types of triangle formations are typically 'way-stations', or consolidations, in the direction of the larger trend.

Why we should pay attention to Dow Theory now. Dow Theory is one of the oldest, but most neglected methods available to technical analysts. For the past 15 months, it has been deadly accurate. In late November 2007, the Dow Industrials and Dow Transports moved lower together and confirmed that a primary bearish trend was established. This occurred one month before the 50-day moving average sank below the 200-day moving average on the S&P 500, a situation which has yet to be reversed. Since the initial Dow Theory trend change signal, the Dow Industrials and Transports have continued to confirm the validity of the bearish trend at each significant point in the decline.

In early February 2009 the Dow Transports made yet another new closing low, which was not confirmed immediately by the Industrials. This increased the optimism of some bulls that the bearish primary trend might be reversed. Not so. Last week's precipitous decline in the Industrials has moved the two indices back into unison. The primary trend remains down according to Dow Theory. Calculated on today's charts, a considerable rally – exceeding at least the January 2009 peak and more likely exceeding the November 2008 peak – would be required to reverse the primary bearish trend.

The importance of the weakness of financial stocks. The prominence of financial stocks in the S&P 500 is dragging down that Index considerably. This is not surprising in an environment of credit and financial crisis. In Toronto, the weakness of the five major Canadian banks is telling. For months, these five stocks (as well

as the major insurance stocks) have spent most of their time below their respective 50-day moving averages. Last week all made new bear market lows and their declines are accelerating. Majority market sentiment, which tended until recently to believe that bank dividends were virtually untouchable and would offer price support, has turned decidedly mixed.

It is very unlikely that the S&P/TSX Composite Index can undertake a significant and sustained rally – even if the materials and other sectors show strength – without Canadian financial stocks at least showing some technical stability. Until they gain technical strength, these stocks are deadweight for any rally prospects in the broader market.

Sentiment and other notes of cautious optimism. In mid-January we noted that the percentage of bullish advisers (using Investors Intelligence numbers) had risen dramatically since mid-December. This is an inverse indicator and we expressed doubts that so many advisers could be so right on the market's direction. Since then, bearish sentiment has grown. This is positive for the markets, but not yet at levels that would forecast an imminent turnaround.

Two other technical measures deserve close watching. The number of new 52-week lows reached extremes in October-November of last year. As prices approach the November lows, will we see fewer new lows, setting up a positive divergence and non-confirmation? The same set-up applies to internal momentum measures, which are generally well off their October lows.

Summary. The markets' current condition and immediate prospects can be summarized in the following points:

1. Two months ago, the market's main challenge was to use the upside portion of a new 39-week cycle to support a counter-rally. That opportunity has apparently been wasted. Now, the immediate task is to hold at or above the November 21st lows.
2. Any successful re-testing of those lows can tolerate slightly lower lows for a short period. However, moving 3-4% percent below the November lows beyond a few trading days will qualify as a failure of the re-test.
3. The re-test is occurring in the context of a powerful bear trend. There is no sign yet that the major indices are on the verge of breaking the bear pattern of 'lower highs and lower lows'.
4. If the markets do successfully re-test in the days ahead, the upside potential for any rally is only towards the declining 200-day moving averages.
5. The weight of the technical evidence suggests that the November 2008 lows could be violated. Any such breach raises the risk of a severe selling wave.
6. Risk in individual stocks remains high. Long positions must be protected by close stops.
7. Severe bear markets typically end in an environment of abject despair, capitulation, resignation and indifference. We are not there yet.

S&P/TSX Composite Index



In 2009, the best that the S&P/TSX Composite Index could accomplish was to almost arrest the decline of its 50-day moving average. A continuation of the modest up move from mid-January could have turned the moving average upward and provided a platform for a possible further advance. Instead, the Index collapsed, losing over 1,200 points in the last two weeks. This latest decline has moved the Index out of its consolidating, triangle-shaped formation.

At the same time, the S&P/TSX Composite Index is oversold, and

is showing a slightly improved internal momentum picture compared to last November. The new 52-week low picture is also comparatively positive.

If strength is maintained in some key sectors (such as golds), the Toronto market may be able to resist a decline. However, even if the market is able to turn to the upside, there is strong resistance at 9,000. Failure to hold the November lows, coupled with the breakdown from the symmetrical triangle formation, could project a downside target below 7,000.

S&P 500 Index



The prospects of a 'V'-shaped or inverse head and shoulders bottom faded in the S&P 500 as it renewed its weakness in January. The Index struggled without success to keep its head above its 50-day moving average. As we observed in a previous Market Comment, a key indicator that the Index is doing something different and that bear influences are waning would be to see the S&P 500 stay above this moving average for an extended period of time. This observation remains valid.

Having broken down out of its triangle formation, the S&P 500

is in a similar situation to the Toronto market: oversold and is on the verge of a re-test of its November lows. The MACD has also turned lower. The downside projection from the triangle formation is near 600. On the upside, there is near-term resistance at the 50-day moving average (860) and then at the upper line of the triangle (about 900).

The S&P 500 needs to hold above 710-720. Below that, we have to question the Index's ability to stay above 600.

Dow Jones Industrials



The Dow Industrial Average has been the weakest performer of the three major U.S. averages in 2009. It has led the drop towards the November lows, which last week offered little in the way of immediate support. The Industrials and the Transports are moving in tandem and the picture at the end of last week was of a collapsing Index with considerable overhead resistance in the 8,000 zone.

As the markets' downside leader, the next few weeks will be very instructive for the Dow Industrials. Will there be immediate downside follow-through, or will this Index find some firmer support in the low 7,000s?

The bearish triangle formation projects to 6,500. Immediate upside prospects are to the low 8,000s.

NASDAQ Composite Index



The NASDAQ has performed well compared to other major market indices recently, but this is just a matter of being relatively 'less bearish'. We mentioned in the mid-January Market Comment that the Index was forming a potentially negative 'rising wedge', and this formation was indeed an indication that further declines were likely.

As we indicated at that time, if the NASDAQ had shown the ability to

stay in the 1,500-1,600 zone, building further support, it might have formed a launching pad for a rally. Instead, the Index has plunged below 1,500 and its 50-day moving average. There is still some distance to go before the November lows are re-visited.

Immediate upside potential is confined to the low 1,600s. The downside projection from the broken triangle formation is about 1,150.

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