

MARKET COMMENT

(S&P/TSX - 12068; S&P - 1304; DJI - 11382; NASDAQ - 2186)

**THE BULLS ARE PREPARING ANOTHER SURPRISE.
AUTUMN IS LIKELY TO DISAPPOINT THE BEARS.**

Labour Day is looming, and as the summer draws to a close, it's been yet another disappointing few months for those who are skeptical of the underlying strength and persistence of this bull market. To be fair, the sell-off into the June lows looked somewhat promising for the hopeful bears, many of whom saw the decline as the first down leg in an emerging bear market. Indeed, the bears had one very good argument on their side – the 2002-2006 bull market's longevity. This bull seemed to have overstayed its welcome.

However, during the summer the bull market said "my time is not yet up" to the bears. The last two months have seen a period of quiet but persistent up trending, on low volume and with very little excitement. There have been few fireworks to draw investors back from their summer holidays, but the S&P 500 has rallied nearly 7% from its June lows, and the S&P/TSX Composite by over 12%.

Our Market Comment has remained consistently on the right – and bullish – side of this market. Our last few Market Comments have expressed concern about the possibility of an imminent "cycle failure", which would have brought the bull market to a close. However, this has not occurred, and as the markets continue to probe upward through August, the possibility of a cycle failure is receding.

North American markets are currently somewhat overbought, and could undergo a minor pullback in the short-term. But as we detail on page 2, the sentiment picture is positive, there are very few signs of euphoria or greed, the markets continue to perform well in terms of their moving averages, and the 39-week cycle is showing that it has some upside vigor.

When September arrives, we can expect that the media will be filled with reminders of past autumn market collapses. In early October, this bull market will celebrate its fourth anniversary, and we can also anticipate that this milestone will bring out the bears. But, we think a contrary view is still warranted. This bull market has consistently surprised the majority, and the best surprise this market could offer now would be to *not sell off in September and October*. If we get a short, healthy pause to correct the current minor overbought status, then the technical picture would be even more persuasive about a positive fall season.

The pressure is still on the bulls to keep the bull market going, but the technical picture remains positive, and investors should prepare themselves to take advantage of more upside advances over the next two months.

An examination of the recent behavior of the major North American market indices still suggest that we are in a bull market. Both the S&P 500 and the S&P/TSX Composite Index have rallied back above their respective 200-day and 50-day moving averages, and despite the declines in May and June of this year, the longer-term 200-day moving averages remained pointing upwards. This action is not a sign of an early stage bear market.

The rally from the June lows has occurred on the back of the rising portion of the 39-week cycle, which has, thus far, done the job that it is expected to do. If the cycle behaves in a normal symmetrical fashion, it still has at least a couple of months of rising action, which should further support the autumn rallies.

Even with the recent rally, stocks are only in a minor overbought condition. The percentage of stocks trading above their major intermediate (50-day) and longer-term (200-day) moving averages is a good way of gauging whether the markets are at an extreme point. In both Toronto and New York, these indicators reached bearish extremes in June as the sell-off reached its climax. The rallies since June have improved the figures. In Toronto, the reading for stocks above their 200-day moving average is currently about 57%; for NYSE stocks, the comparable figure is 51%. Both figures indicate improving strength, but no signs yet of the types of excess enthusiasm one would expect at a major top.

Sentiment also remains very positive. The Investors Intelligence weekly figures – a contrary indicator -- suggest that market letter writers remain bearish. The percentage of

bears is still near 34%, and the percentage of bulls is only at 42% -- not at all near the 22% bears and 60% bulls that is usually seen at market tops. Overall, these data suggest a bullish market. Put-call ratios remain in neutral, and options premiums in New York are declining, indicating that investors are not expecting much volatility in the week ahead. This can be an indicator that a “coiled up” market is about to spring to life.

Since 1990, North American markets have followed a 4-year cycle. The current bull market began in October 2002, and the 4-year cycle would suggest that a major low is due this October. However, this would require a quick and catastrophic decline over a number of weeks to be characterized as a bear market. The odds of this occurring -- given the current technical picture – are low.

This raises another question – must markets always weaken in the fall period? In 2005 the post-Labour Day period saw a significant sell-off into an October low. But in 2003 and 2004, sell-offs occurred during the summer, and the buyers returned for bargains in the fall, causing the markets to rise. Current market behaviour does not by any means present a negative picture and leaves the door open for a repeat not of 2005, but of 2003 and 2004.

In sum, with higher point and figure targets still visible in the major indices, an influential cycle pointing upwards, and a cautious-to-skeptical investment climate, the stage is set for some eye-catching market action. North American markets have a good chance of setting new bull market highs in the next few months.

THE TORONTO COMPOSITE INDEX

(S&P/TSX – 12060)

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



The correction from late-April to mid-June took the S&P/TSX Composite Index down below its rising 200-day moving average for the first time in over a year. At the same time, in keeping with the Market Comment's view that the Toronto market is the leader in this late stage bull market, it was not surprising to see that the index led the rally from the June lows. While indexes such as the S&P 500 had to re-test their lows in July, the S&P/TSX Composite Index continued to advance with only minor pauses.

The Toronto market has rallied now for over two months. We previously called attention to the formation of a "inverse head and shoulders" pattern which had a neckline just under 11,900. (see "SHS" and dashed line) It is a renewed bullish sign that this neckline has been exceeded and that the S&P/TSX Composite Index has been able to remain above this level, and above the rising 50-day moving average. Somewhat surprisingly, it has been the recently out-of-favor sectors such as the financials (along with the takeover plays in the metals) that have powered the recent rally – the energy and gold sectors have been only minor participants.

The completed inverse head and shoulders pattern now projects a minimum high of 12,700. Our immediate minimum Point and Figure target, based on the action of the past few months, is now revised to 13,000, but the longer-term 14,000 target is still visible.

The rising trend from the June low is still intact, and both the 50-day moving average and the 200-day moving average are rising. The MACD Indicator is a little extended, but remains bullish.

The S&P/TSX Composite Index is slightly overbought, and a pause or minor correction is likely in the near-term. The immediate challenge is a move to new all-time highs above 12,500, which should be exceeded during the autumn period. How high the Toronto market ultimately goes in the remainder of this bull market still depends on the strength and performance of its main drivers – the Energy, Materials and Gold sectors.

THE S&P 500 INDEX

(S&P 500 – 1304)

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



As we anticipated in a previous Market Comment, the S&P 500 made a successful re-test of its June low on a positive internal momentum divergence. The action over the summer has now taken the form of a very bullish-looking “W” formation, with the move out of the formation being well-supported by the rising 50-day moving average. The 200-day moving average continues to track upwards, and the MACD indicator remains positive. The overall bullish picture remains as long as the June-July lows are not violated on the downside.

The S&P 500 has had a good run for the past six weeks, and has achieved the target of the upper 1200s that we forecast in mid-summer. It may be time for a short rest to gather further strength

– which will be needed as there is further short-term resistance from the March-April period in the low 1300s. But the good news is that the action over the summer now permits the calculation of a new Point and Figure target, which is 1425.

The S&P 500’s ability, so late in the bull market, to make a successful stand in the low 1200s and then rally back to 1300 is impressive. This index still has some upside power in it. If the S&P 500 can overcome the remaining overhead resistance, then a run towards 1425 is very possible.

THE DOW JONES INDUSTRIALS

(DJI - 11370)

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



The Dow Industrials stopped its spring decline by putting in a double-bottom in June and July, around the 10,700 level. The second bottom in mid-July was accompanied by a strong positive divergence in internal momentum. The rapidity of the decline in May-June meant that the 200-day moving average remained upward sloping – a good sign for the bull market.

The rally that started in mid-July has had to overcome short-term resistance in the 11,200-300 zone, the area that had repelled previous advances in May and June. This zone appears to have been breached in the last week, although a further period of positive action is needed to confirm this. The Dow Industrials is now above its rising 50-day moving average, but is slightly overbought. The 10,700 level must hold for the index to remain overall bullish.

Point and Figure projections suggest that the Dow Industrials could reach a new all-time high of 12,600. At the same time, while the Industrials have been performing well in recent weeks, the Dow Transports have been lagging. Any new high in the Industrials (i.e., above 11,700) will need to be confirmed by the Transports soon afterwards, for a renewed Dow Theory “buy signal” to be triggered.

The Dow Industrials have built up some technical strength in the past few weeks. The index’s overall direction will continue to follow that of the S&P 500. The chances are growing that the Dow is preparing to make a run to a new all-time high.

NASDAQ COMPOSITE INDEX

(NASDAQ – 2172)

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



The last time we looked at the NASDAQ in mid-July, we declared that the index had peaked and was in the initial phase of a bear market decline. But we also noted that the NASDAQ was “deeply oversold” and that a rally could be expected.

The small positive divergence in internal momentum that appeared as the NASDAQ hit a low in mid-June was followed by an even bigger divergence at the mid-July low. From a technical set-up such as this, there was a very good chance of a counter-trend rally, and that’s exactly what has happened for the past six weeks.

The recent rally broke the initial downtrend line, and has succeeded in turning the 50-day moving average upwards (currently just above 2100). But the index remains under its 200-day moving average, which is flattening out.

The immediate prospects for the NASDAQ continue to be linked to the fate of the S&P 500. If the S&P 500 rallies strongly through the fall, there is a chance that the NASDAQ will be able to penetrate its 200-day moving average and approach its April high of 2375. But that is a maximum expectation. A one-half to two-thirds retracement of the April-July decline is more likely, which would target the index to reach the 2200-2250 zone only.

Expect that the counter-trend rally will fail at some point, and that the major bear market trend will reassert itself. At this point, the NASDAQ is only appropriate for the most nimble of investors. There is further downside to come.

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