

# PHASES & CYCLES®

(S&P/TSX – 13940; S&P – 1526)

*Good afternoon.* Let's update our outlook and the potential behavior of the markets for the rest of the year.

The 50 basis point drop in interest rate has created a major move in the markets as some of it was unexpected. Obviously, the market reacted more in New York than in Toronto, but I don't believe that the action changes the picture a lot. So let's go back and see where we've been and where we are heading.

Our indicators turned bullish about the market in October 2002. Then, as early as February 2006, we published a 14,000 target for Toronto (S&P/TSX) and a 1,500 target for New York (S&P 500). We continued to see bullish signs until April-May of this year, but when the above targets were reached we noticed that many of the technical indicators were becoming overbought, that too much exuberance was entering the markets (overconfidence, bullish statements, etc.). Therefore, in July 2007 we published a message to suggest that the market was ready to experience something that we've classified as a "short, sharp, shock".

Well, that's exactly what occurred, as the markets fell heavily in August. Toronto sold off from about 14,500 all the way to 12,500, a loss of about 2,000 points and New York declined from

1,550 to about 1,375, roughly 200 points. This was the first segment of the correction.

Later on, our September Market Comment suggested that although the August low was a significant low, it was probably not the final low because there was not enough bearishness "out there". As an example, market-letter writers were not as bearish as they usually are at major lows, etc. Since similar sell-offs are usually followed by a one-third to one-half upward correction of the previous drop (second segment), we suggested that a halfway recovery may follow. In other words, the 2,000 point drop in Toronto should be followed by a 1,000 point rise back up to about 13,500, and the 200 point drop in New York could be followed by a 100 point rally to 1475. As it happened, the markets have done better than these levels, as Toronto got to 14,000 in the last few days and New York did even better (interest rates!) as it reached 1539.

Putting together current readings on technical indicators, cycles, market letter writers, the percentage of bull vs. bears, the percentage of stocks above the moving average, etc., it seems that the action of the last few days was an "overshoot", an extension of expectation, but not something that should change our expected scenario.

Now to the rest of September and October. We expect that after the second segment is over, the projected third segment may be less severe than the first one, but it could take some time, because the 39-week cycle does not bottom until late-October or very early November. Hence our recent Market Comment with the title “Not how low, but how long”, which means that it is possible that the market would not come back all the way to the lows of mid-August, maybe only towards 13,250 for Canada and 1450 for the States, but that there could be a meandering period until the usual weak October period. Just in time for the usual start of the late-October/early-November year-end rally. So this is our outlook for the rest of the year. Are there any questions?

*Why are you still looking for another low?*

The main reason for looking for another down-leg is that sentiment in mid-August never reached extreme proportions. After only two-three days, the general consensus quickly turned, to suggest that it was just another buying opportunity. Markets bottom on fear, not greed.

*What about the stocks on the reject list?*

These stocks continue to be vulnerable to declines. Clients should consider removing these from portfolios, to generate cash, to have fuel for the bargains that should appear towards late October.

*What are the most bullish and bearish Sectors?*

Despite last week’s news about royalties, the Energy Sector is selectively positive. Stocks such as CNQ, Petro Canada, Imperial Oil, Encana and the more speculative Connacher have all held their grounds despite the August sell-off.

In Materials, Barrick, Agrium and Teck ‘B’ are targeted significantly higher.

As for Financials, Banks continue to have problems. TD is probably still the best of the lot and Bank of Montreal is still the worst. Bank of Nova Scotia got a little bit higher than its falling 200-day moving average (200dMA), Commerce just managed to get back up there, and Royal is still significantly below its 200dMA. At the same time, Insurers look much better, as Manulife, Sunlife, Great West and Industrial Alliance are all on the verge of very important breakouts.

Consumer Staples are still a major disappointment as Loblaw and Weston are hitting new multi-year lows.

Elsewhere, Northern Telecom may have a small rally, but it is probably heading to \$10 or even \$5.

*Assuming the markets pull back to the levels you described, do you see them rallying to new highs by the end of the year or in the first quarter of 2008?*

Our research, based on the much discussed and presented 40-year cycle suggests that once the markets complete the current negative period, a new bull market could ensue, which could last through 2008 and possibly the first half of 2009. At the same time, just like 40 years ago when the “nifty 50” was the only game in town, stock selection will be more important than it was through 2002-2007, since some stocks (see above) may not make any headway.

Thank you very much for your participation.

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