

PHASES & CYCLES®

THE FEAR-INDUCED SELL-OFF COULD SET THE STAGE FOR A KICKBACK RALLY

Let's look back and ahead.

Our forte has been cycle and trend analysis. This disciplined and unbiased approach allowed us to sail through both rough and smooth water without any serious harm for quite a while. In fact, our subscribers profited from our bullish stance from 1987 to 2000, stayed protected during the 2000-2002 bear market and profited throughout the recent bull market. Last but certainly not least, we warned about the deteriorating technicals in the banking sector as far back as July 2007.

Then, it happened. The man-made disaster has resulted in a tsunami that has destroyed the usual market cycles, taking down both good and bad stocks.

Therefore, our conclusion that Energy and Gold sectors would withstand this financial tsunami was plain wrong.

We were mistaken in not recognizing the danger earlier this year. We apologize for this misinterpretation and hope not to repeat it again. At the same time, we hope that this faux pas will not undermine our long-term relationship and ask for your continued patronage.

Now, let's review the markets.

The decline in the North American markets has reached fever pitch in the last few days. The media quickly grasped the opportunity and replaced the "doom and gloom" soothsayers with an army of "end of the world" preachers. Hysteria quickly emerged and "SELL, SELL, SELL" has become the new worldwide phenomenon.

Turning away from all the gossip, let's look at the current state of the markets from a technical perspective. Is there any end to this decline? What will it take for the markets to turn around?

MARKETS NOW: To borrow a pun from the humorist Art Buchwald – who once explained that his candidate lost the election owing to "not enough votes" – the market could collapse from not enough buying.

This is exactly what occurred in the last few weeks. The massive supply of stocks could not find enough buyers. The calamity started with a rapid deterioration in the bank stocks. A torrent of negative news has only deepened the atmosphere of intimidation and fear.

The major US stock indices were left at the mercy of the over-weighted financial stocks spiralling in a free fall. It was just a matter of time before the litany of bankruptcies would depress the indices further, leaving them no time for a break or consolidation.

The early decline was confined to Banking stocks, leaving the Energy and Gold sectors relatively unscathed. This unequal treatment ended in mid-July when the drained and exhausted market participants began to sell off their entire holdings, including Gold and Energy stocks. It caught highly leveraged commodity hedge funds off guard and forced them to liquidate their long-positions, which in turn accelerated the carnage.

This synchronized "get me out now" quickly clogged the markets with sell orders and sent stocks into a free-fall. The technical damage was clear: the 200-day moving averages (200dMAs) and primary support levels were violated. The decline put the indices into deeply oversold territory, well below their 200dMAs in no time.

This is clearly illustrated below. Based on numbers supplied by Investors Intelligence, only 5.8% of all New York listed stocks are currently above their 10-week Moving Averages (10wMA) and only 7.0% are above their 30-week Moving Averages (30wMA).

Compare this with the all-time lows in our data base (from January 1, 1999) of 3.8% and 11.5% respectively on July 24, 2002 and get a sense of how oversold the market is today.

Furthermore, let's look at the latest data from Investors Intelligence about the number of bulls and bears. The bears

climbed to an all-time high of 53% and the bulls shrank to an all-time low of 25.3%! Compare this to the October 16, 2002 data of 43.2% and 28.4% respectively.

These numbers demonstrate the low morale of investors. On the other hand, given that a large number of investors are now on the sidelines, this also means a huge potential demand.

What to look for?

The severe oversold conditions along with the huge discrepancies between the indices and their 50-day Moving Averages (50dMA) seems to be fertile ground for a kickback rally. The strength or weakness of an anticipated reaction should provide clues about the coherence of the market. The best-case scenario would be a rally toward the 50dMAs (S&P 500 - 1175, DJIA - 11,000, S&P/TSX - 12,300), but even if these levels are reached, there is a need for a successful retest of recent lows (just as in 1987).

In addition, a latent advance between mid-October and the end of December would fit well into a seasonal map. The cycle indicator conveys that the latest sell-off was part of the tail end of a 39-week cycle. The start of a new cycle could provide the markets with the necessary power for a rebound.

STOCK COMMENTS: All sectors have been victims of the latest decline.

Energy Stocks suffered considerable technical damage and will require a long time to repair. Although they could rally toward their 50dMAs, they are most likely to revisit the recent lows later on.

Gold stocks are in the midst of a test of their early September lows, which, to date, seems to be successful. This recovery rally could turn them into a full-fledged bull move later on. A sustainable move above the 50dMA would confirm this.

Banking stocks should participate in a rebound; however, they may need an extended period to build basing patterns before they are ready for any longer-term advance.

Consumer stocks have not received much attention in the last few years, therefore they could fare well in comparison to the market. Focus on consumer-essentials stocks such as Weston (WN) and Metro (MRU.a) in Canada and Heinz (HNZ) and Kellogg (K) in New York.

There are no attractive **Health Care stocks** in Canada, but Johnson & Johnson (JNJ) and Baxter (BAX) merit a look-and-see in the States.

Above all, all purchases should be immediately followed by a reasonably-spaced stop-loss order!

Serious technical damage has occurred in stocks and stock indices. However, the speed of the recent decline suggests a potential for rebound that could make Santa feel a little less troubled.

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