PHASES & CYCLES®

THE FIRST SEGMENT OF A THREE-PART CORRECTION IS OVER.

THE CURRENT RALLY SHOULD LAST TO THE END OF FEBRUARY.

The robust rally accompanied by an improving economic picture has provided a solid boost to investors' spirit in early January. The quick and athletic recovery had put market participants at their ease and the New Year ballrooms seemed to be filled with cheering crowds as if the declines of 2008 had never happened. This manifestation of "over-confidence" coupled with weakening market momentum and a maturing 39-week cycle has prompted our early January warning, "*The markets may face some risks as 2010 opens.*"

As forecast, the early-January glee had given way to downside pressures. Falling stock prices had quickly pushed investors into the Winter Blues. The recent headlines told it all: *"Why stocks may fall further"; "2010 will be a year of horrible market declines*" and the most recent *"Another major crash around the corner*". If this was the beginning of a bear market, <u>it would have been the most advertised bear market on record.</u> Shouldn't the start of a new bear market be a non-media event?

This negativism then led to a wave of selling that culminated with a selling-climax on February 5th, exactly on the day that the 39-week cycle matured.

In the short-term, the market has reached oversold levels with technical indicators at prior low levels. Main averages should undergo an initial recovery effort (the 'B' segment of the A-B-C correction). This undertaking should ideally be followed by a retest of the previous lows and more base-building (the 'C' segment of the A-B-C) before this market is ready to begin another major up-leg.

We said repeatedly in our previous Market Comments that one of the main characteristics of the bull market is its ability to camouflage itself. It is normal to have pullbacks follow the lift-off from a bear market bottom. Therefore, initial pullbacks in bull markets are usually complex and confusing. This is the case this time.

The multi-month buying marathon was due to give way to some corrective move. Therefore, the current market "hangover" is a normal and an anticipated sequel to the muscular rally that preceded it. The probable continuation of the current A-B-C pattern, where the 'A' has just ended on February 5th, is a 'B' that should last until the end of February.

Olaf Sztaba, Ron Meisels

The market's action, in relation to the 50- and 200-day moving averages, provided us with the strongest argument for a bull market back in March 2009. However, the strength of the rally that followed had created a large discrepancy between major market Indices and their rising 50- and 200-day moving averages.

Therefore, the main purpose of the correction that started in mid-January was to close those big gaps. Market Indices and individual stocks had started to pull back toward their 50- and 200-day moving averages. This was happening while the 200-day moving averages remained upward sloping, which is a healthy sign. At the same time, some of the 50-day moving averages turned down for the first time in over a year. This technical gauge will be closely monitored; however, at this point we view it as a by-product of the correction.

While in early January the number of bulls was at dangerously high levels, the market decline caused advisers to become more tentative. The average recommended equity exposure among advisers, according to the Hulbert Financial Digest, fell from 65.2% to 48% in a short time. A drop of this magnitude is especially noteworthy because it occurred just after an impressive rally. This change is consistent with the latest mutual-fund data (more redemption, less contribution) and the recent Investors Intelligence report, which showed a dramatic decline in the number of bulls from 53.4% on the 12th of January to the current 34.1%, as well as a major drop in the percentage of stocks above their respective 10-week and 40-week moving averages from 83.8 to 19.2 and from 87.0 to 46.0 during the same period.

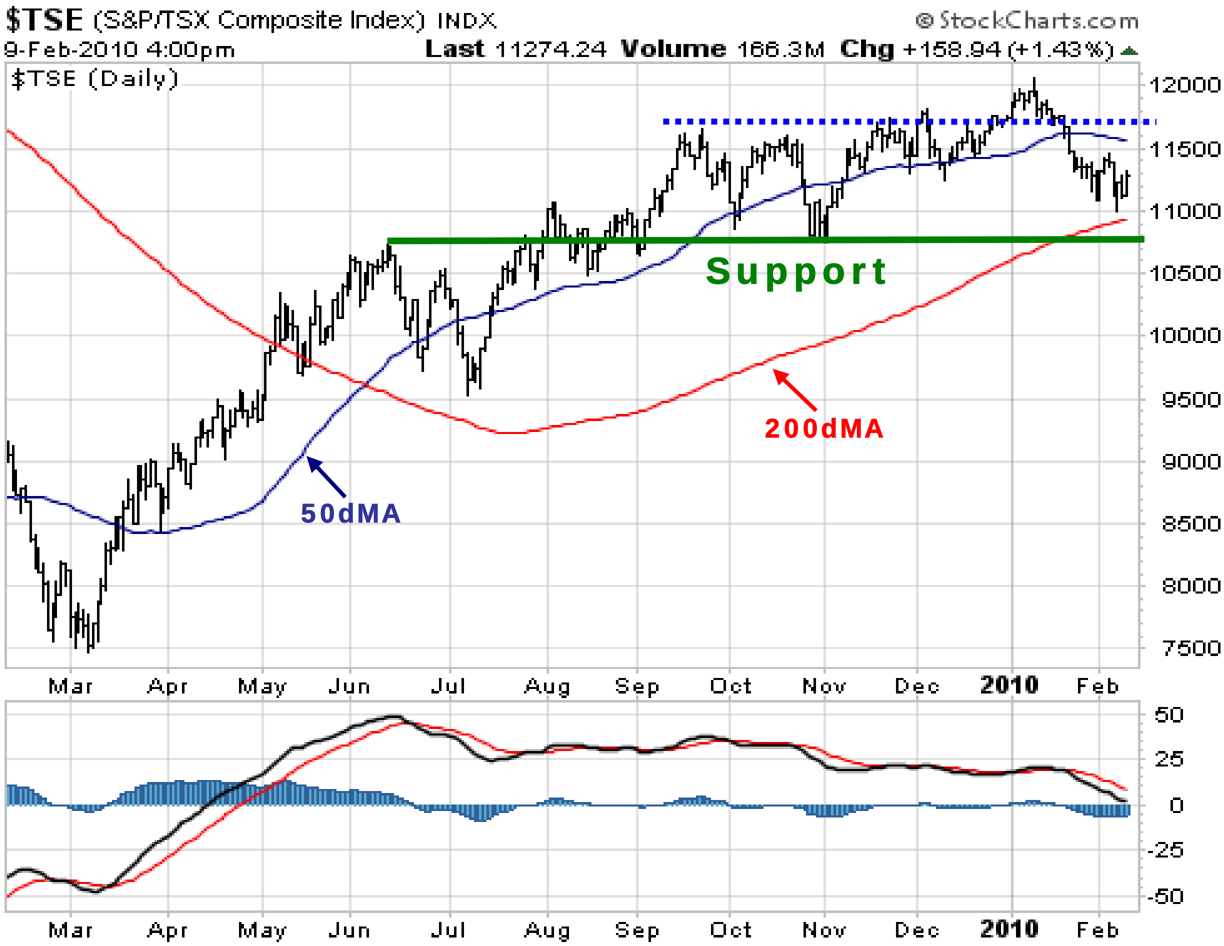
Banks, which usually initiate most major up-legs, have already arrived near their rising 200-day moving averages and they appear to be undergoing a brief base-building. We will be watching the sector for any signs of strength in the upcoming weeks. Similarly, breakdowns below October and November lows and below the 200-day moving averages would be extremely negative for both the sector and the entire market.

Other key sectors to watch are Energy and Mining – the cornerstone of the current long-term "hard assets" cycle. Even though resource stocks usually lead in the later stages of the rally, these stocks should remain "in the running" during this, the late stages of the 40-year cycle.

The market is undergoing the first major correction of this bull market. The objective of the pullback was to align major Indices with their rising 200-day moving averages. This is happening right now.

Investors should continue to monitor stocks for any signs of weakness and re-evaluate any position where the 200-day moving averages begins to reverse. At the same time, many stocks will find support near their respective longer-term averages and provide a timely entry point.

S&P/TSX Composite Index



Following a vibrant rally, the S&P/TSX composite Index has traded within a horizontal trading range roughly between $10,700 and $11,800 for the last five months. The early-January attempt to break out from this range had resulted in a quick reversal, a violation of the 50-day moving average, and a decline toward the lower level of the trading range.

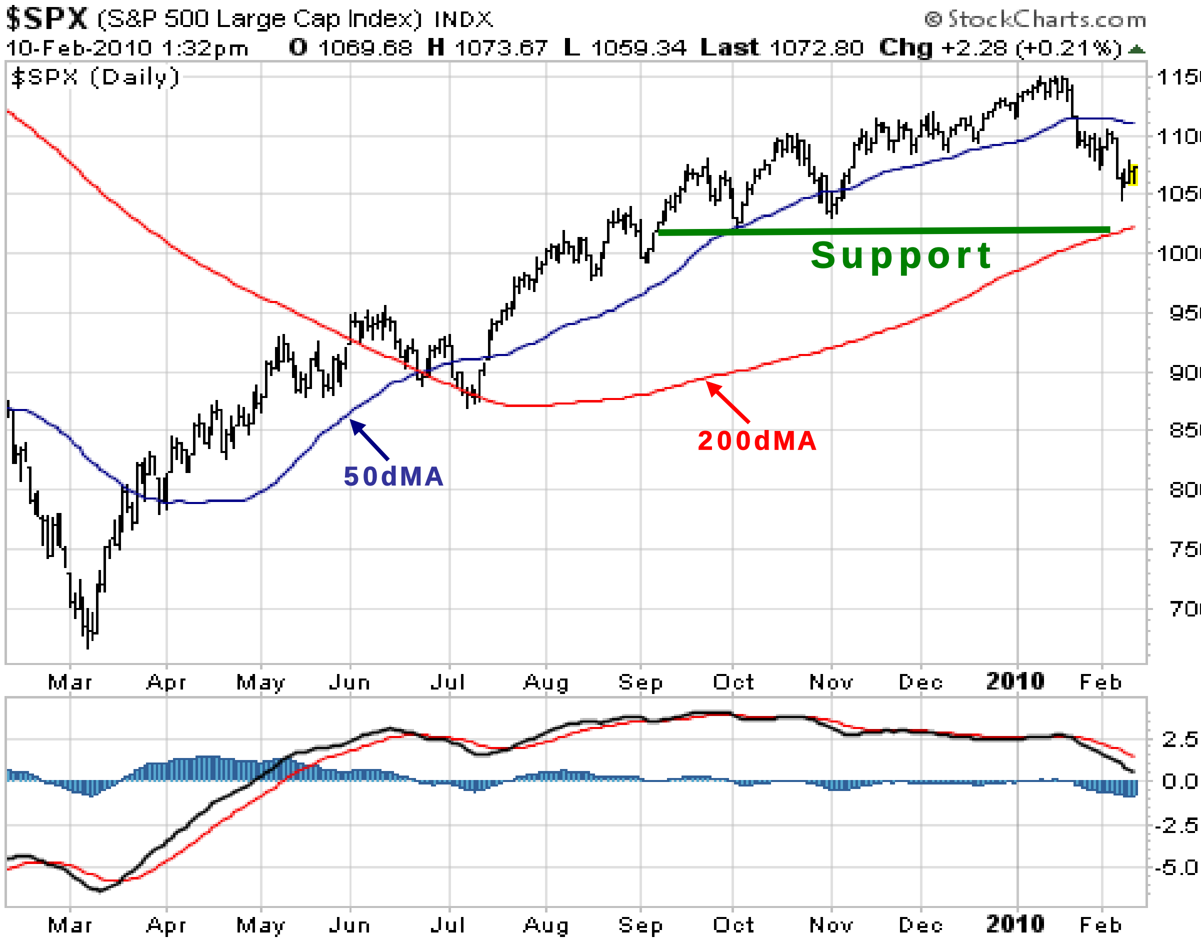
The Index has now reached the level where the rising 200-day moving average (currently at 11,000) intersects. This strongly enforced support area stopped the decline and provided the bulls with a basing platform for a recovery rally.

A forceful decline below the 11,000 support level and below the rising 200-day moving average would be extremely negative and open the door to more weakness. However, we suggest a low possibility of such an event.

The most likely scenario is a brief base-building followed by a rally toward the 50-day moving average (part 'B' of the A-B-C move outlined on page 1).

Furthermore, provided that the lower level of the trading range and the rising 200-day moving average are not seriously violated during the upcoming "C" part, the subsequent major up-move should be towards bull market highs.

S&P 500 Index



The brief, early January stabilization turned out to be a distribution pattern – a prelude to a corrective move. The Index turned decisively down in mid-January, forcing its way down through its 50-day moving average, which, for the first time since April 2009, has turned down. This technical event confirmed the start of a correction period.

After the 50-day moving average was violated, the S&P 500 declined towards, but not quite to, the next major support area at 1,025, which is where the 200-day moving average now intersects.

Investors should watch signs of stabilization, followed by a brief base-building and the "B" segment of the A-B-C correction. This process may involve some back-and-forth market action in the next few weeks.

The well-deserved correction toward the 200-day moving average took some pressure off the overheated market.

Following the decline (A) that terminated on February 5th, the Index may spend the next few weeks somewhere between the 1025 and 1050 levels as part "B" of the correction, before a retest (C) of major support occurs.

Phases & Cycles Inc., 2020 University, Suite 1903, Montreal, QC H3A 2A5
Tel.: (514) 393-3653 E-mail: RonMeisels@phases-cycles.com www.phases-cycles.com