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North American Marketletter

MARKET COMMENT

AS EXPECTED, IT IS STILL "BLUE SKY" FOR THIS BULL, BUT DARKER CLOUDS MAY APPEAR AS THE SUMMER APPROACHES.

May 7, 2007

In March the Market Comment called for a "very significant spring rally", and our early April headline was "although grey-haired, this bull may charge ahead". While others may have been surprised by the renewed strength of North American markets over the past six weeks, we certainly were not. By the end of April, the major market indices in New York and Toronto had all achieved new highs for this bull market.

Since the lows of June-July 2006 the market action has essentially been up, punctuated by a brief correction in March of this year. This is a remarkable performance for an aging bull market. Indeed, the major surprise for us – and what may become a greater point of concern as the summer approaches – is just how short the correction turned out to be. For ongoing market health, and after a multi-month rally dating from last summer, we thought a continued period of "rest and recuperation" into April would have been ideal, which would have also decreased the risk of a major failure later in the year. But the "R and R" period was cut short by two powerful reversal days in March, and it's been "up and away" ever since.

The markets are now well into a new upleg, supported by the "up" portion of the new 39-week cycle. The news from first quarter earnings reports has been absorbed comfortably, with some stocks selling off on good news (as in "it won't get any better than this"), but others are propelled into new high territory for this bull market. The major up-trends in the major indices remain intact, with indexes comfortably above their rising 200-day moving averages. The prospect of a major bull market "double top" has receded as many indexes have reached significant new highs. "Buy the dip" has thus far turned out to be a good strategy in 2007!

So, is it worry-free blue skies ahead, with "all aboard the bull train" as the rallying cry for the rest of this year? Short-term the markets are over bought; an expected condition after a multi-week rally. Some pause can be anticipated, allowing the gap to narrow between the indexes and their respective 50-day moving averages. This should be followed by another rally, leaving many of the major indices at even higher highs for this bull market. This would fulfill our expectation for a spring rally of significance.

If the market action unfolds along these lines and shows strength into mid-year, then the storm clouds should appear. As observed before, the quality of the spring rally will show how potentially vulnerable North American markets are to a downturn in the second half of the year. But if this truly is a *five-year* market cycle – as we have contended for many months – then the second half of 2007 is shaping up as a very ominous period for the bulls. The "light at the end of the tunnel" will likely be the oncoming train marked BEAR.

In sum, the markets probably have a couple of months of energy left to continue the spring rally. However, by the end of the second quarter the bull's fuel tanks will likely run close to empty. Therefore, the second half of the year may include a potentially strong "downside surprise", to bring to an end the 2002-07 bull/bear cycle.

Ron Meisels

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Has the rally since mid-March been sufficiently strong to convince us that the North American markets have many months of bullish action ahead of them? The evidence is mixed. On the plus side, as we pointed out in the last Market Comment, the appearance of a technically rare "Nine-to-One Up Day" in March (indicating a surge in volume in rising stocks on the NYSE) was a bullish sign. Price action, as measured by the S&P 500 index, has been impressive: from March 14 to April 25 the ratio of "up" days to "down" days was over 2:1. The rally of the last few weeks has also found support by the rising tide of the new 39-week cycle.

At the same time, there is a declining trend in the number of new 52-week highs of NYSE stocks. A peak in these figures was made in early December 2006, followed by lower reading in early February and mid-April 2007. Although, the S&P 500 index continues to make higher highs, this prolonged divergent picture indicates that market leadership is narrowing – not a surprise considering the age of the bull market – which may also indicate an underlying pattern of distribution as the market continues higher.

The pattern of the new 52-week high data also sheds some light on the recurring question whether this is the late stage of a bull market that began in 2002 (our view), or the early stage of a bull market that began in mid-2006 (the view of some other technical analysts). A frisky, relatively new bull market usually would not show such an extreme peak in 52-week new highs so soon in its life (in this case, within a matter of six months from its alleged start in mid-2006). Therefore, we see the current multi-month pattern as indicative of a declining bull. Only a rise above the December 2006 figures would convince us otherwise.

As to sentiment, the Investors Intelligence data remains mixed. The March-April rally has resulted in a small increase in the percentage of bullish advisors and a corresponding small decline in the percentage of bears. These figures continue to indicate professional advisory complacence, and are not at the extreme levels normally associated with major market tops.

Could the North American markets continue their impressive performance in the months ahead? The May-June period has historically been a tricky period for the markets, but the current widespread negative expectations is the perfect psychological set-up for a continuation of the rally. The percentage of NYSE and TSX stocks above their respective moving averages have moved towards an "extended" territory, but still have room to go even higher. The major market indices remain well above their respective medium and longer term moving averages (which could cause some pause and corrective activity) but their rising status supports further upside activity.

If the North American markets continue to go "straight up" from here, the prospects will increase that we may see a "blow-off" top by mid-year which would slam the door shut on the bull market. However, a more likely scenario calls for some further consolidation, followed by a resumption of a more modestly-paced "spring surprise" rally. As we have said before, this should be viewed as a late-cycle rally of limited duration and potential – since the negative tendencies of the seventh year of the decade still loom.

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THE TORONTO COMPOSITE INDEX

The S&P/TSX Composite Index completed its brief correction in mid-March with a "double-bottom" in the mid-12,000s (A). The second low was accompanied by a pronounced positive divergence in internal momentum, and provided the launching pad for the rally that has carried the index to new all-time highs in April.

For the past two weeks, as its short-term overbought status persists, the Toronto market has been treading water. Leadership, as indicated by the number of stocks making new 52-week highs, appears to be narrowing. The distance between the S&P/TSX Composite Index and its 200-day moving average is considerable, and the gap between the two could easily narrow. The MACD indicator appears to be topping, which would indicate at a minimum that there is further pausing action to come. The low 13,000 zone should provide good support for any attempt at sell-off in the days ahead.

With the 39-week cycle still pointing up, and a Point and Figure target of 14,000 still visible, any pausing action in the Toronto market should be relatively short-lived. Look for the S&P/TSX Composite Index to attempt to make another all-time high in the weeks ahead.

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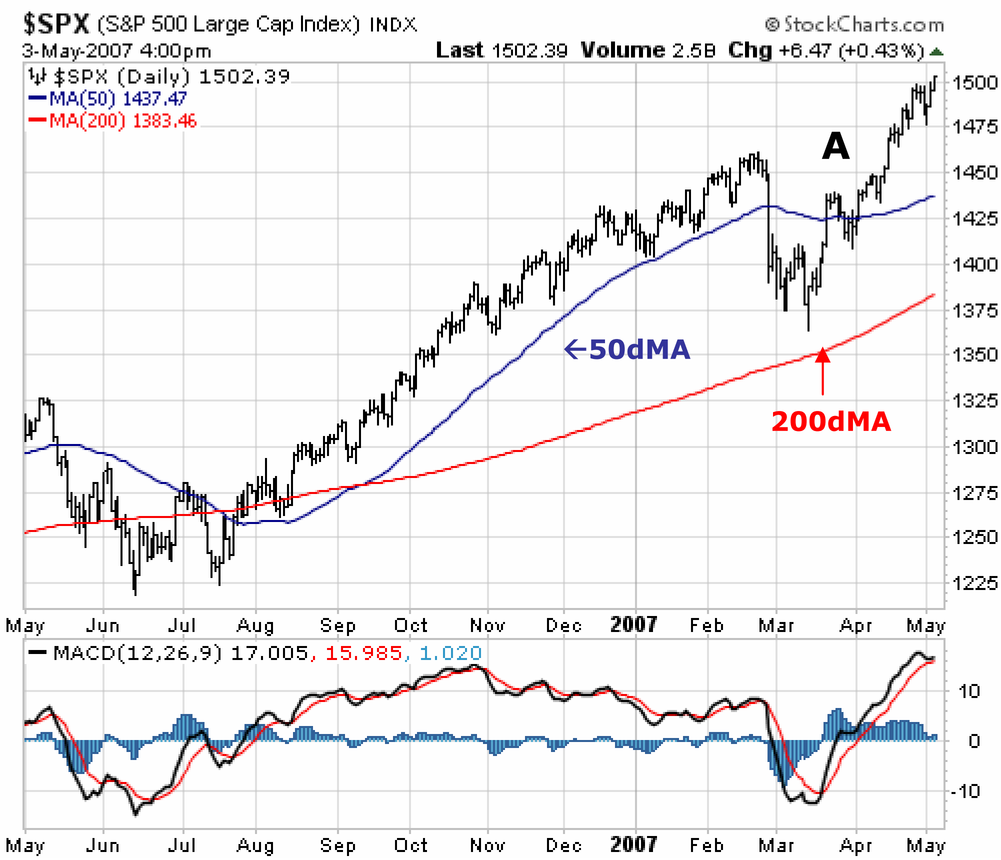
THE S&P 500 INDEX



The decline from late February proved to be a short one, of the down-up-down variety. The S&P500 found support at a level above its rising 200-day moving average in mid-March. We had expected some backing and filling, and re-testing of lows, before any resumption of the major up trend. However, the S&P 500 quickly reversed itself, easily surmounted the short-term resistance offered by a declining 50-day moving average (A), and powered upwards to new highs for this bull market. The index has added about 10% in the space of six weeks.

Can the up trend continue? The upper trend channel will offer resistance in the 1500 zone. Internal momentum indicators are stretched short-term, and the S&P 500 is now well beyond its (now-rising) 50-day moving average. Past behaviour suggests that these conditions should result in at least a short-term pause. Above 1500, the next major resistance zone – and a potentially formidable one -- is the long-term resistance posed by the top of the 2000 bull market in the low- to mid-1500s.

The S&P 500 continues to lead the markets higher. There is a very good chance that recent new highs will be exceeded before the summer.

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THE DOW JONES INDUSTRIALS

Dow 13,000, a new all-time high, Dow Transportation confirmation and front-page news in the media. Is this "the start of something big" or "the last stand"?

The Dow Industrials bottomed quickly in mid-March on a positive internal momentum divergence and without testing the rising 200-day moving average (A). The subsequent action has been powerful, encountering expected resistance around 12,500, but then effortlessly moving above the 13,000 level. A one-thousand point move has been accomplished within a few weeks.

However, the Industrials have now moved into a short-term overbought territory, and look extended. The index is also at the upper end of the trend channel that has contained the price action since mid-2006.

Any further rallies will take the index well beyond its 200-day moving average (currently at about 12,100), and will increase the prospects of a sharp decline as summer approaches. If the Dow continues virtually straight up from here, it should be considered as an "exhaustion" or terminal move.

The Dow Industrials' recent strength must be respected. The best prospect is a short-term rest followed by renewed rally in May and June, well into the 13,000s. At that point, we expect to see the index correct more significantly.

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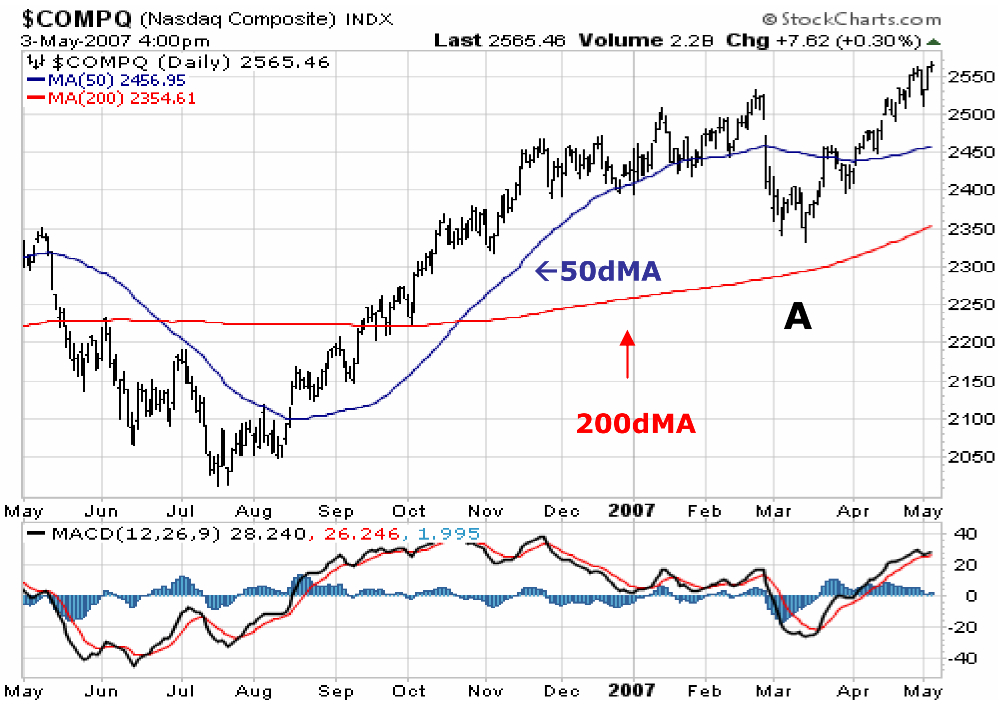
NASDAQ COMPOSITE INDEX



The NASDAQ surprised us by putting in a shorter than expected correction from the end of February to the middle of March (A). The correction re-traced about one-third of the previous rally. The signal for the end was the appearance of a positive divergence in internal momentum between the early- and mid-March lows.

Since then, it's been a strong move back above the 50-day moving average, toward a marginal new high around 2550. Significantly, the NASDAQ has reached short-term overbought status right at the upper trend line that has contained its action for the past couple of years. This trend line has proved to be the stopping point for several previous rallies.

What are the prospects? The NASDAQ is unlikely to out-perform other major market indices. If the markets still have a couple of months rallying left to do, then the NASDAQ may be able to exceed its upper trend line – what is referred to as a "throw-over" – and move beyond 2600. This would, however, very likely be an "exhaustion" move, signaling a last gasp before a more significant correction unfolds.

The NASDAQ has surprised by its continued ability to recover and eke out marginal new highs in 2007. Any renewed strength in the coming months – even with new bull market highs -- should be treated as an opportunity to lighten holdings. The March 2007 lows could be challenged in the months ahead.

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