

PHASES & CYCLES®

DECEMBER SHOULD BE THE LAUNCH MONTH FOR AN UPSIDE BOUNCE, BUT THIS BEAR MARKET HAS MORE DOWNSIDE SURPRISES LATER IN 2009.

When the bear is on the prowl, there are sometimes periods when many market participants begin to be a little less fearful – or more hopeful. At such times one may hear expressions such as: ‘stocks are cheap’; or ‘stocks can’t possibly continue to go down’; or ‘the selling has been exhausted’; or ‘the technical indicators are at historical extremes’. The months of October-November 2008 was one such period, and it is important to dissect exactly what occurred then in order to understand where this bear market might go next and when.

What happened technically to the markets in recent months?

The downside penetration by the North American major market indices of their respective 200-day moving averages in early and mid-2008 was followed by a ‘waterfall’ decline into early October. Months of deterioration followed by a mini-crash led to some extraordinary readings on many technical market indicators. The Volatility Index (VIX), the percentages of bearish and bullish advisers, the number of new 52-week lows, the percentage of stocks below their 50-day and 200-day moving averages – all were among the indicators hitting extreme levels.

October 10 was a pivotal day, and a ‘fooler’ for more than a few. That day marked an internal momentum low for the markets, but it was not a price low and definitely not a ‘capitulation’ or a ‘selling climax’. The ‘October technical lesson’ was that it is difficult to use extremes in momentum indicators as signs of market turning points.

October 10 was not an end point – in fact, it was the starting point for a multi-week volatile ‘trading range’ in which the markets attempted to stabilize themselves.

However, that trading range was very deceptive. Yes, there were several days when upside/downside volume figures suggested that a sustained rally might follow. But there was no follow through – the market indices were unable to reach their declining 50-day moving averages – and the sellers were always around (especially towards the end of the day).

Mid-October to mid-November was also not the burial ground for the bear market that many market participants hoped it would be. Indeed, from the point of view of what is needed to turn the markets around, there has actually been too much hope and wishful thinking and not enough panic and ‘blood on the streets’. The repeated assertion that there is a vast pool of cash on the sidelines just waiting to leap into the markets and send them zooming upwards is perhaps the best expression of the hopeful mentality.

What is the current state of the markets?

November 21 may have been a significant price low for the major market indices. These indices are now showing substantial positive divergences in internal momentum readings, compared to early October.

However, any optimism about November 21 must be tempered by the recognition that the market indices are still in a pattern of ‘lower highs and lower lows’ and there has yet to be any successful re-test of recent price lows. Also of concern is the false belief that the market action through October and November actually helped resolve some of the severely oversold conditions. Finally, a renewed Dow Theory sell signal was given in late November as both the Industrials and Transports hit new closing lows.

What is likely to happen next?

With such extensive and widespread declines, the tax loss selling period has probably started earlier this year, and will continue to exert some downward pressure on the markets in December. Offsetting this is the prospect of a December low in both the 70-day and 39-week market cycles. In other words, if there is going to be a significant market rally, it should start before the end of the year. A successful re-test of the November 21 lows would be a good launching point.

Meeting our definition of a 'significant' rally requires passing three tests (see charts on next pages). First, the market indices would have to go above their declining 50-day moving averages (50dMAs). Second, these 50dMAs should turn up. Third, the rally should exceed the top of the October-November trading range. Meeting these three tests would put the major market indices somewhere above their 50-day moving averages, perhaps even approaching or slightly exceeding their declining 200-day moving averages.

The downside risk facing the markets in the near-term – and which is always a risk in a bear market – is that the forthcoming new 39-week cycle becomes 'right-translated'. This means that the 'up' portion of the cycle is prematurely terminated, leaving most of the cycle subject to downside pressure. Such a right-translation would likely be accompanied by more bad economic news, dividend cuts, etc.

The longer-term outlook

In our Market Comment #199 of October 28, we situated the current state of the markets in relation to the 'big picture' 40-year cycle. This analysis suggested that a medium-term cycle low was forthcoming, setting the stage for a recovery rally into 2009.

The important point to keep in mind about any recovery rally is that it would be characterized – until evidence says otherwise – as a counter-trend rally. Bear market rallies are not opportunities for long-term investors. These rallies do, however, offer opportunities to traders and medium-term investors, as long as they are protected by tight stop-losses.

Some words of wisdom from the past:

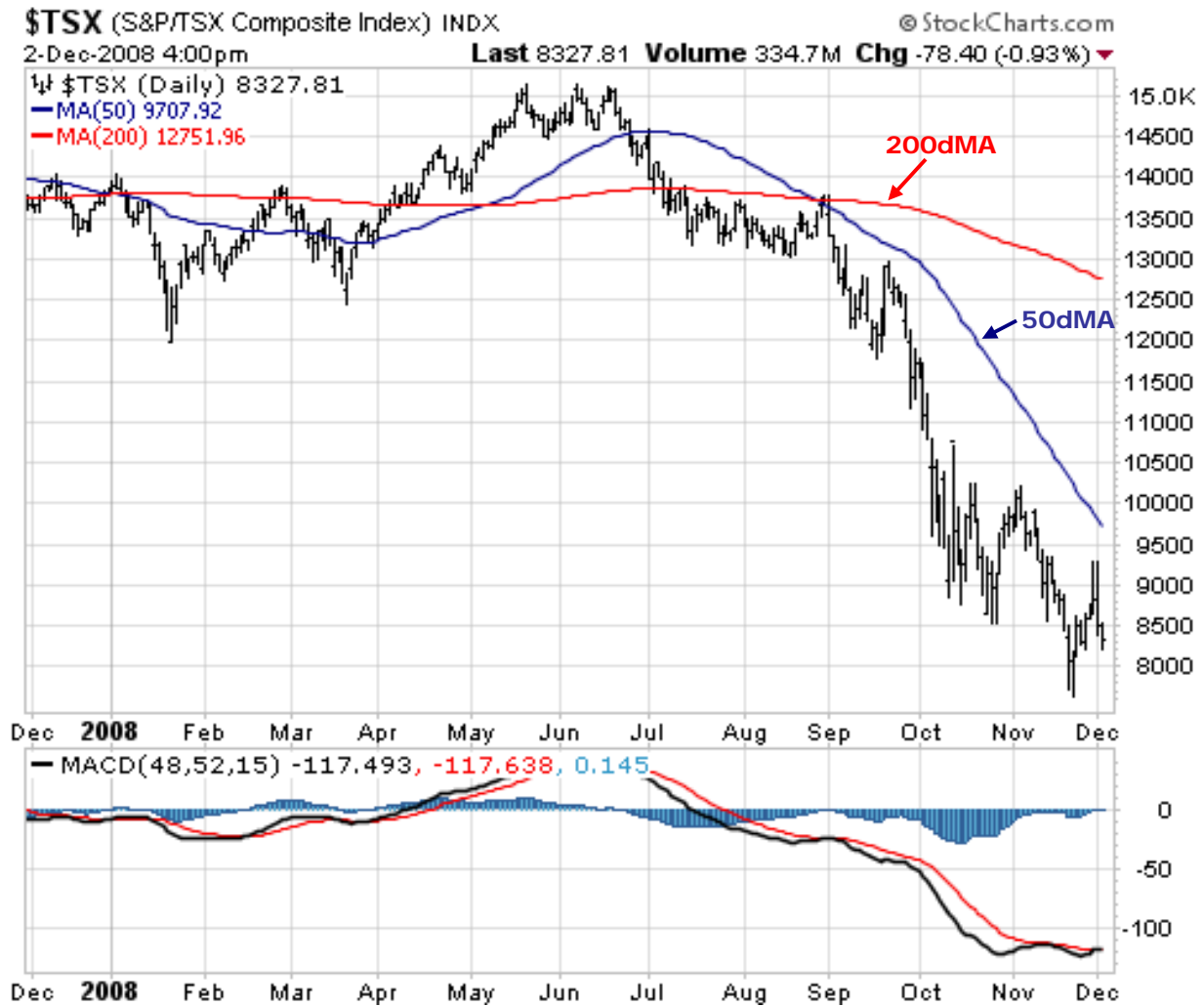
We place little value in efforts to use previous bear market chart patterns as guides for projecting the length and severity of the current bear. This bear will have its own unique character. But our knowledge of market history does cause us to note that extended bear markets of the past are littered with the casualties arising from attempts to anticipate – prematurely, and without confirmation – the bear market's end. We recall something along the following lines:

'The dumb money lost its shirt in 1929-30. The smart money lost its shirt in 1931-32'.

In sum, there has been massive technical damage in the major market indices and individual stocks. The markets continue to grope for a temporary bottom. A medium-term tradable rally, and one which can be used by longer-term investors to lighten up holdings, may materialize shortly.

Only small percentages of stocks are above their 200-day moving averages. These stocks, such as SXC and WN in Toronto that we have highlighted recently, are one category for potential purchases, as long as tight stops are also entered.

S&P/TSX Composite Index



From its peak in June 2008, the Toronto market has declined roughly 50%. One reading of the chart of the S&P/TSX Composite Index is that its decline has unfolded in a 5-wave pattern and that wave-5 terminated in late November. This is supported by the MACD indicator which now shows a positive divergence in internal momentum that extends back into early October.

A one-third retracement rally would take the Toronto market up to the vicinity of the top of its October-November trading range and above the falling 50-day moving average. A more extensive rally retracing 50% of the decline would place the

S&P/TSX Composite Index at about 11,400. If this rally occurred over a number of months, it would see the index approaching its declining 200-day moving average.

Despite, or because of its rapid and savage decline, the S&P/TSX Composite Index is now well-positioned to mount an attempt at a rally. If such a rally occurs, the behavior of the index around the 50-day moving average will be critical. Will the index have the strength to turn the 50-day moving average upwards, or will approaching that average be another opportunity for the short-sellers to initiate new positions?

S&P 500 Index



The technical condition of the S&P 500 is similar to that of the S&P/TSX Composite Index in that both indices are showing a positive internal momentum divergence. But the S&P 500 has a longer bear market pattern – its negative crossover of the 200-day moving average occurred in early 2008 – and this provides some guidance to how the index might behave in the coming months.

When it rallied for an extended period in 2008, the S&P 500 managed to get itself above its 50-day moving average. If this pattern continues, the index should approach that average, currently resting at about 960. This would also put the index near the top of its recent trading range. A move below 750 would indicate that a new bear market down-leg has begun.

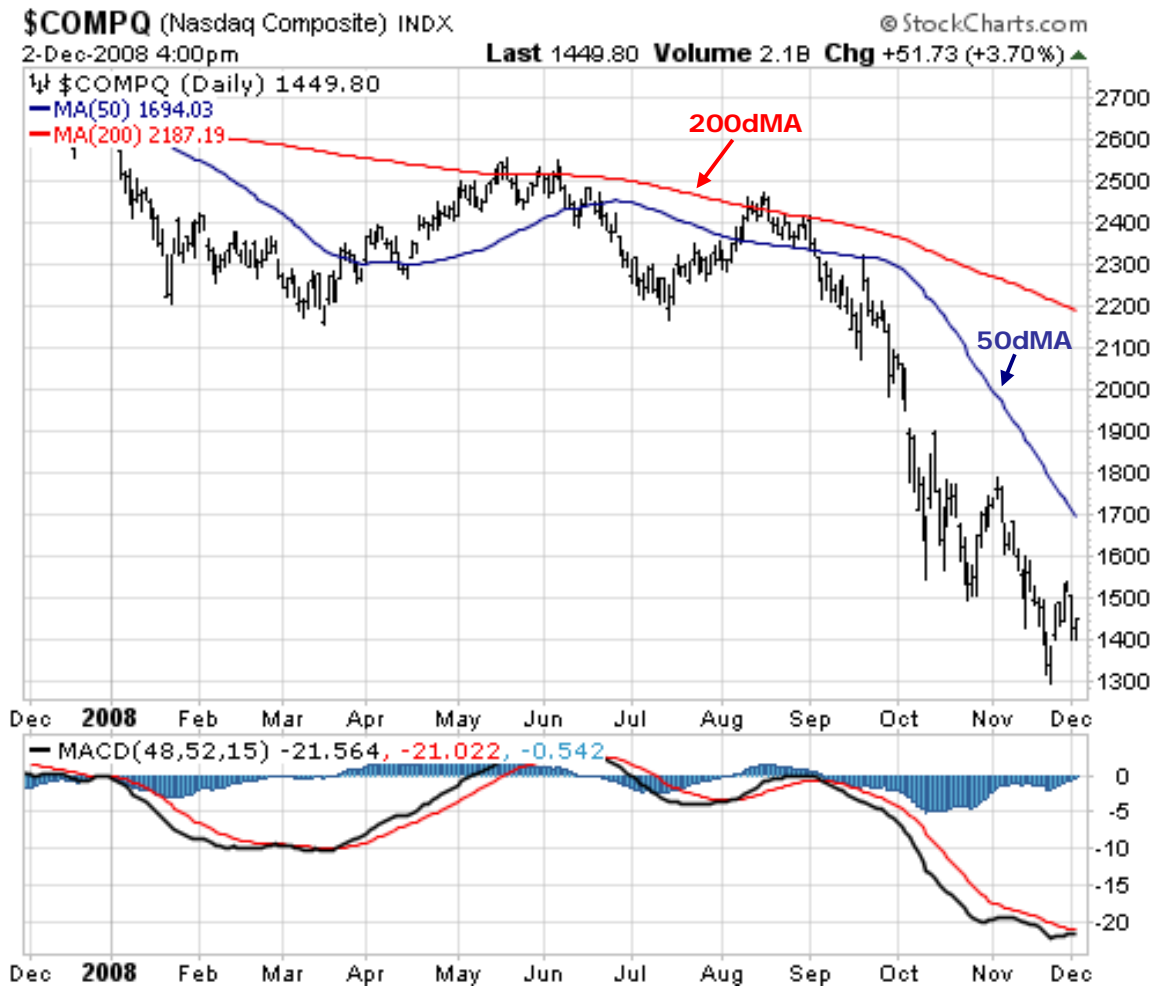
Dow Jones Industrials



The renewed 'Dow Theory' sell signal on November 21st does not preclude the possibility of a significant attempt at a rally in the forthcoming months. The Dow Industrials also show a positive momentum divergence, which could provide the springboard for an up-move.

The Dow Industrials will encounter problems if it reaches the 9500 area, where it would be challenged by resistance arising from the top of its trading range.

NASDAQ Composite Index



Compared to the other market indices that we have reviewed, the NASDAQ looks slightly weaker. Its positive internal momentum divergence is not as pronounced and its breakdown below the temporary October lows was slightly more severe.

A rally in the NASDAQ towards the 1700-1750 level looks like a best-case scenario for the near-term. The recent sharp decline in the NASDAQ suggests the need for some base-building or re-testing of the November low before a rally can get off the ground.

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