

PHASES & CYCLES[®]

**THE PRIMARY TREND REMAINS POSITIVE.
A NEW UPLEG COULD HAVE STARTED YESTERDAY.**

What happened during the last few months? One thing we have learned from our many years of observing and analyzing markets is that at the point of major change in the primary trend – from bull to bear, or bear to bull – *only a minority “get it right”*.

In the spring and early summer period there was an abundance of market participants and commentators who were too bearish too soon, and were convinced that they were right. There was a gleeful; almost “we told you so” sense of eagerness in many media pronouncements that the 2009-10 bull market had come to an end. What was scarcely noticed is that many of these comments came from the same sources who were the long-term deniers that the bull market even existed – since, in their eyes, everything from March 2009 was supposedly just a “bear market rally”.

This bearish conviction was supported by supposedly “obvious” technical indicators. First up to the plate was the “head and shoulders” top (people see more “head and shoulder” tops than there are stars in the sky!). Then the so-called ‘death cross’ occurred. The bears expected the major market indices to flame out on cue as the 50-day moving average crossed downward through the 200-day moving average. How dramatic, and what irony: the “sell signals” supposedly generated by these two indicators *coincided with the launching point of the July rally!* This reminds us of market technician Joe Granville’s most famous observation concerning the markets: *“the obvious is obviously wrong”*.

Another thing that our market experience has taught us over the years: when a technical indicator becomes widely quoted in the popular media (as above) and when virtually everyone is convinced of a particular interpretation of that indicator then its forecasting value diminishes exponentially.

What is the current status of the markets?
The bears discovered in July that their

“enthusiastic pessimism” had to be curtailed, at least for a while. As illustrated by the S&P 500 Index on page 4, many of those on the short side of the markets were picked off in two phases – the initial rally from the early July lows to the 50-day moving average (July 13th), followed by the resumption of the rally up to the 200-day moving average (July 27th).

We made a detailed case in the “Thought of the day #61” (August 3rd) that a series of technical, cyclical and sentiment measures had combined in July to lay the basis for a new up leg in the bull market. The five-week rally from early July to the first week of August put the major market indices near their respective 200-day moving averages – a normal pause point – and more importantly put the markets in a short-term overbought position. As expected, the *Investors Intelligence* survey of investment advisors – a contrary indicator – became more positive as the rally proceeded: from a dead-even reading of 35.6% on July 20th, the bullish advisors increased to 41.7% and the bears dropped to 27.5% by August 10th. The markets were, in sum, ready for a rest.

Viewed from this perspective, the pullback that occurred last week looks to be normal and healthy. Of course, the bears immediately seized the opportunity afforded by last Wednesday’s broad decline to shovel yet more “doom and gloom” in the direction of investors. For example:

- At the Wednesday close, the *Globe and Mail* quickly posted a “September slaughter; how to prepare” video!!
- *Bloomberg* put up two articles: “Government bonds to collapse, avoid stocks” and “U.S. is bankrupt and we don’t even know it”.

Currently what we see is a market environment where negative news and bearish expectations are emphasized. This pessimism looks excessive, but, at the same time, it creates the “wall of worry” the markets need, in order to climb higher.

What will North American markets do next?

Forecasting the behavior of the major North American market indices over the next few months needs to start from the following:

1. The markets have apparently made an important intermediate-term low in early July.
2. The markets are about to enter the historically volatile September-October period, which in many (though by no means all) past years has seen an important low.
3. The current bull market, in its 18th month, is now in middle age – some stocks have now fallen by the wayside for the duration of this bull.
4. The new up leg that is now underway needs to re-assert itself to lift the major market indices out of the “trading range” pattern that has existed since mid-May. The rise of the respective 50-day moving averages above the 200-day moving averages will be a confirmation that the up leg is flexing its muscles once again.

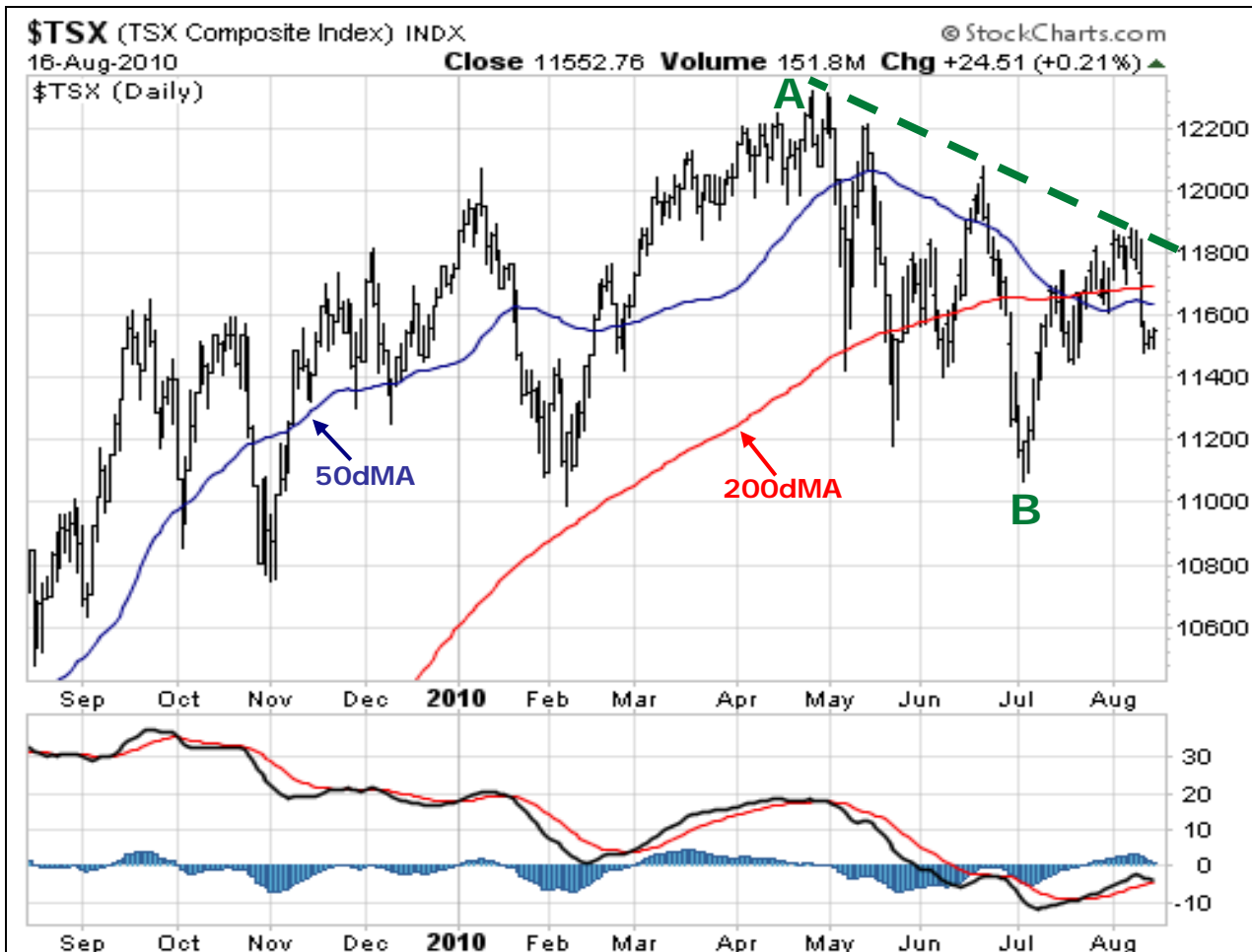
To this list of factors we have to add two others. First, the cycle picture is delicately poised. In mid-October, a number of cycles – including the 21-day, the 70-day and the 39-week –

are expected to mature. It is not yet clear how this maturation will affect the markets, but one thing is certain: the last time the 70-day and 39-week cycles matured at the same time was near the March 2009 lows --- and we all know what followed! Therefore it is quite reasonable to expect a mid-September high and a mid-October low, leading to a strong year-end rally.

The other factor to monitor closely is the price pattern on the weekly charts of the major market indices. All of them show a potential “inverse head and shoulders” pattern that no one has yet even hinted at. Of course, it is premature to call it a “bird in hand”, but should the markets move above their respective “necklines”, it would result in substantial upward moves (see details on subsequent pages).

In sum, the balance of the technical and sentiment indicators that we follow suggest that the up leg that began in early July should extend well beyond Labor Day. Market progress may be more labored and choppy than in the early phase of the bull market, and fewer stocks will participate. Market participants should concentrate on stocks that have a positive technical profile and proven recent strength, and maintain appropriate stops.

S&P/TSX Composite Index



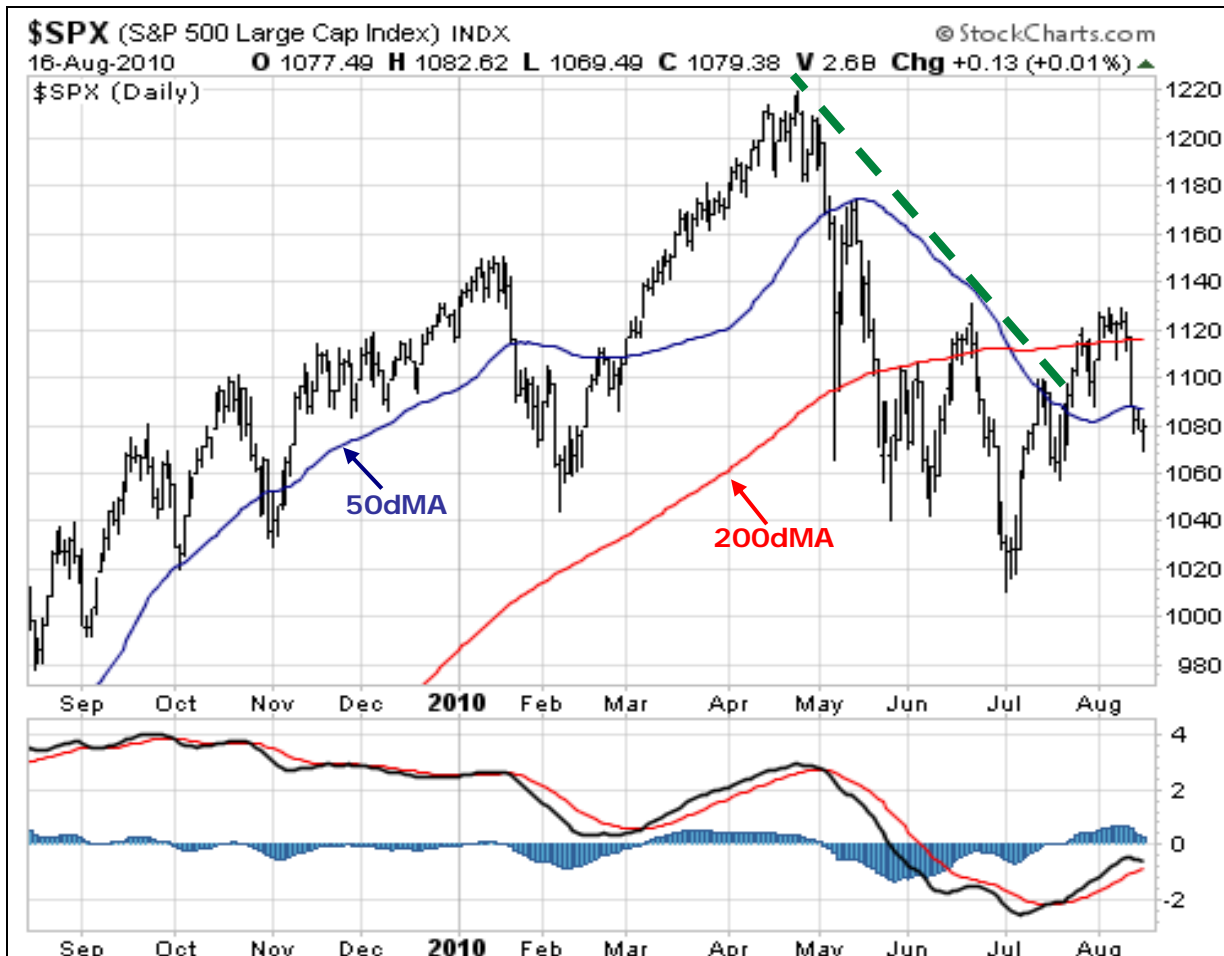
The correction since the April 2010 high (A - B) has only amounted to about 26% of the bull market's gains, which is a good performance relative to other North American major market indices. However, the action during the correction itself has been comparatively disappointing. The Toronto market, alone among the four major market indices that we highlight in this Market Comment, has been unable to break its down trend line dating from the April high – this would require a move above 11,900 (see dashed line). This is due mainly to the weakness of the most heavily weighted Financials and the Energy Sectors.

Otherwise, the S&P/TSX Composite Index has behaved in a similar fashion to the other major market indices. The Toronto market leapt upwards from its July 5th low (B) and has moved back to both its 50-day and 200-day moving averages.

However, the Toronto market needs to make an additional upside move to cement its performance. To do so, the S&P/TSX Composite Index needs to get above the 11,900 level, which is also the approximate “neckline” level. This would place the Index firmly above both its 50-day and 200-day moving averages. On the downside, the early July lows must hold – a move below 11,000 would violate support and set up an extended and bearish pattern of lower highs and lower lows.

The Toronto market is currently oversold. We look for the S&P/TSX Composite Index to stabilize itself in the low- to mid-11,000s and then make a strong upward move. A Point and Figure target of 12,700-12,900 is clearly visible, which would take Toronto to a new high for this bull market.

S&P 500 Index



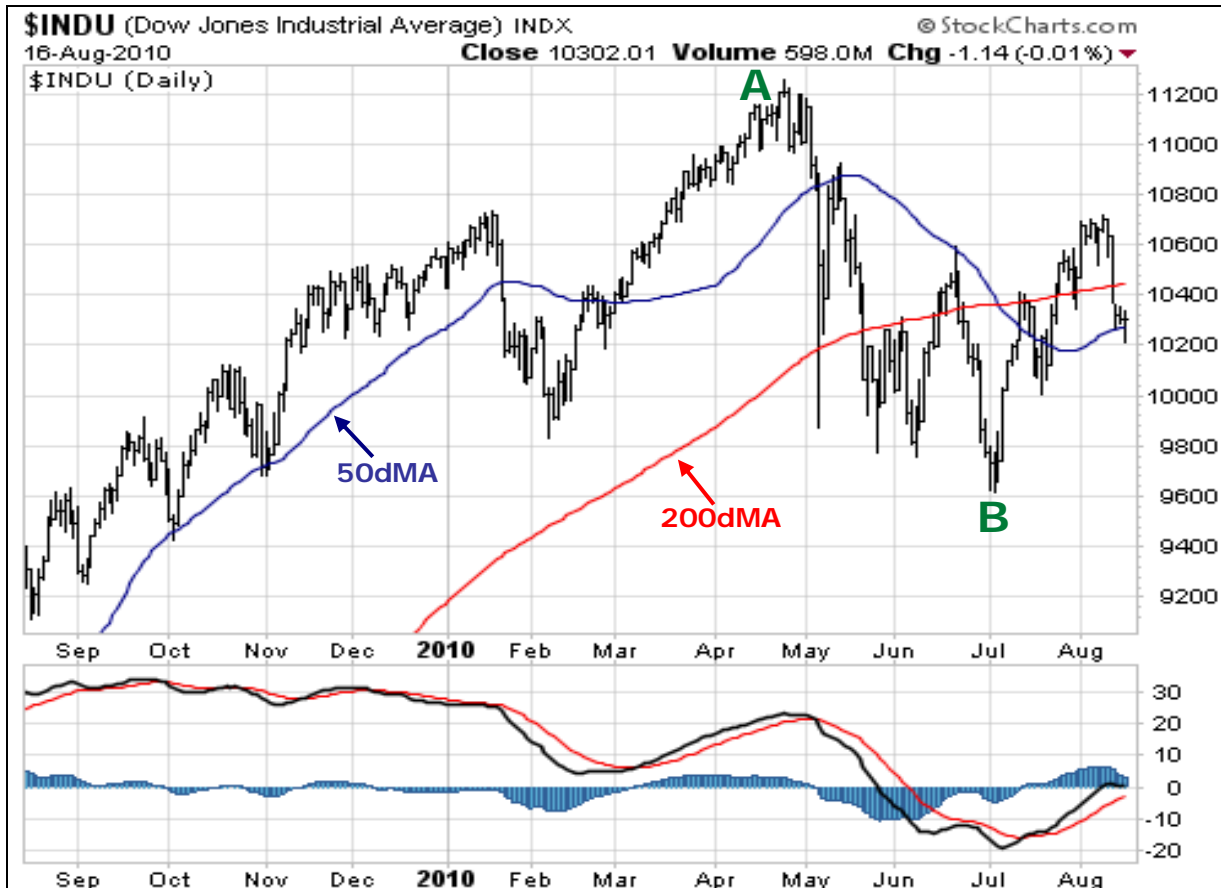
In mid-July the S&P 500 Index exceeded the down trend line formed from the late-April peak (see dashed line). This confirmed that the late-June and early July activity was a “bottoming action” and created a potential “inverse head and shoulder” formation.

Over the last few weeks the S&P 500 has been trying to establish a firm relationship with both its 50-day and 200-day moving averages. At the moment, the relationship is uncertain: in the past couple of weeks the Index moved both above and below each of these moving averages. The 50-day moving average will need more positive market action in the short-term to turn convincingly upwards. The 200-day moving average, while beginning to flatten, still retains a positive bias.

The critical upside level is 1,130 in the near-term, which is also the “neckline” of the potential “inverse head and shoulder” formation. A move above this level would clear all the near-term supply and overhead resistance and keep the 200-day moving average rising. At the same time, the S&P 500 must not make any significant move below 1,000, otherwise the overall bullish scenario would be seriously damaged.

The S&P 500 could build further strength over the next little while, and move back toward the April highs. The current trading range (congestion area) could support a rally towards our Point and Figure target of 1,225.

Dow Jones Industrials



The Dow Industrials made a “normal” pullback (A – B) of about one-third of its overall bull market advance between March 2009 and April 2010. Encouragingly, the July rally that followed was able to exceed both the 50-day and the 200-day moving averages, as well as the mid-June peak. Internal momentum was reasonably good on the rally, but the Index did move into short-term overbought territory in early August.

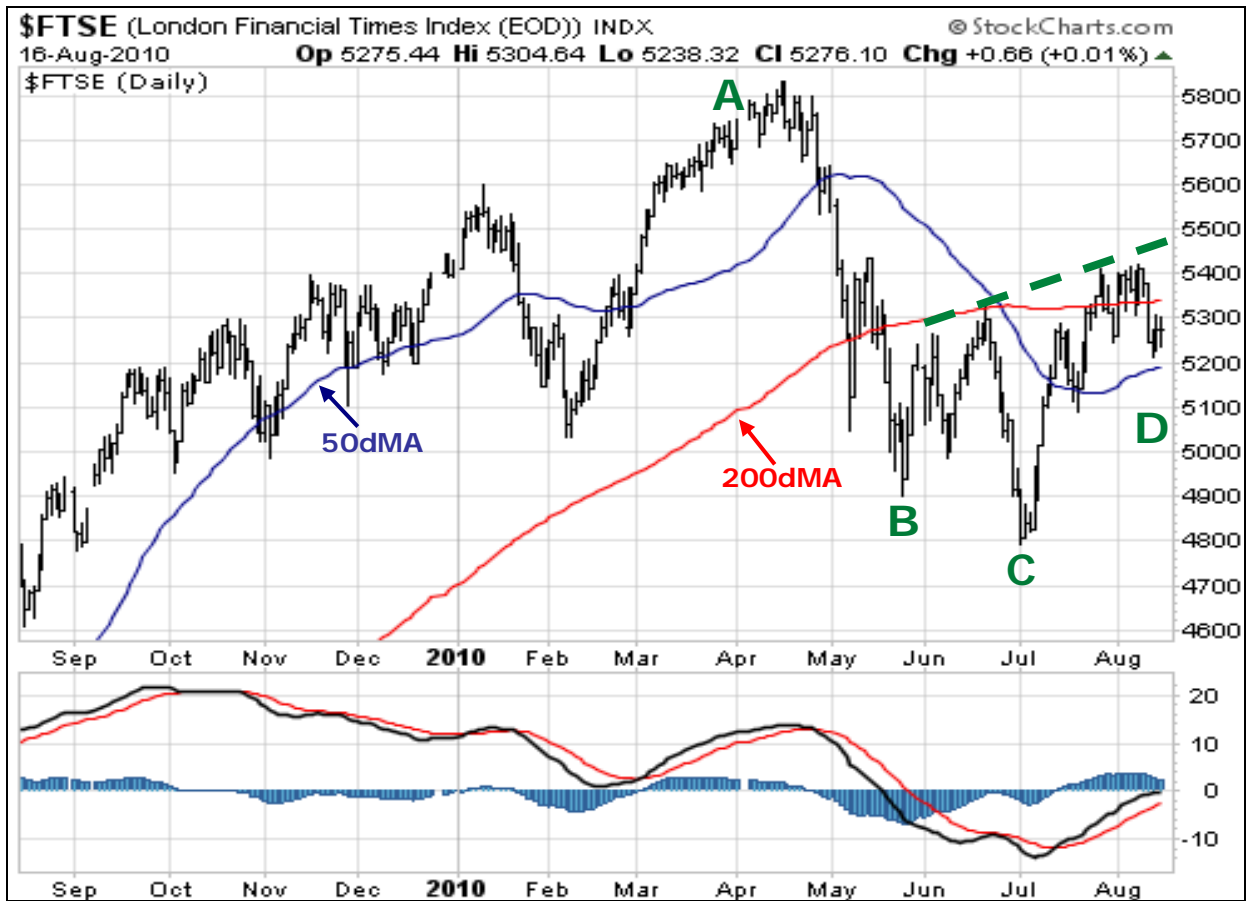
The *Dow Theory* remained positive during the corrective period. Despite rumors, at no time was there a closing low made jointly by the Dow Industrials and the Dow Transports, at no time did they take out their respective previous secondary low points made in February 2010. The early July low, at about 9,600 (B), has assumed the status of potentially important secondary low and must be watched closely. But, for the moment, the *Dow Theory* still asserts

that the primary market trend is upward.

The Dow Industrials had a little rest after the July recovery, but the 200-day moving average continues to rise. The potential “Inverse Head and Shoulder” formation is not as visible here, but a move above 10,750 will be extremely bullish anyway. A move down towards 10,000 can easily be tolerated, but not necessary.

The Dow Industrials have moved into oversold territory. The current pullback is healthy and should set the stage for a run above 10,750, which would make a lot of participants question their bearishness since such a move would make the re-appearance of the new bull market upleg more apparent. Our immediate Point and Figure target for the Dow Industrials is 11,500.

FTSE-100



The decline from the late April peak (A) was significant and re-traced over 40% of the bull market advance from March 2009 to April 2010. The correction ended in early July (C), boosted by a positive divergence in internal momentum. The correction also exhibited some symmetry – the FTSE-100 peaked in April about the same distance above its 200-day moving average as it declined in early July.

As the London market moved out of the July low and above its 200-day moving average, it became short-term overbought and met resistance just above 5,400, just where the previous recovery attempt in early May halted. The July/August recovery has regained about two-thirds of the April/July decline. The 50-day moving average appears to provide good short-term support and has recently turned upward for the first time in nearly three months.

The FTSE-100's major challenge is to move above the overhead resistance zone in the 5,400 to 5,500 area, which in turn will establish the 200-day moving average as a support. This level may also be the "neckline" (see dashed line) of a potential "inverse head and shoulder" formation (B-C-D) which, if it is truly this, points to a target of 6,100. On the downside, the mid-July lows must not be violated for the bull market and the potential "Inverse Head and Shoulder" formation to remain intact.

The ideal scenario for the FTSE-100 is to spend some time building strength above its rising 50dMA, followed by a continuation of the bullish advance dating from the July lows. This would overcome the 5,400-5,500 resistance zone. Should this occur, a run back towards the April highs or above could be anticipated.

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