

PHASES & CYCLES[®]

'THE RISING TREND IS YOUR FRIEND' REMAINS THE DOMINANT THEME OF THE 2009-11 BULL MARKET. HOWEVER, A 1Q2011 PAUSE IS STILL EXPECTED.

The sustained rise of stock markets during the last four months of 2010 contributed greatly to something that we have not seen since mid-2007 – a sense of belief that good things can happen in the markets. During the bear market of 2007-09 and the bull market that followed, the predominant view of investors has been one of doubt and negativity.

That sceptical view was eroded during the last few months of 2010. Although more than a few investors stayed put on the sidelines, and others remained under-invested, it was possible to detect a change in mood in media reports and commentary late last year. One expression of this was the attention given to the Investors Intelligence data which showed bullishness amongst advisors at high levels.

Then the media discovered 'contrary opinion'. If most market advisers and participants were bullish already, then that surely meant that there was nobody left to buy and therefore the markets must fall. January became the month of 'let's wait for a correction' or even, 'we must surely be close to the end of the bull market.'

But there is another way to view these sentiment indicators. Given the previous period of sustained scepticism, what we have seen in the last few months can be viewed simply as growth in bull market recognition – not the type of excess that usually characterizes major market tops. All the other interpretations – particularly, that the past 22 months have been a glorified bear market rally – have fallen by the wayside. It is to be expected that more investors and advisors (and the

financial media) will feel positive about the markets as 2011 begins. But that does not mean the bull market is in its end game. It just means that during this latter half of the bull market more people will come to the party. However, the late-comers face a challenge – some stocks have already topped out, and some sectors underperform. This means, as we said several weeks ago, that 2011 is going to be the year of astute stock selection within a rising trend.

Our recent Market Comments shared the opinion that the markets would have a slow start in 2011. We have not changed our view, despite the powerful performance of the markets in January. The markets have been rising for 7 months since the mid-2010 lows, and the technical evidence (see page 2) still holds out the possibility of a first-quarter pause or correction. But what all investors must bear in mind is that the larger price trend of the major market indices has been resolutely 'up' for nearly two years. This rising trend – the friend of every bull – must be considered in force until such time as the price parameters of the bull market are challenged conclusively. We review these parameters on the next page.

The markets remain susceptible to a short-term pause or pullback during the February/March period. This would be a further buying opportunity for carefully selected stocks and sectors. The bull market still has plenty of fuel in its tank for the balance of 2011.

(a) The shorter-term technical status of the markets is mixed:

The strength of the markets' performance in January should not obscure some underlying technical concerns. Some small divergences have appeared in internal momentum and the number of stocks making new 52-week highs in the New York and Toronto markets peaked in November 2010, in the middle of the current rally. The overall advance/decline figures are, however, holding up well.

It is also possible to count an 'up, down, up, down, up' pattern from the mid-2010 lows in many major market indices, which could indicate that the current rally is nearing an end. There has also been some 'round number hesitation' for the S&P 500 (at 1,300) and the Dow Industrials (at 12,000) which can sometimes act as resistance.

On the cyclical side, the picture is mixed, with many cross-currents. The 70-day cycle matured at the end of last week (perhaps coincident with last Friday's mini sell-off), the 39-week cycle matures towards the end of February, and the 105-day cycle will mature at the end of March. This pattern of rising and falling cycles nesting within a small period of time suggests that the markets could spend much of the next two months marking time.

If the markets do move in a 'trading range' pattern for the next month or two, this will still mean we are seeing a meaningful pause in terms of time. Such a pattern also suggests that there could be considerable sector rotation as some areas of the markets take a breather and others come to the fore. It will also mean, most importantly, that the uncomfortably large gap which we have noted in previous Market Comments between the indexes and their respective 200-day and 50-day moving averages will narrow. Whether this comes from a lateral movement of the indices, or from a more visible correction, does not matter. The important point is that it would be healthy for longer-term market prospects.

(b) But the longer-term bull trend remains firmly in place:

Two factors will bring smiles to the bulls in 2011. First the 'January indicator', calculated on the S&P 500, which says that 'as January goes, so goes the year', is positive. January was a very strong month.

Even more convincing is the longer-term price performance of the major market indices that we follow. As we have noted in previous Market Comments, the major market indices have generally moved within a well-defined price channel since the start of the bull market in 2009. Using the S&P 500 Index as an illustration, the market, in its lift-off phase from the March 2009 low, moved quickly into the upper half of the trend-channel and stayed there until the intermediate-term peak of April 2010. The correction that followed took the Index back below the mid-point of the channel, and eventually stopped at the lower trend line. Then, from mid-2010, the Index has moved back up towards the mid-point of the trend channel.

The trend channel parameters are currently near 1,150 (the lower trend line) and slightly higher than 1,400 (the upper line). It would take a sustained move violating the lower trend line – along with other technical evidence – to suggest that the bull market was at an end.

In sum, the markets' vigorous exertions over the past 7 months deserve a rest, which we expect will come sometime during the months of February or March. Following this pause, our expectation is that the market indices will make a concerted attempt to move towards the upper half of their respective bull market trend channels. The upper trend lines of those channels remain a realistic target.

S&P 500 Index



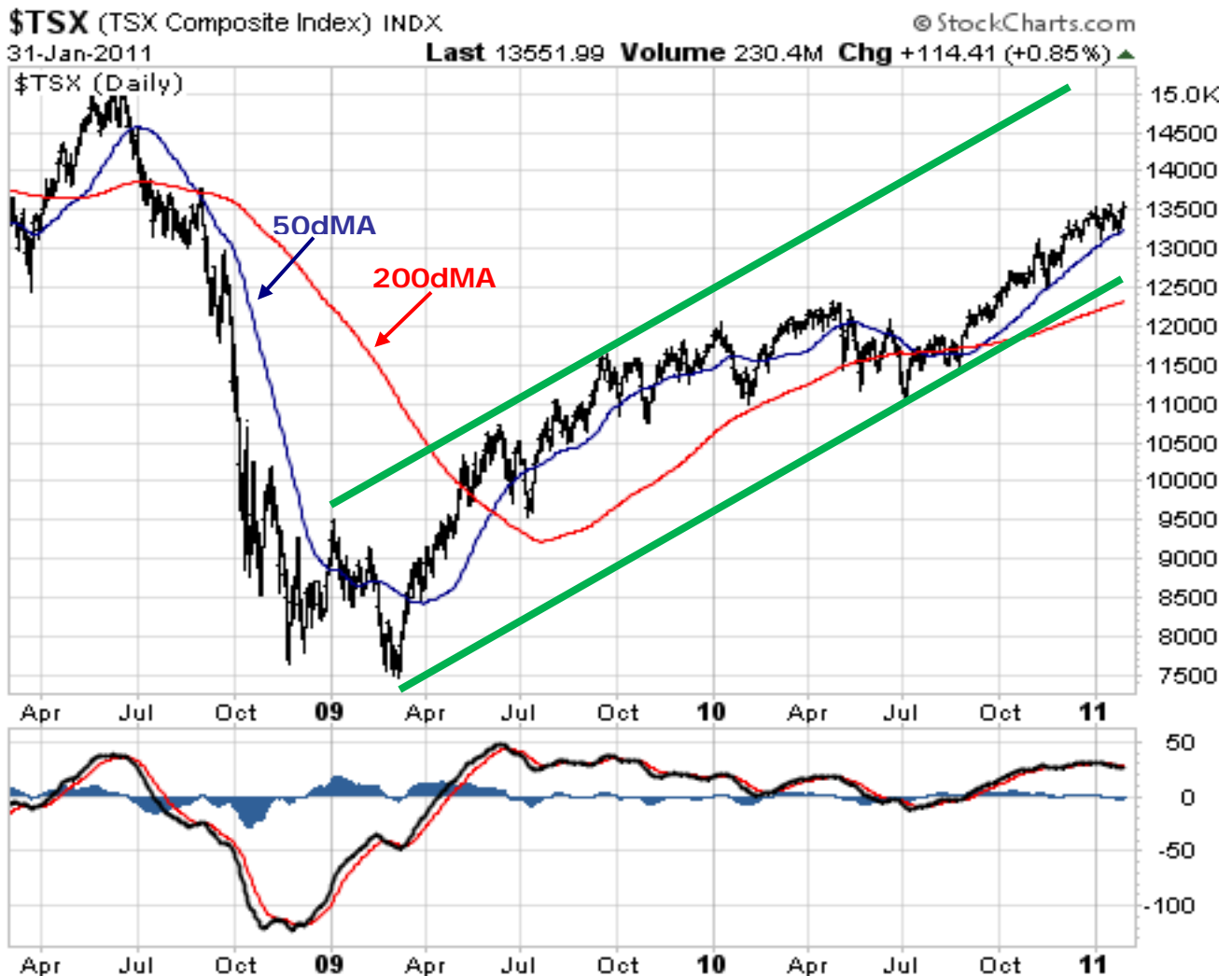
The S&P 500 had a very good January in terms of price advance, as the Index spent the entire month well above its 50-day moving average. Since the mid-2010 lows, the Index has put on 292 points, or 29%. This is a brilliant and sustained performance by any measure.

If the S&P 500 does correct in the coming weeks, there is good initial support in the 1,250-1,260 range, with the rising 50-day moving average just below this zone. If there is a substantial correction in the offing, the one-third level of retracement of the rally of the past seven months would place the Index just above 1,200 (between the 50-day and 200-day moving averages).

An – unlikely – 50% retracement would bring the S&P 500 back to its rising 200-day moving average which, coincidentally, is in the same area as the lower trend line of the major bull market trend channel.

The S&P 500 remains somewhat overbought and vulnerable to either a trading range or a mild correction of the recent multi-month advance. We would wish to see a pause before the Index launches itself towards the substantial upside targets above 1,350.

S&P/TSX Composite Index



The S&P/TSX Composite Index had a choppy January (probably reflecting some sector rotation in such areas as materials and golds), as the Index made a marginal new high for the bull market but only modest net progress for the month. The Toronto market has risen 23% (over 2,500 points) since last summer.

The Toronto market briefly visited its 50-day moving average, which acted as good short-term support in the latter half of January. Underneath the price action, the number of new 52-week market highs was unable to reach the levels achieved in November 2010. In addition, January was a month of noticeably declining internal momentum (as measured by the MACD indicator). There remains a substantial distance –

about 10% -- between the Index and its rising 200-day moving average, which suggests that the S&P/TSX Composite Index could be ripe for a correction.

A one-third decline would take the Toronto market back to the 12,750 area. The lower trend-line of the major bull market channel is located at about 12,600, above the 200-day moving average.

The S&P/TSX Composite Index has significant upside targets for this bull market. Shorter-term, the Toronto market looks vulnerable to a pull back. A period of gathering strength below its 50-day moving average would be a good launch pad for a run at 14,000-14,500.

Dow Jones Industrials



Since mid-2010, the Dow Industrial Average has risen an extraordinary 25%. Most recently, December and January were months of persistent advance. The Dow continues to make new bull market highs, and has now reached our most recent Point & Figure target of 12,000.

In terms of technical indicators, the Dow Industrials has performed well recently. Internal momentum has steadily risen with the market, without a negative divergence (but with a very high reading at the end of the month). Declines have been met quickly with renewed buying power.

This persistent strength has, however, led to some vulnerability. The Dow Industrials is well above its 50-day moving average, and, at the end of last week, was nearly 1,200 points above the 200-day

moving average. There is little visible support to arrest a decline until the 50-day moving average is encountered. Also of note – but not yet of concern – is the fact that the Dow Transports has yet to confirm the late January high as in the Industrials.

If a pullback does occur, the Dow Industrials should encounter good support in the 11,500 to 11,600 zone, and later on in the 10,800 to 11,000 area. The lower trend line of the major bull market trend channel is also located in the latter area.

A small short-term correction in the Dow Industrials, ideally contained in the low 11,000s, would be a tonic for a future advance. This would set the Index up for a run to the upper half of its major trend channel to new bull market highs.

FTSE 100



Of all the major market indices that we follow in our Market Comments, the FTSE had the weakest January. Indeed, as the month ended, the FTSE's internal momentum tailed off, as the London market tested its 50-day moving average. The 6,000 area may be another example of short-term 'round number resistance'.

The FTSE, as the other market indices, has had a significant rise since the middle of last year. It gained 27% and came very near to achieving our Point and Figure target of 6,100. The relative weakness of January may very well prove to be a leading indicator for declines in other indices. Certainly the FTSE can easily accommodate a short-term pullback.

Should the weakness continue, a one-third correction of the previous advance would take the London market down to the 5,600 area, which is in the vicinity of the sharper rising trend-channel. The 5,400 to 5,500 zone offers even more support, coinciding with the rising 200-day moving average and the lower trend line of the FTSE's major bull market trend channel.

The FTSE is giving strong signs that it is in the midst of a resting period. A pull back may already have started in mid-January. A retracement back to a level between the 50-day and 200-day moving averages would be healthy preparation for a renewed advance.

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