PHASES & CYCLES®

**THIS MAJOR CORRECTION WILL TAKE TIME TO RUN ITS COURSE.
BUT THE BULL MARKET IS STILL ALIVE AND
PATIENCE WILL BE REWARDED.**

At the start of January, in our Outlook for 2018 issue (MKT-430), we said that "2018 is going to see a more volatile and uncertain market." We noted how stretched New York was to the upside after its huge run-up and that conditions were ripe for a correction. By the end of the month, in our January 31 Market Comment, with New York *even higher* we said that while the S&P 500 had no upside resistance "the risk of short-term upside exhaustion is growing" and the "advancing phase could end at any time with a bout of profit-taking". The pullback that we anticipated in Q1 is now well underway and has turned quickly into a full-scale correction. The rapidity and severity of the recent decline was not expected by most observers, including ourselves. Downside momentum in the S&P 500 cut through nearby support areas with ease.

What is the bigger picture? The S&P 500's "Final up leg" or "Leg 5" began in February 2016. We expect this will be a 5-part move consisting of Parts 1-up/2-down/3-up/4-down/5-up. An incredibly powerful "Part 3-up" just ended on January 26 at 2,873. Its end was characterized by extremely overbought conditions and growing confidence, but there was little deterioration in other indicators. "Part 4 down" is now underway with the S&P 500 falling 11.8% to date. This is a correction in the bull market. It is definitely not the end of the 2009-18 bull market. In four previous bull markets the S&P 500 has corrected more than 10% during Part 4-down and each time it recovered to new highs.

What will happen next? We expect that "Part 4-down" will be an A-B-C down-up-down pattern. The "A" portion began with a "waterfall" decline, and stopped last Friday as the S&P 500 found support at its rising 200-day Moving Average. The decline was accompanied with extreme readings on upside/downside volume and daily advance/decline statistics. It looked like a temporary panic selling climax. New York is now in the early phase of the "B" upside recovery move. We expect this will be a volatile rally lasting several weeks and as this recovery approaches the recent highs we should see some self-congratulatory "wasn't it smart to buy the recent sell-off" assertions. But the correction will have one more sting in its tail – a final "C" wave down, possibly to a lower low than wave "A". This could coincide with a cluster of cycle maturations in mid-April. At that point we should hear the bears in full voice and see some major positive divergences, setting the stage for the completion of the entire correction and the start of a final "Part 5-up". This will take the bull market to new all-time highs. The S&P 500's "January indicator" – as January goes so goes the year – was positive, giving a further reason to expect an eventual strong recovery.

Toronto, as we noted at the end of January, was starting a more extended pullback. The problems with a lack of leadership and a negative divergence in internal momentum finally took their toll. The S&P/TSX Composite Index fell about the same amount in percentage terms as the S&P 500, but the former's chart has become more complicated. The S&P/TSX Composite Index violated its major trend channel to the downside and fell below its 200-day Moving Average, but Toronto's decline succeeded in stopping near the critical 15,000 level. Toronto needs to get back above its 200-day Moving Average in the coming weeks to keep its bullish outlook intact.

In sum, the recent sharp decline is a normal, and overdue, corrective move within the bull market. The correction started from a very strong bullish position, which gives us confidence that the underlying major uptrend will resume after a flushing out period that might last until early spring. Investors need to remain patient and hold their nerve through this volatile period.

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David Tippin, Ron Meisels

S&P 500

The S&P 500 has dropped 340 points from its recent all-time high, retracing almost exactly one-third of the "Part 3-up" advance from February 2016. On its waterfall decline the S&P 500 sliced through all nearby potential supports and its 50-day Moving Average. A small positive internal momentum divergence and a deeply oversold status late last week helped the Index find some solid footing. The low 2,500s are now an important reference point for any further downside action.

The recovery rally that is now underway faces an immediate upside obstacle at the 50-day Moving Average, currently at about 2,720. We expect that if the recovery rally gets into the low 2,700s this will be an area for the S&P 500 to pause and try to consolidate. From that point the rally could continue a little higher, possibly into the high 2,700s.

The S&P's recent decline has established a "lower low." The rally that started this week should eventually establish a "lower high" when it ends. This will confirm that the correction still has more room to run and that a re-test of the recent low at 2,533 will occur later on.

S&P/TSX Composite Index

In a period of two weeks Toronto gave back all of its gains from the previous five months and re-traced about one-third of its entire advance from early 2016. The S&P/TSX Composite Index made a new all-time high in early January on a negative divergence in internal momentum, weakened through the month and then dropped dramatically as New York tumbled. Neither the key price level, the major trend line (15,800) or the 50-day and 200-day Moving Averages could support the Index. Fortunately for the bulls the second key price support level at 15,000 appears to have stopped the decline, at least temporarily.

Late last week only 13% of S&P/TSX Composite Index stocks were trading above their respective 50-day Moving Averages. The sell-off has been widespread. Any recovery rally from current levels will need to overcome a flattening 200-day Moving Average at about 15,600 and a declining 50-day Moving Average at about 16,000.

A bullish outlook for Toronto rests on two key issues. First, the S&P/TSX Composite Index must not have a sustained decline below 15,000. Small probes below this level are acceptable, e.g., when downside momentum overshoots, but a quick recovery is necessary. Second, the Index must eventually get back above its 200-day Moving Average.

Toronto is deeply oversold and has a lot of repair work to do to right itself. Ideally, this will be done in the low 15,000s. If this is successful, Toronto's bullish advance can resume.

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