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MARKET COMMENT

A HORIZONTAL CORRECTION MAY OCCUR IN THE FOURTH QUARTER, BUT THE BULLS RETAIN FIRM CONTROL OF THE STEERING WHEEL

October 20, 2009

September and October are the months that many investors in North America regard with some degree of anxiety. The post-Labour Day period has, more than a few times, coincided with major 'market events', especially after markets have risen for an extended period of time. The possibility of a significant correction in the autumn looms large in the minds of many market participants.

The market gloom and doom crowd have been out in force since the summer months. As the markets recovered from the March 2009 lows, calls for the rally to be terminated – since it was, after all, just a 'bear market rally that couldn't possibly last' – have increased. The bears' anxiety levels grew further when the alleged parallels between the recent rally and what the markets did way back in early 1930 failed to materialize, as the market continued to rise. And any characterization of the advance of the last seven months as the early stages of a new bull market – well, that was greeted with even more skepticism.

Let's review what the Market Comment has said recently about the markets as they have moved through the often-hazardous autumn period. Here are the headlines from the last three issues:

'This market has a relentless quality. The autumn months may disappoint those bears who expect a significant correction or a new bear market.' MKT-154, September 1.

'The third quarter will end on a high note, the fourth quarter may bring some corrections, but the long-term bull market is intact!' MKT-155, September 26.

'To correct or not to correct, that is the question.' Market Update, October 14.

There's a pattern in these Market Comment forecasts. We liked this market advance and have been on the right side of it for many months. From the end of August to the end of last week, while many expected a major stumble, the S&P 500 rose over 7%.

Why have the bears and skeptics got things so wrong since March of 2009? Our headline refers to driving while looking in the rear-view mirror. This is not the thing to do in the markets! The market top of 2007-2008 and the subsequent severe bear market still continues to form the dominant frame of reference for many. From this perspective, any rally that does not exceed the previous market highs is regarded as suspect, not 'valid', and to be avoided. But, those that continue to wait for a gold-plated buying opportunity – at or even below the March lows – may be waiting for quite a while.

Our approach is different. We take the recent technical evidence on its own merits: major market Indices and many individual stocks have formed extended bases and are now rallying above their 200-day moving averages. We do not need to see a repeat of the 2007/2008 highs to conclude that the major market trend remains up, that the markets are impressively climbing a very intimidating 'wall of worry', and that this is, indeed, bull market behaviour.

The bottom line remains that this bull market is very much alive and well.

Pullbacks should continue to be used as buying opportunities.

This is not to say that North American markets are bullet-proof. After seven months of advance, it would not be a surprise if the markets chose to take a refreshing break for a while.

The key to understanding why North American markets have performed so well in the post-Labour Day period lies in the behaviour of the markets during the late spring and early summer months. We'll use the S&P 500 to illustrate.

The 'lift-off' period – Leg 1 up – for the new bull market in March and April was followed by a trading range from early May to early July. This took the form of a potential 'head and shoulders' topping formation, and was accompanied by declining internal momentum and low volume. The bears thought this action was terminal and that the next step was a renewal of the bear market and a trip back to the level of the March 2009 lows.

The significance of this period is that the markets shook off a potentially very negative technical position and subsequently rallied to new recovery highs. As a general rule, when markets can overcome a negative position like this, it is an indication of great underlying strength. So, the May-June period, once survived, served as the springboard – with the jumping off point being the 200-day moving average – for a Leg 2 up.

We believe that this second up-leg ended in mid-September. Internal momentum, as measured by such indicators as the MACD, started to wane in late August and that trend has continued to mid-September.

Action since the mid-September peak has seen a noticeable drop-off in volume, although the percentage of stocks above their respective 200-day moving averages has remained at very high levels and all Indices remained above their rising 50-day moving averages.

Counterbalancing these potential weaknesses is the continued ability of the major market Indices to carve out patterns of 'higher highs' and 'higher lows'. The number of stocks making new 52-week highs continues to track higher, but professional advisory sentiment, as measured by the Investors Intelligence figures, remains mixed – the percentages of bullish and bearish advisers have moved very little for the past two months.

These signs point to the possibility of a horizontal trading range at the beginning of the 4th quarter in both New York and Toronto: to calm both fear and greed, to create a pause, to let prices adjust to evidence, and most importantly, to create a springboard for the next advance. Only a decline below support levels or the up-trend channels illustrated on the next pages would violate this outlook.

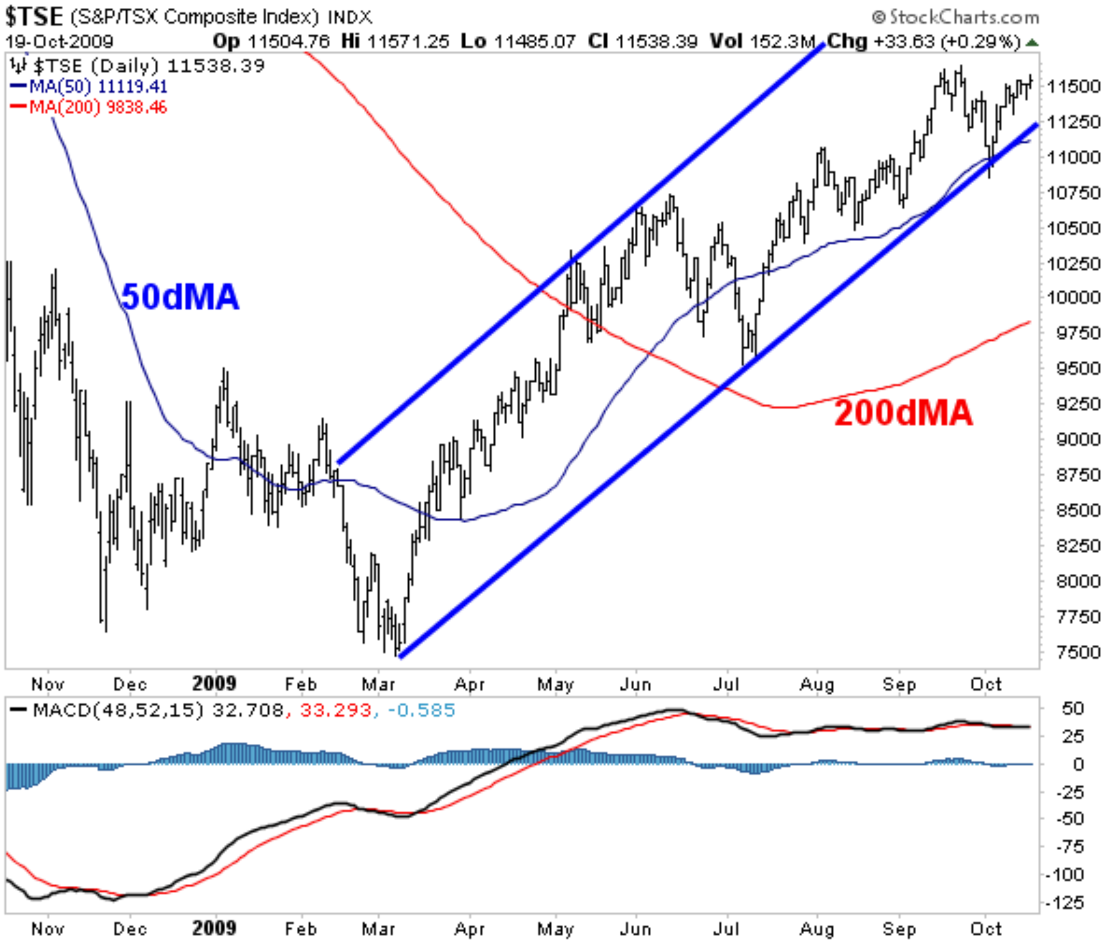
In sum, the bull market is intact. Market strength since March means that there is plenty of capacity to absorb a corrective period without damaging the underlying bullish trend.

Any declines should be treated as further opportunities to buy strong stocks in strong sectors, with appropriate stop-loss strategies.

Ron Meisels

S&P/TSX

(Daily chart with 50- and 200-day moving averages)



The S&P/TSX Composite Index continues to move within a very well-defined up-trend channel, bounded by two almost parallel lines. The number of stocks making new 52-week highs continues to expand. For the past two months, however, most of the Toronto market's action has taken place within the middle of this channel. This indicates some loss of upside momentum. In addition, the banking sector, which led the market charge off the March 2009 lows, has shown a noticeable weakening over the past month.

The 50-day moving average continues to offer good support in the near-term, and the 200-day moving average has started to turn up more vigorously. The key support to watch is the lower trend line, which is currently located at about 11,100. A decline below this trend line could forecast a move back towards the mid-10,000 range, that is, closer to the rising 200-day moving average, but the probability of this minor.

Having met our initial target of 11,500, the Toronto market's next immediate upside target is 12,000. Beyond that, a move to the upper regions of the trend channel would place the index near 13,000.

The Toronto market can accommodate a pull back into the mid-10,000s, while still remaining in an overall bullish position. If the market refuses to decline in the next couple of weeks, a quick move to new recovery highs near 13,000 is entirely possible.

S&P 500

(Daily chart with 50- and 200-day moving averages)

The S&P 500 is behaving in a similar way to the Toronto market – still moving within an upward sloping parallel channel, but with most of the recent market action occurring in the middle of this channel.

The S&P 500 has now spent three months above its 50-day moving average, which is quite an impressive performance. A pull back to the 50-day moving average – currently near 1,040 – would be a normal event in a bull market.

A resting phase for the S&P 500 would be 'the pause that refreshes.' After the pause further rallying could take the S&P 500 to the upper reaches of its trend channel, and near our immediate upside targets of 1,150 and 1,200.

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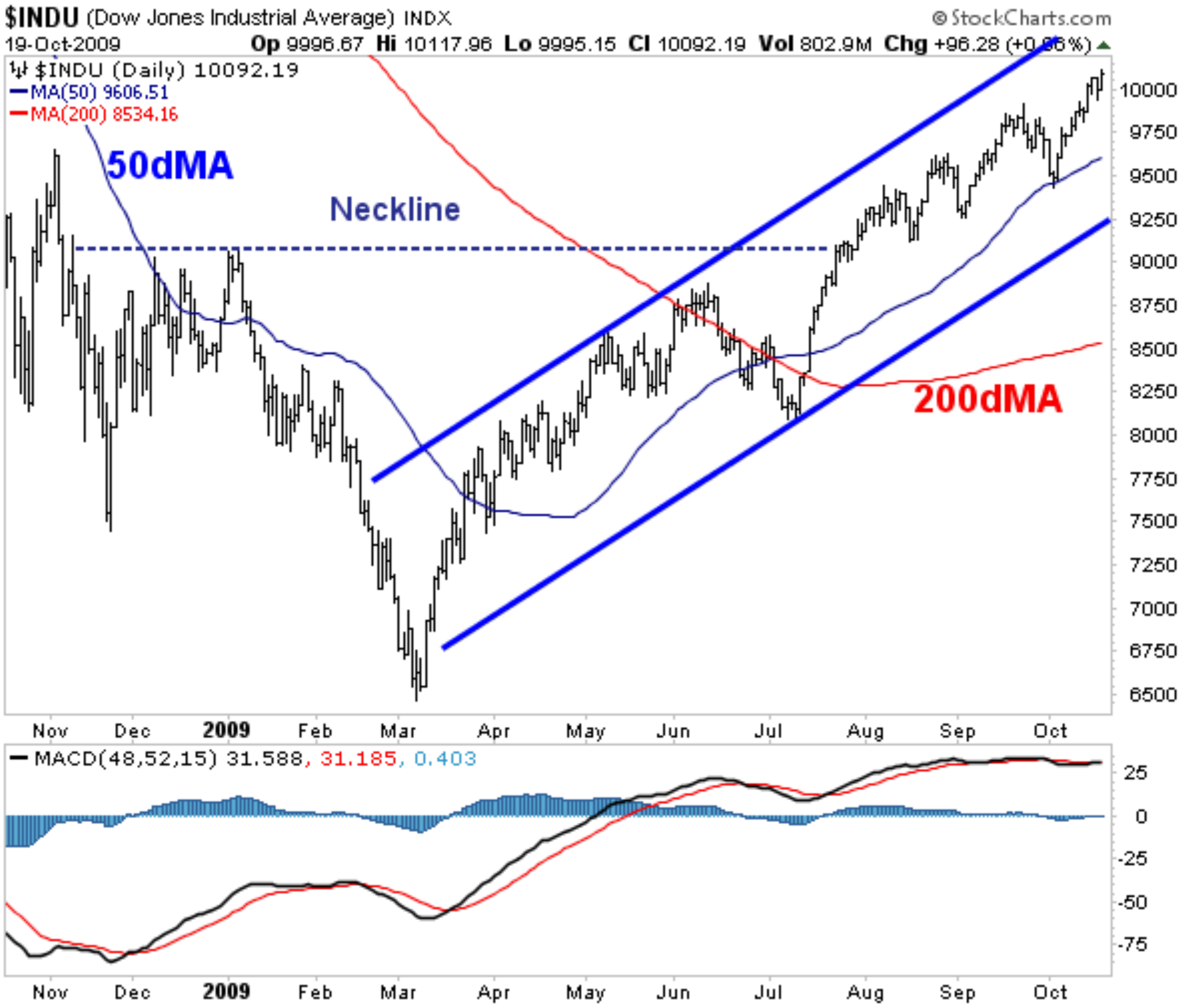
DJIA

(Daily chart with 50- and 200-day moving averages)



We last looked in detail at the Dow Industrials at the end of August. The Dow Industrials was at about 9,500 at that time and we noted a very bullish upside target of 11,500 and that the Dow Theory had flashed a bullish confirming signal.

Since that time, the Dow Industrials has continued to march upwards, remaining above its rising 50-day moving average. The rising trend channel remains intact, with strong support offered in the low 9,000s. This is also the area of the 'neckline', now broken on the upside, of a major inverse head and shoulders formation which forms the basis for the current bull market.

Internal price momentum has waned since August, and this factor may precipitate a short-term pull back toward the 50-day moving average. A move above 10,000 – which would be a new high for the bull market – would suggest that the Dow Industrials could then move to the upper reaches of the trend channel near 10,500.