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Riding the wave

How the stock market rally ends: signs to watch for

A debate is raging in the financial media as to whether this current rally is the start of the next bull market or just a short-term rally in a long-term bear market.

Regardless of your view, there are signs to watch for in the equity markets that indicate when to add to your investments and when to be cautious and "dance close to the door."

After all, with the volatility of the last 19 months, it is easy to be nervous with your "winners" since it wasn't so long ago that many of us saw our winners quickly turn into losers.

So, how do you determine if a market pullback is a minor slide in a longer-term money-making uptrend or a major trend reversal and a time to get out of the market?

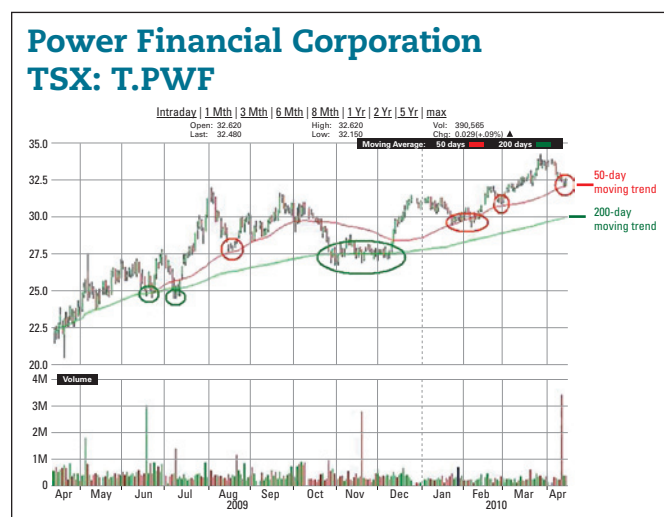
Here is some food for thought.

MINOR MARKET PULLBACK

In a minor market pullback, we see downside corrections in the 5 to 10 per cent range. This is often when the market has gotten ahead of itself and needs to pause before continuing the uptrend.

If you look at a one-year chart of any investment, you will see that many minor market pullbacks find support (stop dropping in price) at the 50-day moving average. A stronger correction will often find support at the 200-day moving

average. Look at the chart below of Power Financial to see a good example of this over the last 12 months. The circles show where the stock dropped and then found support at the 50- and 200-day moving averages before moving up again. ►



While it can be tempting to buy a stock that has momentum and is moving higher quickly, a better strategy is to wait until the stock pulls back to its upward trend line—often at the 50- or 200-day moving average.

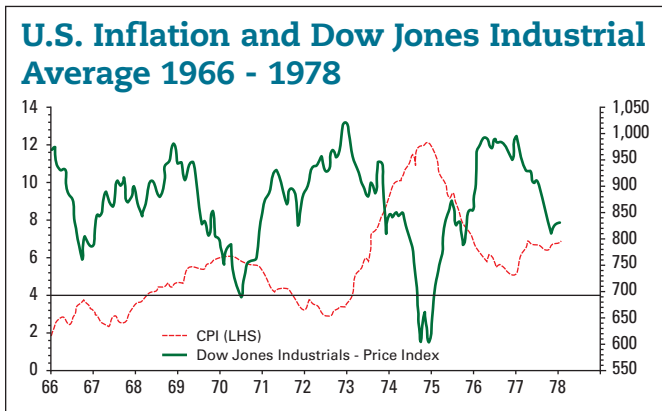
MAJOR TREND REVERSAL

Inflation is one of several indicators to watch.

The following group of charts shows major market corrections in the Dow Jones Industrial Average over the last 50 years. Whenever inflation has moved up from a low level to approximately the four per cent level, it has been followed by a major market pullback. A good summary of historical inflation data may be found at www.inflationdata.com.

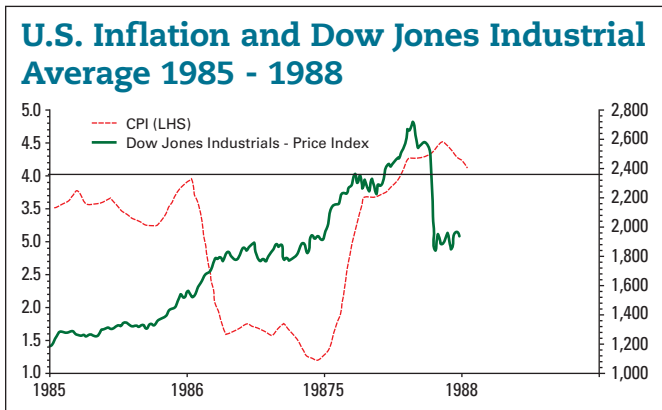
In June 1968, inflation was 4.2 per cent after having climbed from lows of one per cent earlier in the decade. By early 1969, the Dow Jones had reached its peak and subsequently fell to lows in mid-1970. (See Figure 1)

FIGURE 1



In 1987, historical U.S. inflation moved up quickly from 1.46 per cent in January to 4.28 per cent in August, and was subsequently followed by a major market correction in October of the same year. (See Figure 2)

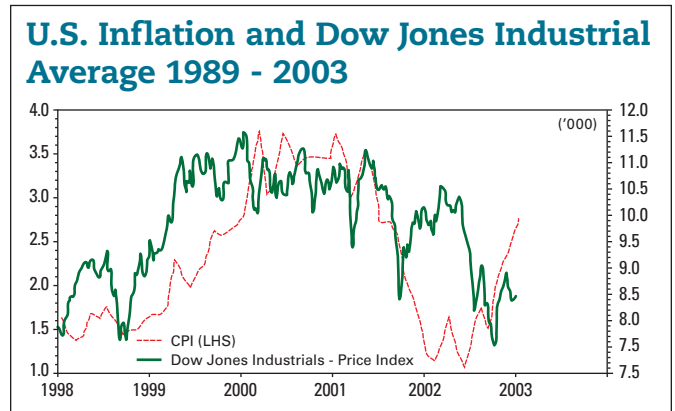
FIGURE 2



THE LESSON IS THAT ANY INDICATOR MUST BE USED IN CONTEXT WITH OTHER ECONOMIC EVENTS.

The bear market of 2000–02 was not quite as clear-cut. Inflation rose from 1.67 per cent in January 1999 to 3.76 per cent in March 2000. The four per cent level wasn't reached, yet a major correction still occurred (see Figure 3).

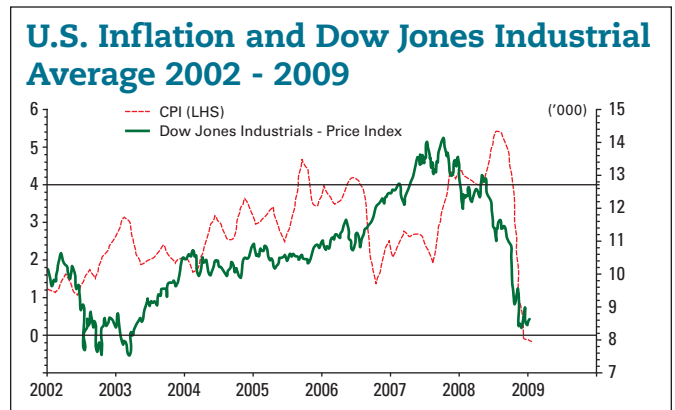
FIGURE 3



The lesson from this is that any indicator must be used in context with other economic events. A review of historic price-to-earnings ratios of the market will show that in 2000, the price-to-earnings ratio of the Dow was over 27x—the highest it had been since the market crash of 1929.

In November 2007, inflation breached the four per cent barrier (see Figure 4). The market became volatile in early 2008, and dropped significantly from September to November 2008, almost a year after the initial breach of the four per cent inflation level. Coincidentally, the National Bureau of Economic Research, the organization officially responsible for determining the beginning and end dates for recessions, labelled December 2007 as the start of the latest recession.

FIGURE 4



Based on the inflation indicator today, the equity markets have room to move higher. After a year of deflation in 2009, inflation is currently in the low two per cent range. We are likely to see continued economic recovery and earnings to support further price increases in the stock market.

When investing, watch for minor market pullbacks to support levels at the 50- or 200-day moving averages as good entry points when adding new money to the market.

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