Market Commentary

Please refer to Appendix – Important Disclosures and Analyst Certification

Cyclical Bull Intact

Outlook Summary

Marketweight Stocks, Underweight Bonds

Correction Within Context of Ongoing Cyclical Bull Rally

Sector Strategies Favor High-Quality Cyclicals

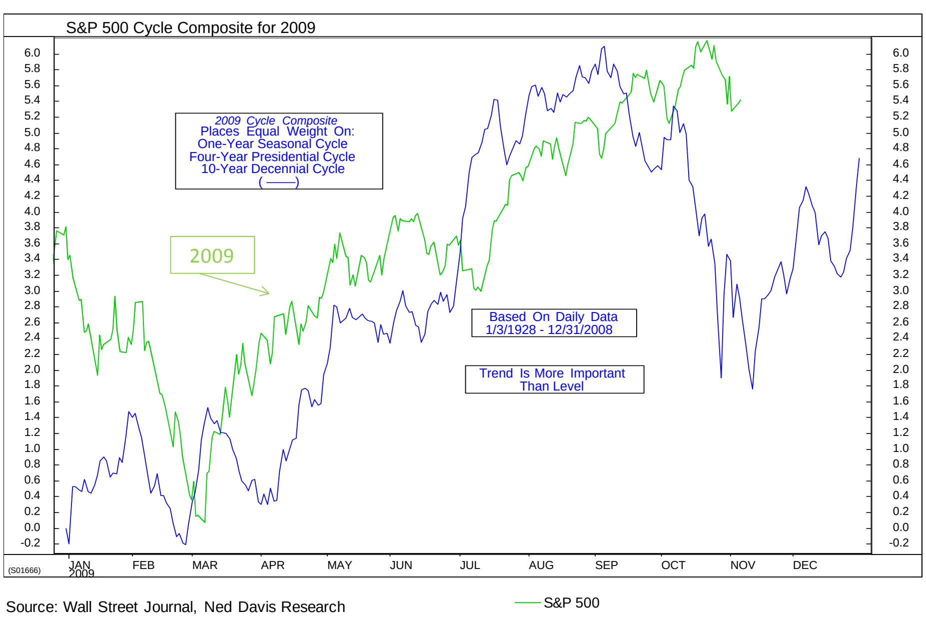
Mid-Caps in Lead, with Modest Bias Towards Growth

Bottom Line:

- **Rise in Complacency Anticipated Correction**
- **Breadth Strength Will Be Tested**
- **Index Divergences Emerge**
- **Trends to Moderate, Focus on Quality**

The stock market action over the past several weeks has been consistent with a mid-trend correction. Widespread oversold conditions and surging skepticism suggest that correction may have substantially run its course. **The sustainability of the rally off of the cyclical low in March may be crucially determined by continued broad market strength.** A test of this strength is expected as the indexes rally towards their mid-October highs.

Rise in Complacency Anticipated Correction. The correction off of the October highs emerged as many were hoping that the typical September/October seasonal weakness had been avoided, and that the final quarter of the year would provide opportunity to consolidate gains as the indexes worked higher, albeit at a somewhat slower pace than had been seen in recent months. The VIX volatility index moved to a new cycle low, the put/call ratios plummeted, and the AAII data showed more bulls than bears for two weeks in a row. While the annual seasonal patterns may have encouraged this view, the cycle composite (which draws on the four-year cycle and the ten-year cycle as well as the one-year cycle) suggested that risks of a sell-off remained elevated into November.



Source: Wall Street Journal, Ned Davis Research

The market behavior that accompanied the pullback from the mid-October peak has been largely fitting with a correction (as opposed to change-in-trend) scenario. This suggests that weakness could be limited in degree and duration, and in fact, it may have already run its course:

- Volatility has surged, with the VIX moving above 30 for the first time in four months.
- Skepticism has returned, with the 10-day CBOE put/call ratio rising to its highest level since the March stock market

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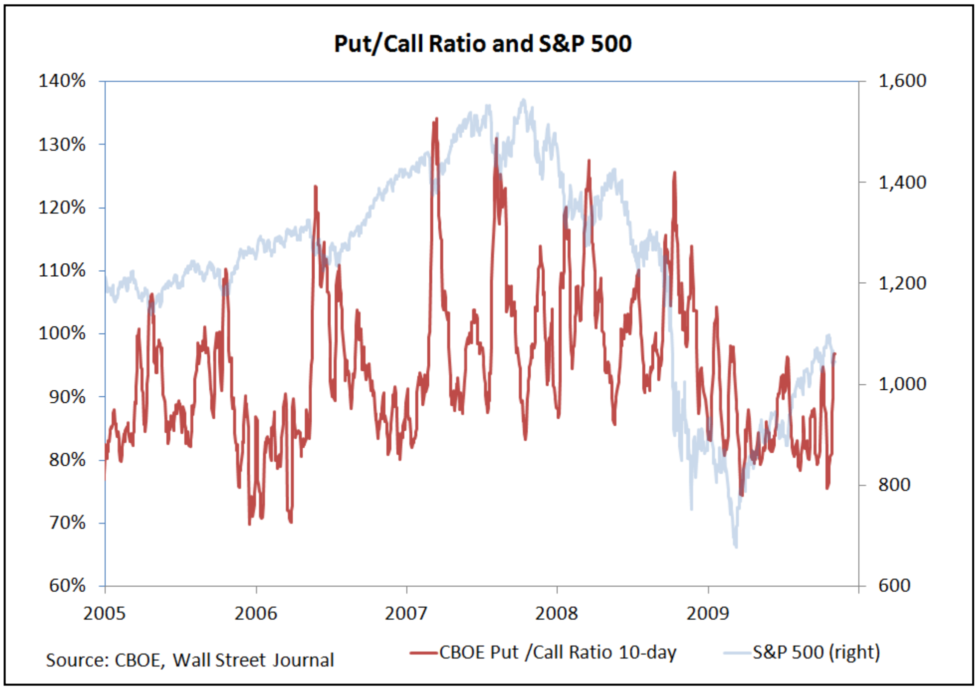
low. The 3-day total market equity put/call ratio has soared from 60% in mid-October to nearly 100% by month end.

- The pullback has pushed the stock market into oversold territory, with all 30 of the primary and secondary indexes flashing "oversold" signals, and the 10-day TRIN moved to is highest (most oversold) level of the year.



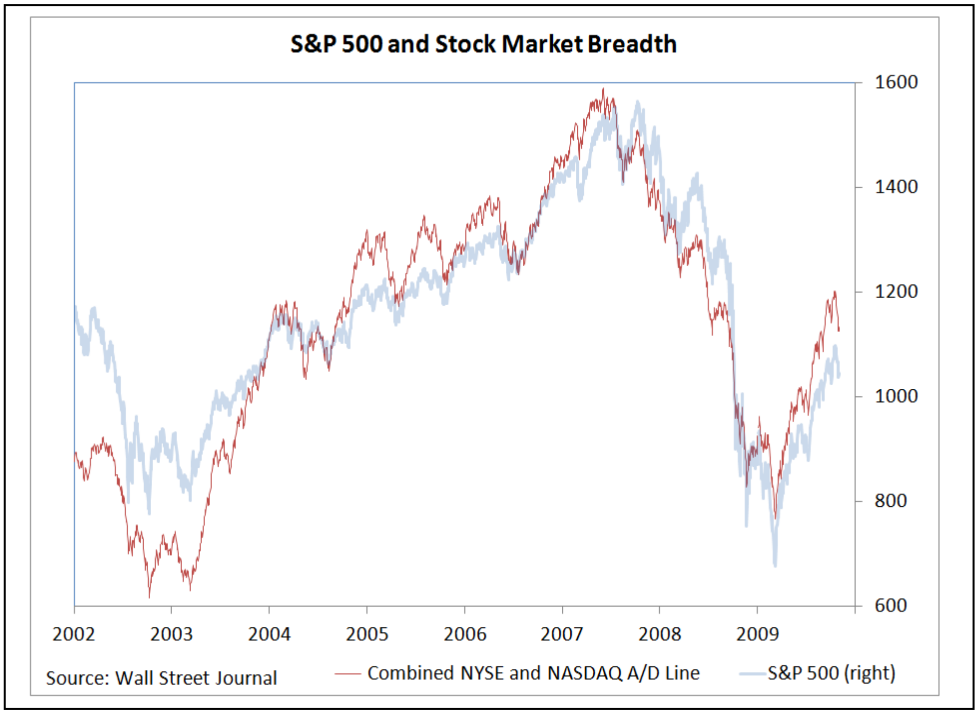
While all of the indexes have cracked their 50-day averages, well more than half have 50-day averages that continue to rise, and all 30 have their 50-day averages remaining above their 200-day trends.

Breadth Strength Will Be Tested. With seasonal trends improving into year-end, downside momentum beginning to ebb, and near-term skepticism running high, stocks could be poised to work off of their recent lows and test the October highs. This would be a chance to test the resiliency of the broad market, which did not avoid the recent weakness unscathed but yet remains a tailwind for stocks. **The damage done on the downside has not been inconsequential, but nor is it insurmountable**. Selling came on high volume, and was accompanied by multiple days on which downside volume outpaced upside volume by better than 10-to-1. Volatility in the markets of late has increased the occurrence and reduced the importance of these breadth thrusts (they were important in part because they were rare), but their occurrence does retain some value. An inability for a year-end rally to be accompanied by at least a single day's upside thrust would signal a change in character in the volume flows and could add to the divergences that are mounting.

Index Divergences Emerge. From an index perspective, the S&P 500 and the Dow Industrials have both held above their early-October lows (near 1020 and 9430, respectively), while the small-cap Russell 2000 and the Dow Transports not only failed to make meaningfully higher highs in October, but have since broken below their early-October support levels (near 576 and 3656, respectively). Transports have caught a bid on news of Warren Buffet's latest (and largest) move, but a failure to break above the double-top that has formed could represent an important divergence.

The aggregate breadth measures

have traced similar paths. The total (NYSE+NASDAQ) advance/decline line made a meaningful new high in mid-October, but the breadth of the selling over the second half of the month still carried this cumulative indicator below its early-month low. **A failure for the advance/decline line to make a new high if a year-end rally unfolds could start the clock ticking for the completion of the cyclical bull market.** Some deterioration has been seen at the industry group level as well. Our industry group up-trend indicator has pulled back from its peak, but at still close to 80% it remains supportive of a resumption of the cyclical rally.



Trends to Moderate, Focus on Quality. The overall trends and breadth in the market suggest the cyclical rally has further to run, but we expect to see moderation in the trend, and more selective participation. The aging of the rally is seeing a shift in leadership, particularly from a size perspective. Small-caps have moved into a lagging position relative to large-caps, failing to match gains on the upside and leading the way lower on pullbacks. From sector perspective, breadth deterioration in the Financial sector (where the A/D line has made a lower high followed by a lower low) is reason for caution, while Energy, Consumer Staples, and Utilities all show still favorable breadth trends (higher highs, followed by higher lows).

While the recent correction has offered little by way of hard evidence that the cyclical rally has run its course**, it is now up to the bulls to re-assert their voice and prove their case.** Breadth deterioration to date has not been outside of acceptable levels given the aging of the cyclical rally and anticipated moderation in the trend going forward. However, **a rally in the indexes that does not attract broad participation, or which adds to the divergences that have already emerged, is unlikely to be sustained for long and should be viewed with appropriate caution.**

Appendix – Important Disclosures and Analyst Certification

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