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Intermediate Technical Update August 21, 2009

OVERVIEW

Bottom-Line: In the short term we think the S&P500 has the potential for more upside over the next few weeks (20-25 trading days), which would result in new highs. We believe we will not go above the 1040-44 resistance area, but if we break above that level, it will open the door for the 1100 area given the vacuum of resistance that exists above 1044. We maintain our bearish intermediate outlook believing that we need another major move lower over the next few months into late '09/early '10 before we see a much larger and longer-lasting cyclical rally. A break below the 940-960 support area would confirm that the major intermediate move lower is underway. Furthermore, we are confident that we have seen the highs/top in the Shanghai Composite, Copper, and the Aussie Dollar, and that we have started the "bottoming" process in the U.S. Dollar.

We don't believe we are starting a multi year primary bull market but rather that the counter-trend rally has probably not run its course, and we still believe that we are in a secular bear market that started in 2000, which should last roughly 15-20 years according to our cycle work. Yes, we are close to a cyclical recovery! We don't dispute that. In fact, at the beginning of the year we thought it would start in February/March. Our first research piece in January of '09 argued for one more move lower to ~650-700 followed by a major primary counter-trend rally (cyclical rally) that would last for a few months. On January 28 we said "We reiterate our view that we believe an important intermediate bottom will be formed no later than mid-March... We then expect to see a major primary counter-trend rally (that will look and feel as the beginning of a new primary bull market) that should last for a few months, which could last for the better half of '09".

On June 8th, in light of the technical evidence we saw at that time, we revised our thinking a bit and released our intermediate update, where our general recommendation was to start taking a cautious/defensive stance in preparation for a major move lower over the next few months into late '09/early '10. After carefully analyzing the technical structure and internals we now believe that the whole move from the March lows is "corrective". In fact, we argue its part of a major "corrective" pattern that began in November of last year. So what does that

The results presented should not and cannot be viewed as an indicator of future performance.
Charts courtesy of Bloomberg Finance L.P.

mean? Well, it simply means that we still need one more move lower over the next few months to complete the “structure” since the top in October of ’07 and at that point we can get a major cyclical rally that could last for at least a year. We had also alerted our clients that a breakout above 930 in the S&P500 would open the door to 1020-1040. We still believe we will see a major move lower in equities that will complete no later than March 2010 (please refer back to our June 8th “Intermediate Update”).

In our short-term update released July 22nd, we said that we were watching the Shanghai Index (SHCOMP) for signs of the top in the global markets. We stated that there was a confluence of resistance in the 3360-3450 area, and that we would be looking to short into strength at those levels. We now believe that we have seen the secondary top in the Chinese market, and forecast this market significantly lower over the next few months. Given the high correlations between the Shanghai Composite and both Copper and the Aussie Dollar, we also feel confident that we are likely close to exhausting those counter-trend rallies as well. Furthermore, we believe we are close to seeing a major bottom in the U.S. dollar and that we will see the dollar move higher versus the majority of currencies in the next few months.

Everywhere we turn we hear about “green shoots”, the end of the recession and the return of economic growth, so we are not surprised that sentiment is back to extreme levels not seen since the top in October of ’07. Sentiment still has room to the upside but we should be mindful that the daily sentiment index recently registered 88% bulls while in March we were at a record low of 2%. Again, we concur that we are closer to a cyclical recovery, albeit, in the context of a secular bear market. The majority of technical evidence is still telling us that the move from the March lows was “corrective”. Having said all of that, we think there is still some upside potential likely for U.S. indices in the next few weeks before we fully exhaust the counter-trend rally from the March lows.

CHINA / EMERGING MARKETS / AUSSIE DOLLAR / COPPER

We have seen large rallies in emerging markets, helped by rising commodity prices and increasing liquidity brought about by massive coordinated central bank intervention and unprecedented fiscal stimulus. This type of liquidity driven rally can last longer than one expects, but we are seeing some strong signals from a technical perspective that suggest there is a high probability that the counter-trend rally in China is ending and that we are starting the process toward the next major move lower.

The first chart below shows the Shanghai Composite with Copper, and the Aussie Dollar. The correlations remain extremely high, so investors are still betting on whether the trade will be “risk-on” or “risk-off”. We are confident that we will see the “risk-off” trade put on over the next few months as it relates to these markets. Copper and the Aussie Dollar have not broken down as much as the Shanghai Composite in recent weeks, and since we expect to see a significant bounce in China in the short-term (more on this below), we would wait for this bounce to short into strength on any of the aforementioned instruments.

In the next chart, we replaced the Shanghai Composite with the MSCI Daily Emerging Markets Index, to illustrate once again how dramatic the correlations have been, especially the correlation between emerging markets and the Aussie Dollar.

CHART 1 – CORRELATIONS BETWEEN SHCOMP, AUDUSD, AND COPPER

<HELP> for explanation.

CurrencyHMSM

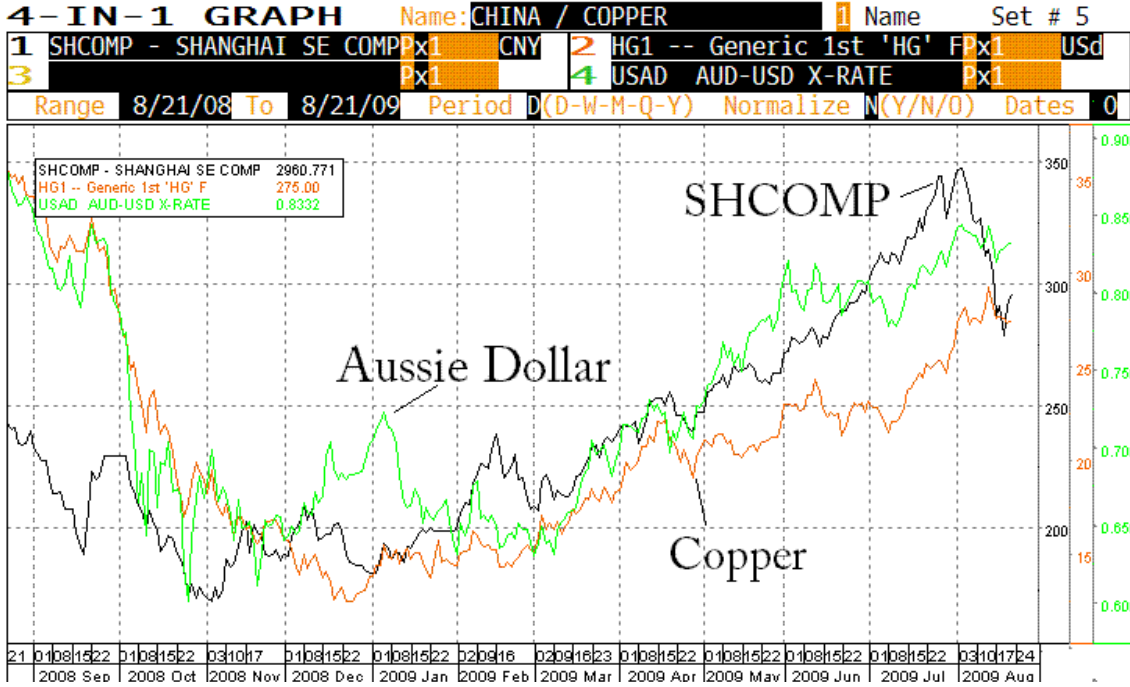
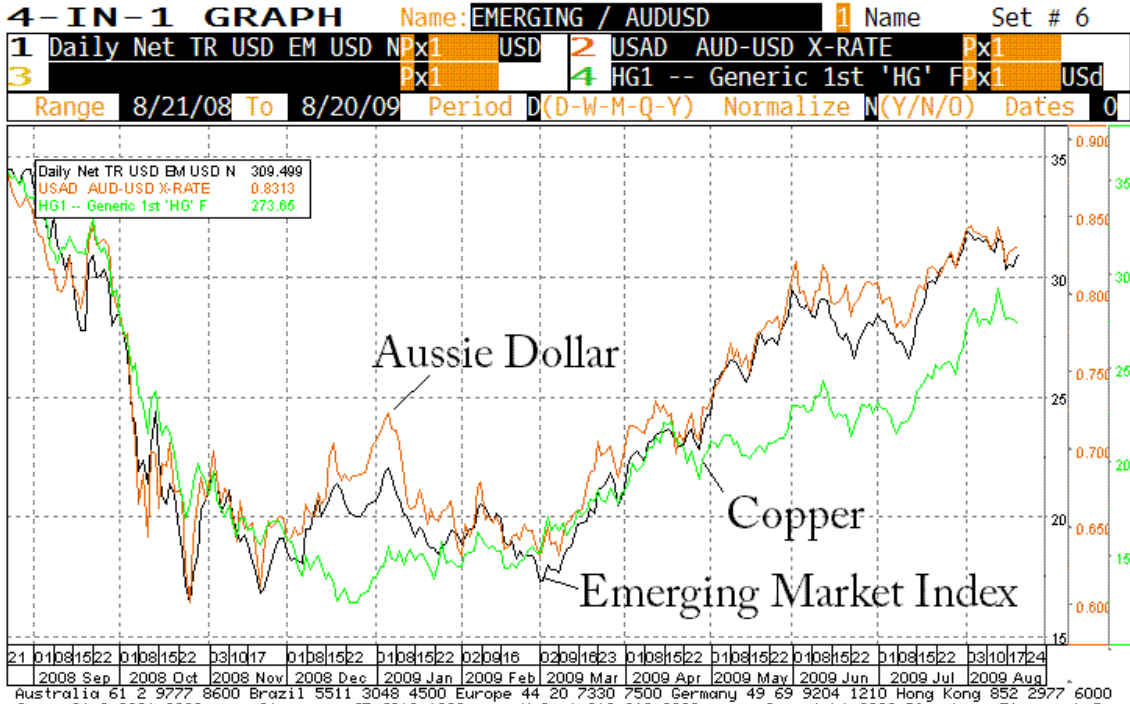


CHART 2 – CORRELATIONS BETWEEN MSCI EM INDEX, AUDUSD, AND COPPER

<HELP> for explanation.

CurrencyHMSM



Below we have a weekly chart of the Shanghai Composite. SHCOMP has failed at the 38.2% Fibonacci retracement from the top in October '07 to the bottom in October '08. We also failed at the 3450 level, which we pointed out as a significant pivot level, since this represents the top of a major gap back in April of '08. Lastly, you can see that the Relative Strength Index on this weekly chart reached extreme overbought levels (approx 80) once again.

CHART 3 – SHCOMP WEEKLY



On the other hand, the daily chart below illustrates how quickly the daily RSI has reached oversold conditions after the recent sell-off. We actually broke below the 40 RSI level (using a 21 day periodicity), which has bearish implications for the intermediate term, and increases the probability that we have seen the top. Having said that, we are short-term oversold, and we did bounce off the 38.2% Fibonacci retracement from the low in October of '08 to the most recent top. Given how vicious the sell-off was over the last weeks, we expect to see a continuation of this bounce higher, but we are betting that we will see a lower high being formed, and that we have already seen the secondary top. We will let this bounce play out to initiate short positions at higher levels where there is a better risk/reward.

CHART 4 – SHCOMP DAILY

SHCOMP 2911.582Y as of close 8/20 **Index G**
 Vol 110,039y



The Elliott Wave (EW) technical counts suggest that we have completed the “structure” from the low in October of ’08, and we have already started the final major wave “C” lower that will lead to new lows before we get much larger and longer-lasting cyclical rally/recovery.

CHART 5 - ELLIOTT WAVE COUNTS FOR SHCOMP



This intermediate outlook shares many parallels with what we think will happen in the S&P500, and we believe that the S&P500 has the potential to rally for a few more weeks. With respect to timing we think the odds favor a “lag” between the Chinese and the US markets. We fully expect China to lead to the downside, just as it led to the upside at the end of last year and will maintain this view until shown evidence to the contrary.

The daily chart below illustrates how the Aussie Dollar has failed at the 61.8% Fibonacci retracement from the highs in July of '08 to the lows late last year. The EW technical “counts” in the following chart also illustrate why we think this was just a major counter-trend rally (corrective in nature). This suggests we are close to starting the next major move lower over the next few months to complete the pattern/structure from the highs.

CHART 6 – AUDUSD DAILY

SHCOMP 2911.582Y as of close 8/20
Vol 110,039y

Index G



CHART 7 - ELLIOTT WAVE COUNTS FOR AUDUSD

SHCOMP 2911.582Y as of close 8/20
Vol 110,039y

Index G



Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 2 2201 8900 Singapore 65 6313 1000 U.S. 1 313 218 2000

The technicals are very similar when we look at the weekly chart of copper below. It shows us that we have reached the most critical/pivotal longer-term resistance level (coincident with the 61.8% Fibonacci retracement level from the high in July '08 to the low in December of '08), and we failed precisely at those levels. RSI once again failed at the bear market resistance level (approx 70). Just like in the Aussie Dollar, we think the recent rally over the last few months was a counter-trend move, and we will soon start moving lower over the next few months to complete the pattern/structure from the highs in '08. We think we are on the verge of completing the 5th leg from the lows to complete major wave "B" and the risk/reward at these levels is too compelling for us not to initiate shorts.

CHART 8 – COPPER WEEKLY



U.S. DOLLAR AND COMMODITIES

Since risk appetites started to improve in March, the dollar (DXY Index) has been in a steady decline, but we are becoming increasingly bullish on the dollar and believe that the dollar will rise significantly over the next few months.

In recent months we have seen a strong inverse correlation between the dollar and the equity markets, but the dollar doesn't necessarily have to stay a risk aversion play, and that relationship could and, in fact, periodically does break down on a cyclical basis. Therefore, even if you disagree with our bearish intermediate term market outlook, we believe that betting on a rise in the dollar is still going to be rewarding. One possibility is that the dollar could start strengthening because of signs of stabilization in the US economy allowing the dollar and equities to rise together if investors believe there are signs of bona fide economic growth. This argument likely rises and falls with the markets themselves but nonetheless we have begun to hear this posited recently as we have discussed the path of dollar strength with our colleagues and customers. We on the other hand don't believe this correlation will break down in the foreseeable future, and we expect to see the equity markets move lower over the next few months while the dollar rallies as risk aversion comes back into the markets.

The EW technical counts for DXY suggest that we have either completed or are very "close" to completing 5 legs lower from the peak in March of '09, and we say "close" because according to this technique it can extend one more time for another move lower before completing the 5th leg around the 75-76.

Nevertheless, we think there is a high probability that we have already bottomed after analyzing the DXY index using other technical techniques. The following technical "bullish" developments reassure us. Firstly, we have seen major bullish divergences being formed across longer time frames with various oscillators, as illustrated in the following charts. Secondly, at the peak we had over 90% bulls and recent sentiment readings showed less than 5% bulls. We respect the powerful contrary message of the sentiment indicators and usually when you reach these extreme readings it suggests that we are close to a turn.

CHART 9 – DXY INDEX (U.S. DOLLAR) DAILY

SHCOMP 2911.582Y as of close 8/20
Vol 110,039y

Index **G**



CHART 10 - ELLIOTT WAVE COUNTS FOR DXY INDEX

SHCOMP 2911.582Y as of close 8/20
Vol 110,039y

Index **G**



U.S. EQUITIES / S&P500

Bottom-Line: In the very short-term, we think the S&P500 has the potential for more upside over the next few weeks (20-25 trading days), which would result in new highs. We believe we will not go above the 1040-44 resistance area, but if we break above that level, it will open the door for the 1100 area given the vacuum of resistance that exists above 1044. However, a break below the 940-960 would confirm that the top was on August 7th. We maintain our bearish intermediate outlook.

The daily chart below of the S&P500 shows the confluence of resistance levels where we failed last week between the 1007 and 1015 level. It also shows us how the RSI failed at the traditional overbought level and that we had a momentum “sell” signal.

CHART 11 – SPX DAILY



With the sell-off this past Monday, we “locked-in” the EW pattern/structure since the July 8th lows as 5 legs. This would either lead to:

a) completion of the entire “corrective” pattern from the lows in March where August 7th is the top, and we have now started the final intermediate move lower

or

b) simply the completion of minor leg “a” from the lows on July 8th, which means we still have a minor leg “c” to complete higher (in 5 legs once again) which would take us to new highs (1040-1044) over the next 20-25 trading days before starting the final intermediate move lower. This is our preferred and highest probability scenario.

CHART 12 – SCENARIO A: EW COUNTS FOR SPX



CHART 13 – SCENARIO B: EW COUNTS FOR SPX



We saw the S&P500 bounce off the minimal 23.6% retracement level at the beginning of this week, while sentiment is becoming extremely bullish again. Thus, we believe that we have already started the final minor “c” leg higher and a new top is ahead.

If the S&P500 does fail to break above the 1007-1015 resistance area in the next few trading days and head back towards the 945-960 support area, we believe it simply means that the corrective minor “b” leg (illustrated as the alternate EW count in red below) is not complete. Thus, we would recommend going long at that support area, betting that we have one more surge higher for a minor “c” leg higher to the 1040-1044 resistance area.

CHART 14–POTENTIAL EW COUNT FOR NEXT FEW DAYS IN SPX IF IN SCENARIO (b)

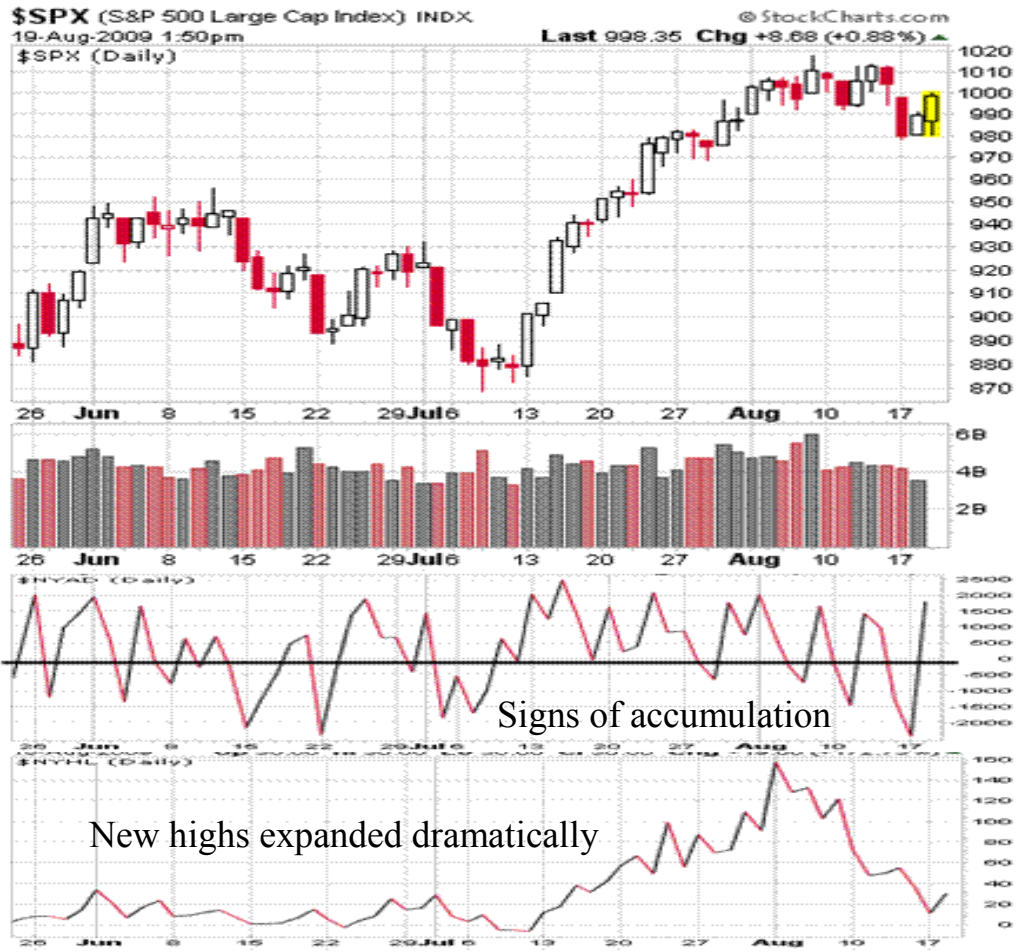


We are also paying attention to the rising trend-line connecting the lows in March and July (as seen in **CHART 12**), and we don't want to see a break below this trend-line, as this would confirm scenario (a).

Another reason why we think that there is a high probability that China has already seen the top but that the S&P500 has the potential for one more surge higher is that the S&P500 already experienced a major corrective/consolidation period in June/July while the rally in the Shanghai composite had not experienced a similar consolidation period.

Furthermore, the market internals since July 8th on the S&P500 are bullish. We saw signs of accumulation (down days showed little distribution), and new highs (see chart below) expanded quite dramatically with the market, which are positive developments in the short-term. Therefore, we believe the rally in the S&P500 has more room to the upside.

CHART 15 – SPX INTERNALS



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