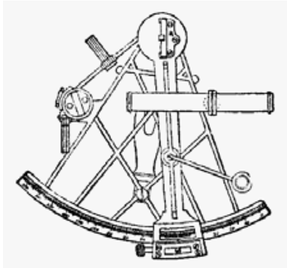
The Sextant Market Letter

Weekly Analysis of the Australian Equity Market



Australian Market Summary

Indices	Previous Close	Year-to-date (%)
All Ordinaries	4096.7	15.48
S&P/ASX 200	4034.8	14.97
S&P/ASX 20	2427.7	14.28
S&P/ASX Midcap 50	3702.1	17.13
S&P/ASX Small Ordinaries	2319.6	19.81
Sectors	**Previous Close**	**Year-to-date (%)**
S&P/ASX 200 Financials	3720	14.71
S&P/ASX 200 Consumer Disc.	1159	22.79
S&P/ASX 200 Transportation	4395	10.98
S&P/ASX 200 Industrials	3188	14.67
S&P/ASX 200 Materials	11823	16.03
S&P/ASX 200 Energy	12956	19.60
S&P/ASX 200 Consumer Staples	7029	8.89
S&P/ASX 200 Healthcare	7335	17.89
S&P/ASX 200 Utilities	4045	8.34
Interest rates	**Previous Close**	**Year-to-date (bp)**
RBA Cash Rate Target	4.75	0.00
90-day Bank Bill Rate	4.76	0.20
CGB 3-year Bond Yield	3.84	1.31
CGB 5-year Bond Yield	4.00	1.32
CGB 10-year Bond Yield	4.60	0.91
Yield Curve	-0.16	0.71
Markit iTraxx Australian Index	146.25	42.75
Miscellaneous	**Previous Close**	**Year-to-date (pp)**
Aussie Volatility Index	42.58	26.54

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The Sextant Market Letter provides an alternative viewpoint on the Australian equity market.

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Summary

S&P/ASX 200 YEAR-END FORECAST:	**4500** (28-December 2010, Townsville Bulletin)
Liquidity risk level:	**Extreme**

Short-term outlook:

The ASX 200 has well and truly broken through my near-term target of the May-2010 intraday low of 4175 points. It is also threatening to achieve my medium-term target of 3200 to 3700 points, much earlier than anticipated. While I have remained steadfast in my view that the market would ultimately retest the March-2009 low, I have to admit that even I have been stunned by the speed of the descent. With respect to the near-term, the market is extremely oversold. The market should retest yesterday's low of 3765 points in the near-term (although it is not necessary) before bouncing hard into year-end. At this stage I am retaining my unrevised year-end forecast of 4500.

Medium-term outlook:

I see no reasons at this stage to revise my medium-term outlook for the market. Based on my interpretation of the price structure at this juncture, I am looking for the ASX 200 to decline to between 3200 and 3700 in the September 2012-March 2013 timeframe. The preferred target from a NEoWave stance is 3018 points. The ongoing bear market since late 2007 (early 2008 from a psychological standpoint) appears to be of the same degree as the 1987 to 1992 bear market, which lasted 5 years and 2 months. The All Ordinaries fell 49.2% measured from the price high to the orthodox price low. The Australian economy endured a recession during 1990-91. Property prices fell significantly during this period. So far the ASX 200 is following a similar path, having lost 54.4% at its worst level. The bear market to date is 3 years and 9 months.

Long-term outlook:

My tentative long-term count suggests that a bull market (multi-decade advance with minimum retracement) is due to commence sometime this decade.

Situation Report

Australia

Aussie index leadership is bearish on a medium-term basis. Small caps are underperforming the larger cap stocks, indicative of risk aversion. On a longer-term basis though, small caps are outperforming. I believe this is an indication that the top of the commodity bubble is ahead of us, rather than a pointer to strong economic growth.

Aussie sector leadership is bearish on a medium-term basis. The Utilities and Consumer Staples segments are outperforming the broader market, indicative of risk aversion. The anomaly remains the Transportation sector, being the third best sector year-to-date.

The broking house Goldman Sachs has revised its year-end target to 4450 from 5125. Its target for the end of 2012 is 5000, revised down from 5600.

Aussie volume is rated bearish, on a medium-term basis.

I have been mentioned in a few places over the past week.

Townsville Bulletin: Reduce standard of living to save the economy

FNArena: Rudi's View: Change is coming to Australia

United States

US 10-year bond yields are comfortably below their respective March 2011 low. This is bearish for equities.

Corporate hit new highs in the US before the decline. This is bullish for equities.

The internal backdrop in the US suggests it is likely that their market will attempt to retest their recent highs in due course.

Asia/Europe

All markets have taken a big hit this past week. The only insightful thing I can say here is that US equity markets are outperforming their Asian counterparts, which is bearish on a medium-term basis.

Credit Spreads

On a medium-term basis, they do not look disconcerting but it will be worth monitoring whether the short-term negative trends continue to extend into the medium-term.

Commodities

Silver and copper have held up relatively well, despite the decline in equities. This is bullish for equities.

The copper price continues to outperform oil. Investors should watch for signs of a change in leadership, which would be a bearish tell.

Wrap

While the technical evidence remains bearish on a medium-term basis for Aussie equities, we have probably witnessed the majority of the decline this year. A strong bounce should occur to alleviate the oversold nature of the market, before it turns back down next year. The global picture remains neutral at best, and bearish at worst.

Price Structure and Behaviour

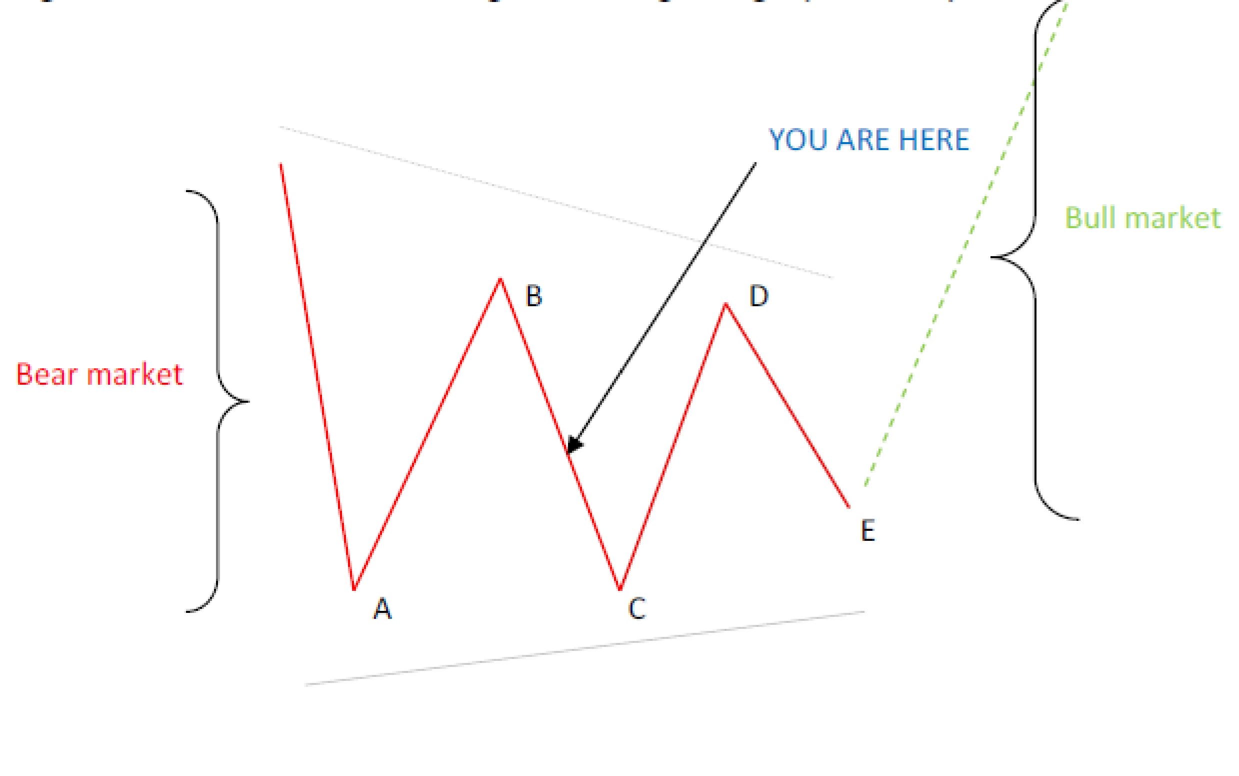
Chart One depicts the ongoing bear market from early 2008 and the path of likely evolution going forward. NEoWave time rules suggest a bottom between September 2012 and March 2013. While I am open to a higher low (above 3120 points) for the bottom of 08WC, I think the most likely outcome based on the technical evidence is where 08WC = 0.618*08WA, a common Fibonacci relation. This targets 3018 points, 102 points below the March-2009 low. This is the most likely outcome if we are tracing out a NEoWave Non-Limiting Contracting Triangle. In the event another pattern is forming such as a Flat, this Fibonacci relation is still a plausible outcome. The market is well ahead of its path of probable evolution so we can expect a prolonged period of consolidation before the downtrend resumes in earnest.

> The geometry that describes the shape of coastlines and the patterns of galaxies also elucidates how stock prices soar and plummet.
>
> -- Benoit B. Mandelbrot

Chart Two depicts near-term price structure as well as the likely evolution of the market over the next few months. From a NEoWave standpoint, the decline is corrective, which lends itself to my view that we are in Wave-C of a NEoWave Non-Limiting Contracting Triangle or possibly a Flat, with a Terminal Impulse for its wave-C. The current bounce is probably a b-wave or x-wave, suggesting the market needs to break yesterday's low of 3765 points before a multi-month bounce can kick off.

Figure One is a graphical depiction of where I believe we are with respect to the next few years. I believe a NEoWave Non-limiting Contracting Triangle is unfolding. Post the terminus of wave-E sometime middle to late this decade, a bull market (multi-decade) will kick off. I have made my first revision to this chart, based on the significant sell-off this past week.

Figure One: NEoWave Non-limiting Contracting Triangle (A-B-C-D-E)




XJO.ASX (4034.8);
Chart One: The ASX 200
08WB
w
y
61.8% Retracement 08WA
x
61.8% Retracement 07WB
1991 Lower Containment Line
Target
08WA
3018 = 0.618*08WA
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XJO.ASX (4034.8);
Chart Two: The ASX 200
08WB
Blow-off rally
NEoWave Expanding Triangle
NEoWave Diametric
An Irregular Failure Flat
X
Standard & Poors downgrades the credit rating of the US to AA+
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Internals

I have fielded a number of enquiries over the past week with respect to the Liquidity Risk Indicator. This indicator was built on the insights provided to me by Dave Breslaw (known as Fib) of Technical Watch. I highly recommend his subscription service. This indicator seeks to quantify the maximum likely level of downside risk based on developments in the market (known knowns and known unknowns) from a historical precedent. I am maintaining the level of liquidity risk at Extreme. I have been asked when I may revise this rating. A change is possible but unlikely in the near-term.

The internals of the market are analogous to the vital signs for a human being. They can reveal underlying strength or weakness long before it becomes apparent in the marquee indices.

The Aussie All Ordinaries Cumulative Advance-Decline Line is moving in-line with the market in the near-term. It remains bearish in the medium-term. See Figure Two. The Aussie All Ordinaries Cumulative Up-Down Volume Line (not shown) is performing significantly better than the market, cautioning us not to become too beared up at current levels.

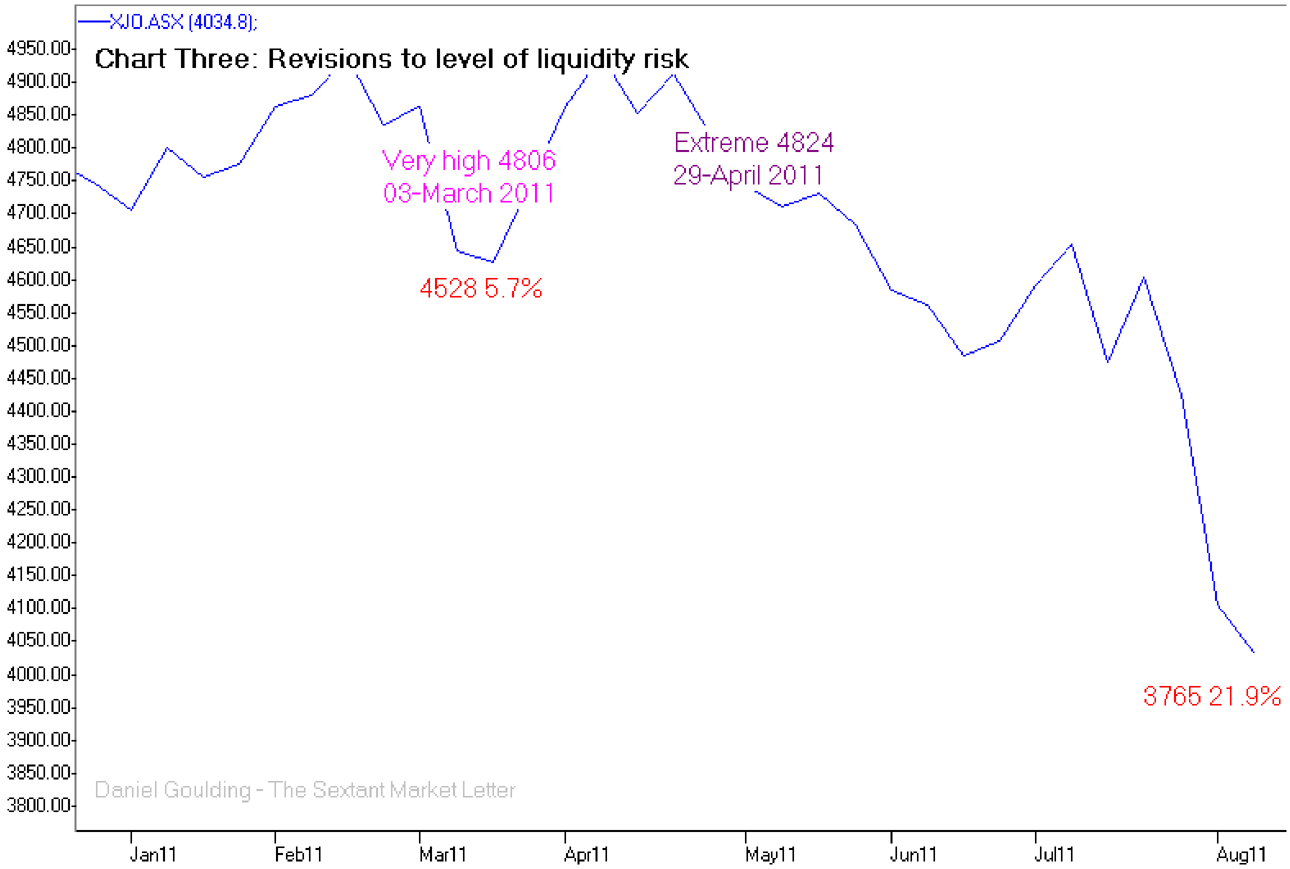
The Composite McClellan Oscillator (McO) and the Composite McClellan Summation Index (McSUM) remain in bearish territory. See Figure Three.

RISK LEVEL	
Reading	**Description**
Low	Downside risk likely contained to 3%.
Moderate	Downside risk likely contained to 6%.
High	Downside risk likely contained to 8%.
Very High	Downside risk likely contained to 10-15%
Extreme	Downside risk unquantifiable

These descriptions are a guide to determining plausible downside outcomes based on prevailing liquidity considerations. Unknown unknowns fall outside the scope of this methodology. There will be false positives and false negatives

Last week I warned that the bulls had failed. The market remains significantly weak under the hood so it is unlikely that a multi-month bounce has kicked off. A better foundation will be built if the market retests yesterday's low with a bullish divergence in the internals.

Chart Three depicts the revisions that have been made to the liquidity indicator. This indicator was introduced on the 3-March 2011.



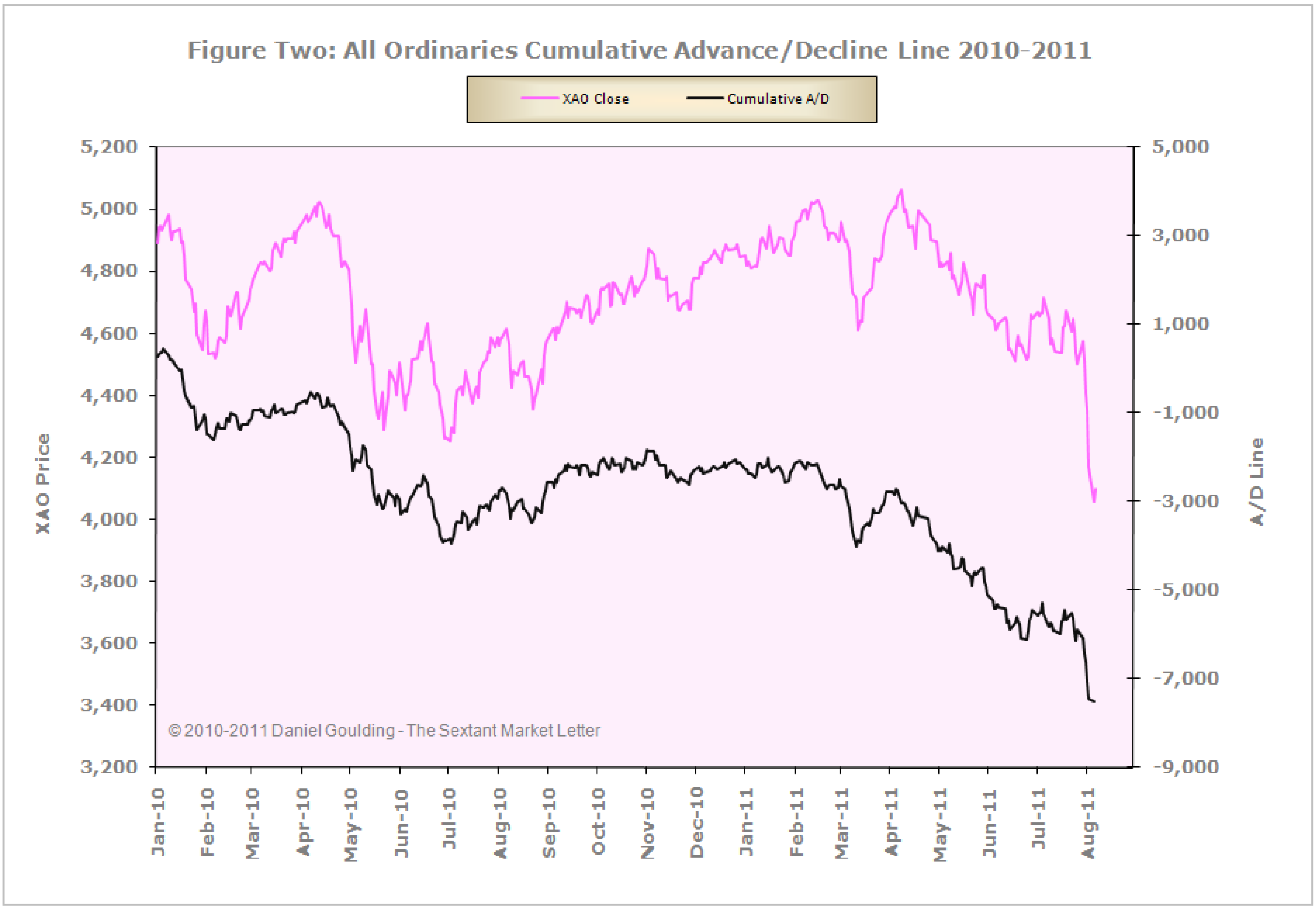


Figure Two: All Ordinaries Cumulative Advance/Decline Line 2010-2011
XAO Close
Cumulative A/D
XAO Price
A/D Line
5,200
5,000
4,800
4,600
4,400
4,200
4,000
3,800
3,600
3,400
3,200
5,000
3,000
1,000
-1,000
-3,000
-5,000
-7,000
-9,000
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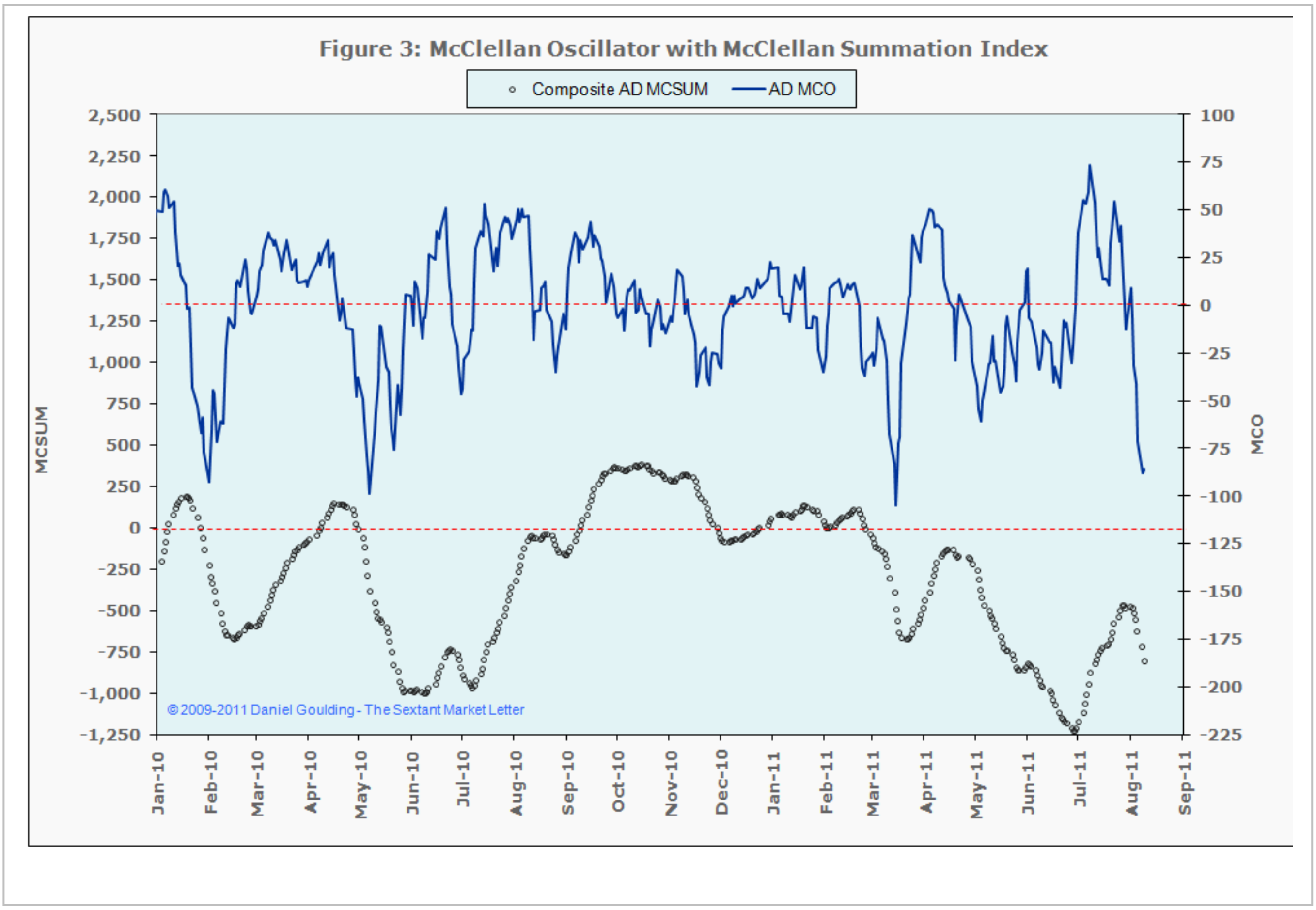
Figure 3: McClellan Oscillator with McClellan Summation Index
Composite AD MCSUM
AD MCO
MCSUM
MCO
2,500
2,250
2,000
1,750
1,500
1,250
1,000
750
500
250
0
-250
-500
-750
-1,000
-1,250
100
75
50
25
0
-25
-50
-75
-100
-125
-150
-175
-200
-225
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Mar-11
Apr-11
May-11
Jun-11
Jul-11
Aug-11
Sep-11

Cicero's Corner

Chart Four below is a weekly chart of the yield on a 5-year bond. This yield is 75 points below the RBA cash rate. The bond market is anticipating that the next move by the RBA will be to cut rates.

All markets are interconnected

... this system of credit and finance which operates at Rome, in the Forum, is bound up in, and depends on capital invested in Asia; the loss of the one inevitably undermines the other and causes its collapse.

-- Cicero, Pro lege Manilia, aka De imperio Cnaei Pompeii, 66 B.C.