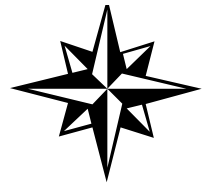


THE SEXTANT REPORT



Weekly Analysis of the Australian Equity Market

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This research material has been prepared by Daniel Goulding through independent research facilities and contains an independent view to ABN AMRO Morgans Limited. Note the disclaimer at the bottom of this report.

The Long-term Outlook (Twelve months or more)

Primary Target: 2693

Alternative Target: 1358

Anticipated timeframe for the final bottom: July 2010 or September 2012.

The Medium-term Outlook (One to Twelve months)

Primary Target: 5034

Alternative Target: 4300

Anticipated timeframe for an intermediate term top: May 2009 or August 2009

My technical work is predicated on a number of factors including price action (The Waves), market internals, sentiment, time, intermarket analysis (Cicero's Corner) and the Austrian school of economic thought (Old School Economics).

THE WAVES



Elliot Wave Theory is a type of technical analysis named after its founder, Ralph Nelson Elliott. He concluded that market prices unfold in repetitive cycles that give rise to specific patterns. Essentially, the market is alternating between five and three waves at different degrees of the trend. Bull moves unfold in 5 waves, 1-2-3-4-5. Corrections unfold as 3 waves, A-B-C.

LONG-TERM OUTLOOK

From a technical perspective, November 21 was not the final bottom for the benchmark Aussie equities index, the S&P/ASX 200 (XJO). The move off this low into the top on November 28 consisted of three waves. Corrective moves play out as three waves; bull moves play out as five waves. I can therefore assert unequivocally that November 21 2008 was not the final bottom.

I am looking for the market to trace out its final bottom in the vicinity of 2693 (the print low from March 2003) or 1358 (the print low from 1992 representing the terminus of the 1987 to 1992 bear market). The former target is a key gravitational point in my technical work. Long time clients have heard me repeat many times how vertical moves in the market have a tendency to being retraced completely. As far as I am concerned the bull move from the March 2003 low was a vertical move. It is highly unlikely that it will not be retraced in full before the next bull market commences. The latter target presumes that what we are witnessing is a correction of the 1974 to 2007 bull market. While a target of 1358 may sound incredulous to most technicians, mainstream economists and the general populace, I should point out that the Aussie Real Estate Investment Trust index (REIT aka Property Trusts) has taken out its 1987 crash low. This index proved itself as a leading indicator, topping out well ahead of the market in February 2007, so the price action of this index bears acknowledgement at a minimum. The fact that this index has yet to bottom is disconcerting to say the least.

Whether the XJO follows a similar path as the Aussie REIT index or bottoms instead in the vicinity of the 2003 lows depends on many different variables. Chief among these is intervention. Unfortunately policymakers and orthodox economists believe that they operate with impunity from the laws of economics. Unfortunately, the economic logic of the Austrian school and more than a thousand years of financial history serve as a damning indictment on government intervention. Any attempt to maintain an existing state of affairs that is untenable from an economic perspective will result in further impoverishment. The Great Depression and the Lost Decade in Japan are cases in point.

In terms of time, I expect this bear market to play out via a Fibonacci three or five years at a minimum. I have pencilled in July 2010 or September 2012 as possible bottoms. However, if the government becomes obsessed with saving the economy at all costs, we must entertain the notion that this bear market could extend much longer in time.

MEDIUM-TERM OUTLOOK

The intermediate bottom I called on November 21 2008 remains intact, with the benchmark Aussie equities index, the S&P/ASX 200 (XJO), up in excess of 6% from the lows.

With the XJO having completed its final descent into circa 3300, I am taking the pulpit to preach to the masses that an intermediate bottom is in. Investors, subject to their own nuances, should be fully invested as the great sucker rally of 2008-09 kicks off. I expect the market to reclaim, at a minimum, 50% of its losses from the all-time high by the middle of next year. This suggests a 5 handle on the XJO inside 6 months.

-- Daniel Goulding, The Sextant Report, November 21 2008.

I remain steadfast in my technical view that the XJO will print a 5 handle by August at the latest (see section *Time* as to why I have extended my timeframe for such a move). The specific targets remain:

- Δ 5034, a Gann/Fibonacci 50% retracement of the losses from the all-time high; or
- Δ 5462, a Fibonacci 61.8% retracement of the losses from the all-time high.

While such targets would seem incredulous to the general populace, history is replete with examples of strong rallies post significant declines. I cover a few examples that I have covered in the past again in the section *Time*.

SHORT-TERM OUTLOOK

From an objective perspective, the monthly wheel of time remains down for the XJO. With the XJO entrenched in a downtrend, ordinarily, any new positions should be focused on the short side, not long side at this conjecture. However, my subjective interpretation of sentiment and timing leads me to favouring the long side at this conjecture.

On a bullish note for the blue chip index, the S&P/ASX 20 (XTL), it managed to hold the February 11 lows and in the process traced out a nice reversal signal on the daily chart. If the prevailing trend is up, the index should move sharply higher from this point on.

On a bearish note however, the volume associated with the sell-off yesterday was a little higher than what I was looking for. While the volume was not great enough to indicate something sinister in the works it does suggest a rest of the lows yesterday is a possibility.

It is a similar story for the broader market represented by the XJO. The XJO managed to hold the lows from February 11 tracing out a reversal signal on the daily chart. If the prevailing trend is up, the index should move sharply higher from this point on. That said, volume was a little higher than what I was looking for so a retest of yesterday's low may need to take place to cement in the bottom.

My count for the XTL is depicted below. There is only a marginal difference between this index and the broader market given that the top 20 stocks dominate the S&P/ASX 200 (XJO). I prefer to count the XTL given it tends to be more conducive to counting.

The Sextant Report, 19 February 2009

While I continue to run with a bullish count, the fact that the XJO remains entrenched in a downtrend from an objective point of view suggests the odds are balanced with respect to November 21 proving an intermediate bottom versus only a short-term bottom.

Given my subjective bullish view, I am rating it a 55/45 proposition of an intermediate bottom in place versus only a short-term bottom. These odds are subject to revision in favour of significant new lows if the market turns back down in the very near-term.

Hourly Chart of the XTL

Source: Iress



My preferred count for the blue chips above. The move off yesterday's low has been strong as anticipated by the count above. In the alternative scenario (new lows), we are in wave 2 up of a larger 3 down. The dreaded wave 3 down of a larger wave 3 down awaits.

INTERNALS



The internals of the market are akin to the vital signs for a human. A calm exterior may belie an unhealthy interior. Deteriorating vitals tend to provide an early warning that something is amiss. The same can be said for the market. Market internals can reveal hidden strength or weakness long before it becomes apparent in the headline index.

US internals are mixed – while a number of short-term measures are bearish, they are offset by strength in the medium-term measures.

Essentially we are on the cusp of a big move.

Here in OZ, a somewhat similar situation.

SENTIMENT



The market rarely accommodates the majority. As a result, the herd is always leaning the wrong way at important tops and bottoms.

Sentiment does not provide any strong leads at this conjecture.

Here in OZ, sentiment is modestly bearish - equivalent to what we witnessed in July-August before the index commenced its plunge into the November low.

However, sentiment is well off the levels we witnessed at the May bear market top.

Essentially sentiment can be used to support the call for new lows or support the case that we are in a multi-month bear market rally. Next week I will unveil for the first time, the Sextant Sentiment Indicator.

TIME



port, 19 February 2009

“Time is more important than price; when time is up price will reverse.”

-- W.D. Gann.

While I had been expecting the February 18-19 timeframe to play out as a top, it appears as though these dates will mark a nice bottom.

Why is this timeframe significant?

February 18 is a Fibonacci 89 days from the low.

February 19 is 90 days forward in time from the November 21 low which I believe was an intermediate term bottom. The 90 day cycle is significant in Gann lore culminating in many tops and bottoms. It was particularly important following the 1987 crash here in Australia. The initial crash low was November 11. The market successfully retested the bottom 91 days. Six months later the market was trading 50% higher.

Post the 1873 and 1929 panic bottoms in the US, the market rallied for 5 and 6 months respectively rallying approximately 50% in both cases (n.b. the 1873 rally was circa 46% according to the very crude numbers I have at my disposal). These models underpin my medium-term forecast.

The 1937 Dow model and the 1987 Aussie All Ords model suggest a bear market rally of 50% from the bottom over 9 months.

With the market appearing to retest the lows, perhaps the latter models are a better representation of reality. If this is indeed the case, we may need to look further out in time to circa August for a top.

Even in the event we break to new lows in the near-term, I would still be on the lookout for a 40% to 50% rally following the bottom, up to circa 4300.

CICERO'S CORNER



All markets are interconnected.

For, coinciding with the loss by many people of large fortunes in Asia, we know that there was a collapse of credit at Rome owing to suspension of payment. It is, indeed, impossible for many individuals in a single State to lose their property and fortunes without involving still greater numbers in their ruin. Do you defend the commonwealth from this danger; and believe me when I tell you - what you see for yourselves - that 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.

The Sextant Report, 19 February 2009

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

The idea of containment is an old wives' tale. Nevertheless, this hypothesis receives persistent promotion whenever a market experiences a calamity. The orthodoxy asserts omnipotent policy will prevent contagion; the spread of the crisis to other markets. A perusal of the annals of financial history is sufficient to consign this hypothesis to the dustbin. Difficulties in one asset class or market will reverberate through other asset classes and markets. No asset class or market should be viewed in isolation.

Credit markets, given their sophistication, tend to lead equity markets. Corporate bonds have moved well off their lows in December. If they can hold on to their recent gains, the greatest risk for equities in the short to medium-term is to the upside, contrary to what the doomsayers would have you believe.

OLD SCHOOL ECONOMICS



Economic wisdom from the qualitative economists.

A letter to the editor I submitted to The Australian late last week.

I write with respect to Stephen Sewell's letter to the editor (Roosevelt's New Deal must have got something right 7,2) in which he asserted that FDR's New Deal was positive for the US economy.

While the statistics he quoted paint a pretty picture, I am reminded of the quote by former UK PM Benjamin Disraeli: "There are three kinds of lies: lies, damned lies, and statistics."

Henry Morgenthau Jr, who served as the Secretary of the Treasury under FDR, saw the New Deal in a markedly different light. In 1939, testifying before the House Ways and Means Committee, he said: *"We have tried spending money. We are spending more than we have ever spent before and it does not work. And I have just one interest, and if I am wrong ... somebody else can have my job. I want to see this country prosperous. I want to see people get a job. I want to see people get enough to eat. We have never made good on our promises ... I say after eight years of this Administration we have just as much unemployment as when we started ... And an enormous debt to boot."*

The bastions of the free-market, predominantly the Austrian school of economic thought, warned repeatedly of the inevitable consequences of central and fractional reserve banking. Further, they warned that the blame would fall squarely at the feet of the free market even though such institutions are the anthesis of the free market, they are an outgrowth of government intervention.

Unfortunately, the warnings of the Austrian school continue to fall on deaf ears. Cutting the benchmark interest rate and the significant pick-up in government spending will only serve to exacerbate the crisis. Such policies precipitated the Great Depression and the Lost decade for Japan. Printing money was the poisoned chalice that precipitated this mess in the first place. Unfortunately, its "bottoms up" according to the government and the central bank.

Till next week ciao.

Intermediate-term bullishly yours

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