

THE McCLELLAN MARKET REPORT

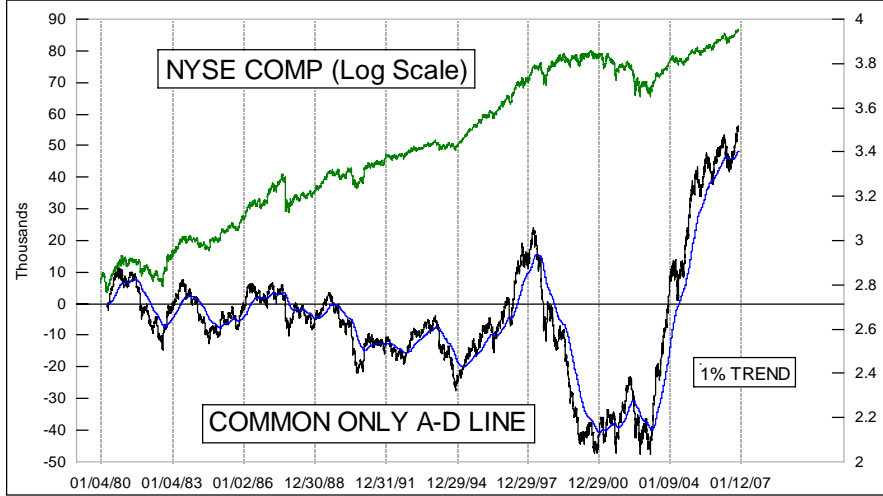
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Prepared After the Market Close, November 30, 2006 Report #280, December 1, 2006

New A-D Line High Unquestionably Bullish

Back in March 2006, in Report #263, we shared the results of a simple study that address the implications of the NYSE's A-D Line making an all-time high. The common only version of the NYSE's A-D Line is shown in our first chart, and it too is at a new high. As a digression, many analysts dismiss the implications of strong breadth numbers, citing the presence of interest sensitive issues like preferred stocks and closed end bond funds within the NYSE list of "issues". The Common Only data factors out those issues, and focuses only on the stocks of operating companies. Seeing it make a new high now confirms the strength we are seeing in the composite A-D Line (which is shown in shorter form on page 3).

For that study, we wanted to quantify just what it means for the future to have a new A-D Line high. To study



this, we posed the following question. Suppose for a moment that one knows nothing else about the market except that the NYSE A-D Line is at a new 3-year high. How does the market behave over the next 3 months?

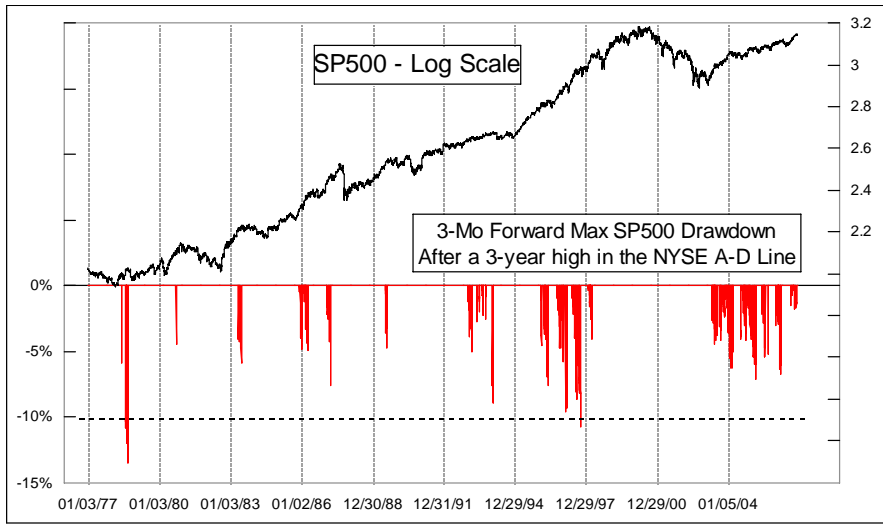
Using data from 1977 to 2006, the answer is that the average return exactly 3 months later is a 2.3% gain for the SP500 Index. Picking an exit point on the calendar 3 months later after some signal is not how we would go about designing a trading system, but it is

helpful for illustrating the implications of a strong A-D Line.

During each of those 3 month periods following a new 3-year A-D Line high, there was an average drawdown in the SP500 of -2.9%. That means you may have to suffer through a temporary decline along the way for that "trade" to work out. The chart at the bottom of page 1 shows those drawdowns which occurred after a 3-year high in the A-D Line. In only a couple of instances did that drawdown exceed 10%.

BOTTOM LINE

While the SP500 has not yet made a new all time high, the NYSE A-D Line is showing plenty of liquidity by making its own new highs. This is even true if we factor out the bond funds, preferred stocks, and other contaminants. A strong A-D Line means that liquidity is so plentiful that even the least deserving issues can go up more than down, and that is a condition that tends to persist for a long time. Likelihood is very small for any serious drawdowns. Stocks should pause here briefly, bottoming Dec. 6-8, then surge higher to finish the year strong and carry that momentum into 2007. Bonds and gold are making a short term top now. Bond prices should resume the climb upward toward a top due Dec. 18-21. Gold may have to chop around a bit more however before its next trending move.



Those drawdown statistics are more meaningful when we compare them to the -4.3% average drawdown for all 3-month periods within the study, and a max drawdown of -33.2%. So if you know that the A-D Line is at a new high, you know that the market is statistically in a much lower than average risk profile.

Drawdowns are important to watch out for, but they are not the only story. The average “draw-up” in the 3 months after an A-D Line high was +5.1%, meaning that at some point during those 3 months the SP500 moved up to a level that was 5.1% higher (on average) than the “entry” price.

The summary point of this exercise, and of the current market situation, is that until and unless we see a divergent condition develop between prices and the A-D Line, we have a pretty good assurance that the risk of a big decline is minimal, while the potential for further gains remains strong.

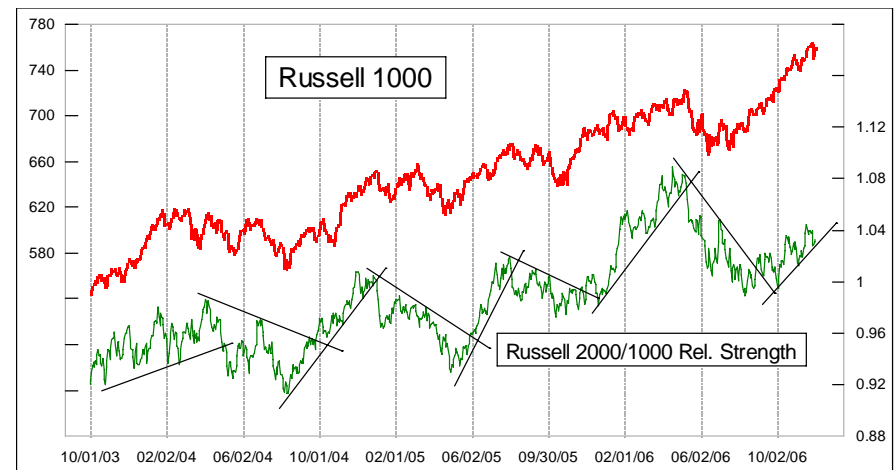
One other piece of bullish confirming news is the continued strength of small caps. The relative strength ratio shown in the chart at the top of page 2 continues to rise, meaning that the Russell 2000 is acting stronger than the Russell 1000, which is bullish for both indices.

Bottom Line: The strong A-D Line, and the strength of small cap stocks, says that liquidity is healthy. That is the best environment for all stocks to have the chance to do well, with minimum risk of drawdown.

Page 3 Charts

Chart 1: The A-D Line is continuing its very bullish chart pattern rising from lower left to upper right on the chart. Last August was the last time that it seriously tested its 10% Trend. The one-day sharp move down by the stock market on November 27 caused the A-D Line to pull back down toward its 10% Trend, but only about as close as the other down moves of the last 3 months. The extreme distance between the 10% Trend and the 1% Trend emphasizes the large liquidity pool at work in the economy and available to the market, but it will likely create a pretty good hangover when the liquidity dries up, probably starting in the late summer of 2007.

Chart 2: The Daily Volume Line used that November 27 dip to retest the May and October 2006 highs on this indicator. Then it used the next three days to



lift itself into new high territory and continue to show superior strength. Until the A-D and Volume Lines show enough weakness to get down to their respective 5% Trends, there will be no question but that the trend is clearly up. **Chart 3:** The McClellan A-D Summation Index is spending considerable time above the +4,000 level affirming the market trending strength. It is only 21 Oscillator points away from making a higher high for the chart period shown. This indicator will need to show a lower low to indicate loss of upward momentum. This is something that it has been unable to do since July.

Chart 4: The Volume Summation is moving more horizontally, but at a high enough level to affirm that a strong trend is at work. The more sideways Summation over the past month does correlate with a slightly reduced slope of the price advance. It is clear on the left side of the chart that having a high Summation Index is not enough by itself to call for the end of a price trend. The Summation made its high in January and prices did not top out until May. It may not take that much time in this up move for the price top to show up, so it is time to begin paying attention, as a more important price top could form in the next 1 to 3 months.

Chart 5: The McClellan Oscillator has a clearly defined downtrend line that can be drawn across the August-November highs. This is a normal structural development as acceleration decays into momentum throughout a trending move. The oscillations across zero are more equal now. When the negative oscillations become much greater than the positive moves, then it will begin to be time to worry over the continuation of the uptrend.

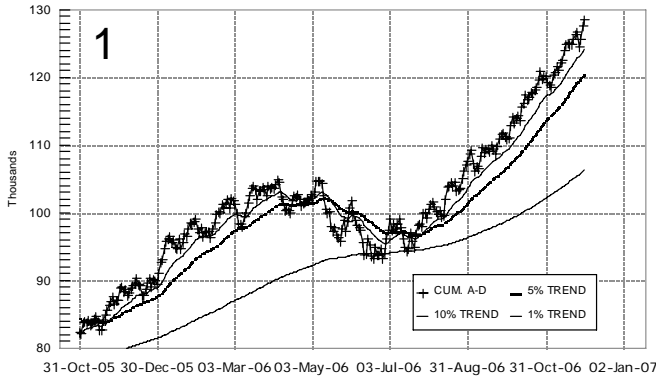
Chart 6: The Volume Oscillator also

shows a less well defined series of lower tops since the end of June. The stock market may be entering a period where price action will be more choppy. This would not be unusual as the clock winds down on 2006 and year end portfolio adjustments are made.

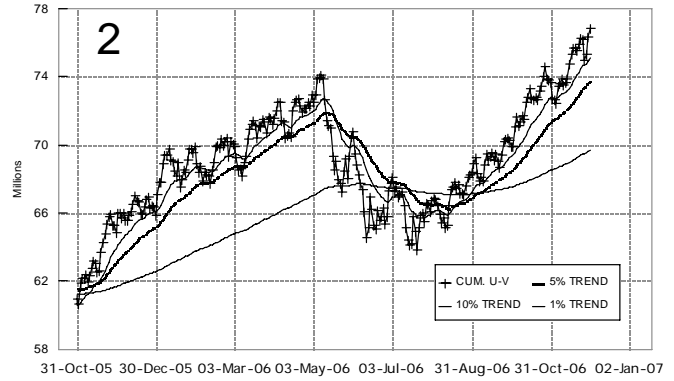
Chart 7: The DJIA Price Oscillator is the most negative indicator on page 3. It is showing lower highs and lower lows and is still declining, in spite of the price bounce following the Nov. 27 swoon. The tops at the left side last year and in May could provide support right here, but should this level not hold then there could be some more price deterioration showing up. It can be argued that the DJIA has broken its uptrend line across bottoms since July and that this week's rally was just a return move to the underside of that uptrend line. Having the Price Oscillator continue to move lower would require the DJIA close to remain below its Price Oscillator Unchanged level that is currently at 12309.30. Of course that number changes every day depending on each day's price action.

Chart 8: The CBOE Volatility Index (VIX) had its first trip above its upper band since last July to mark this week's price low. The VIX immediately dropped below its 50-day moving average to suggest that Monday's weakness was not going to continue. Prior to the May top and decline into the June low, the VIX had a couple of warning blips above its upper band. It will take a further extension well above the upper band to confirm that a final price top has been put in place. Until then, another small blip above the upper band that is quickly retraced should be understood as just texture within the uptrend and topping process.

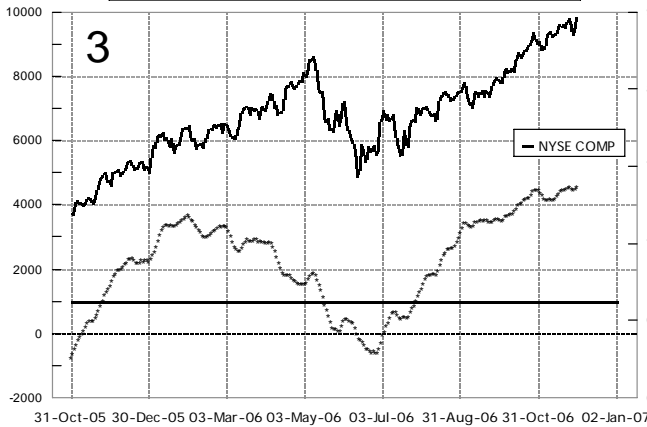
NYSE CUMULATIVE ADVANCE-DECLINE LINE



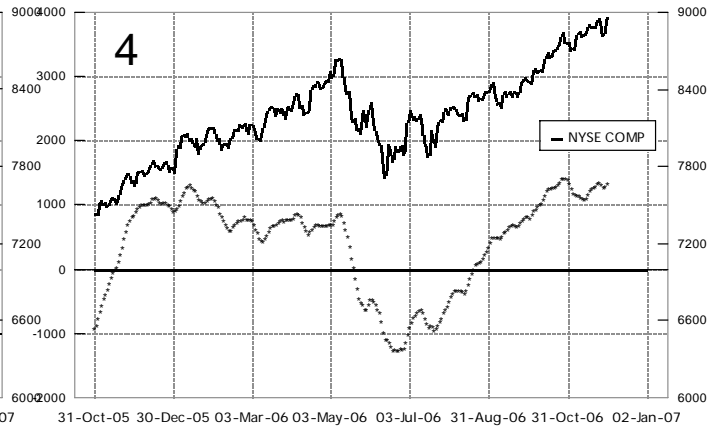
DAILY CUMULATIVE UP-DOWN VOLUME LINE



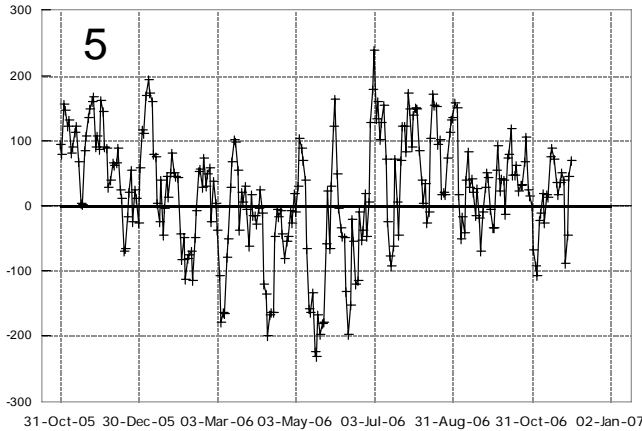
McCLELLAN SUMMATION INDEX: ADV-DECL



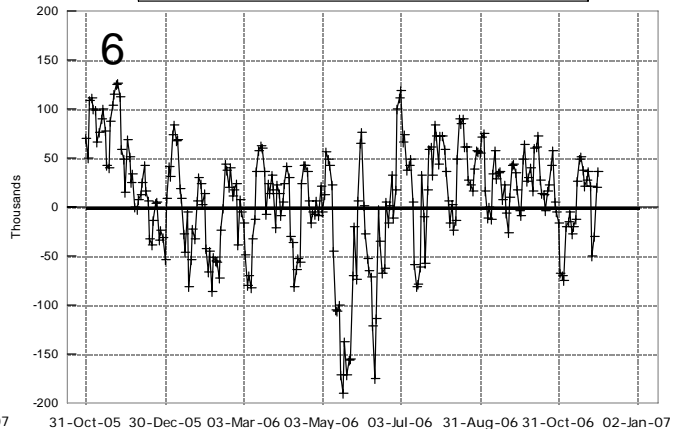
McCLELLAN SUMMATION INDEX: VOLUME



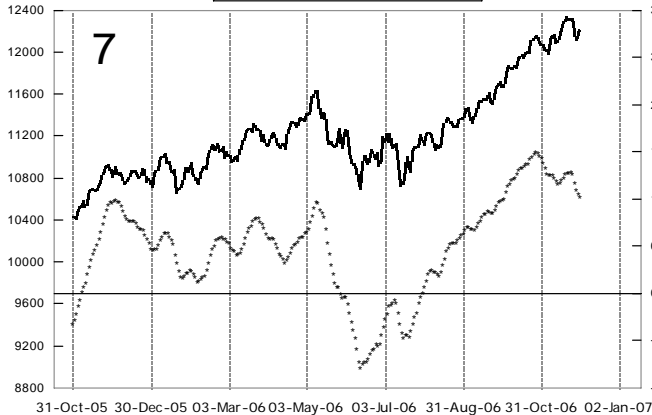
McCLELLAN OSCILLATOR (ADVANCE-DECLINE): NYSE



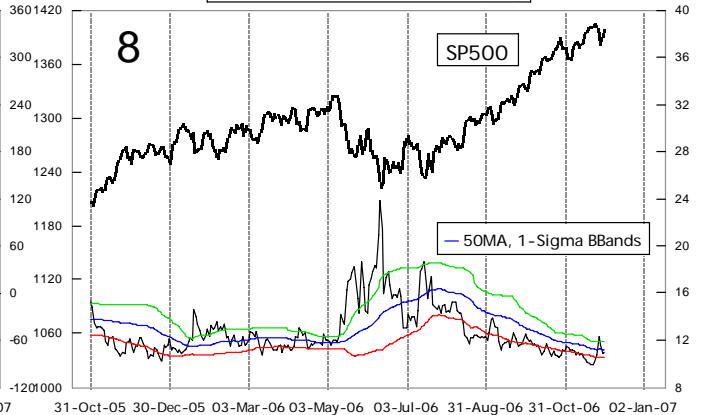
McCLELLAN OSCILLATOR (VOLUME): NYSE



DJIA CLOSE & PRICE OSC



CBOE VOLATILITY INDEX (VIX)



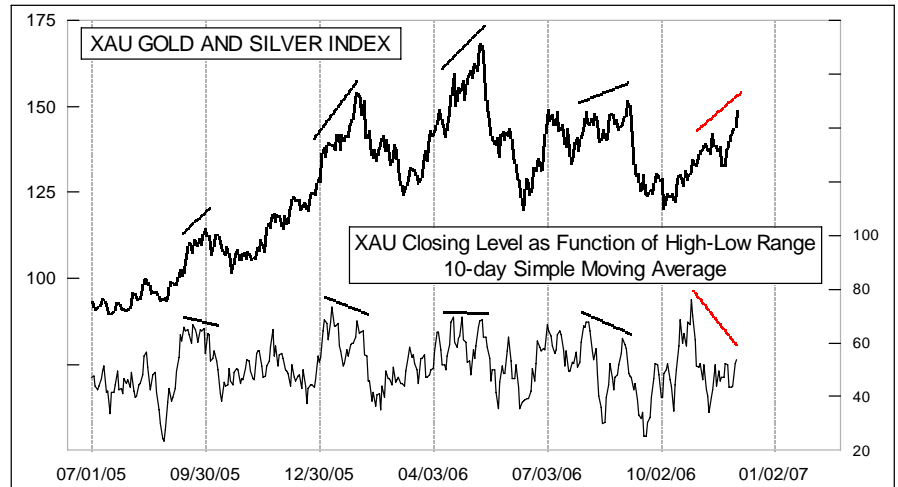
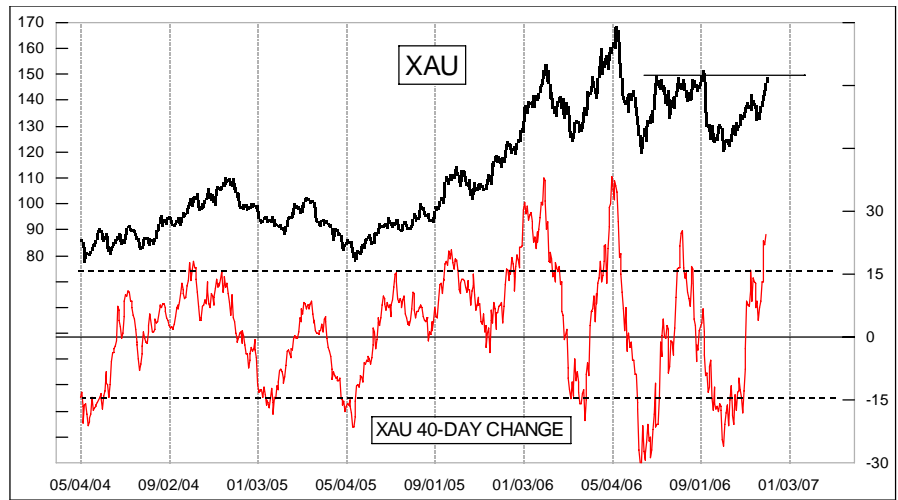
Gold Extends Up Move, Now At Roadblock

Gold prices have now had a nice run up off of the October low. If anything, the run has been a bit too fast for sustainability, and the horses may need a rest.

One of the most evident signs of an overbought condition is shown in our first chart. This indicator simply looks at where the XAU is now versus where it was 40 trading days ago. High readings like this tend to be associated with tops for the XAU, although as we saw in January 2006 it is possible for uptrends to continue after posting such a high reading. We think that such an upside continuation will be difficult this time because of the XAU reaching the 150 level, which marked highs this past summer. There will likely be some willing sellers among the traders who bought at those highs, and are now happy to get out of those positions with prices back to flat (for them).

The second chart shows another problem for the XAU's chances of upside continuation. To create this indicator, we look at each day's close as a function of where it lies within the day's high-low range. We then assign it a score from zero to 100 based on that standing. A zero reading would mean a close at the intraday low; 100 would mean a close on the high. Next, we smooth this with a 10-day simple moving average. In effect, we are creating a 1-10 stochastic oscillator, which you can re-create using those same parameters in just about any charting program.

The highest readings in this indicator almost never coincide with the highest levels for the XAU, so when we saw



the spike high on Oct. 25, we figured there was more ahead. Now, we have the sort of divergence across a time span similar to the sort that has marked important highs in the past, and this makes us conclude that upside continuation is much less likely.

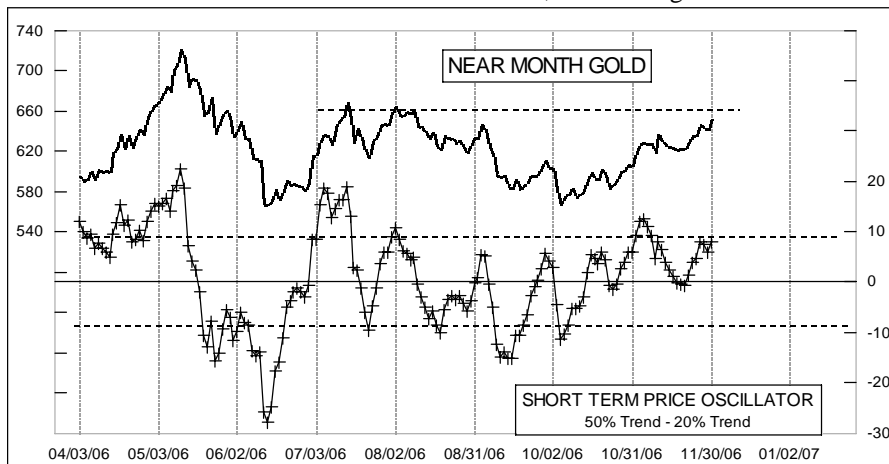
Gold prices themselves show a similar problem for the possibility of upside continuation. The lower chart shows gold futures prices now at around \$650/oz, and nearing the resistance

encountered before at the \$650-660 level. The Short Term Price Oscillator in that chart is also up to a fairly high level, not as high as it ever gets, but high enough to equal the levels that have marked short term highs in the past. Gold probably has a couple more days' worth of pop left, and then there should be at least some sideways chopiness to chew on the overhead resistance, if not a more significant correction.

Bottom Line: It has been a really nice up move for gold prices, but it is now time to harvest some of those gains, and wait for the next growing season.

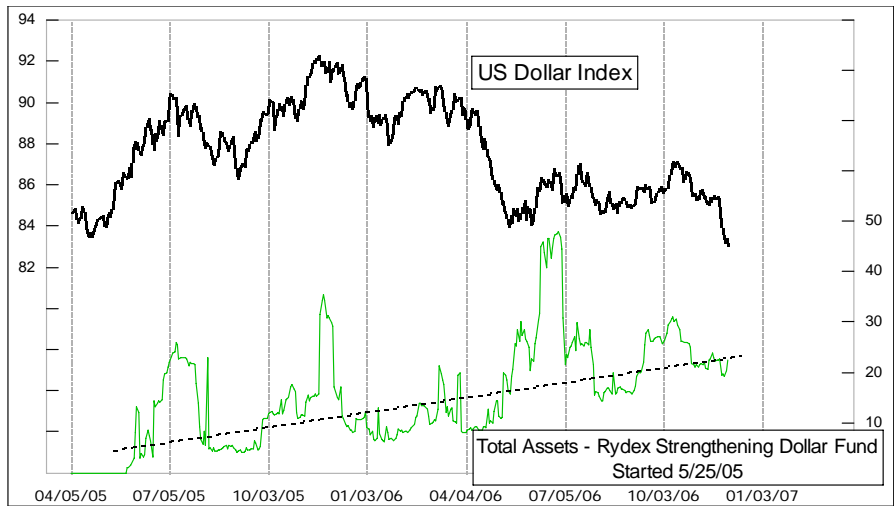
Dollar Rebound Should Hurt Gold's Uptrend

Listening to the news, one cannot help but be bearish on the dollar. The Fed may soon have to cut rates, while the European Central Bank is expected to raise rates. The U.S. economy is slowing, while the trade gap still exists. And to top it off, China is reportedly



dumping the dollar from its currency reserves in favor of gold. It's no wonder that investors are fleeing the dollar like mad with that sort of news.

A good contrarian, however, knows that when it cannot get any worse, then it can only get better. The foregoing comments about sentiment toward the dollar are anecdotal, but the top chart on page 5 shows a more quantitative measure. A year and a half ago, Rydex introduced a couple of funds for mutual fund traders who wanted to play the dollar. One was the Strengthening Dollar Fund, and the other was the Weakening Dollar Fund. The two move in opposite directions. The top chart shows the total assets invested into the Strengthening Dollar Fund, and while this asset level has been in a general uptrend, this has more to do with the gradual rate of adoption of this fund into investors' portfolios than it has to



do with specific sentiment toward the dollar.

The upward sloping dashed line denotes our crude representation of where low readings lie for this fund. Eventually, things will settle down and more static levels of "high" and "low" may appear. For now, however, the total assets level we see looks a lot more like a low reading than an excessively bullish one.

Our Trend Indicator for the Dollar Index is shown in the lower chart on page 5, and it is getting down to an oversold level. This is not the most oversold reading that can possibly occur, but it is at a level that has been low enough to mark decent bottoms in the past.

Also noted in this chart is the behavior of the Dollar Index relative to a 40-week cycle. The 185 trading day spacing of the vertical grid lines is the same period of the 40-week cycle we follow in stock prices, although the timing of their lows is not coincident. As an aside, 185 trading days is actually about 38.5 weeks, but "40-week cycle" tends

to roll off the tongue more easily. It remains one of the more pervasive mysteries we have ever faced, trying to understand why such a cycle exists at all, let alone why it would manifest itself on different schedules in stock prices and the dollar, .

As the labeling on the X-axis shows, the next 185-day bottom is not ideally due until February 2007. But there is another interesting behavior of this cycle, at least as it pertains to the Dollar Index, in that sometimes the low will arrive a month or two early, as was the case with the two circled instances shown in this chart. Interestingly enough, such early arrivals do not change the underlying schedule, at least in the years of data we have examined, and subsequently the Dollar Index gets itself back onto the old schedule. Given the terribly negative sentiment we are seeing toward the dollar right now, and given one more situation we discuss on page 8, we consider it likely that this next 185-day low will arrive early this time.

continued on page 8



Sherman McClellan
Publisher

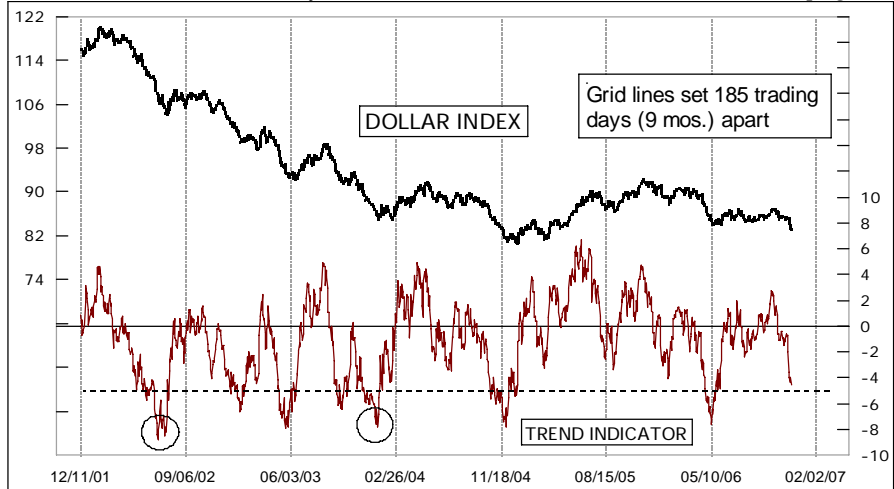
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TIMING MODELS

Stock Indices (DJIA, SPX, Nasdaq, NYSE Comp., etc.)				Bond Market (Corporate & Treasuries)			
SIGNAL	SOURCE	PREDICTED	ACTUAL	SIGNAL	SOURCE	PREDICTED	ACTUAL
Top	NYSE A-D Osc	Nov 15	Nov 17	Top	T-Bond Up-Dn Osc	Nov 22-27	forming
Top	Uncommon A-D Osc	Nov 15	Nov 17	Top	T-Bond Close/Sum	Nov 22-27	forming
Top	DJIA Stochastic	Nov 20	Nov 17	Top	T-Bond Price Osc	Nov 29-Dec 1	forming
Bottom	SP500 ST Price Osc	Nov 21	Nov 20	Top	T-Bond Stochastic	Nov 30	forming
Bottom	NYSE Volume Osc	Nov 24	Nov 27	Top	Bond CEF A-D Osc	Dec 21	
Top	Nasdaq A-D Osc	Nov 28	Nov 28	Bottom	Bond CEF A-D Osc	Dec 26	
Top	DJIA Stochastic	Nov 29	Nov 28				
Bottom	SP500 ST Price Osc	Nov 29					
Bottom	DJIA ST Price Osc	Nov 30					
Top	DJIA ST Price Osc	Dec 4					
Bottom	Volume Summ Index		Dec 6				
Bottom	Uncommon A-D Osc	Dec 8					
Bottom	Nasdaq ST Price Osc	Dec 12					
Top	SP500 ST Price Osc	Dec 12					
Top	DJIA Up-Dn Osc	Dec 14					
Top	Uncommon A-D Osc	Dec 20					
Top	Uncommon A-D Osc	Dec 22					
Bottom	Uncommon A-D Osc	Dec 27					
Top	Nasdaq ST Price Osc	Dec 29					
Top	SP500 Stochastic	Jan 2					
Top	Nasdaq Price Osc	Jan 12-18					
Bottom	Nasdaq Up-Dn Osc	Jan 23					
Top	NYSE Volume Osc	Jan 24					
Bottom	Nasdaq A-D Osc	Jan 31					
Bottom	NYSE Volume Osc	Jan 31					

Gold and Precious Metals Stocks			
SIGNAL	SOURCE	PREDICTED	ACTUAL
Bottom	XAU Close/Sum	Nov 20	Nov 17/20
Bottom	Gold ST Price Osc	Nov 20	Nov 17/20
Top	XAU Up-Dn Osc	Nov 21	---
Bottom	XAU Up-Dn Osc	Nov 30	---
Top	Gold ST Price Osc	Dec 1	
Bottom	[Dollar Index Top]	Dec 7	
Top	[Dollar Index Bottom]	Dec 8-12	
Top	XAU ST Price Osc	Dec 13	
Bottom	Gold ST Price Osc	Dec 14	
Bottom	GDM Close/Sum	Dec 21	

top. Dec. 6-8. A decent bounce should arise from that bottom, so be ready. A top Stock prices as measured by the DJIA have been going sideways for the last two weeks despite the strength

Bonds should top with gold on Dec. 1, and then set about correcting the overbought condition that has built up over the last few weeks' advance. Another top due Dec. 21 is our candidate at the moment for the end of this bond price uptrend.

Gold is moving in concert with T-Bonds at the moment, a condition which we are certain is temporary but it is the operating condition for now. Gold should top Dec. 1, then chop sideways for a while at around the current price level until it decides what to do next. The easy money part of the uptrend is behind us.

The Signals

The interesting recent phenomenon in the markets is the remarkably strong positive correlation between bond prices and gold prices. The two do not normally display such a tight relationship, but both have been moving higher in lockstep, and even taking their rest days along the way together.

This is important to note because we have a large collection of top signals for bonds due right now, and bond prices appear to be zooming upward into that top cluster. We also have one lone top signal for gold prices due Dec. 1, and as we discuss on page 4, gold prices are getting to an overbought condition likely to turn into at least a short term

in the A-D Line and elsewhere. Judging from these signals, that sideways action may last another week until we get to a pair of bottom signals due Dec. 6-8. One of those is even a bold lettered signal, because it is of a type that tends to be associated with stronger and/or more reliable signals. It just so happens that Dec. 8 is when we get the next monthly report on nonfarm payrolls, plus consumer sentiment data, and those two reports ought to either shock the market out of its fibrillation or mark the final bottom of that sideways movement.

What To Expect

Stocks should make a minor top on Dec. 4, then correct to a minor bottom

HOW THEY WORK

These timing models are based on our proprietary calculation method. This technique involves a computationally complex comparison of two or more carefully selected indicator values. This yields the date and direction of a projected future turning point. Making several such comparisons can help paint a picture, one reversal point at a time, of the future structure.

Once generated, signals remain in effect, though the result can have greater or lesser significance based on what the market is doing when the date arrives. Certain indicators are slightly less accurate in pinpointing the exact date, so we may print a range of dates. Price Oscillators and Summation Index signals are usually more important, though sometimes not as precise in time. Uncommon A-D refers to an oscillator derived from NYSE stocks that are not part of the Common Only list in Barron's. Dates in bold denote signals of greater potential strength according to our research.

These models do not catch every market turn, but the signals usually show some effect in the market action. It is important to understand that the market does not have to go up from a bottom; it may just stop going down. It does not have to go down from a top, it may just stop going up. Some bottoms turn out to be just a flat spot before a continuation up.

"Actual" dates listed for NYSE Indices are for the NYSE Comp/Dow Jones Industrial Average. Letter groups denote clusters of signals. ST Price Osc means "Short Term Price Oscillator."

Past performance of these mathematically generated turning point projections in no way guarantees future results. These dates may be useful in planning for the future, or giving greater confidence at turning points. **We would not, however, attempt to trade any of the markets based solely on these models.**

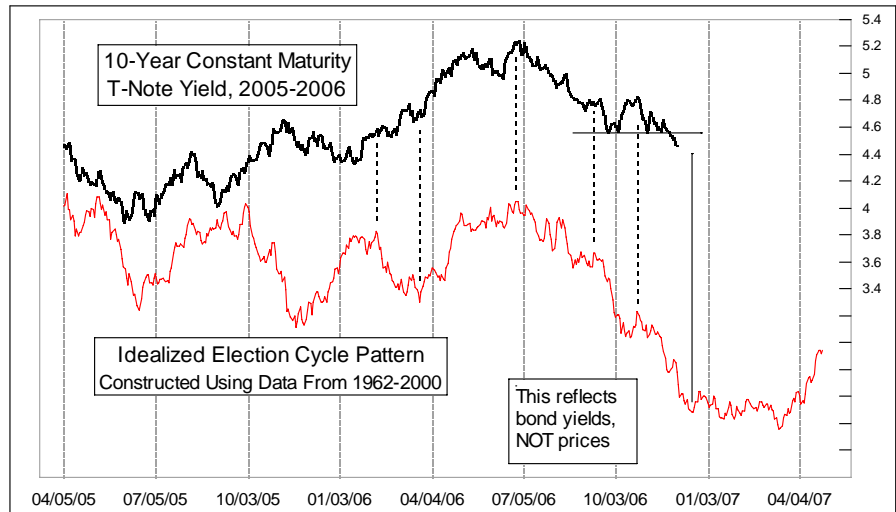
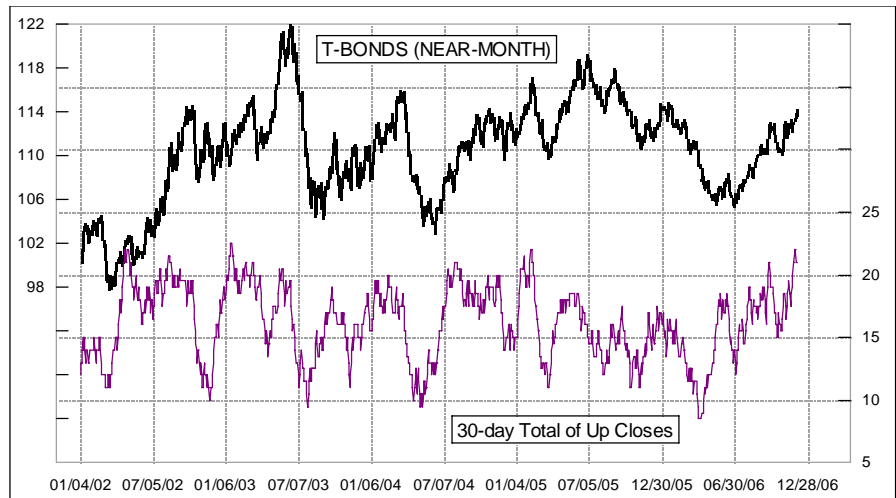
Bonds Break Thru Resistance, Now Appear O'Bought

The pause that T-Bond prices made at the 113 level took a couple of months to get resolved, but bonds are now clearly through that resistance and seemingly headed upward. We say "seemingly" because a new problem has developed which may get in the way of further progress.

The top chart on page 7 shows a very simple indicator which measures the number of up closes in T-Bond futures prices over the past 30 trading days. It makes a nice overbought and oversold indicator, wherein readings around 10 or below mark oversold conditions, and readings at 20 or above show overbought situations. We currently have a reading of 21, just down from a high of 22 a couple of days ago. Such readings have been seen at blow-off tops in the past, which makes this a cause for concern. But muddying the waters a bit is the fact that not every 20+ reading stops an uptrend in its tracks.

We know from watching the Election Cycle Pattern for bond yields that a change in the current trend is looming. The middle chart shows an updated version of that indicator, extending out well into 2007. The solid vertical line marks the inflection point that is coming, and if bond yields continue to follow this pattern like they have been, then that ought to be where the bottom for yields will come. That line equates to Dec. 18, although bond yields are usually not perfect in their alignments to this pattern, so we would not suggest setting your watch by it.

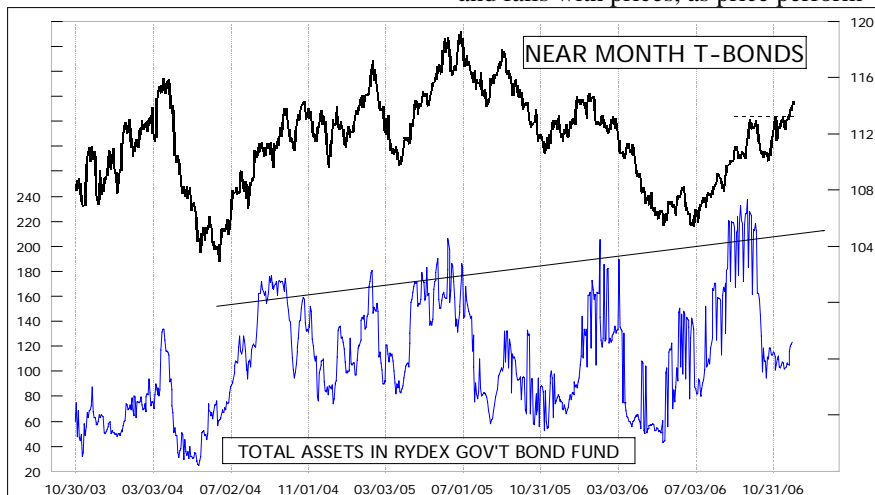
A bottom for yields would be a top



for bond prices. Seeing two more weeks of upward movement for bond prices should produce an even bigger overbought situation than what we see already.

Yet the curious thing about the strength in bond prices is that it has not yet caught the public's attention. Usually public sentiment toward bonds rises and falls with prices, as price perform-

ance attracts the momentum chasers. That has not happened yet, at least not according to the data on total assets invested into the Rydex Government Bond Fund shown below. Over the past two years, important price tops have been made when this asset level gets up to a much higher level than this, marked by the rising solid line. Even though T-Bond prices have risen almost 4% above their Oct. 23 low, investors who use Rydex funds are not yet chasing that rally, and are keeping the total invested assets down at about the same level we saw at that Oct. 23 price low. This says that while bond prices may be getting overbought, retail sentiment is not yet showing the sort of condition which would indicate that rally is done. **Bottom Line:** Bond prices are getting overbought, and deserve a very minor rest break next week. But there is more upside ahead, as we head toward a Dec. 18 due date for a bottom in yields and a top in bond prices.

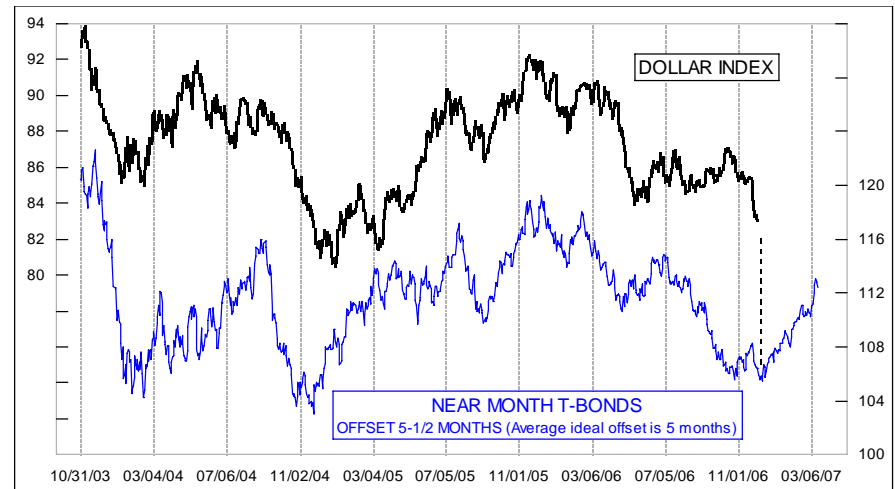


Dollar Rebound

(cont'd from p. 5)

One relationship that makes us think the dollar will see an early bottom in its 185-day cycle is shown in the top chart on page 8. The price pattern of T-Bonds has a well established history of acting as a leading indicator for the Dollar Index, albeit an imperfect one. If one had interpreted this relationship literally from July through October 2006, one would have been terribly disappointed in the Dollar Index for failing to follow directions. Now, however, it looks like the Dollar Index is trying to make up for lost time by plunging down all at once to make the low that was supposed to be under construction for the last four months. This is not an unheard of behavior, and in our view it does not mean that the time lag has shifted. Rather, it just means that the Dollar Index suddenly realized where it was supposed to be, and has been working hard to make amends.

The upturn in T-Bond prices which began back in early July should now have its echo in the Dollar Index. A ris-



ing dollar would make it hard for gold to continue its rally, and as we discussed on page 4, gold is going to have a hard time anyway given its over-bought situation.

Bottom Line: The bearish comments you are hearing about the dollar out there are just part of the bottom-building process. We see a dollar rebound coming, which apparently most others do not see, which makes us think

all the more that it should happen.

Crude Oil Update

In the same way that the Dollar Index has been playing hooky from its duty to follow the pattern of bond prices, crude oil has been so far refusing to zoom upward as the echo of the big rally in gold prices shown in the middle chart on page 8. And for the same reasons that the Dollar Index is finally doing its assignment, we think that crude oil prices will soon wake up and realize they are supposed to be a lot higher, and will set about completing that assignment.

A more practical reason for a crude oil rally here is shown in the lower chart, where we examine the spread between the near month crude oil futures contract and the contract 11 months out. Most of the time, this spread is positive, meaning that the near month contract is priced higher than the out months. On the rare occasions that a negative spread appears, it is usually associated with important price bottoms.

It can take a while for that negative spread to matter, and to start bringing about a rally in oil prices. We learned that back in 1998, when the spread stayed negative and crude oil prices declined all that year. But eventually it does matter, and the larger the spread, the more it matters.

Also worth noting in this chart is the fact that we are now at a Fibonacci time expansion point as referenced by the spacing of the tops highlighted in this chart. That increases the likelihood of this moment in time constituting an important turning point for prices. We think it will be a point from which prices turn upward, so it is time to fill up the Winnebago while you still can.

