Year-end 2010 Commentary
Prepared December 15, 2010

Dear Clients and Friends,

In this year-end commentary I summarize my thoughts on the current condition of the stock market and prospects going forward. I have also enclosed a graphical depiction of potential dangers in the market for long-dated US Treasury securities. I hope you find my comments informative.

Bull Market Scorecard. Yes, it's a bull market! Against what, at times, have seemed to be insurmountable odds, the stock market has been in an uptrend since bottoming on March 9, 2009. Some bearishly-oriented commentators will tell you it is a rally in a bear market…..or that the market is not supposed be going up; how can it with economic news being so bad?….or that somehow any gains earned in this market environment are "ill-gotten" because the market is not behaving bearishly as they say it should, and you just wait, it soon will….

All I can tell you from my observations is that, since March 9, 2009, the direction of the major market averages have consistently trended from the lower left-hand to the upper right-hand portion of the graph. That is an uptrend in progress and that fact does not require further analysis.

Excerpts from my 2008 year-end commentary are as follows:

> "The bear market that began in October 2007 accelerated in intensity during the 3rd and 4th quarters of 2008, with most major market averages showing declines of approximately 50% off the prior bull market highs reached in October 2007. The declines of October and early November 2008 indicate the degree of downside intensity typically found during the mature stages of bear markets".

Excerpts from my 2009 year-end commentary are as follows:

> "We are still in the late stages of psychological bull phase I and, while the level of disbelief in the market is still high (characteristic of bull phase I sentiment) the movement to bull phase II is near……psychological bull phase II should contain a substantial market decline that will convince many traders that the old bear market has returned; the magnitude of the mid-bull market correction should fall within the range of 10-20% down in major market averages".

As of the date of this writing, Mid-December 2010, most of the significant characteristics of psychological phase II have occurred: 1) conversion of Phase I skepticism and disbelief to acceptance and belief in the bull market, as fundamental conditions improve. I believe the conversion process began during the market's relentless, but unspectacular advance during the February to April 2010 time frame, and further confirmed by the market's September to December 2010 rally; 2) mid-phase decline that fools the majority (16% market decline in April/ May 2010); 3) late-phase upside penetration of the Dow Jones Industrial Average of its own 200-day trend-line as that average makes a bull market high; 4) a new bull market top in the advance-decline late (late phase II behavior).

If one were to accept the premise that the bull market's most serious correction will occur in the middle of the bull movement, then one might could store in the back of his brain the time frame of autumn 2011 as being a potential target date for the next bull market top. How then, would that potential time frame for a bull market top stack up to historic parameters of bull market durations?

Legendary market technician, George Lindsay, categorized market advances as being likely to fall within one of four distinct time frames:

- Subnormal advance – 414 to 684 calendar days
- Short advance – 704 to 739 calendar days
- Long advance – 770 to 831 calendar days
- Extended advance – 930 to 991 calendar days

Therefore, if the bull market were to conclude on say, October 1, 2011, then the length of the bull market measured from the March 9, 2009 price bottom would be 921 days. This would represent a bull market of above-average length, as measured by the Lindsay statistics. Also, this time frame would neatly fit in with the bullish bias that historically exists in years 2 and 3 of the "Presidential Election Cycle" (2010-11).

So, the conclusion drawn is that the bull movement is still firmly in place, but maturing in terms of age, while being well short of full maturity. As of the end of 2010, the bull market will be about 650 days old, relatively young according to the Lindsay statistics.

TECHNICAL, SENTIMENT AND TIMING CHARACTERISTICS OF TYPICAL BULL MARKETS/ CURRENT STATUS

Bull or Bear. A bull market has been in progress since March 9, 2009.

Duration. Bull markets last, on average, for 2-4 years. With the current bull market being approximately 22 months old, the conclusion drawn is that the bull movement is progressing toward maturity, while still being well short of full maturity.

Psychological Phases. Bull markets, like bear markets, generally are divisible into 3 distinct psychological phases; the first phase being characterized by skepticism and disbelief in the bull market, the second phase characterized by a conversion from disbelief to acceptance of the bull market and an improvement in economic conditions; and the third phase characterized by a full fledged movement to euphoria and investor overconfidence/ the prevailing investor emotion of fear is now greed.

Current Status. We are transitioning from bull psychological phase II to psychological phase III.

Initial Public Offerings (IPOs). Phases I and II contain few high profile IPOs, as economic conditions and investor sentiment do not allow them. The return of the IPO becomes more noticeable in phase III. I note that there were 9 IPOs in the week ended November 15th, the most IPOs since the Lehman Brothers collapse more than 2 years ago. This flurry of IPO activity, combined with the investor excitement over the November 2010 IPO of General Motors is perhaps an early warning sign of an eventual IPO boom that accompanies most market tops.

Advance-Decline Line. The advance-decline line generally tops out well in advance of bull market price tops, giving the observant investor plenty of advance warning to prepare for an eventual price top. As of the date of this writing, the advance-decline line is currently at or nearby its bull market high, a compelling argument that a market top (in terms of major market averages) is many months away.

52-week New Highs. The number of new 52-week highs for New York Stock Exchange stocks peaked on April 26th at 672 issues. The number of 52-week highs soon after the May/June correction collapsed and have not come within 100 issues since. Interestingly, this number of new highs was nearly exactly equal to the number of new highs reached in the prior two bull markets. The 1990s bull cycle reached the maximum number of new highs late in 1997, as the price high of that bull market was reached more than two years later. Similarly, during the 2003 to 2007 bull market, new 52-week highs peaked late in 2003 with a failed attempt to exceed that peak occurring three years later. Both fact situations indicate that the peaking of new 52-week highs does not necessarily occur at a bull market's price peak, and in fact, may occur well in advance of the eventual price peak. In fact, I would be on alert for the event of the exceeding of the 672 issues trading at 52 week highs as bullish evidence that the bull cycle may extend to the parameters set forth by George Lindsay.

52-week New Lows. The statistic, number of stocks making 52-week new lows, has behaved quite well throughout the bull market to date with the daily new lows remaining as close to zero as is practically possible. If daily new lows, currently running at a rate of 20 issues or less, per day, were to begin to trend higher at some point, one should view that event as a warning sign of an eventual market top.

Investor Sentiment. The latest poll results of the American Association of Individual Investors and The Investors Intelligent Advisors indicate a "bulls to bears" ratio of more than 2-1. These are extreme bullish readings that have been maintained for a number of months. This persistence of extreme bullish sentiment is indicative of a transition to phase III psychology.

Projected Angle of Ascent. I would note that the later phases of a typical bull market are usually characterized by a lesser angle of ascent in major market averages as compared to Phase I behavior, and a shift in participation from lower quality securities that performed well during Phase I and early in Phase II, to high quality blue chip names that become perceived to be "on the bargain counter". This factor accounts for the declining number of new 52-week highs even as the advance-decline line remains strong – the sheer quantity of lower-quality, lower-priced stocks making 52-week highs early in the bull market are replaced by a lesser quantity of higher-quality, higher-priced stocks making 52-week highs as the bull market progresses.

Fundamental Backdrop. Announced economic statistics (unemployment data, GDP statistics, etc.) remain weak. In general, economic activity in the United States remains considerably below potential, but has likely bottomed. I would make the general observation that stock market booms are born out of depressed economic conditions. The more that economic conditions remained suppressed, the greater is the potential for an eventually strong economic rebound. If you held a gun to my head right now and made me make a wager on the likeliest of two potential outcomes: 1) the current bull market will run its course close to the outline that I have presented herein; or 2) the current bull market could turn out to be considerably stronger and longer in duration then is generally recognized – I would probably make the wager on the latter of the two choices. We'll see.

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Wishing you a Merry Christmas and a Happy and Prosperous New Year!

John Hegler
21ST CENTURY EQUITY ADVISORS CORPORATION