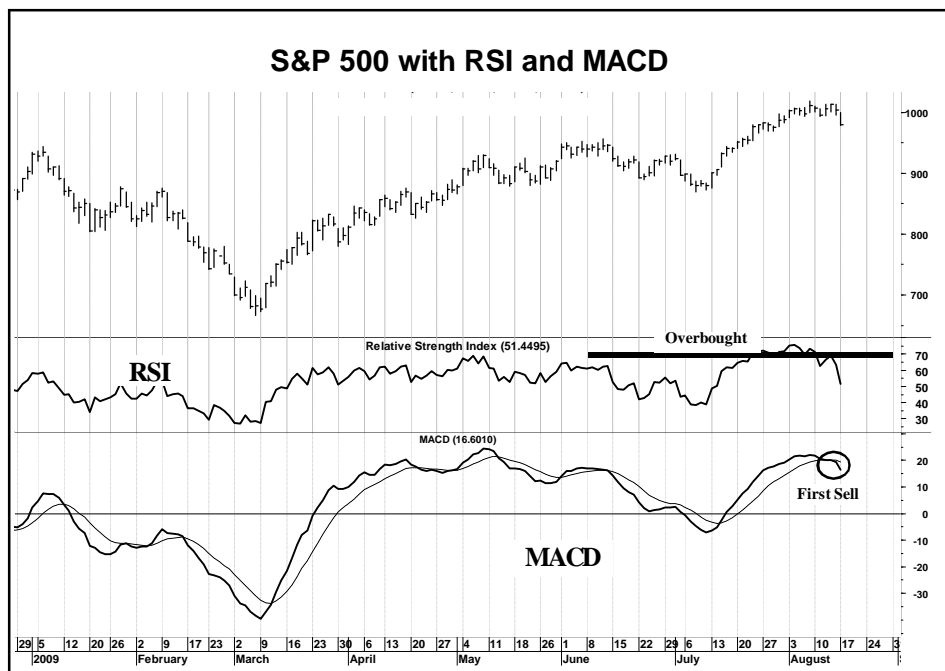


Cracks in the Rally's Foundation



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We have been working through what I termed earlier in the year as the “Obama rally,” but the end is drawing near. Our expectation for this rally was that the market would stage a surprisingly strong move that would extend into August. August is here, and the end is near. Back in March when we were striking a bullish pose, the sentiment was about as bearish as one might ever expect. Now that the rally has brought the averages up some 50%, investors are as bullish as they were pessimistic last spring.

This irrational exuberance, which is being fanned by a giddy media, is the first reason you should be getting very cautious. A more objective reason can be found in the bearish MACD and RSI patterns that are developing in the averages.

You can see that the Relative Strength Indicator (RSI) broke into overbought readings earlier in the month. Since then, the indicator has been falling while prices have been skittering sideways. This is not yet classic negative divergence, but it is a sign that the rally’s underpinnings are weakening. MACD is also showing us a bearish red flag. It is overbought, and it has generated a “first sell signal.” I like to see a second sell separated by an intervening buy - where the solid line briefly recovers over the dashed line before falling under it again. The first sell is a warning. The second sell can easily occur by month’s end.

Our objective timing models, Palio and the Nasdaq Slow Tracker, are both still on buy signals. They will have the last word in all of this, and I do expect to see

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a bit more strength until they finally turn negative. My reason for presenting this chart is to warn you against getting all bullish with the public and buying into strength. We are nearing a serious turn in the market. It is too late to be a buyer.

One reason that the RSI is falling while prices are stagnating is that the pros are liquidating. The professional traders and investors (the guys that bought in March) will typically sit back and let the novices push prices higher in response to the bullish stuff they are reading in the papers as well as the twisted economic statistics they are seeing on the evening news. The pros will then sell into strength - like on August 12 and 13. Once prices begin to weaken, they will back off and let the Street take prices back up again. Then they will step in and sell. The process repeats itself, and the result will be a flat to gently rising market that does not produce enough fear at any one time to stampede prices on the down side.

Professional distribution takes time, and these guys are patient. Another thing to keep in mind about professionals is that they don't care if they get the top price or sell the highs. It is enough to make a profit. They would love to see an excuse to orchestrate a "breakout" of this trading range, and we may well see just that as we approach month's end.

Once the averages turn down, I think the commodity-related stocks will initially follow on the down side. I do not recommend that you sell out and try to get back in again - especially with your precious metals issues. I do not expect to see the gold stocks as weak as they were last fall, but we should see better buy prices than we have currently. In my opinion, it is better to hold what you have and accumulate more at our buy prices during weakness.

The gold market looks potentially explosive. If there is a place for an unexpected event to occur over the next few months, it is in gold. There are worldwide economic problems, and the U.S. is hell bent on ruining the dollar. China intends to compete with us militarily and threaten our global hegemony, which they can afford to do. The banking crisis has not been solved by the current "pretend and extend" solutions. The banks are, in reality, still broke.

These are fundamental viewpoints. From a technical perspective, gold looks even more bullish. The dollar will likely be the key factor in the next gold surge. One of these days, we are going to wake up to a sudden collapse in the dollar, and gold will be through \$1,000 - never to return to current levels again. Don't sell what you have. Buy more as the overall market declines this fall, and I would still stick with the majors on our list. Gold is the best play I see currently; but if you want to speculate a bit, add some silver to your shopping list as well.

Crude oil certainly looks like it would like to sell back to \$60.00, where the 200-day moving average is. It might break under \$60.00 temporarily; but if it does, \$55.00 should offer decent support.

I like the technical action lately in **Great Lakes Hydro** (CA:GLH-TSX-C\$17.48). It is not the most exciting stock on our list, but it is doing a good job for us. It is also offering us a defense against "cap in trade" since they are entirely hydroelectric. Our buy price is C\$16.00 (that's Canadian dollars), and it's still a buy there if it comes off with the rest of the market next month. I am looking at exploiting the energy market during the initial decline and, at the same time, diversifying outside of crude oil. Great Lakes Hydro fits the bill, and it has a decent 7% yield.

Another interesting, energy-related issue you should put on your radar is **American Superconductor** (AMSC-OTC-\$29.67). They produce and sell proprietary equipment and components for wind power installations and other interesting energy applications. Their business is booming - especially to Chinese customers. The technical picture looks great as well - perhaps too great at this very moment. The stock has doubled since March, and it is looking like it will sell off soon, regardless of whether the averages are able to break out of their trading ranges. Consequently, we need to wait for a better price before buying. If we can snag some shares at \$23.00 or better, I think we will be very happy a year from now.

This price may seem a bit too low, but we know there is a selling wave coming. I want to take advantage of it if possible. We can always adjust our buy price higher if need be once we see the nature of the next down turn in the market. I will give you more detailed particulars on AMSC in the September monthly letter. In the meantime, check them out at www.amsc.com, and put in an open order to buy at \$23.00.