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The Kaufman Report

Trade what you see, not what you think.

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Monday August 18, 2008 **Closing prices of August 15, 2008**

Stocks rose for the third consecutive week as the rally off the July 15th low is still intact and market breadth has shown tremendous improvement. The economic picture has changed dramatically over the past month as crude oil and commodities prices have plunged and the U.S. Dollar has rallied strongly. Most markets are now at important inflection points which will keep traders on their toes.

Many statistics of market breadth are at their best levels in some time, such as new highs versus new lows and the percent of stocks in the S&P 1500 which are over their own 200-day moving average. It is now over 50% for the first time since October 15, 2007. However, short-term indicators are starting to come down from overbought levels, options buyers have been showing bullishness, and volume has been decreasing as stocks have moved higher. These and other factors leave stocks vulnerable to a drop.

Stocks have moved higher as the U.S. Dollar spiked and crude oil and commodities dropped sharply. The Dollar is now overbought and crude oil, gold, and the commodities index are at or near oversold levels. As these markets regress to the mean sellers of equities may become more aggressive, and in a low volume environment an increase in selling may cause a move lower to be exaggerated. Volume has not been strong, and the last two weeks of August are traditionally among the lightest of the year.

We remain concerned about the P/E ratio of the S&P 1500, which is at the highest level since January 2004. The difference is now it is rising, while at that time it was coming down. The spread between the 10-year bond yield and the earnings yield based on the current P/E ratio is about zero, meaning the 10-year bond yield is about the same as the S&P 1500 earnings yield. That spread is below levels seen at May 2006, July 2007, and June 2008. Each of those occurrences was followed by a sharp drop in equities. The spread based on the forward P/E ratio is still at levels where stocks would usually be attractive, but that spread has been narrowing also and is in the area it was in during the May to July stock plunge. The problem is that aggregate reported earnings have been dropping precipitously, while projected earnings are also moving inexorably lower, although at a slower rate. With earnings season essentially 95% over reported earnings and projections may level off for a while, but if interest rates move higher in the near-term these spreads will only worsen.

The current rally is still intact, so investors should continue to trade the long side. Valuations are at levels where equities have been vulnerable in the past, short-term sentiment is getting bullish, buyers are becoming reluctant, and we are in the seasonally weak months of August and September. *Therefore, investors should be on high alert for the possibility that equities may be about to make another leg down.* The factors that could help keep the current rally going would be continued weakness in the price of crude oil and commodities, continued strength in the U.S. Dollar, and an extremely active Fed.

The short and intermediate-term trends are up, while the long-term trend is still down. We reiterate that this continues to be a bifurcated, opportunistic trader's market, with adept traders able to take advantage long or short. Investors need to be alert to sector rotation and should not hesitate to move out of lagging sectors and stocks and into leaders.

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So far 473 companies in the S&P 500 have reported second quarter earnings. According to Bloomberg, 67.9% have had positive surprises, 6.8% have been in line, and 25.3% have been negative. The year-over-year change has been -24.1% on a share-weighted basis, -24.3% market cap-weighted, and -12.6% non-weighted. Ex-financial stocks these numbers are 4.2%, 7.3%, and 5.0%, respectively.

Federal Funds futures are pricing in an 86.0% probability that the Fed will *leave rates at 2.00%,* and a 14.0% probability of *raising 25 basis points to 2.25* when they meet on September 16th.

The S&P 1500 (296.23) was up 0.363% Friday. Average price per share was up 0.22%. Volume was 84% of its 10-day average and 73% of its 30-day average. 59.62% of the S&P 1500 stocks were up on the day. Up Dollars was 65% of its 10-day moving average and Down Dollars was 40% of its 10-day moving average. For the week the index was up 0.301% on decreasing and lower than average weekly volume.

Options expire September 19th.

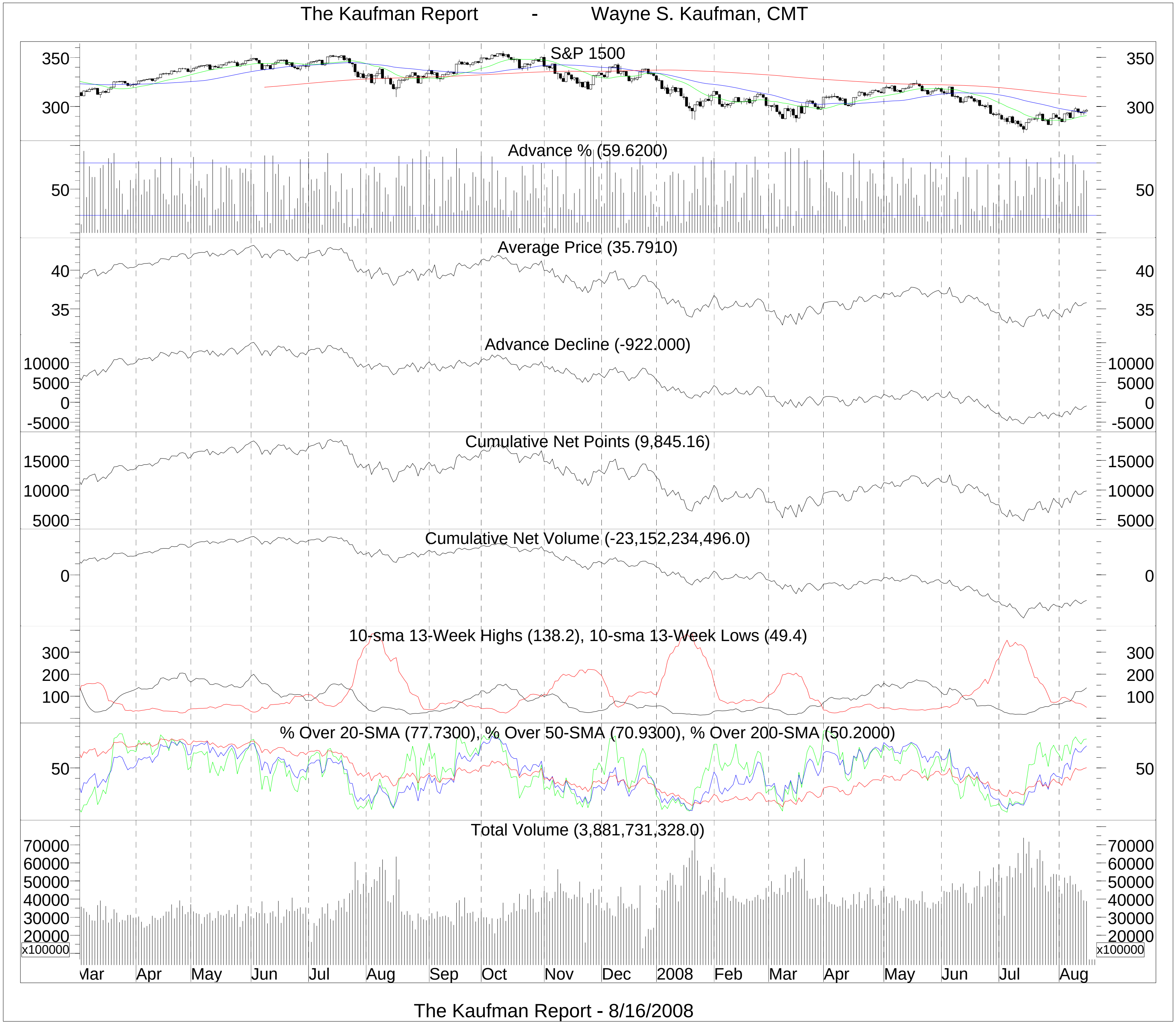
IMPORTANT DISCLOSURES

The rally remains intact as the S&P 1500 stayed above the lower trend line of the bearish wedge and above the 50-day moving average (blue).

Our oscillators are at high levels, leaving stocks vulnerable to a pullback.

Closing highs have been higher than lows.

Our price oscillator, a good indicator of trends, is in positive territory.



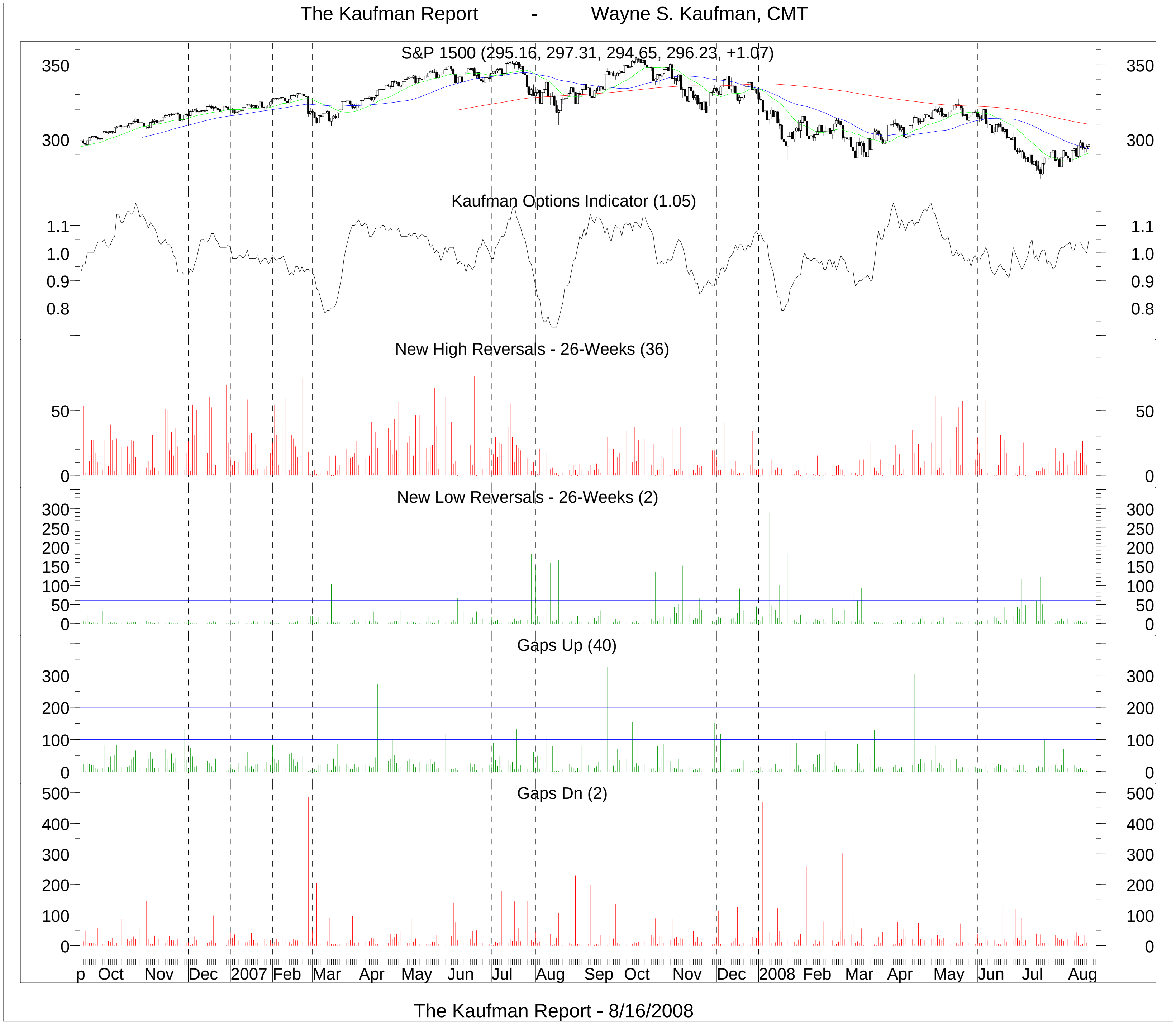
59.62% of the S&P 1500 traded higher Friday.

Statistics of market breadth continue to improve.

The 10-sma of 13-week closing highs is well above the 10-sma of 13-week lows.

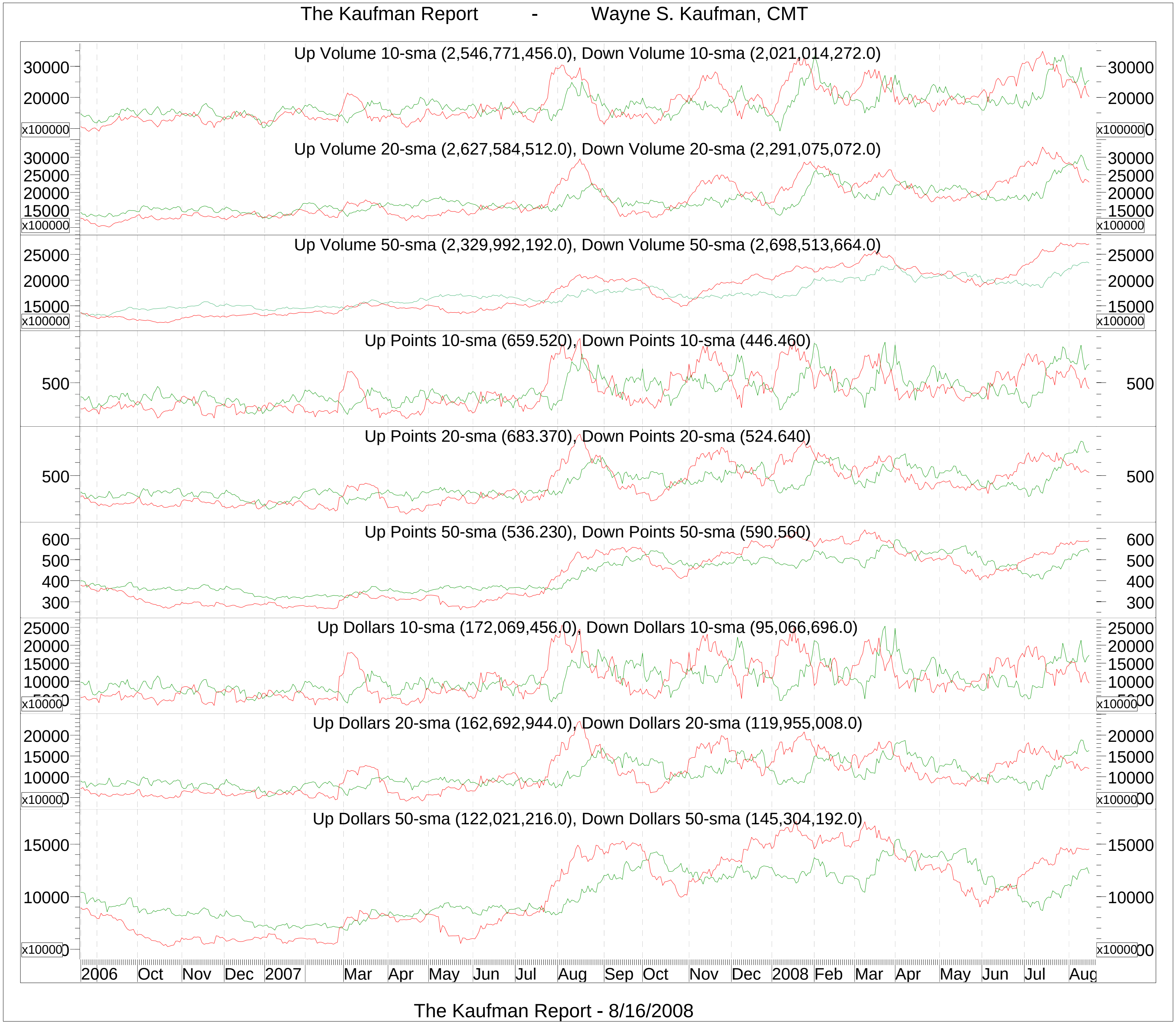
50.2% of the S&P 1500 are above their 200-sma, the first time since 10/15/07 more than half are above that important moving average.

Volume has been decreasing as stocks have moved higher.

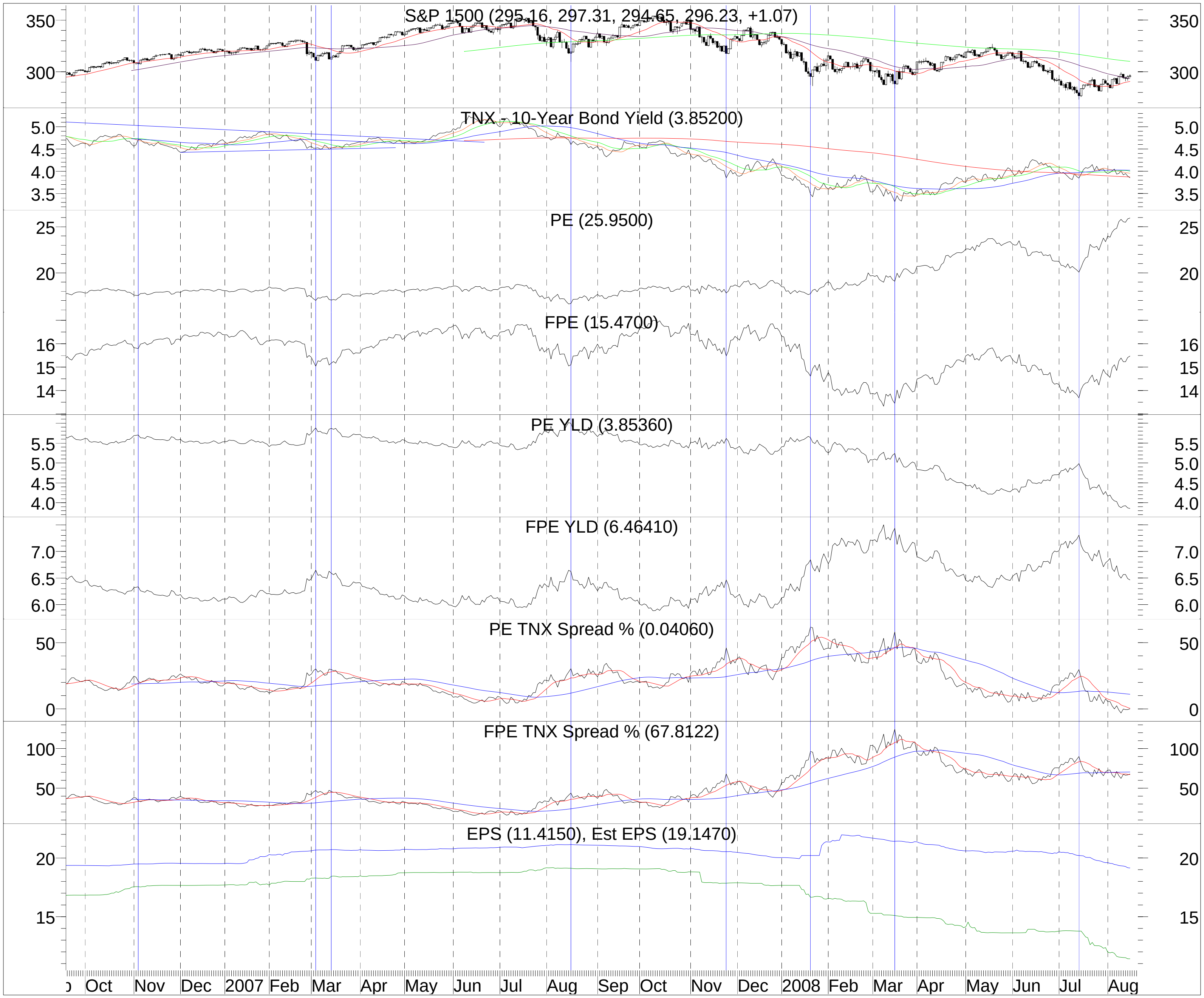


Our proprietary options indicator shows bullishness among options traders. It is not yet at extreme levels, but it does leave stocks vulnerable to a pullback at any time.

There were 36 new high reversals Friday, showing investors increasing desire tom take profits. It has not yet hit the levels where important tops have been made.



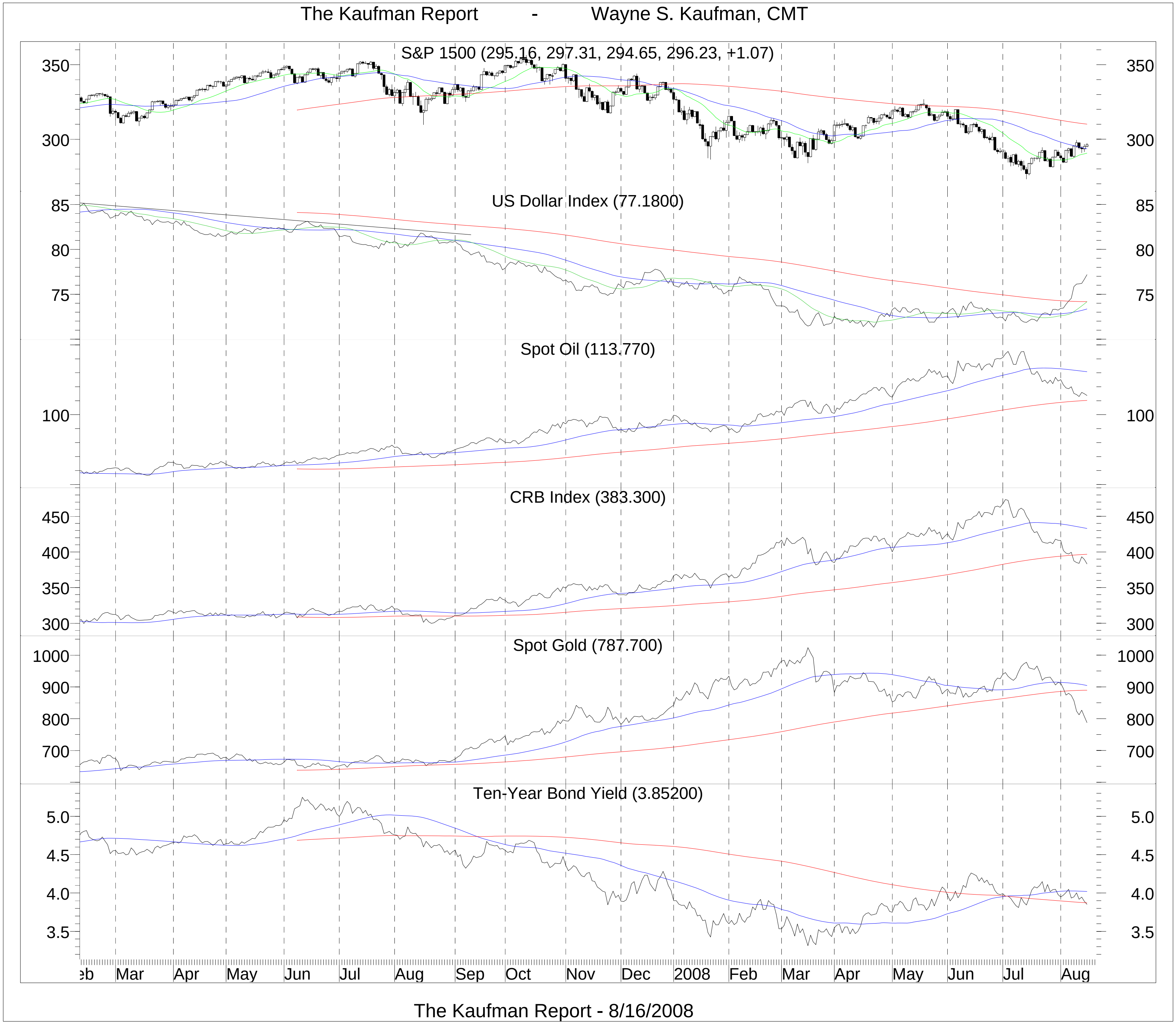
Our statistics of supply (red lines) and demand (green lines) show that buying has been decreasing as stocks have moved higher.



The P/E ratio continues to move higher as stocks rise and earnings drop. It is at the highest level since January 2004. At that time it was dropping. The forward P/E is 15.47, not far from the 15.82 it hit at the May 19th top for stocks.

The 10-year bond yield is about the same as the S&P 1500 earnings yield, making the spread about zero. The spread based on the forward P/E is in the area where stocks should be attractive, but at the level of the May 19th top.

Current (green)and projected (blue) earnings continue to move inexorably lower.



The U.S. Dollar Index has had a spectacular rise, and is short-term very overbought.

Oil has plunged near the 200-sma (red) and printed a hammer on the daily chart (not shown). It is nearing oversold levels.

The commodities index is below the 200-sma. Last week it became oversold.

Gold has had a breath-taking collapse and is very oversold.

10-year bond yields are below their 200-sma and are not yet oversold.