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The Kaufman Report

Trade what you see, not what you think.

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Monday August 4, 2008 **Closing prices of August 1, 2008**

The S&P 1500 was up or down over 1.3% on four of the five sessions last week, but closed the week almost unchanged with a 0.262% gain. This was the third week in a row with the index closing at an almost identical level (287.14, 286.60, and 287.35) in spite of extreme daily swings. Is this a mere coincidence or evidence for Plunge Protection Team conspiracy theorists?

Last week we said we were very concerned about the P/E ratio, which was back near the levels seen at the May 19th top. We remain concerned as the P/E ratio of the S&P 1500 has now hit the highest level since January 2004. The difference is now it is rising, while at that time it was coming down. <u>The spread between the 10-year bond yield and the earnings yield based on the current P/E ratio has reached very low levels. These levels were seen at May 2006, July 2007, and June 2008. Each of those occurrences was followed by a sharp drop in equities.</u> 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.

The problem is that aggregate reported earnings have been dropping precipitously, while projected earnings are also moving inexorably lower, although at a slower rate. <u>If bond yields hadn't dropped sharply at the end of last week, the earnings yield of the S&P 1500 and the 10-year bond yield would be just shy of parity</u>.

Should stocks rally and break resistance levels, we would interpret that as a sign that investors have confidence in forecast earnings, along with the expectation that reported earnings are bottoming. However, we find that scenario difficult to except, considering poor forecasts given of late by major companies, a slowing economy, and the fact that many recently leading sectors still have profit margins well above their historical averages. Therefore, we expect forecast earnings to continue to move lower and narrow the extremely wide spread between current and forecast earnings, which is at the widest level seen in years.

In spite of so many negative developments, options buyers, based on our proprietary options indicator, are becoming bullish. This optimism is not at the extreme levels seen at tops, but it will probably prevent any rally from going too much higher, and could set the stage for another sharp drop.

The current rally is still intact, so investors should continue to trade the long side. However, the recent rally has been led by former laggards, while former leaders appear to have abdicated. Valuations are at levels where equities have been vulnerable in the past, and short-term sentiment is getting bullish. We have entered the seasonally weak months of August and September, and we are also seeing some negatives in short-term timing indicators. <u>*Therefore, investors should be on high alert for the possibility that equities may be about to make another leg down.*</u> The factors that could help keep the current rally going would be a continued drop in interest rates and/or the price of crude oil, and an extremely active Fed.

<u>The short-term trend is up, the intermediate and long-term trends are down, and 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.</u>

IMPORTANT DISCLOSURES

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Monday August 4, 2008 **Closing prices of August 1, 2008**

So far 380 companies in the S&P 500 have reported second quarter earnings. According to Bloomberg, 69.7% have had positive surprises, 6.6% have been in line, and 23.7% have been negative. The year-over-year change has been -20.3% on a share-weighted basis, -20.3% market cap-weighted, and -10.1% non-weighted. Ex-financial stocks these numbers are 4.2%, 7.4%, and 6.0%, respectively.

Federal Funds futures are pricing in a 93.1% probability that the Fed will *leave rates at 2.00%,* and a 6.9% probability of *raising 25 basis points to 2.25* when they meet on August 5th.

The S&P 1500 (287.35) was down 0.506% Friday. Average price per share was down 0.51%. Volume was 85% of its 10-day average and 83% of its 30-day average. 48.65% of the S&P 1500 stocks were up on the day. Up Dollars was 27% of its 10-day moving average and Down Dollars was 88% of its 10-day moving average.

For the week the index was up 0.262% on declining and below average weekly volume. A doji-like high wave candle was printed on the weekly chart, which is a sign of indecision.

Options expire August 15th.

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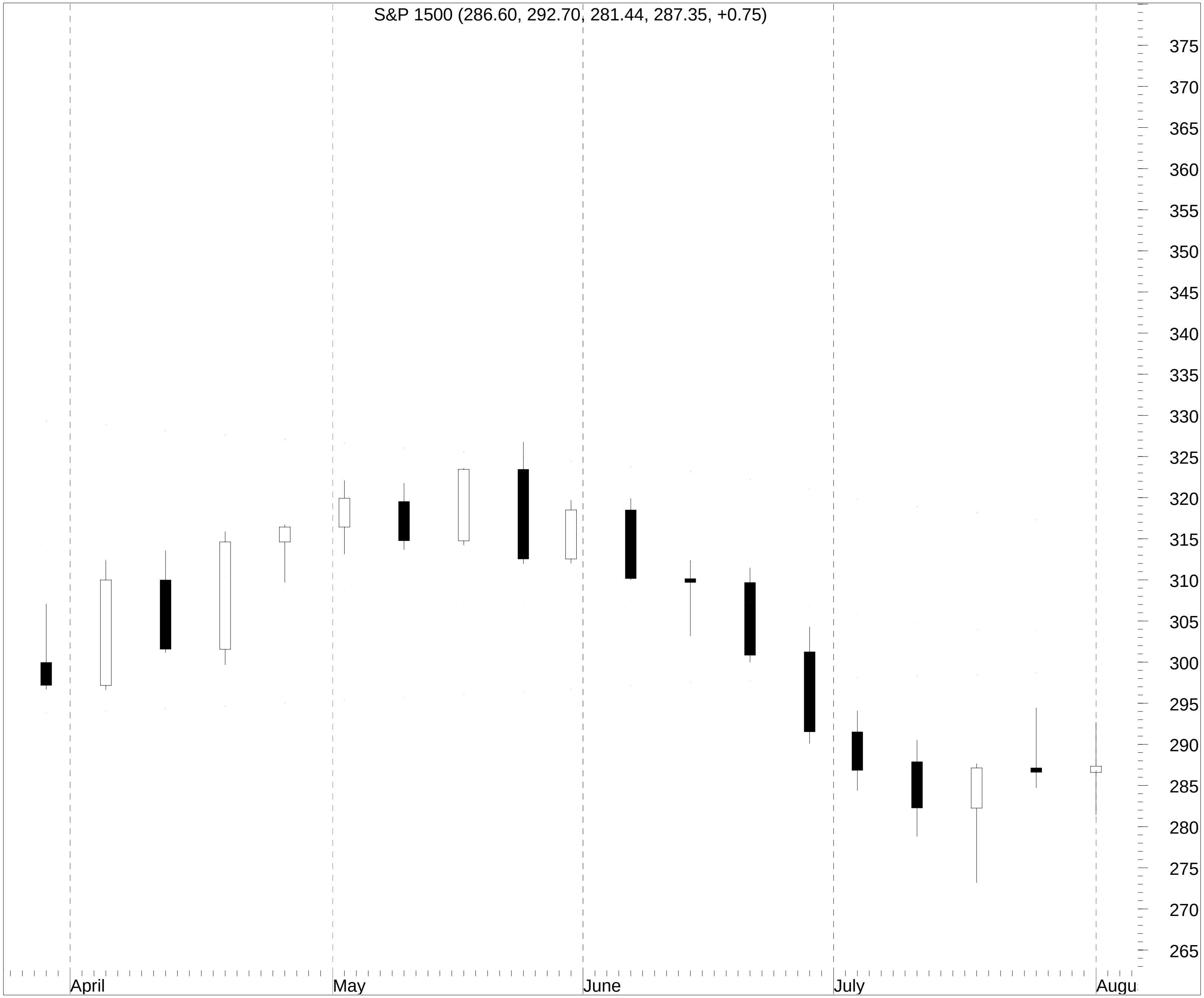


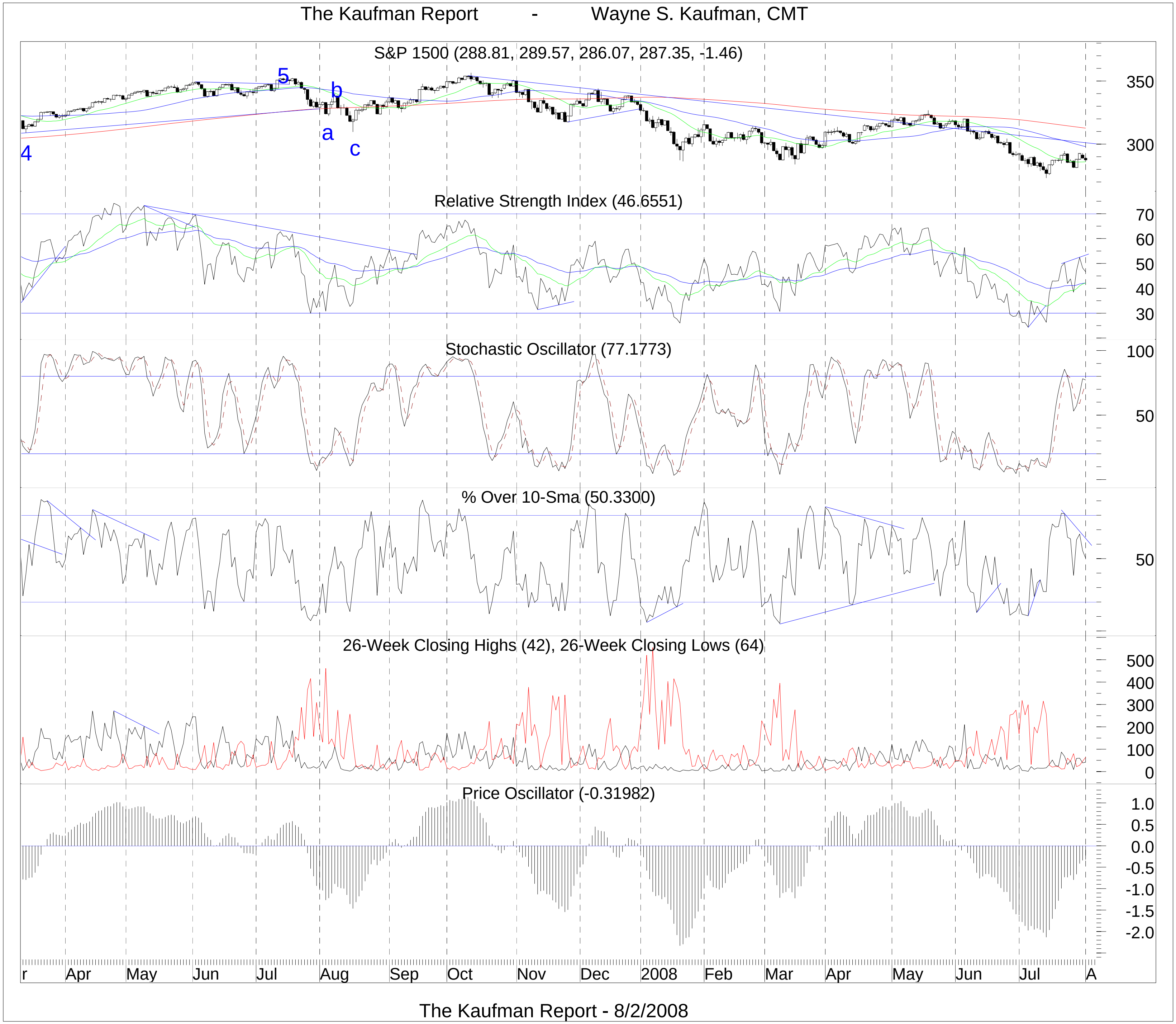
The S&P 1500 has closed the last three weeks at 287.14, 286.60, and 287.35. A coincidence or evidence for conspiracy theorists?

The hammer printed three weeks ago is a positive sign that a bottom could be in. Hammers are bottoming candles.

The Kaufman Report - Wayne S. Kaufman, CMT

We have been calling this a bear market since January 2008 when the S&P 500 and S&P 1500 moved below their 80-week moving averages. There is room for a rebound, but it will take a lot to repair the technical damage.

The S&P 1500 has been following technical supports and resistance. The rally off the July low retraced 38.2% of the plunge from the May top. Then the index moved down and retraced 61.8% of the rally off the July low. After a two-day rally, Thursday and Friday it moved down to the 20-day moving average before bouncing slightly. There is now an up trend line from the July low. A move above resistance at the 294 area targets the 300 area, which is a 50% retracement of the May - July plunge.

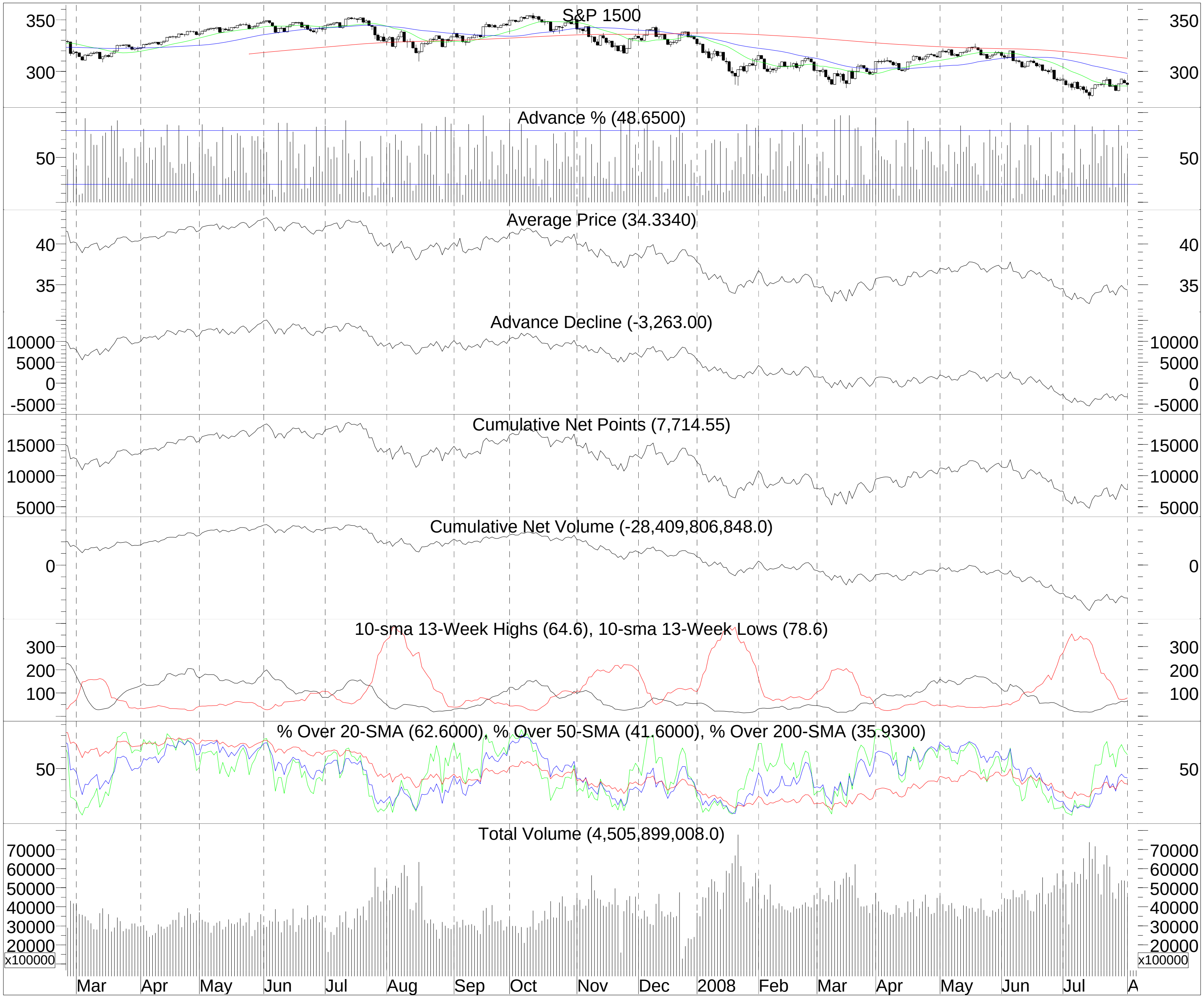


The RSI is showing a negative reversal (higher RSI peak with lower or equal corresponding price) with a target of 279.83, or 2.6% below the current price.

The percent over 10-sma is showing a negative divergence.

26-week highs and lows isn't telling us much.

Our price oscillator remains in negative territory after rebounding from a very oversold condition.



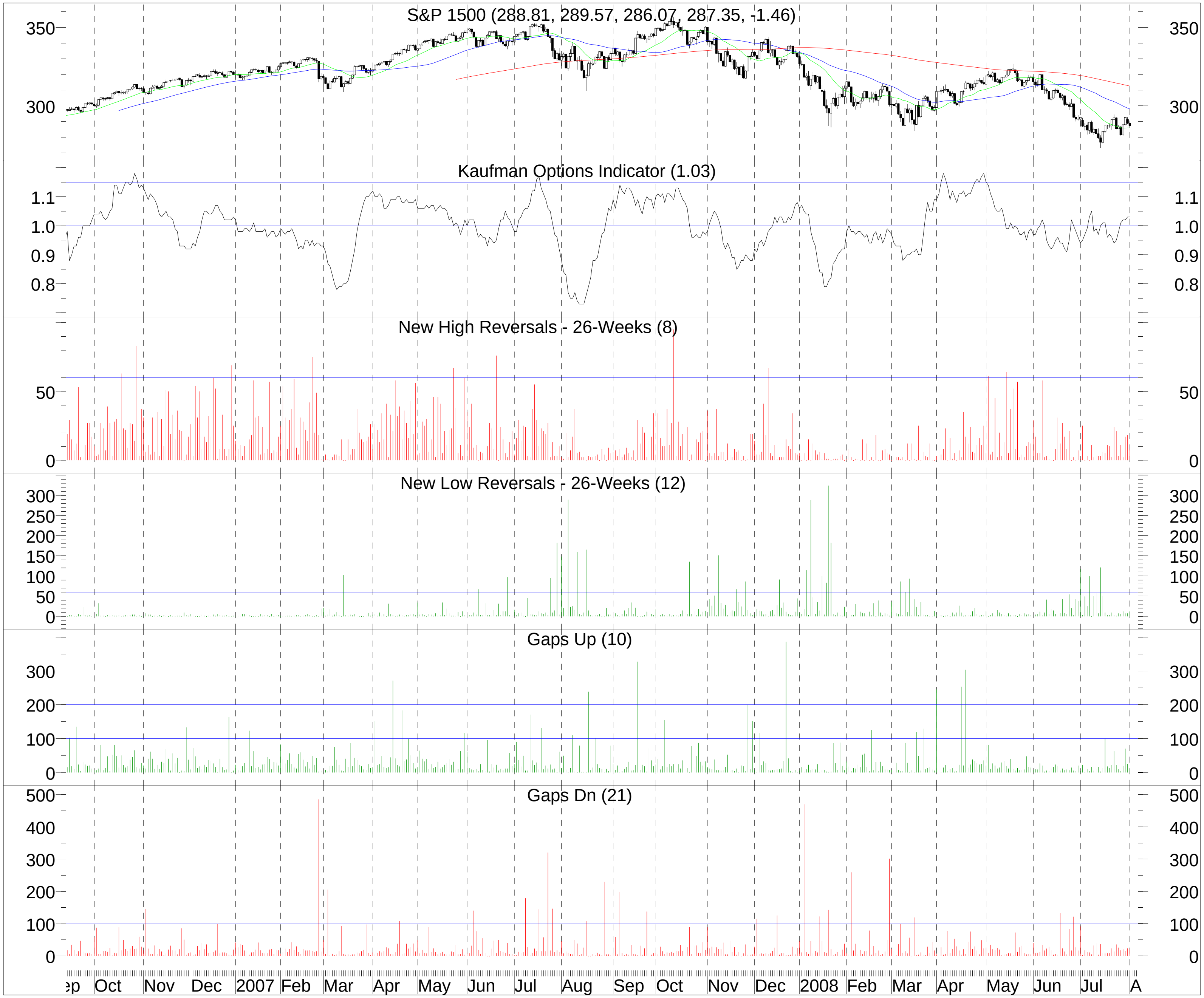
48.65% of the S&P 1500 traded higher Friday.

The AD line is above levels of 20-days ago, which is a positive.

The 10-sma of 13-week highs and lows are very close. However, new lows still dominate.

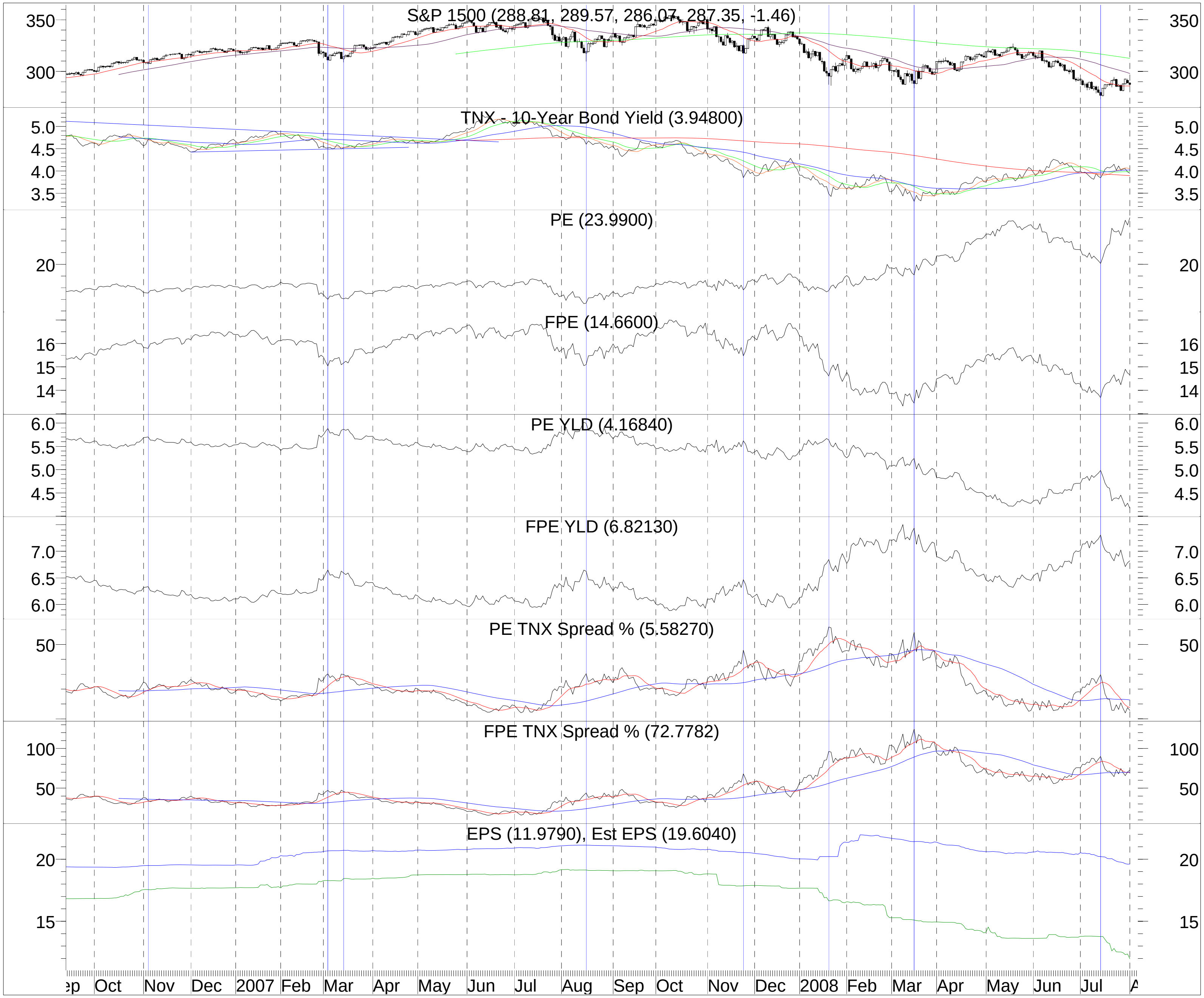
62.6% of stocks are over their 20-day moving avg.

Friday's volume was light, as was the weekly volume.



Options buyers have become slightly bullish, which will probably cap the up side of any rally. Too much bullishness can set the stage for a sharp move down.

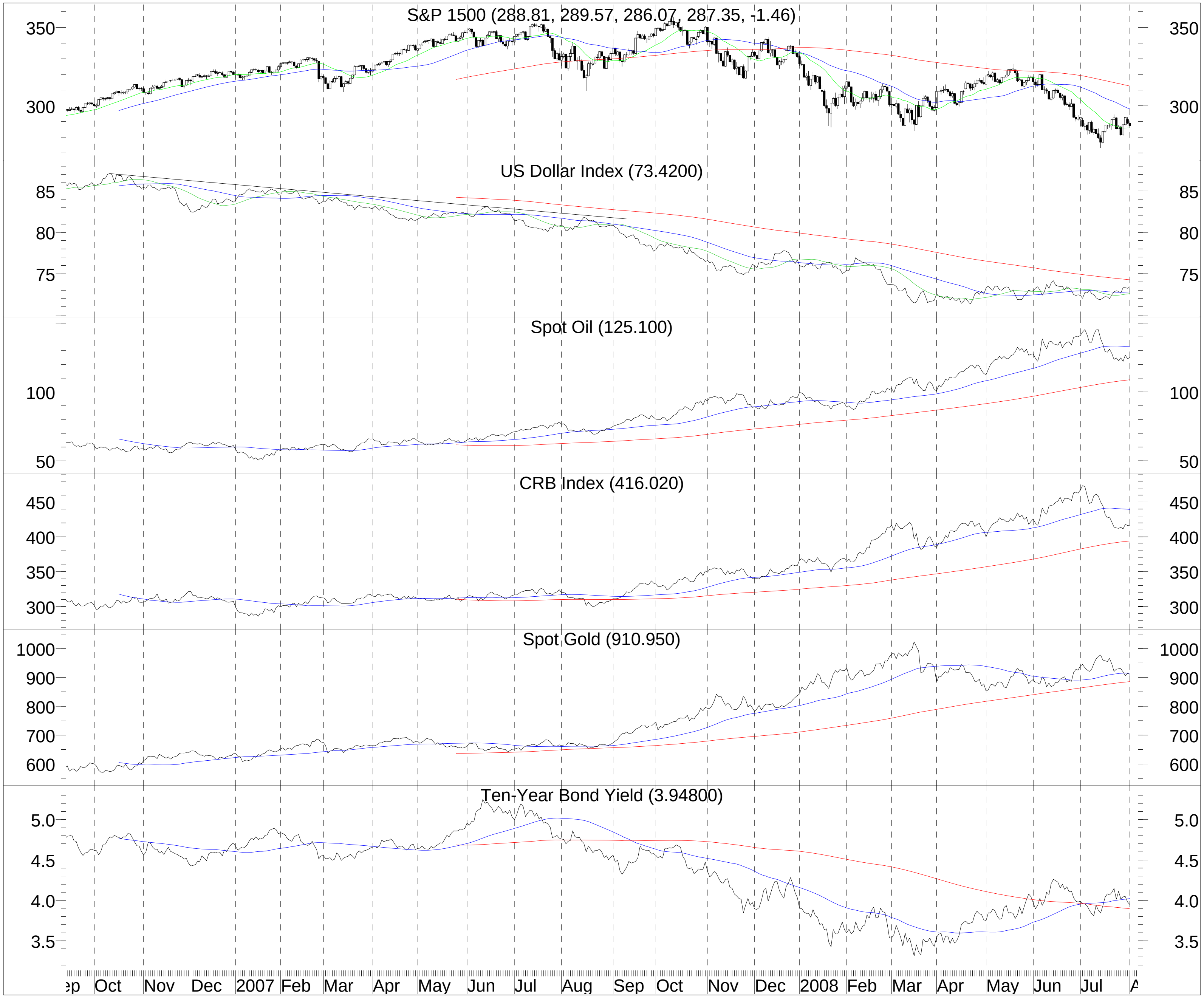
Most of the 10 and 20-day statistics of demand (green lines) are above the statistics of supply. However, up volume and up dollars have been pulling back, while up points are stronger for the 10-day period. This shows a high degree of selectivity in the amount of stocks doing well.



The P/E ratio is breaking out to new highs. It is the highest since January 2004, but at that time it was coming down, while now it is going higher.

The spread between the 10-year bond yield and the earnings yield based on the current P/E is at levels seen at May 2006, July 2007, and June 2008. Each of those occurrences was followed by a sharp drop in equities.

Reported (green) and forecast (blue) earnings continue to move inexorably lower.



The U.S. Dollar Index is showing strength as it stays above the 20 and 50-sma. Important resist-ance is at the 74 area, where there is price and 200-sma (red) resistance.

Crude oil put in a confirmed double top, and is hanging on to support in the low 120s. A break below 120 targets the 110 - 112 area.

Gold is below its 50-sma but still above its 200 (red). Any continued strength in the US. Dollar could push it below the 200-day.

Weak economic reports pushed bond yields lower last week. They are still above the down sloping 200-sma (red).