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The Kaufman Report

Trade what you see, not what you think.

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Friday August 8, 2008 **Closing prices of August 7, 2008**

Stocks dropped sharply Thursday due to greater than expected jobless claims along with bad news from Wal-Mart and AIG.

Pollution in China not only throws smog over the Olympics, it clouds the economic picture. China has shut down hundreds of factories to prevent blackouts from power problems and to stop pollution. Until the Olympics are over it will be impossible to say how much of this slowdown in production is temporary and its effects on global commodities markets.

We remain concerned about the P/E ratio of the S&P 1500, which 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, and on Wednesday the bond yield was actually above the earnings yield. It is below levels 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.

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 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 largely by former laggards, while former leaders appear to have abdicated. Valuations are at levels where equities have been vulnerable in the past, short-term sentiment is getting bullish, and we have entered the seasonally weak months of August and September. <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>

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So far 446 companies in the S&P 500 have reported second quarter earnings. According to Bloomberg, 68.1% have had positive surprises, 6.5% have been in line, and 25.4% have been negative. The year-over-year change has been -21.7% on a share-weighted basis, -21.6% market cap-weighted, and -10.6% non-weighted. Ex-financial stocks these numbers are 4.4%, 7.5%, and 5.2%, respectively.

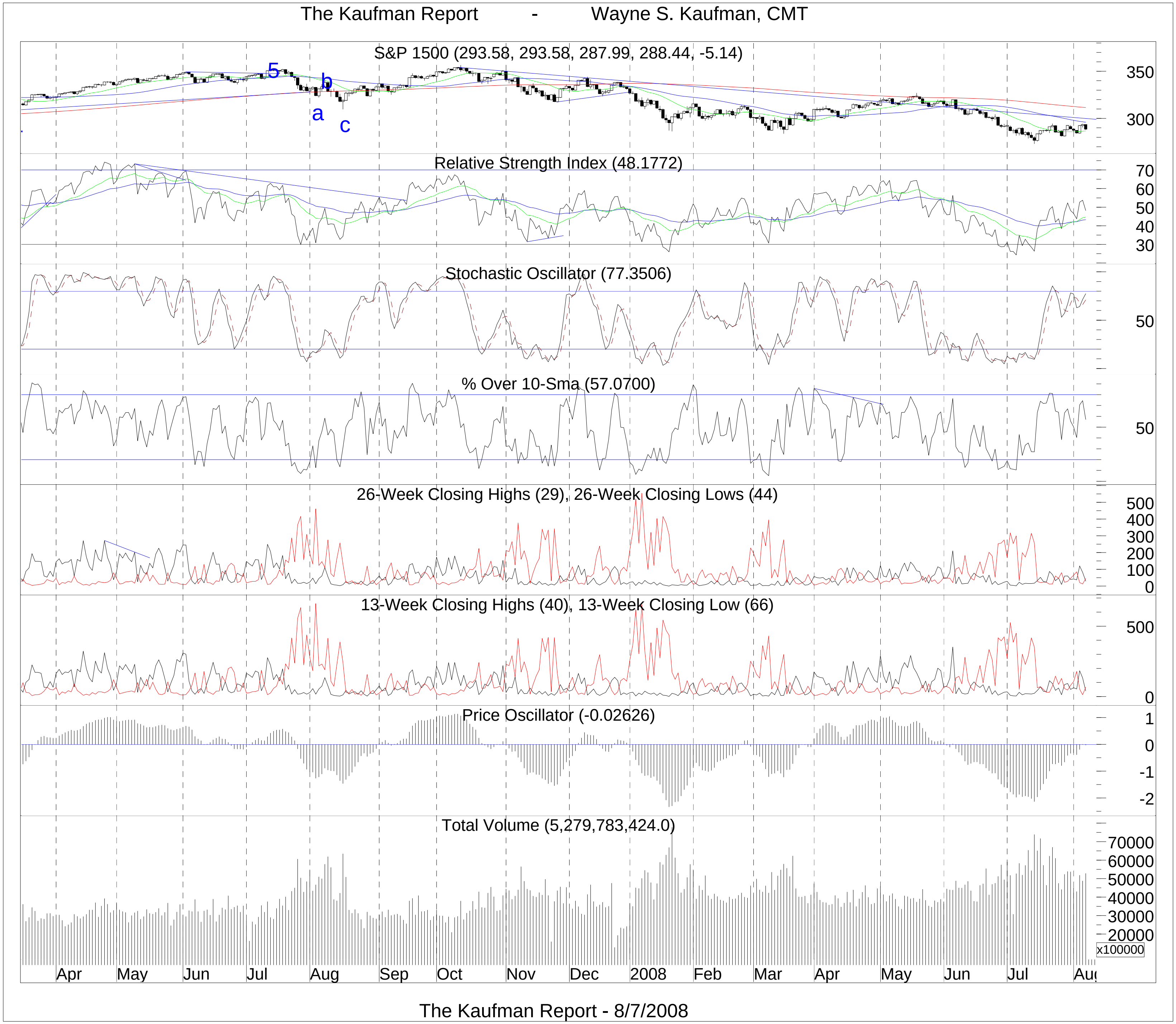
Federal Funds futures are pricing in a 82.0% probability that the Fed will *leave rates at 2.00%,* and a 18.0% probability of *raising 25 basis points to 2.25* when they meet on September 16th.

The S&P 1500 (288.44) was down 1.751% Thursday. Average price per share was down 1.53%. Volume was 107% of its 10-day average and 97% of its 30-day average. 21.57% of the S&P 1500 stocks were up on the day. Up Dollars was 6% of its 10-day moving average and Down Dollars was 221% of its 10-day moving average.

Options expire August 15th.

IMPORTANT DISCLOSURES

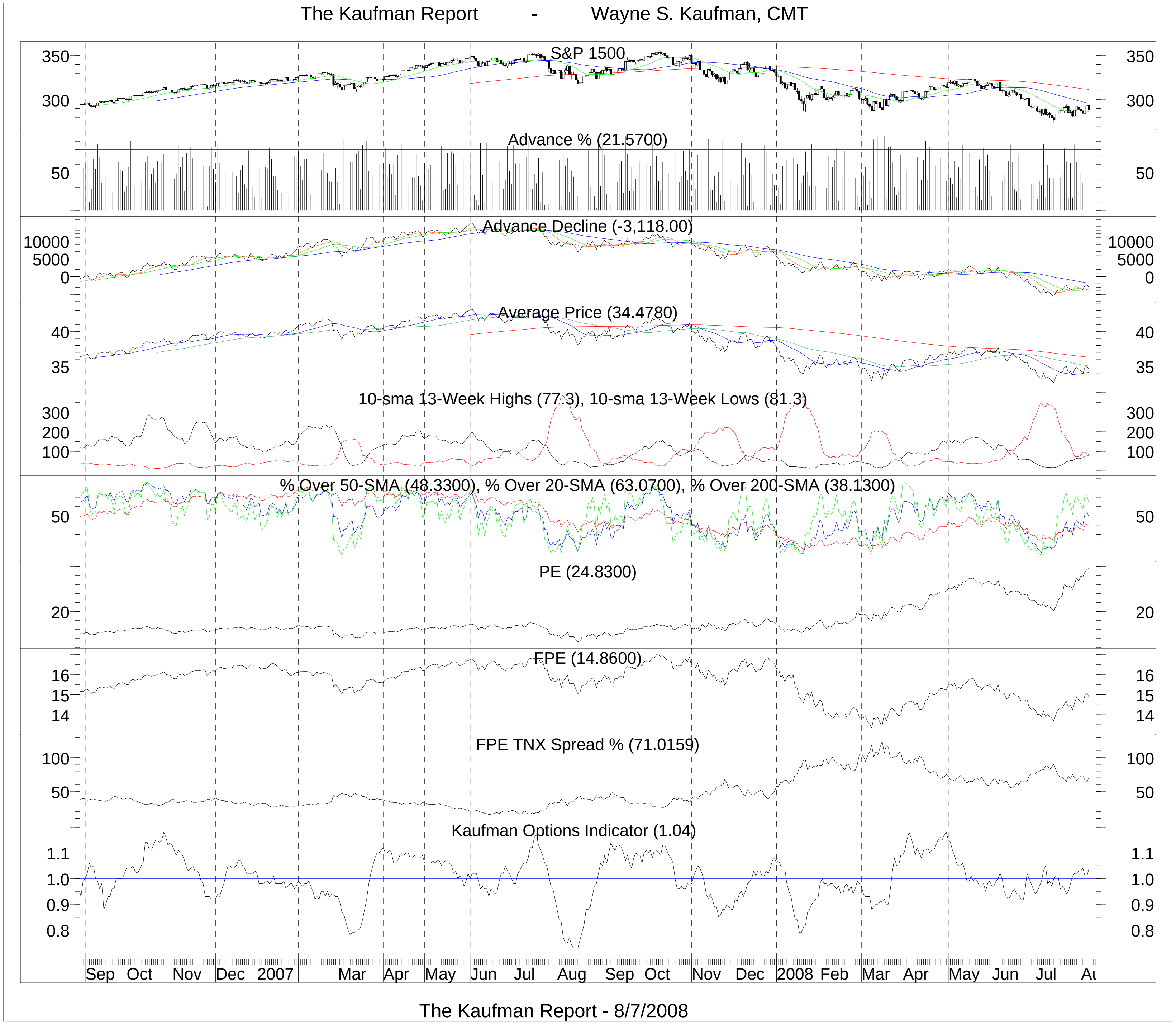
The S&P 1500 pulled back to the up trend line Thursday. There is price resistance at the 295 area, which is the 38.2% retracement level of the May 19th to July 15th plunge, with the 50-sma (blue) just above.



Our oscillators are neutral.

Our price oscillator is near the neutral line.

Volume expanded on Thursday's sell off.



21.57% of stocks traded higher Thursday.

The P/E ratio continues to climb, and is at the highest level since Jan. 2004. At that time it was dropping, not rising.

Current and forecast earnings continue to drop, causing the earnings yield to fall below the 10-year bond yield Wednesday.

Our proprietary options indicator is showing bullishness. It is not the extremes seen at tops, but it will prevent a big rally and leaves stocks vulnerable to a large drop.