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The Kaufman Report

Trade what you see, not what you think.

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Monday December 20, 2010 **Closing prices of December 17, 2010**

Stocks rallied again last week although it was with weakening momentum. The S&P 500 managed to rise only 0.28% for the week, and no major index recorded gains over 1%, but 52-week highs were recorded during the week by all the major indexes except the Bank of New York Mellon ADR Index.

Equities have continued their levitation act in spite of increasing selectivity on the part of investors, momentum indicators that remain overbought, and overbullishness on the part of options buyers. The selectivity can be seen by the 365 13-week closing highs made on Friday, compared to the 506 on 12/10 and 692 on 11/4. The overbullishness is seen in our proprietary options indicator which hit 1.18 on Tuesday, the highest reading since 12/31/2008. This shows options buyers loading up on calls, a condition that leaves stocks vulnerable to pullbacks.

We remain in a period of strong seasonality. **Sellers remain on the sidelines, so even though a pullback can occur at any time, unless major negative news appears the path of least resistance for stocks should be higher.**

We have continually stressed that valuations for equities were very attractive. They still are, but the recent move higher of interest rates has the potential to change this picture should it continue much longer. Spreads between bond and equity yields have narrowed but remain at levels where stocks are attractive versus bonds. Projected earnings have been nudging up recently, and we are hoping to see a replay of January 2010 when reported and projected earnings leaped higher. Currently S&P 500 projected earnings for 2011 are in the $97 range. **A conservative 14 P/E using $97 puts the S&P 500 at 1358.** Should first quarter earnings season follow the recent trend and beat estimates handily, those numbers will move higher.

We are now in a period of positive seasonality for equities. **November through January is historically the best three-month period of the year. As far as the presidential cycle, we will soon be leaving year two and entering year three. Since 1939 the Dow Jones Industrial Average has not had a single down year three, with the average gain being 16.6%. In addition, based on the S&P 500 since 1914, from the low of year two to the high of year three the average move has been 49.2%. Through the last seven presidential cycles since 1982, the average low-to-high move has been 50.06%. From this year's S&P 500 low of 1010 that would equate to a move to 1500 sometime in 2011. We are not forecasting that, just highlighting that it is difficult to be bearish in the face of such strong historical patterns.**

Based on the S&P 500 the short-term, intermediate-term, and long-term trends are up. Pullbacks that are without intensity should be viewed as entry points for investors.

IMPORTANT DISCLOSURES

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The S&P 500 is just below its 52-week high.

30-minute momentum indicators seem to be headed lower.

The S&P 500 candles on Monday and Tuesday formed a "tweezers top". The index dropped Wednesday before rebounding Thursday, then printing a doji on Friday. Doji are signs of indecision. Still, the index did make a new closing high.

Daily momentum indicators are mixed.

The weekly chart of the S&P 500 shows that after breaking out of a resistance zone it stalled out last week printing a doji candle. Doji are signs of indecision. It did print a new weekly closing high.

Weekly momentum indicators are at high levels with a slight negative divergence on the RSI.

The monthly chart of the S&P 500 shows it has moved above the 61.8% retracement level which was resistance in November. The next important level is 1361.50, which is the 76.4% retracement level of the entire bull market.

Monthly momentum indicators are pointing higher, with the stochastic just entering the overbought zone.

The Nasdaq 100 made a new closing high Friday but pulled back printing a spinning top candle.

Daily momentum indicators are moving sideways with the stochastic in the overbought zone.

The weekly chart of the Nasdaq 100 shows it is just shy of its November 2007 high.

Weekly momentum indicators are at high levels but have not turned down yet.

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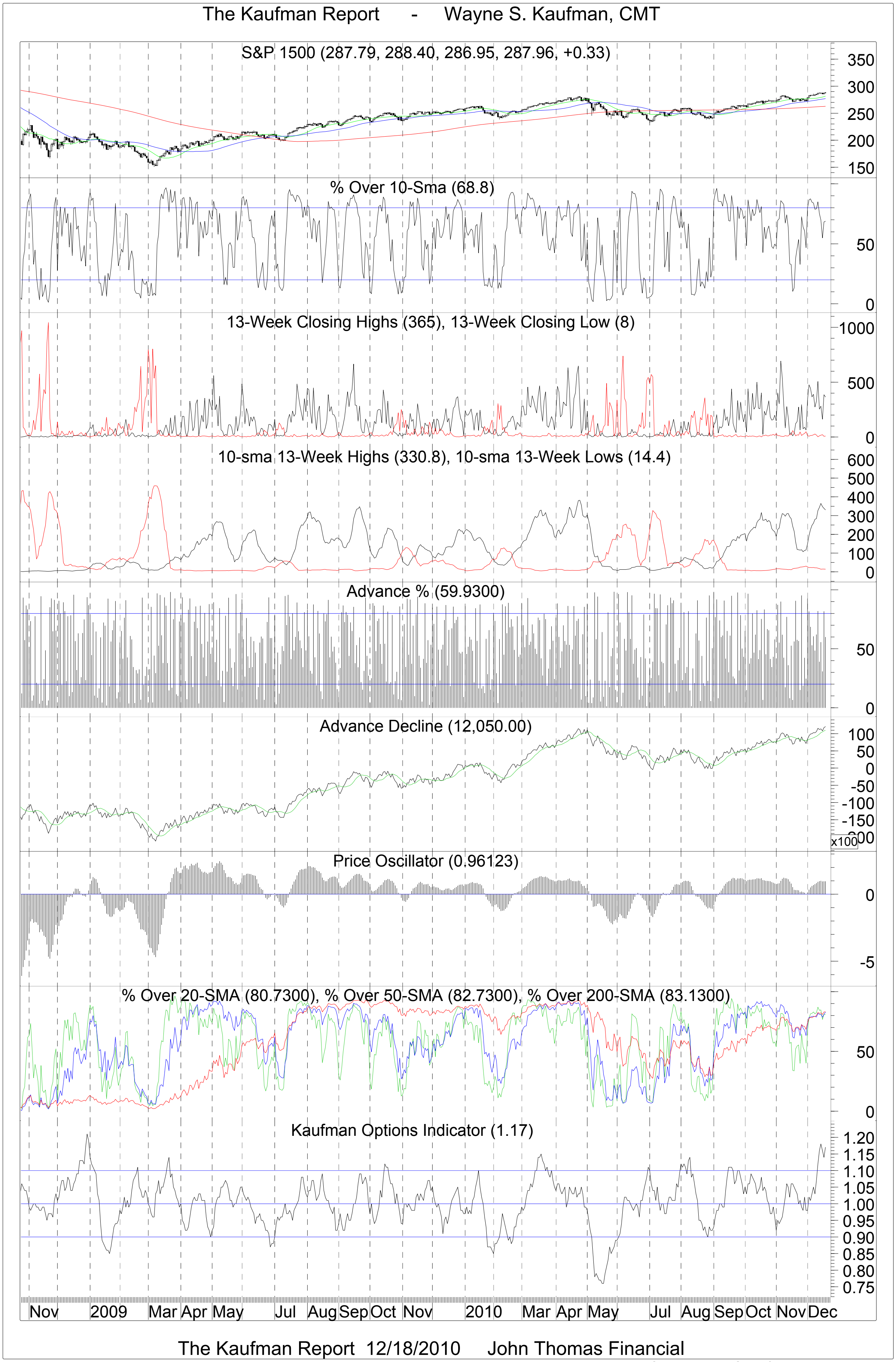
The monthly chart of the Nasdaq 100 shows it is just under its 2007 high. Surpassing 2239.23 will be the highest level since February 2001.

Monthly momentum indicators still look good with only the stochastic in the overbought zone.



In spite of the S&P 1500 making a new 52-week closing high Friday only 68.8% of stocks are over their own 10-sma. This shows increasing selectivity by investors.

365 closing highs Friday is less than 506 on 12/10 and 692 on 11/4, again showing increased selectivity.

The 10-sma of 13-week closing lows has been decreasing, showing a lack of sellers.

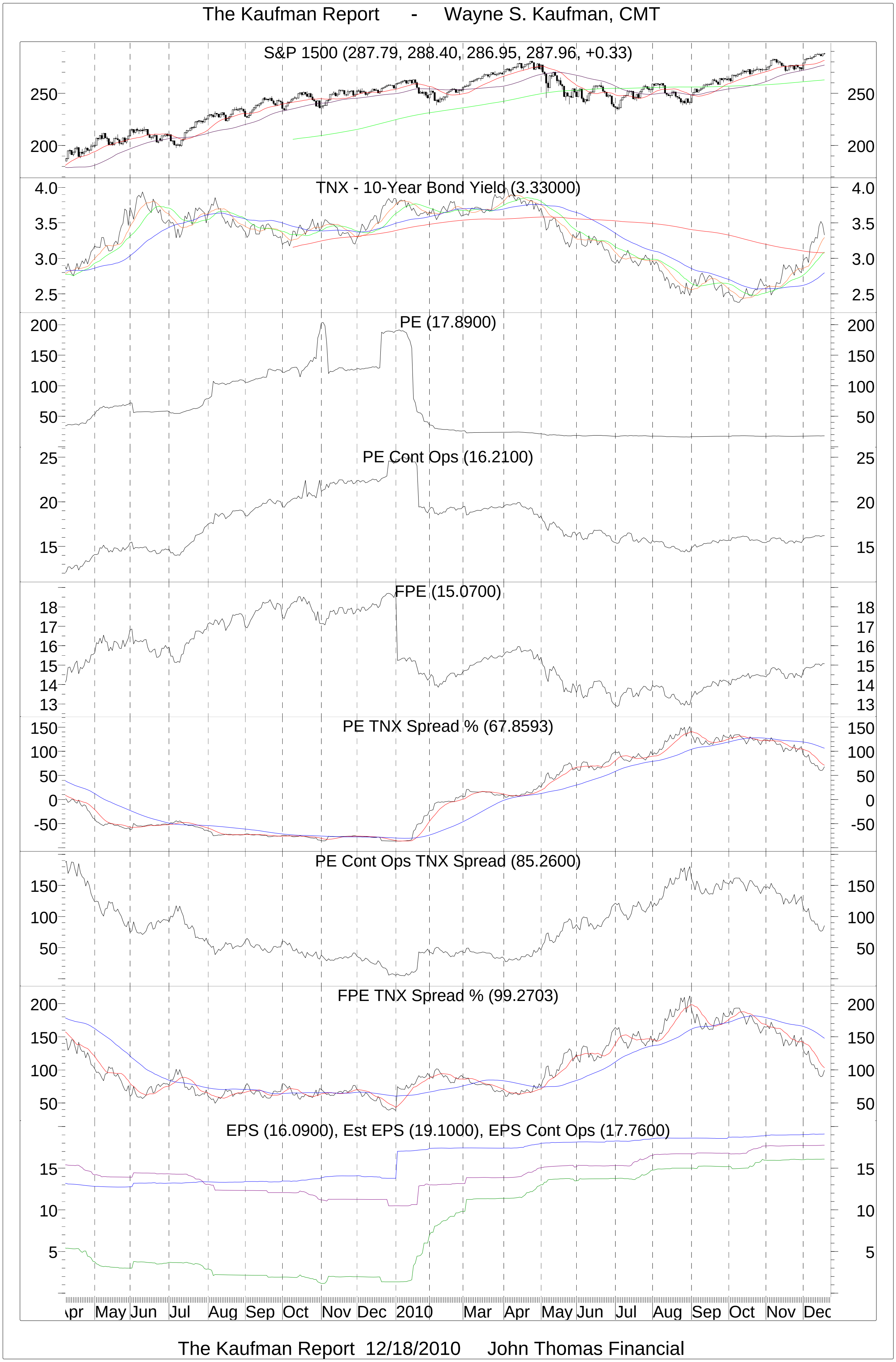
Only 59.9% of stocks traded higher Friday.

The S&P 1500 AD line, a leading indicator, made a new high Friday, pointing to higher prices in the future.

Our price oscillator remains in positive territory.

Bullish numbers here but the percent over 10-sma at 68.8% is a short-term red flag.

Our proprietary options indicator is at 1.17 after hitting 1.18 Tuesday, the highest since 1.19 on 12/31/2008. Options buyers have been buying lots of calls, and this level of bulishness leaves stocks vulnerable to a pullback.



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Last week we said the weekly RSI was at a level where 10-year bond yields had topped in the past. They became very overbought on the daily chart Thursday and then pulled back Friday. It is just above its 10-sma.

P/E ratios have been trending higher as stocks moved higher.

Spreads between equity and bond yields have narrowed dramatically but bounced a little as bond yields dropped at the end of the week. They remain at levels where stocks should be attractive compared to bonds.

Projected earnings have been edging higher. We are hoping for a replay of January 2010 when they made a sharp move higher. If so stock valuations will be very attractive.