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The Kaufman Report

Trade what you see, not what you think.

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Monday December 8, 2008 **Closing prices of December 5, 2008**

We said last Sunday that after the best five-day rally in decades we believed the low for the year was in. We were expecting a pull back from oversold short-term levels, but Monday's plunge was worse than we expected and made us wonder about a possible retest of the November lows. Thereafter the bulls regained control, giving us renewed confidence in our thesis that November 21st would be the low for the year.

The recent rally off of the November lows remains intact unless the low of 12/1 is broken. On the other hand, further upside confirmation will take place on a break above the high of 11/28. We remain cautiously optimistic as stocks are at an inflection point. We also want to reiterate that we consider this to be a bear market rally.

Our reasons for believing November 21st marks the 2008 low are: valuations based on spreads between equity and bond yields as well as the S&P 500 dividend yield moving above the 10-year bond yield for the first time since 1958; the recent uptrend still being intact with the best 10-day breath statistics seen in many years; stocks rallying in the face of very bad economic news; individual stocks having constructive chart patterns for the first time in a while; 591 key reversals of stocks in the S&P 1500 on 10/21; a positive divergence regarding the number of intra-day lows on 10/21 versus 10/10 (764 versus 1187); third-quarter earnings season being 98% over with reported aggregate earnings actually rising slightly since 10/24 and therefore not likely to resume a move lower until January; positive seasonality.

Our concerns would be too much bullishness as shown by our options indicator, the possibility of continued liquidations on the part of hedge funds and mutual funds, and the chance that new horrific economic news is not well received. We also expect continued volatility in the near-term as we have an FOMC meeting on 12/16, a quadruple witching options week with the expiration on 12/19, and mid-month earnings reports by major broker/dealers.

On a different note, the automobile companies continue lobbying for bailout money as we discussed briefly in Friday's report. We view any funds given to them as nothing more than a make work project. We also can't take at pure face value pronouncements that the U.S. automobile industry will just disappear throwing millions out of work if the bailout doesn't take place. If demand for cars is shrinking dramatically, won't huge amounts of these workers be unemployed anyway? The lack of any type of detailed plan is reminiscent of Hank Paulson's early TARP plans, and we all know how that is working out.

Lastly, many Americans were heartened recently by comments made by Fed Chairman Ben Bernanke. He was addressing whether or not the current economic malaise could become as bad as the Great Depression. Bernanke assured everyone that this was not possible, and that he should know, having extensively researched the Depression and written books on the subject. Our reaction to this is that based on his many assertions over the last two-years or so that the sub-prime crisis would not spread to the rest of the economy, we assume his research skipped entirely the subject of recessions and went straight to the Great Depression. Perhaps this would be a good time for him to go back and fill in those gaps.

IMPORTANT DISCLOSURES

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The S&P 1500 (197.70) was up 3.752% Friday. Average price per share was up 4.40%. Volume was 100% of its 10-day average and 102% of its 30-day average. 89.36% of the S&P 1500 stocks were up on the day, with up volume at 88.8% and up points at 95.8%. Up Dollars was 99.6% of total dollars, and was 143% of its 10-day moving average while Down Dollars was 1.1% of its 10-day moving average. The index is down 2.33% month-to-date, down 25.67% quarter-to-date, down 40.34% year-to-date, and down 44.53% from the peak of 356.38 on 10/11/07. Average price per share is $22.87, down 47.10% from the peak of $43.23 on 6/4/2007.

The Put/Call Ratio was 0.918. The Kaufman Options Indicator was 1.07.

The spread between the reported earnings yield and 10-year bond yield is 102% and 221% based on projected earnings. These are unheard of levels*. *The dividend yield on the S&P 500 recently moved higher than the 10-year bond yield for the first time since 1958.

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $10.64, a drop of 44.53%, and have been moving slightly higher since $10.57 on 10/24. Estimated aggregate earnings peaked at $21.95 in February 2008, are still moving lower, and are now $16.87, a drop of only 23.14%. Analysts have obviously been very late in lowering estimates. *If investors had any confidence in current earnings estimates stocks would be much higher than they currently are.*

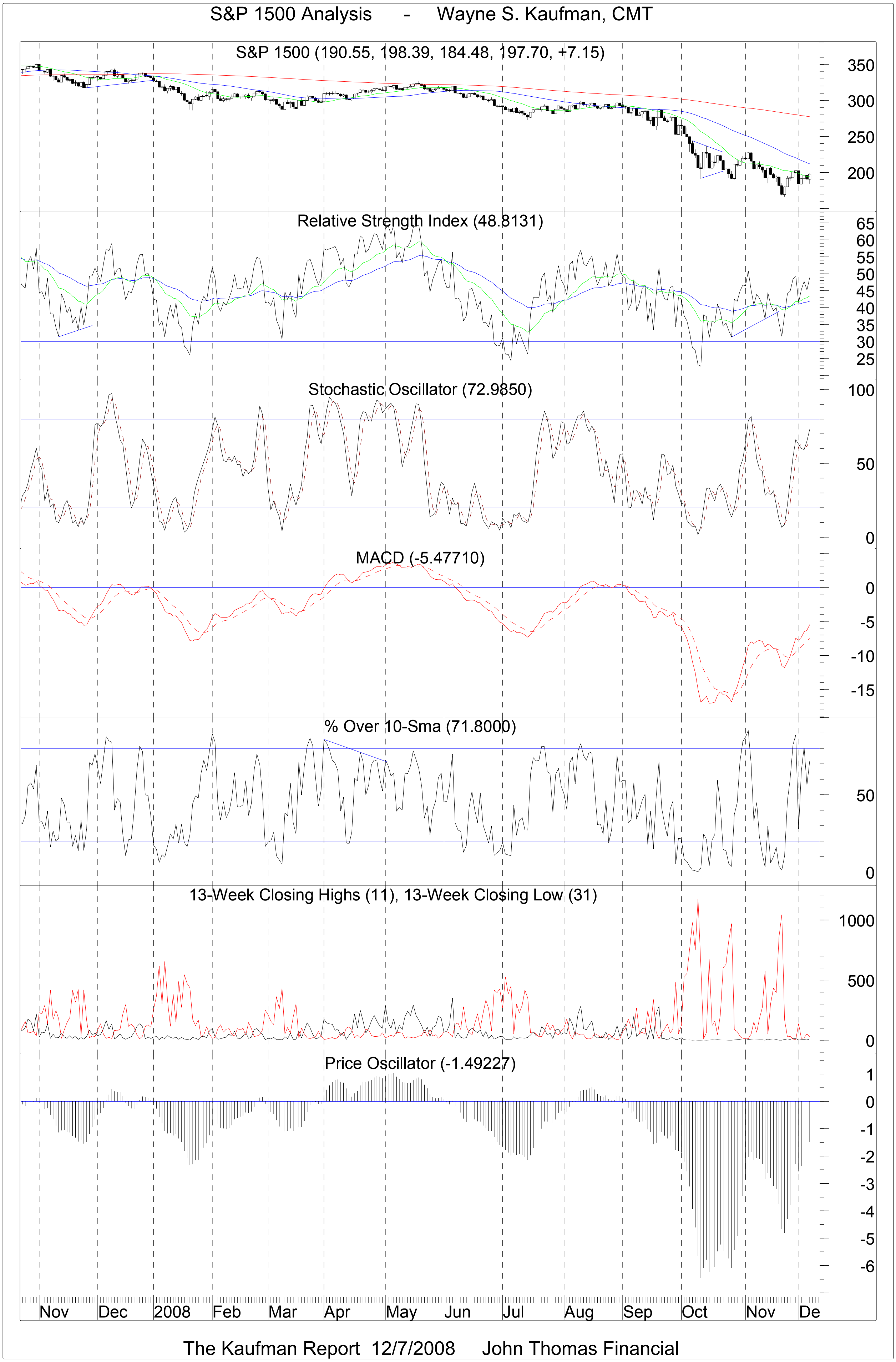
491 companies in the S&P 500 have reported third quarter earnings. According to Bloomberg, 58.3% have had positive surprises, 9.2% have been in line, and 32.5% have been negative. The year-over-year change has been -18.3% on a share-weighted basis, +5.3% market cap-weighted, and -2.6% non-weighted. Ex-financial stocks these numbers are 10.1%, 23.7%, and 16.0%, respectively.

Federal Funds futures are pricing in a 22.0% probability that the Fed will *cut rates 50 basis points to 0.50%*, and a 78.0% probability of *cutting 75 basis points to 0.25%* when they meet on December 16th. They are pricing in a 70.2% probability that the Fed will *cut rates 50 basis points to 0.50%* on January 28th, and a 62.7% probability of *cutting 75 basis points to 0.25%.*

The short-term trend is now up, while the intermediate and long-term trends remain down. We reiterate that this continues to be an opportunistic trader's market, with adept traders able to take advantage long or short, but the primary downtrend must still be respected. Investors should not hesitate to move out of laggard sectors and stocks and into leaders.

IMPORTANT DISCLOSURES

The S&P 1500 remains in a short-term up trend and is above the 20-sma (green). The rally is intact as long as the index stays above the lows of 12/1, while a move above the high of 11/28 would be a bullish signal. The 50-sma (blue line) will be coming into play soon.

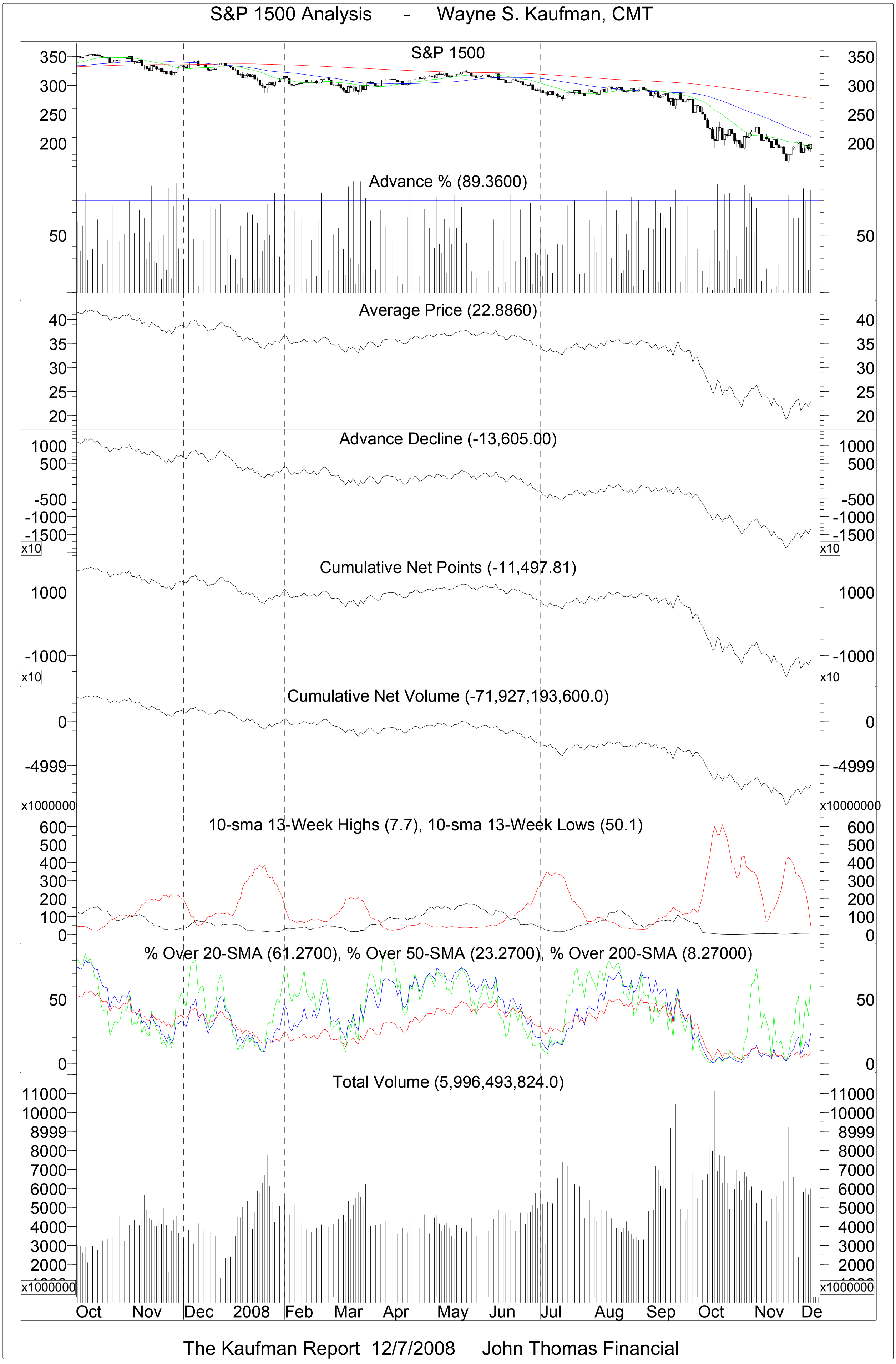


The RSI is at the level where it has topped three times before.

The stochastic is on a buy signal, and the MACD has a positive crossover.

The percent over 10-sma is at a high level, but not overbought.

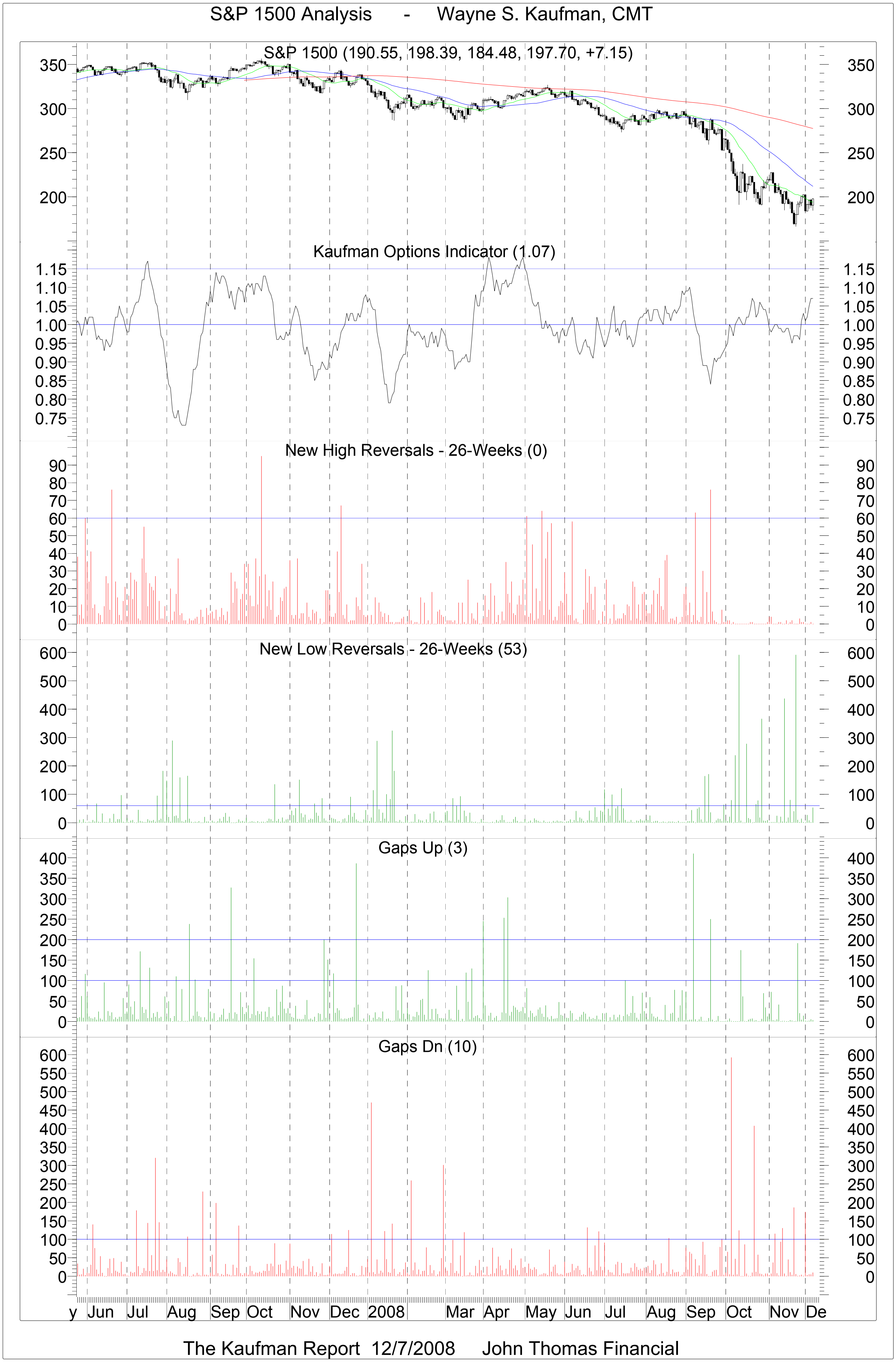
Our price oscillator remains in negative territory and has been there for an extended period.



89.36% of stocks traded higher Friday.

Our breadth statistics have had the best 10-day period in many years.

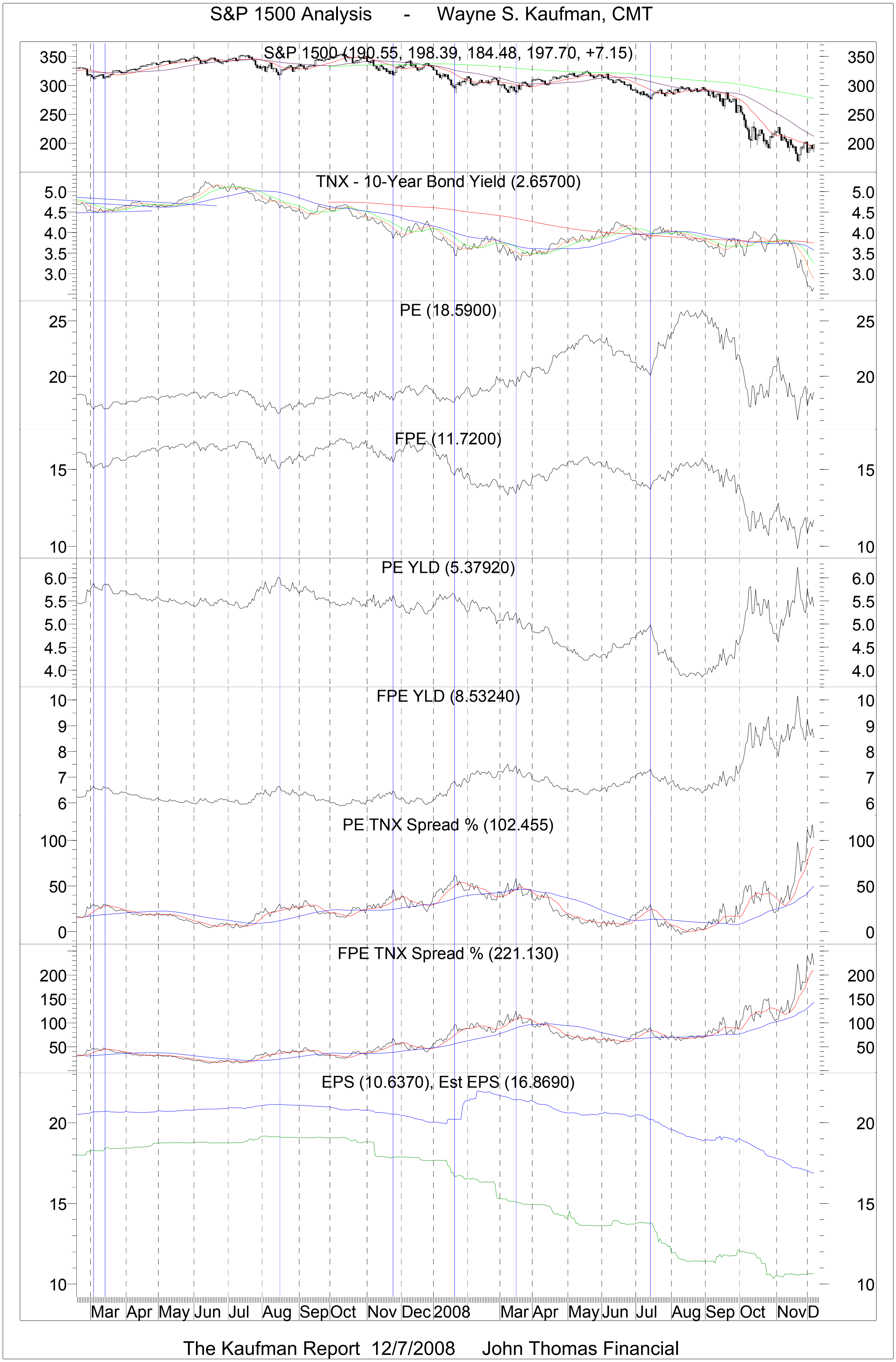
Here too, breadth numbers are improving. Of course, they couldn't have gotten worse.



Our proprietary options indicator is showing optimism on the part of options buyers, and is at the level where an 11.5% four-day decline began on 10/21. It does hit higher levels during bullish markets, so maybe it can go up to the overbought zone. We will be concerned about this either way with quadruple witching options expiration week coming up.

The 591 key reversals on 10/21 is one reason we think the low for the year was seen that day.

Our 10-day statistics of demand (green lines) are all above the statistics of supply (red lines) and have broken out to new highs.

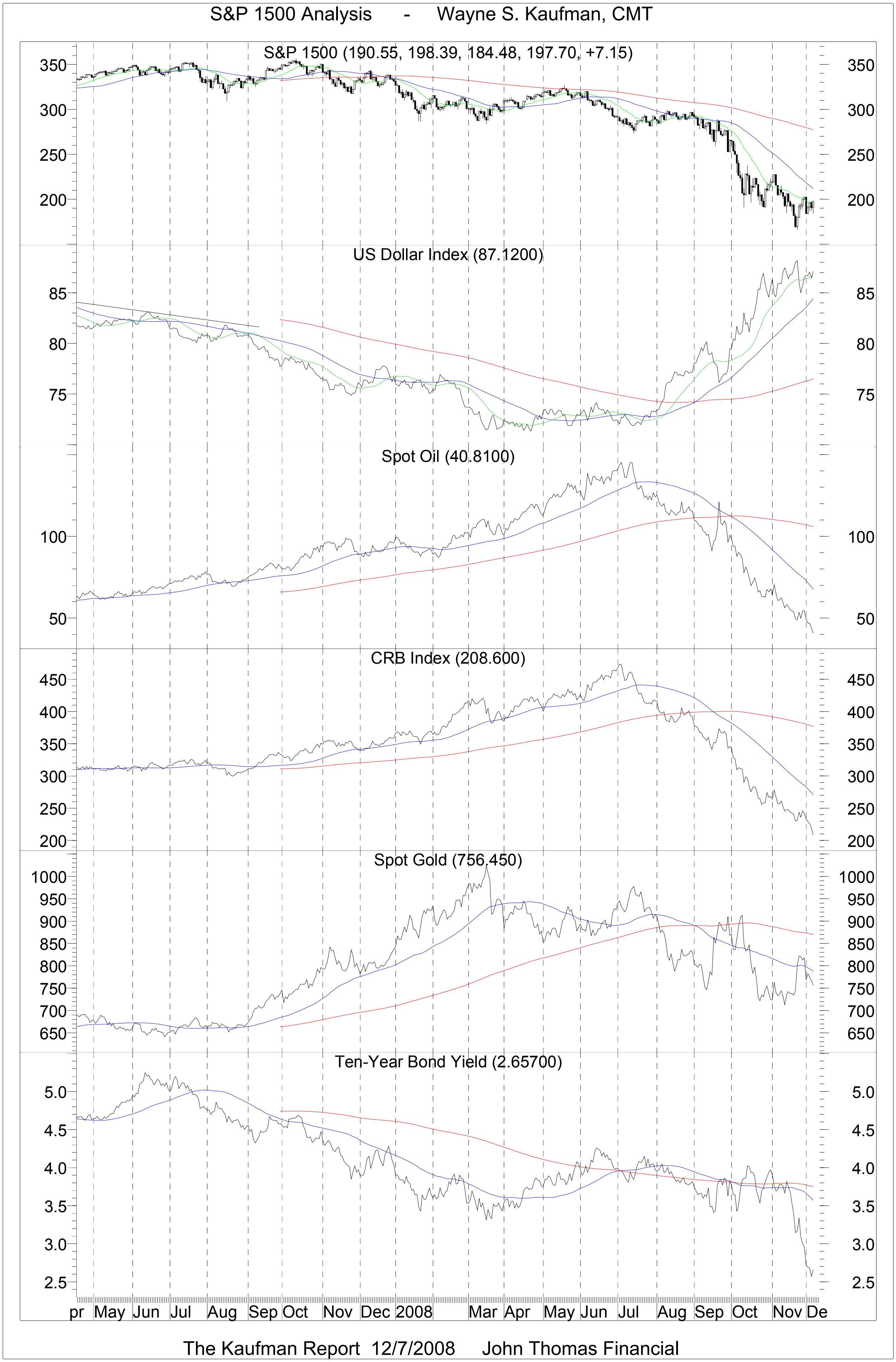


10-year bond yields are at the lowest levels ever, making bonds very overbought.

P/E ratios remain in a range.

Spreads between equity and bond yields are at the highest levels ever, which should make stocks very attractive.

Reported aggregate earnings (green) stopped going lower on 10/24. Projected earnings (blue) continue their inexorable move lower.



The U.S. Dollar Index may yet have one more move higher, but should be topping soon.

Oil, commodities, and gold are all in down trends and may be overshooting to the down side.