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The Kaufman Report

Trade what you see, not what you think.

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Monday June 1, 2009 **Closing prices of May 29, 2009**

We said on May 14th that the terrific rally off the March lows had ended, and we expected to see a pullback or period of consolidation. The question was how deep a pullback or how long the period of consolidation would be. We said we expected stocks to take any pullback in stride, and that certainly was the case last week as a spike in bond yields Wednesday knocked stocks down only to see them rally as the week ended. **We think the consolidation is ending and that stocks will proceed higher shortly**.

We have said we expected one more leg higher after a pullback/consolidation. This would follow the pattern of the average first year of the Presidential cycle. We think that leg higher is about to begin. On Friday the S&P 500 made its highest close since 5/8, along with new rally highs in the Nasdaq 100, the NYSE Composite, the ADR Index, the Morgan Stanley High Tech Index, and the Internet Index.

We still have concerns and we will be watching for false breakouts and more aggressive selling than we have seen during this period of consolidation. Even if a new rally leg starts and it is not truncated, we still have expectations of it ending in June or July. Therefore, we continue our strategy of playing the long side of the market while relying on basic trading strategies to protect us when the market does eventually make a turn that could be painful.

Our main concern continues to be the earnings power of companies, and therefore the valuations of stocks. We are now 98% through earnings season and unfortunately, valuations based on reported earnings (before charges) are terrible, while valuations based on earnings from continuing operations (after charges) and analyst forecasts still make stocks attractive.

This disconnect can't last much longer. The P/E based on reported earnings for the S&P 1500 is 69.75, creating an earnings yield of 1.43%. Ten year bond yields are currently 3.465%, making bonds look far more attractive than stocks. The P/Es based on earnings from continuing operations and projected earnings are 15.01 and 16.35, respectively. Their earnings yields of 6.66% and 6.12% are attractive versus bond yields. The problem is the trend of all three of these earnings metrics remains inexorably lower, although they have leveled off now that earnings season is over. Unless this earnings down trend reverses, along with reported earnings eventually moving towards the continuing operations numbers and the analyst estimates, stocks will look very overvalued and things could get difficult for equities as second quarter earnings season rolls around. The timing of that fits our roadmap which calls for an end to the rally sometime in June or July.

Once we get near the time we expect the next leg up to end (assuming we do get that leg) we will accept the possibility that a healing economy and huge government intervention, along with companies becoming very lean and mean, could create a scenario where profits will start to surprise on the upside and the deteriorating trend will finally change. If so, we will delay our expected bearishness.

This is a bifurcated, opportunistic trader's market, with adept traders able to enter long or short. Based on the S&P 500 the short-term and intermediate-term trends are up, while the long-term trend remains down. Some areas of the market are now in long-term up trends. Traders should not hesitate to rotate out of lagging sectors and stocks and into leaders.

IMPORTANT DISCLOSURES

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The S&P 1500 (209.09) was up 1.387% Friday. Average price per share was up 1.56%. Volume was 105% of its 10-day average and 91% of its 30-day average. 81.02% of the S&P 1500 stocks were up, with up volume at 72.37% and up points at 89.81%. Up Dollars was 97.44% of total dollars, and was 139% of its 10-day moving average. Down Dollars was 6% of its 10-day moving average.

All ten S&P sectors were up on the day, led by Materials +2.97%, Industrials +1.87%, and Financials +1.71%.

The S&P 1500 is up 4.95% in May, up 15.53% quarter-to-date, up 2.23% year-to-date, and down 42.95% from the peak of 356.38 on 10/11/07. Average price per share is $24.95, down 41.33% from the peak of $43.23 on 6/4/07.

Percent over 10-sma: 70.13%. 13-Week Closing Highs: 216 (most since 372 on 5/8). 13-Week Closing Lows: 3.

Put/Call Ratio: 0.771. Kaufman Options Indicator: 1.05.

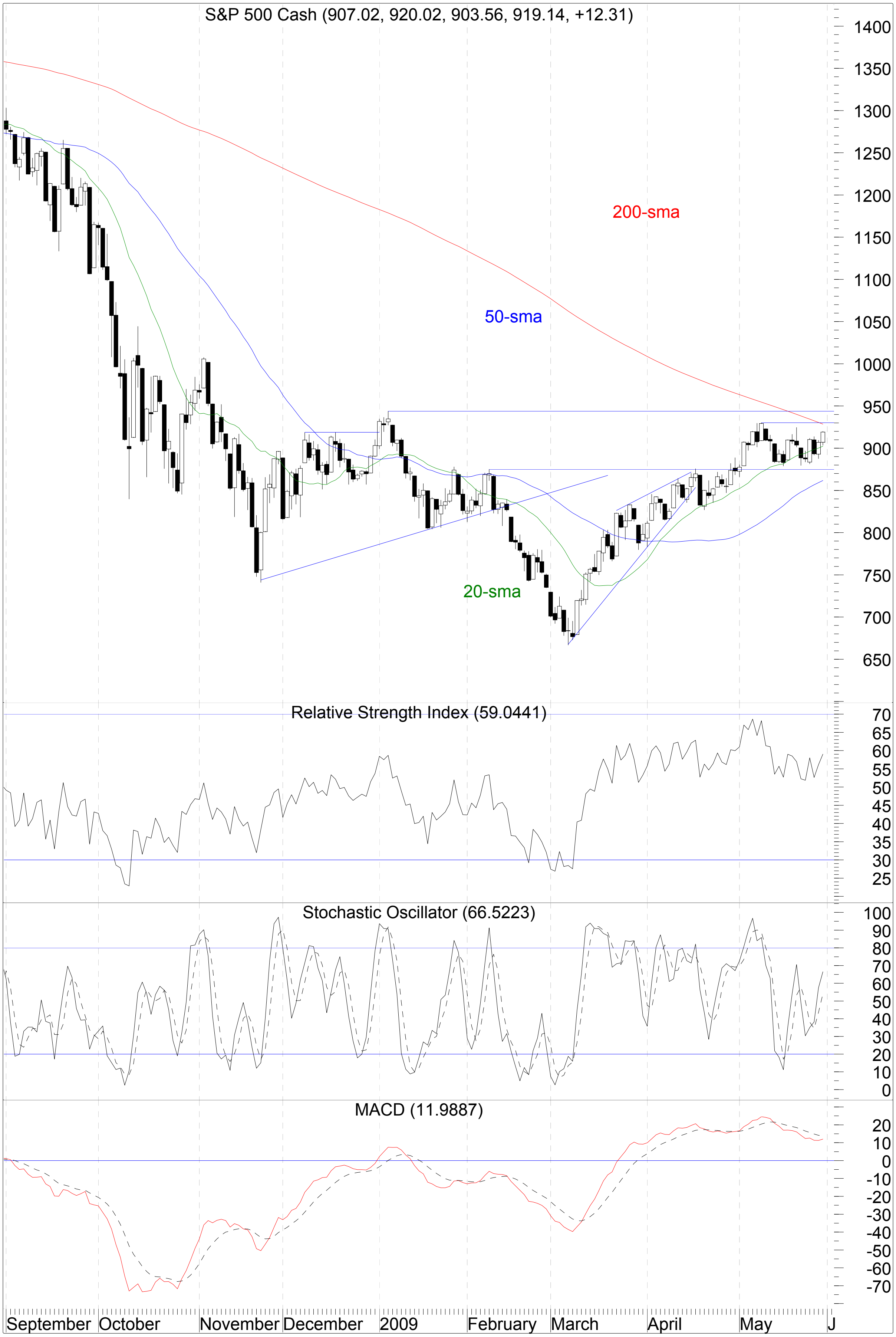
P/E Ratios: 69.75 (before charges), 15.01 (continuing operations), 16.39 (analyst estimates).
P/E Yield 10-year Bond Yield Spreads: ***-58% (earnings bef. charges),*** *92% (earnings continuing ops), and 76% (projected earnings)*.

Aggregate earnings before charges for the S&P 1500 peaked in August 2007 at $19.18 and are now at $3.00, a drop of 84.34%. Aggregate earnings from continuing operations peaked at $19.95 in September 2007 and are now $13.93, down 30.18%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $12.76, a drop of 41.87%.

492 of the S&P 500 have reported 1st quarter earnings. According to Bloomberg, 67.8% had positive surprises, 7.5% were in line, and 24.6 % have been negative. The year-over-year change has been -33.5% on a share-weighted basis, -23.2% market cap-weighted and -34.6% non-weighted. Ex-financial stocks these numbers are -32.9%, -22.6%, and -30.9 %, respectively.

Federal Funds futures are pricing in a probability of 78.0% that the Fed will *leave rates unchanged*, and a probability of 22.0% of cutting *25 basis points to 0.0%* when they meet on June 24th. They are pricing in a probability of 71.0% that the Fed will *leave rates unchanged* on August 12th, a probability of 19.3% of cutting 25 basis points to 0.0%, and a probability of 9.7% of *raising 25 basis points*.

IMPORTANT DISCLOSURES



The S&P 500 remains in its tight trading range but on Friday it closed at its highest level since 5/8. The 200-sma is just above at 928.6. A break above the 5/8 high of 930.17 would be a new rally high and put the index above its 200-sma.

Our momentum indicators are not overbought with the MACD nearing a positive crossover.

The S&P 500 closed above its 40-week sma for the first time since December 2007.

Our weekly momentum indicators are mixed.

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The monthly chart of the S&P 500 shows the stochastic nearing overbought with the RSI and MACD still at low levels.

The Nasdaq 100 made a new rally closing high on Friday. The 50-sma is about to cross over the 200-sma for the first time since July 2008.

Our weekly momentum indicators seem to have room to move higher.


NASDAQ 100 (1,351.13, 1,435.57, 1,350.95, 1,435.57, +72.40)
2300
2250
2200
2150
2100
2050
2000
1950
1900
1850
1800
1750
1700
1650
1600
1550
1500
1450
1400
1350
1300
1250
1200
1150
1100
1050
1000
950
Relative Strength Index (59.0118)
70
60
50
40
30
20
Stochastic Oscillator (87.0550)
100
50
MACD (7.67650)
50
0
-50
-100
-150
Jul Aug Sep Oct Nov Dec 2008 Mar Apr May Jun Jul Aug Sep Oct Nov Dec 2009 Mar Apr May J

The Nasdaq 100 is up three months in a row.

Monthly mo0mentum indicators remain at low levels with the MACD nearing a positive crossover.

The Morgan Stanley High Tech Index made a new rally high Friday and is now up 28.82% in 2009. With the 20-sma above the 50-sma and the 50-sma now above the 200-sma, the only fault that can be found on this chart is the 200-sma is still sloping down.

Momentum indicators are at high levels but the MACD just had a positive crossover, so this index should still go higher.

The Internet Index made a new rally closing high Friday and is now up 39.8% year-to-date.

Momentum indicators are at high levels but can move higher, and the MACD has just had a positive crossover.

The ADR continues to make new rally highs and is up 10% on the year.

The NYSE Composite Index made a new rally high Friday as it moved above its 200-sma for the first time since May 2008.

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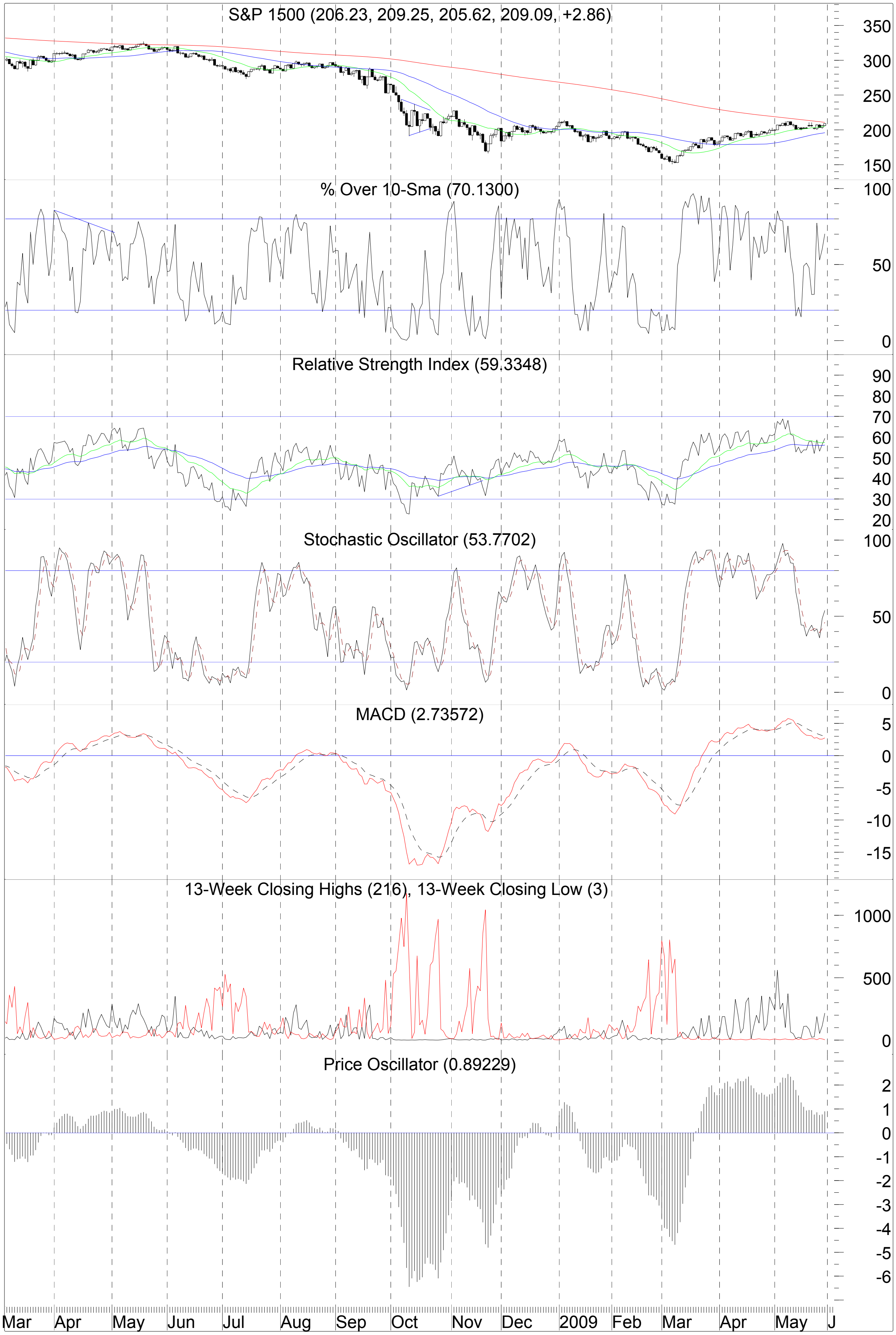
The Gold & Silver Index gapped higher Friday in what may be an exhaustion gap.

Our momentum indicators are in the overbought zone.

The Gold & Silver Index has been outperforming the S&P 500.

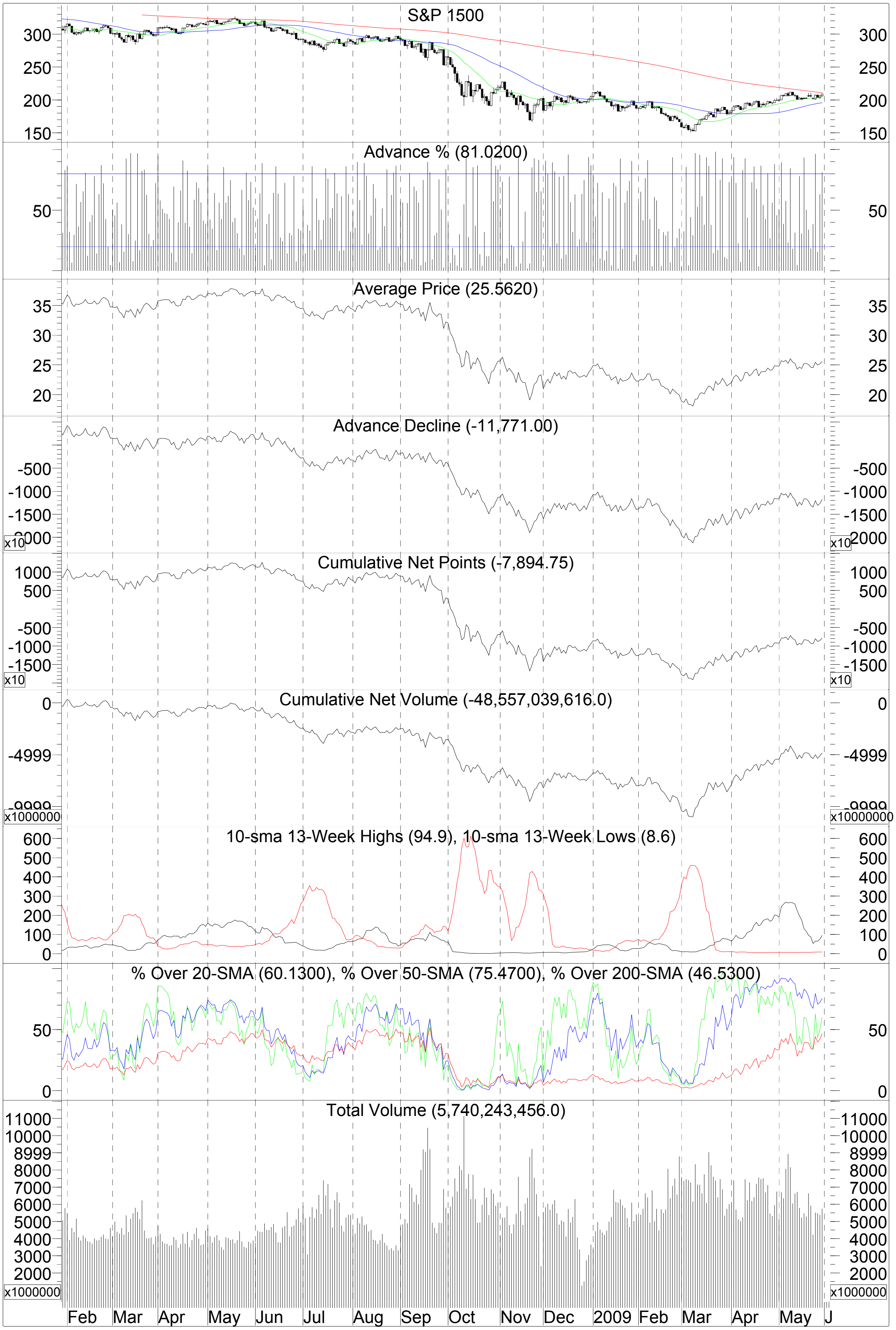
Our momentum indicators are at high levels but can move higher.



Our oscillators are not yet at extremely high levels with the MACD nearing a positive crossover.

13-week highs have started to expand again.

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



81.02% of stocks traded higher Friday.

75.47% of stocks are above their 50-sma, while the percent over 200-sma is just under the 5/8 high.

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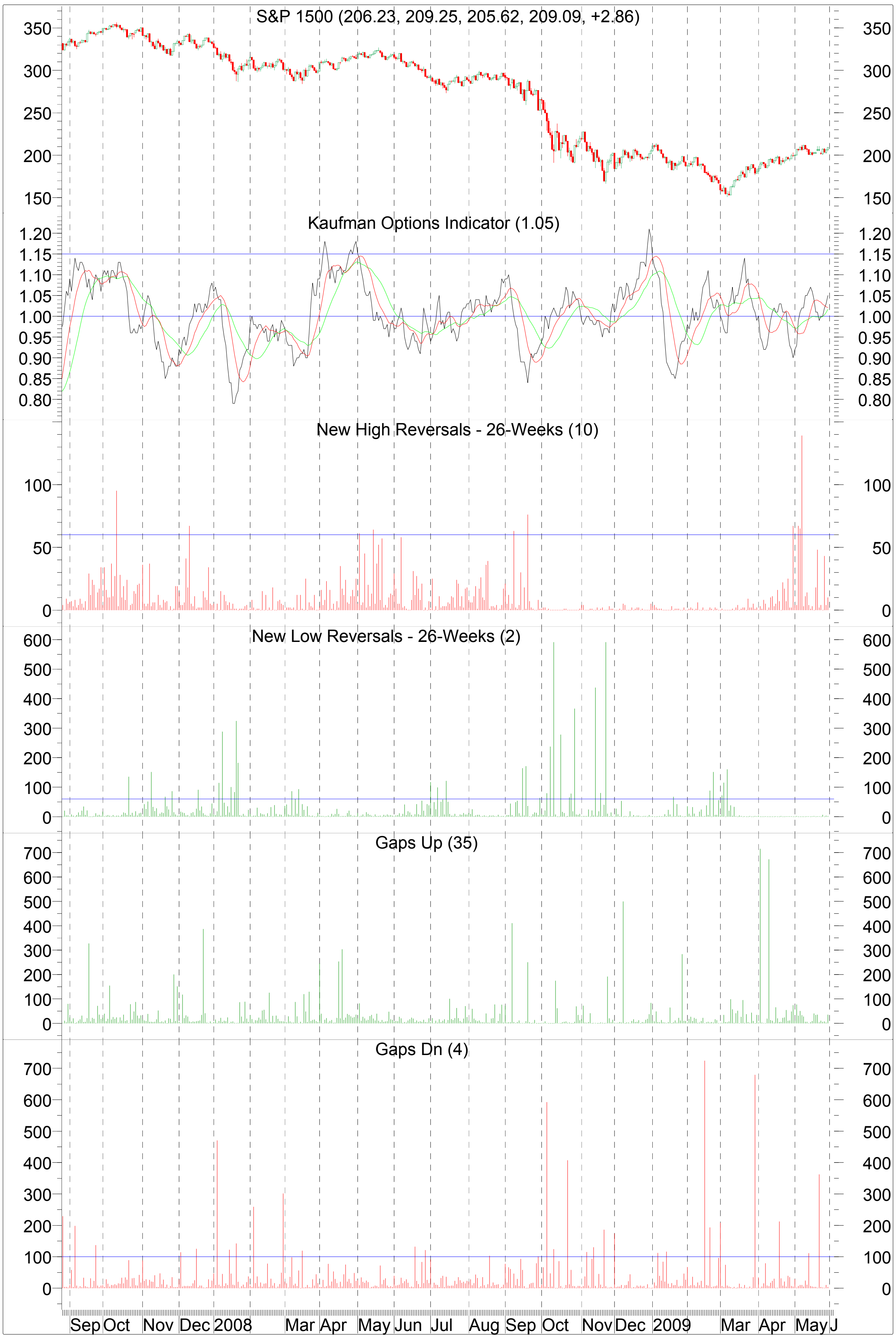
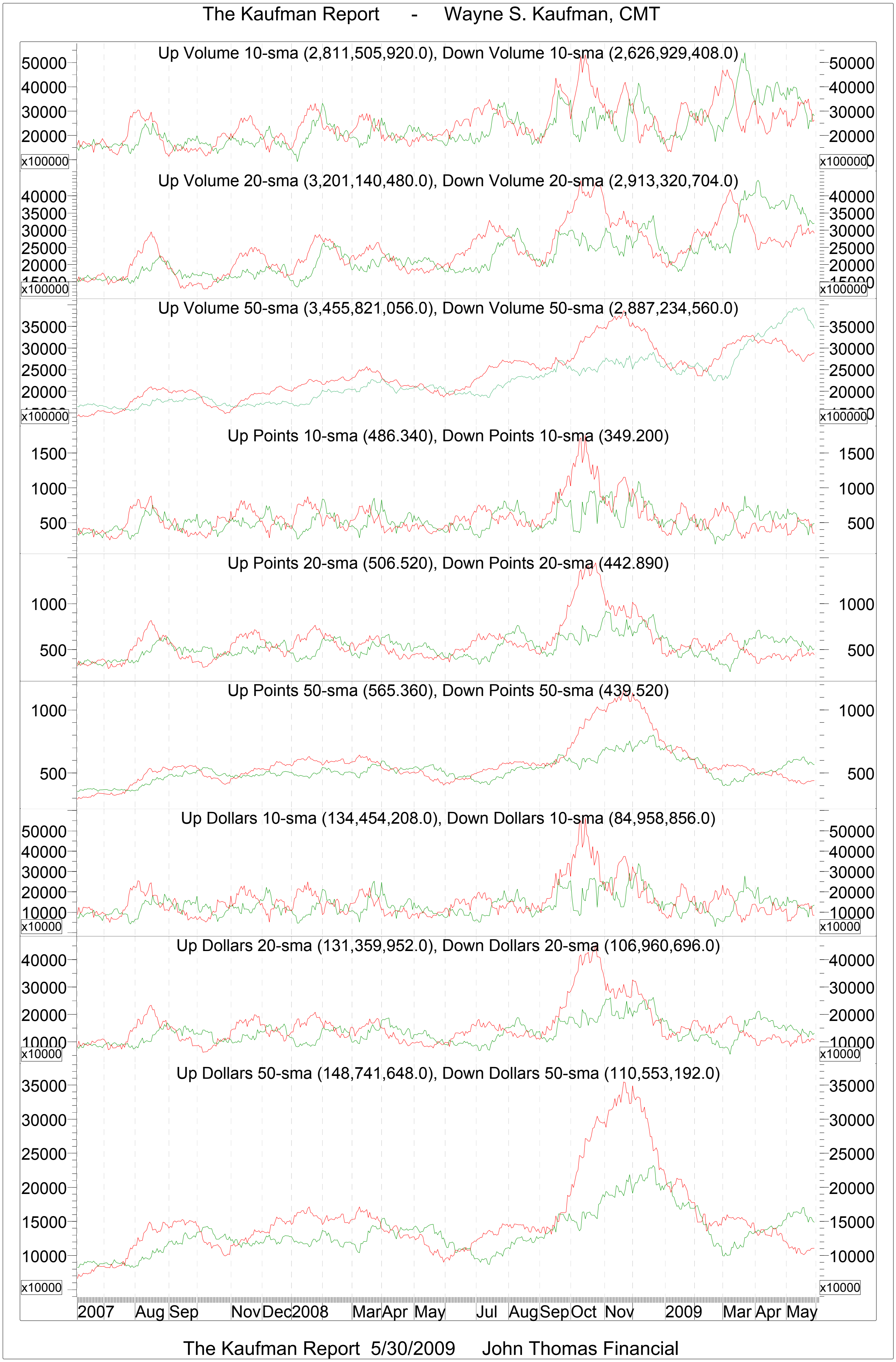
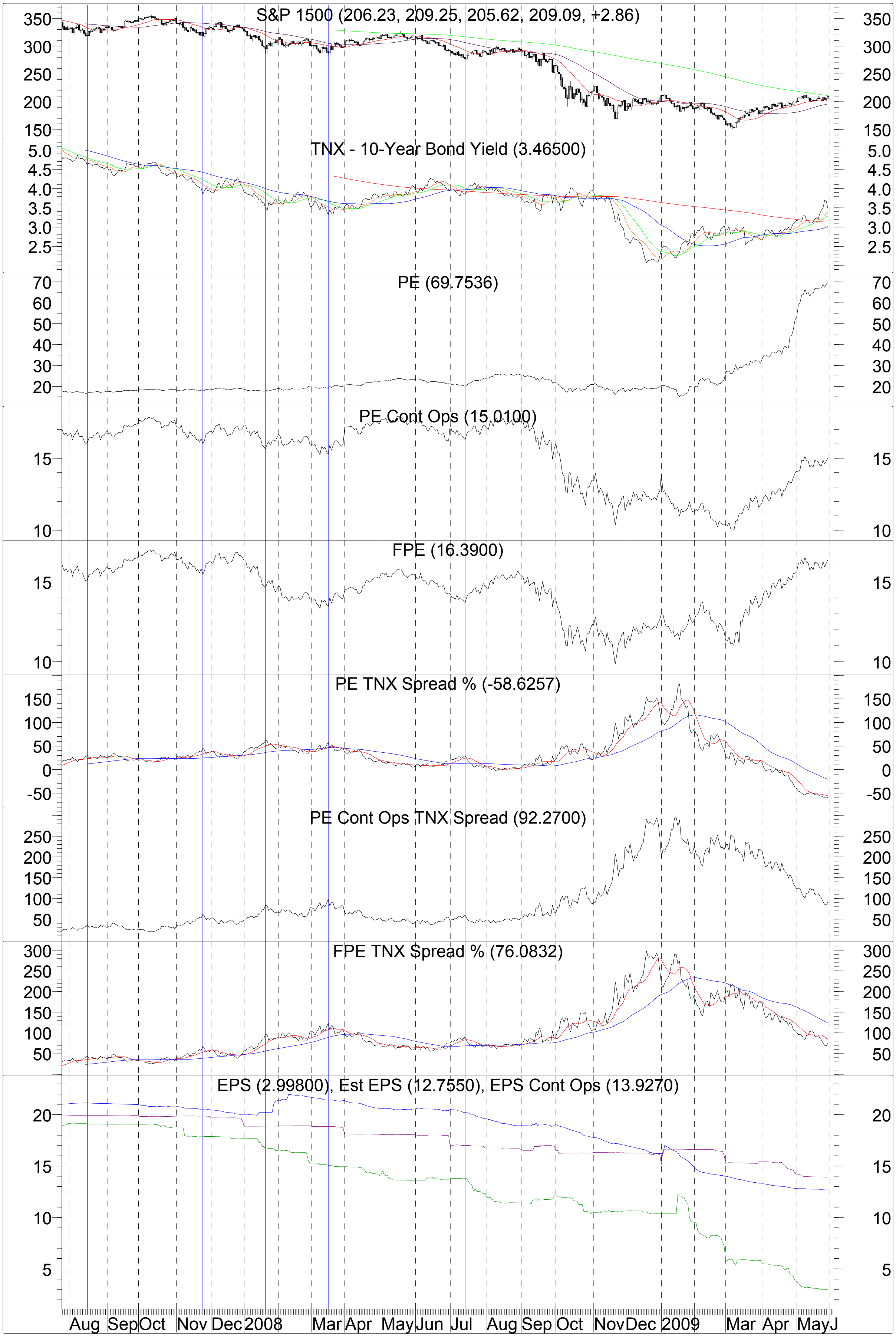


Our proprietary options indicator is showing bullishness among options buyers, but is not at the extreme levels we worry about. Still, moves lower can start from this level.



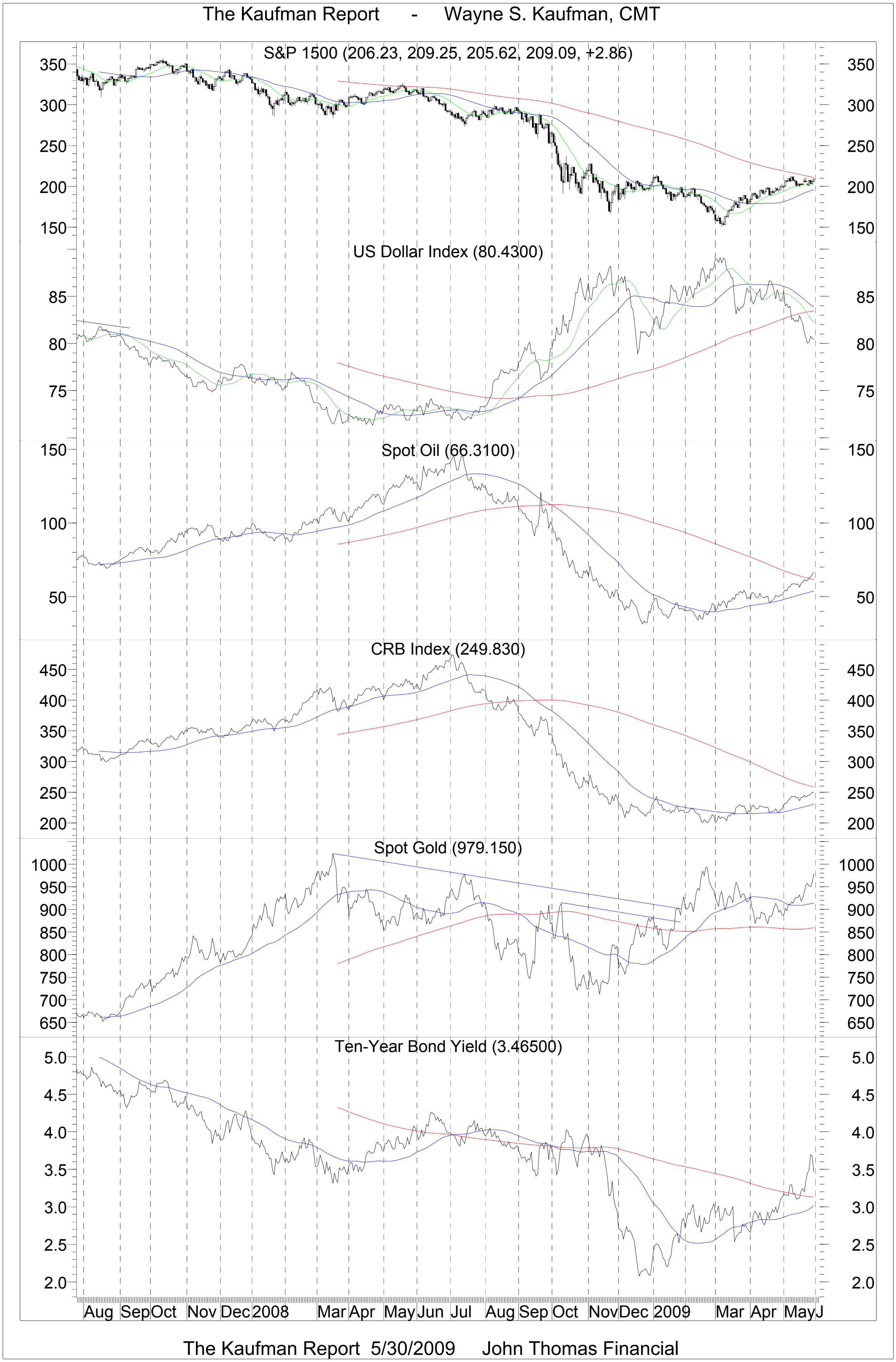
Our statistics of supply (red) versus demand (green) show positive crossovers for all time periods. Still, it is obvious that in spite of the the move higher in the major indexes buyers have not been extremely enthusiastic. Fortunately, sellers have had even less conviction. This type of situation can change quickly.



We continue to worry about the P/E on earnings before charges, now 69.75.

Spreads between bond yields and earnings yields continue to narrow.

With earnings season over our three metrics of earnings are flat lining.



The U.S Dollar Index remains in a down trend but is short-term oversold.

Crude oil is over its 200-sma for the first time since September. It is short-term overbought.

Gold is short-term overbought.