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# The Kaufman Report

**Trade what you see, not what you think.**

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**Thursday May 14, 2009** **Closing prices of May 13, 2009**

It was fun while it lasted! We think that the terrific rally off the March lows has ended, at least for the time being. Wednesday was a 90% panic-selling down day, which we hope will end up to be just profit taking, but investors need to remain defensive. Some short-term indicators are oversold and the S&P 500 is just above important support, so a bounce can occur at any time. The strength of that bounce will be crucial, especially with many short-term momentum indicators still having lots of room to move lower, and our proprietary options indicator still at high levels after too much optimism recently on the part of call buyers.

We have been saying a pull back or consolidation was likely at any time, but that equities would take any pullback in stride and follow the average first year of the Presidential cycle pattern and trade higher afterwards. Still, we have to follow our motto and trade what we see and not what we think. Our concerns now are that investors may have had a change of attitude and will no longer disregard bad news while focusing on the good. Unfortunately there is still plenty of bad. Number one on our list is the incredible story of our automobile industry, which we have been calling Fannie Mae Motors. There is no law the Obama administration can make to turn these lemons into lemonade, but we are sure that no matter the outcome they will tell everyone how perfectly they handled it. If it doesn't go according to their plan they will surely find some group of bankers, investors, or capitalists to demonize and pin the blame on. Number one-A on our list is unemployment, which won't be helped by a possible GM bankruptcy and further auto plant closings.

Number two on our hit parade is earnings. We are now 95% through earnings season and during the recent rally investors have been giving stocks the benefit of the doubt by ignoring bad news and focusing on data points and forecasts that give hope that things are turning for the better. Unfortunately, valuations based on reported earnings (before charges) are terrible, while valuations based on earnings from continuing operations (after charges) and analyst forecasts make stocks very attractive.

This disconnect can't last much longer. The P/E based on reported earnings for the S&P 1500 is 63.06, creating an earnings yield of 1.59%. Ten year bond yields are currently 3.105%, making bonds look far more attractive than stocks. The P/Es based on earnings from continuing operations and projected earnings are 14.37 and 15.73, respectively. Their earnings yields of 6.96% and 6.36% are attractive versus bond yields. The problem is the trend of all three of these earnings metrics is inexorably lower. Investors may be giving stocks the benefit of the doubt at this time, but if reported earnings don't eventually start to move towards the continuing operations numbers and the analyst estimates, stocks will look very overvalued and investors may lose their recent optimism.

**<u>This is a bifurcated, opportunistic trader's market, with adept traders able to enter long or short. The short-term and intermediate-term trends are up, while the long-term trend remains down. Traders should not hesitate to rotate out of lagging sectors and stocks and into leaders.</u>**

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The S&P 1500 (200.65) was down 2.899% Wednesday. Average price per share was down 3.80%. Volume was 97% of its 10-day average and 102% of its 30-day average. 4.76% of the S&P 1500 stocks were up, with up volume at 9.9% and up points at 2.68%. Up Dollars was 1/3 of 1% of total dollars, and was 1% of its 10-day moving average. Down Dollars was 342% of its 10-day moving average.

The S&P 1500 is up 0.71% in May, up 10.86% quarter-to-date, down 2.09% year-to-date, and down 43.70% from the peak of 356.38 on 10/11/07. Average price per share is $24.28, down 43.84% from the peak of $43.23 on 6/4/07.

Percent over 10-sma: 16.13%. 13-Week Closing Highs: 12. 13-Week Closing Lows: 12.

*Put/Call Ratio: 0.891. Kaufman Options Indicator: 1.06.*

P/E Ratios: 63.06 (before charges), 14.37 (continuing operations), 15.73 (analyst estimates).
*P/E Yield 10-year Bond Yield Spreads: **-49% (earnings bef. charges),** 124% (earnings continuing ops), and 105% (projected earnings).*

Aggregate earnings before charges for the S&P 1500 peaked in August 2007 at $19.18 and are now at $3.18, a drop of 83.42%. Aggregate earnings from continuing operations peaked at $19.95 in September 2007 and are now $13.97, down 29.97%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $12.76, a drop of 41.87%.

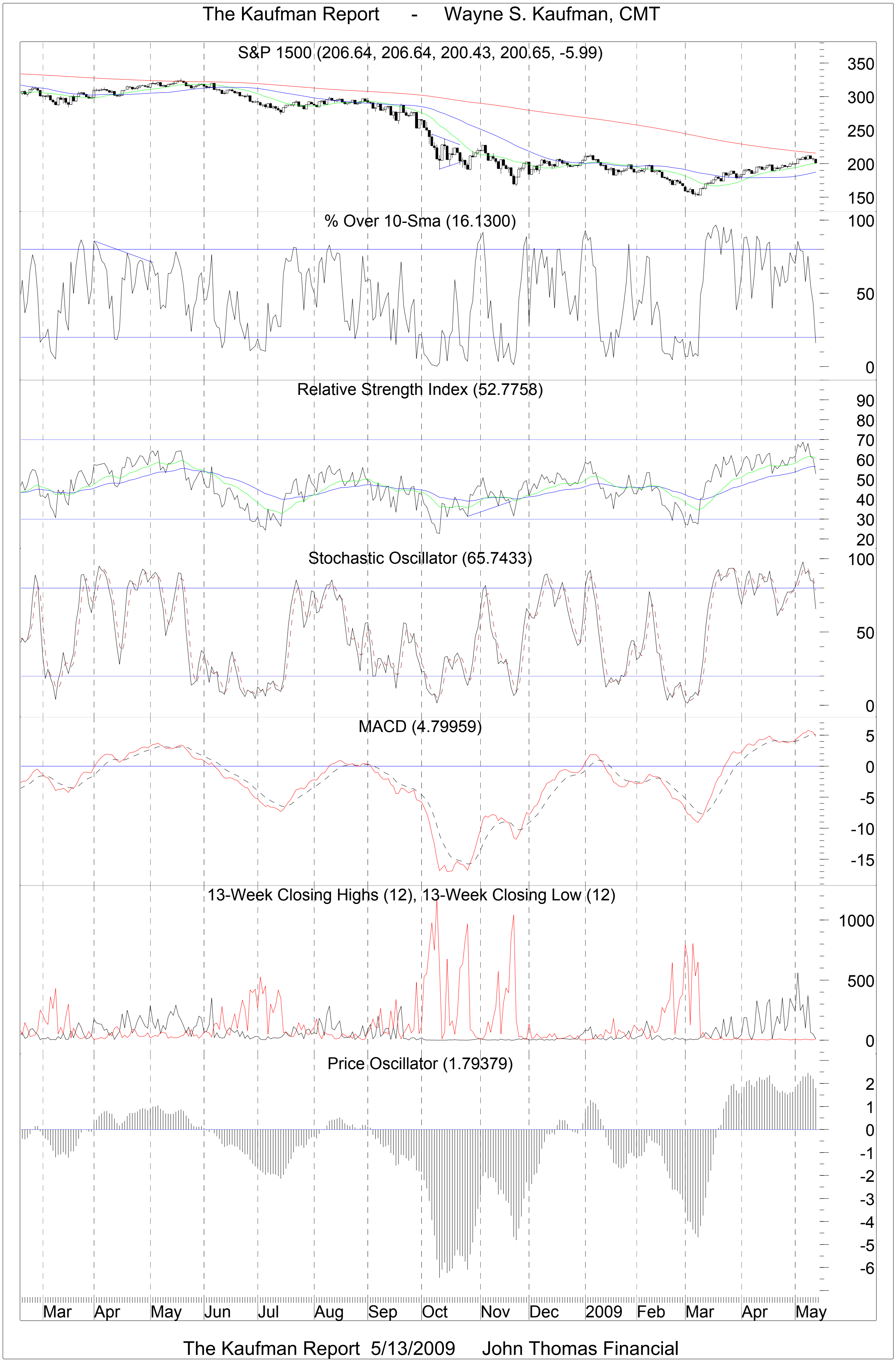
458 of the S&P 500 have reported 1st quarter earnings. According to Bloomberg, 67.4% had positive surprises, 6.8% were in line, and 25.8 % have been negative. The year-over-year change has been -35.2% on a share-weighted basis, -24.3% market cap-weighted and -36.1% non-weighted. Ex-financial stocks these numbers are -34.8%, -23.8%, and -32.2 %, respectively.

Federal Funds futures are pricing in a probability of 82.0% that the Fed will *leave rates unchanged*, and a probability of 18.0% of cutting *25 basis points to 0.0%* when they meet on June 24th. They are pricing in a probability of 72.1% that the Fed will *leave rates unchanged* on August 12th, a probability of 15.2% of cutting 25 basis points to 0.0%, and a probability of 12.7% of *raising 25 basis points*.

## IMPORTANT DISCLOSURES


The S&P 500 has pulled back to just above the 20-sma (879) and the area of the prior breakout (875 - 878) which should be support. However, with our momentum indicators not yet oversold there is plenty of room for stocks to move lower. Fibonacci retracement levels of the rally off the March lows are 829.56 (38.2%) and 798.48 (50%).


The Nasdaq 100 fell below both the 20-sma and 200-sma Wednesday. Our momentum indicators still have room to move lower before getting oversold, so prices can also. There is some support at the 1303 - 1304 area, with important support at the top of the sideways channel at the 1287 area. The up sloping 50-sma is at 1281.




The percent over 10-sma is in the oversold zone and is the lowest since March 9th.

Our other momentum indicators have plenty of room to move lower.

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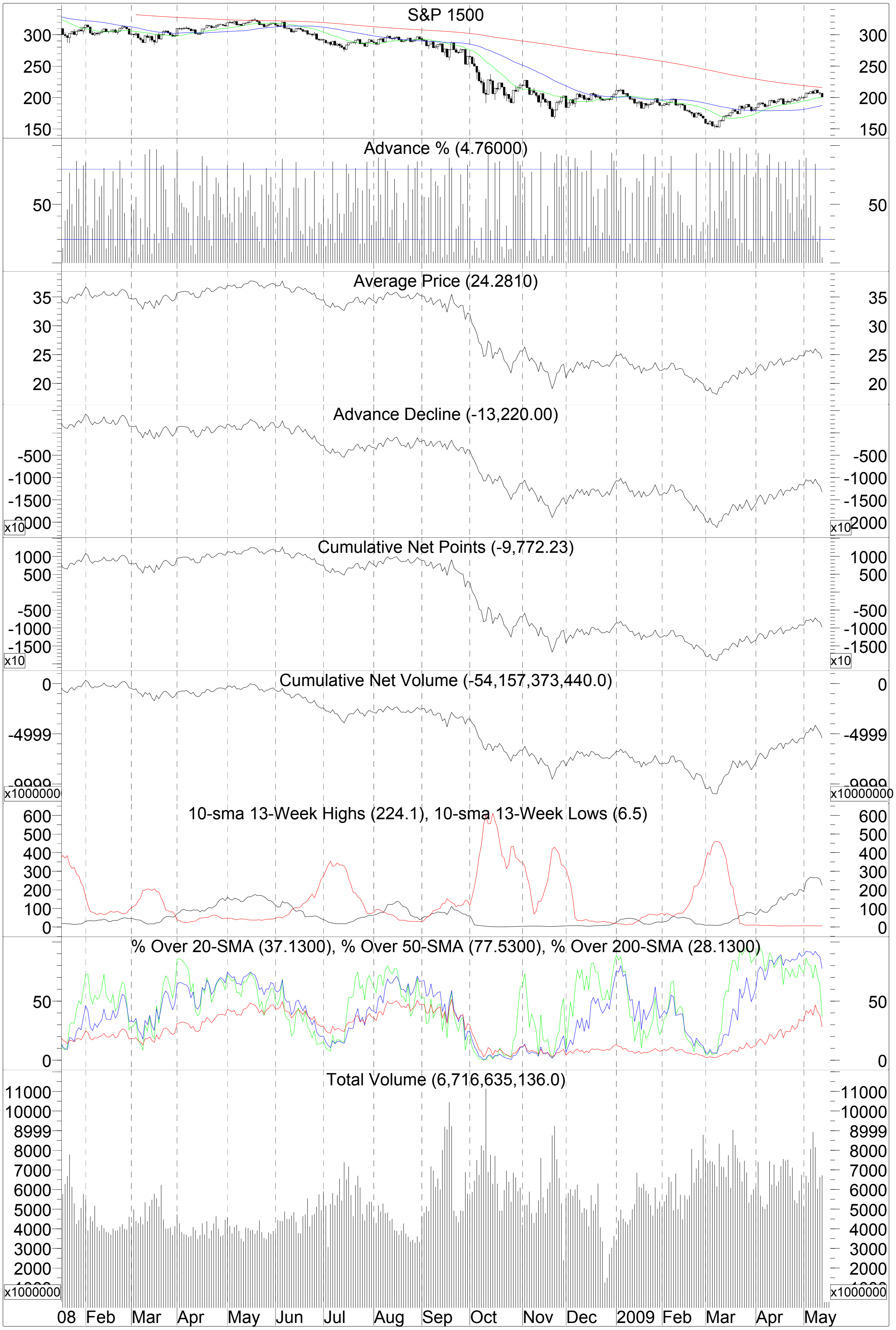


4.76% of stocks traded higher Wednesday.

Volume hasn't been strong during the three-day sell off.

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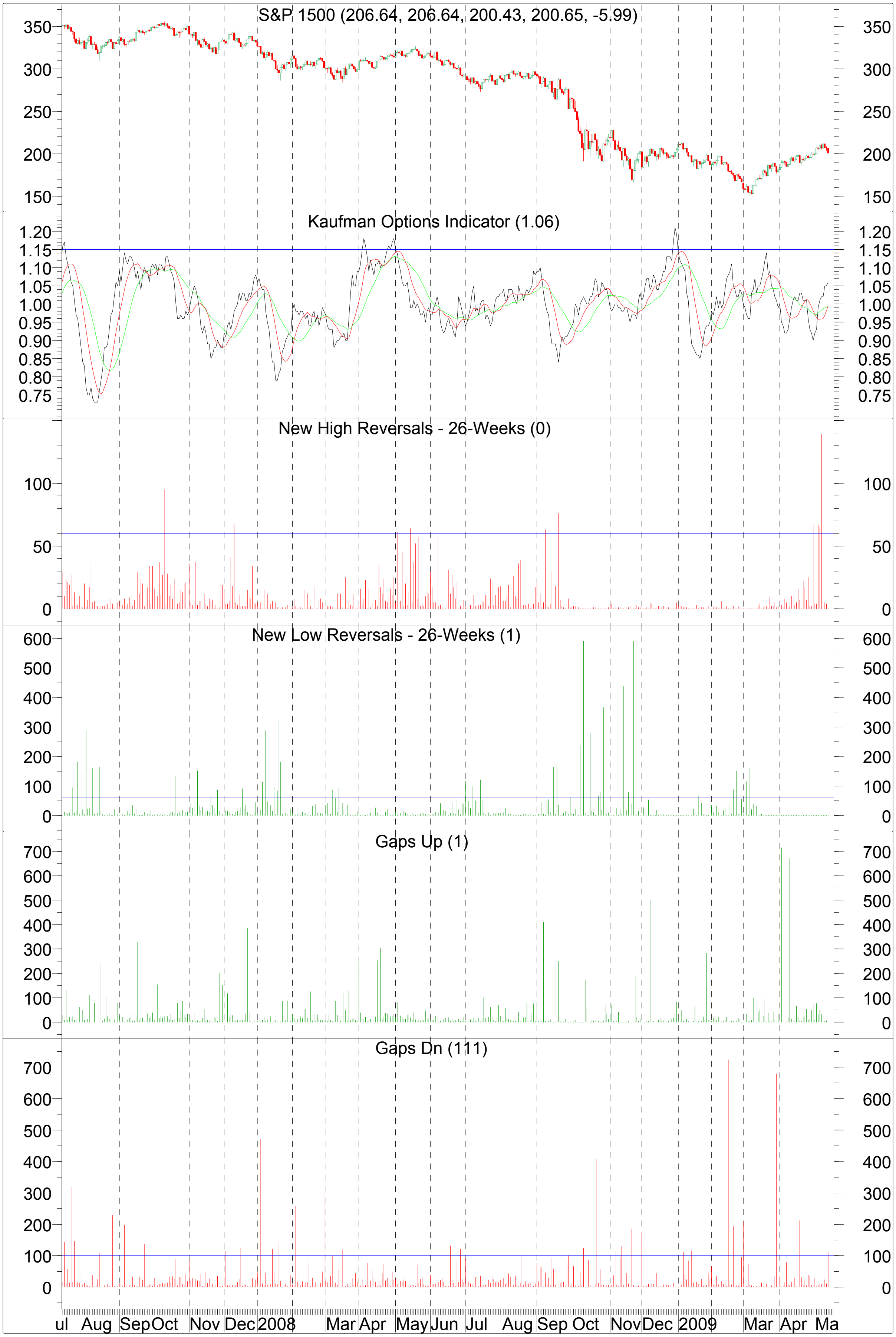
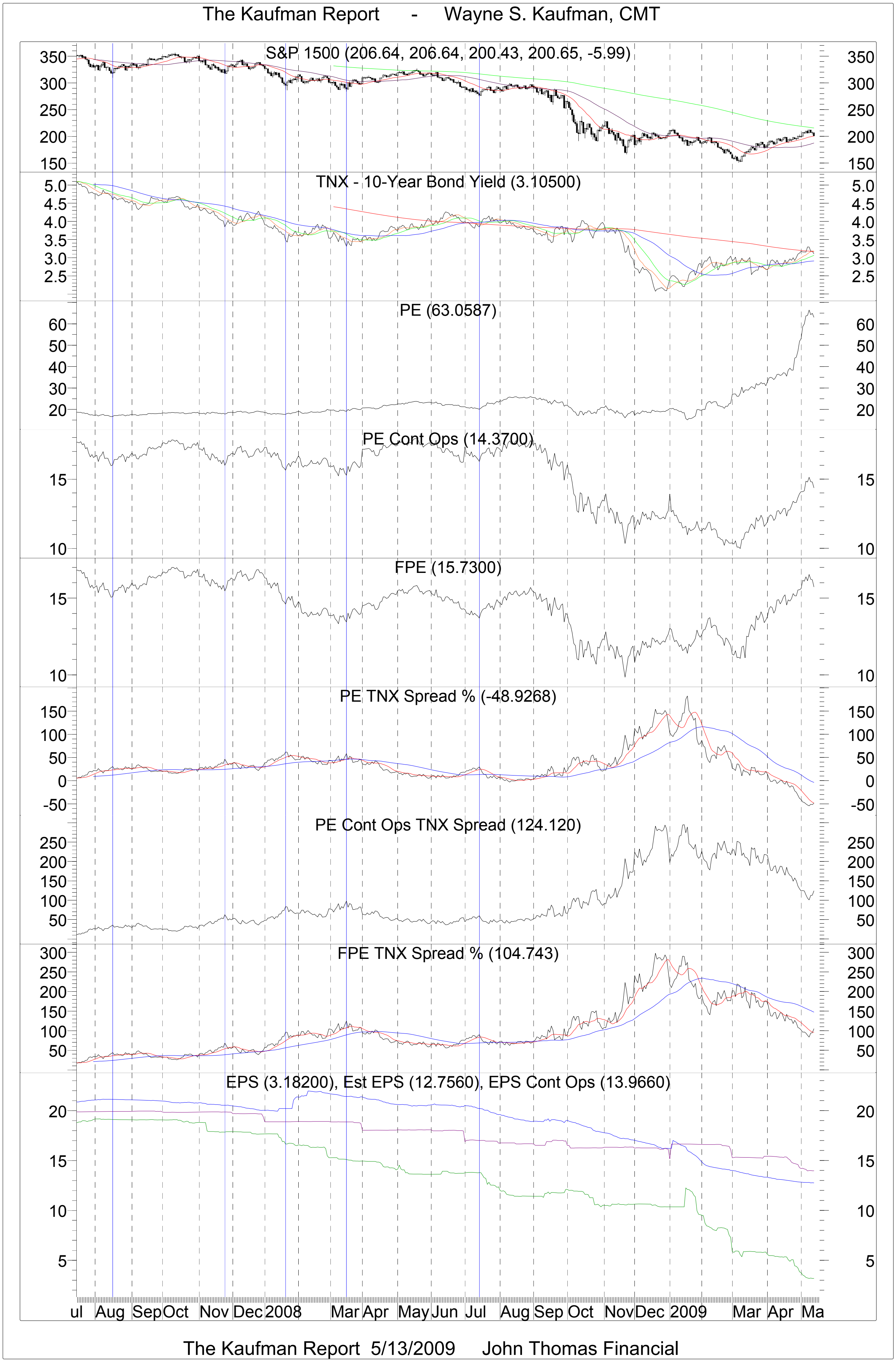



Our proprietary options indicator remains well above neutral, reflecting the large amount of call buying seen recently. This degree of optimism leaves stocks vulnerable to a further move lower.




With earnings season coming to an end our metrics of aggregate earnings seem to be pausing in their inexorable move lower.