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The Kaufman Report

Trade what you see, not what you think.

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Tuesday May 26, 2009 **Closing prices of May 22, 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. That is where we are now, and the question at this point is how deep a pullback or how long this period will be.

So far the period since the May highs has been weak more due to buyers becoming reticent than any great increase in selling pressure. We are expecting further weakness in the near-term, but we have said equities would take any pullback in stride and we still think so. Unless some catalyst causes sellers to become more aggressive, which we will be watchful for, this pullback should not be too deep. We continue to expect one more rally leg after this consolidation/pullback bottoms. This would follow the pattern of the average first year of the Presidential cycle. Still, our trading strategies, which are based more on reacting to market conditions as opposed to forecasting future price moves, keep us from being rigid, and if we need to become more bearish we will do so quickly.

During the recent rally investors gave stocks the benefit of the doubt by ignoring bad news and focusing on data points and forecasts that gave hope that things were turning for the better. Last week investors started to realize many of the current problems may not go away so quickly. We won't bother listing all the problems, but we will repeat our main concern, which is the effect of the problems on the earnings power of companies, and therefore the valuations of stocks. We are now 97% 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 make stocks attractive.

This disconnect can't last much longer. The P/E based on reported earnings for the S&P 1500 is 66.95, creating an earnings yield of 1.49%. Ten year bond yields are currently 3.448%, making bonds look far more attractive than stocks. The P/Es based on earnings from continuing operations and projected earnings are 14.47 and 15.85, respectively. Their earnings yields of 6.91% and 6.31% are attractive versus bond yields. The problem is the trend of all three of these earnings metrics remains inexorably lower. Unless this trend reverses, and unless reported earnings eventually start to move towards the continuing operations numbers and the analyst estimates, stocks will look very overvalued and things could get very difficult for equities as second quarter earnings season rolls around.

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

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The S&P 1500 (201.59) was down 0.208% Friday. Average price per share was down 0.38%. Volume was 73% of its 10-day average and 65% of its 30-day average. 38.52% of the S&P 1500 stocks were up, with up volume at 30.46% and up points at 35.80%. Up Dollars was 29.03% of total dollars, and was 34% of its 10-day moving average. Down Dollars was 44% of its 10-day moving average.

Six of ten S&P sectors were up for the week led by Materials +2.59% and Consumer Staples +2.08%. Financials were up 0.84%. Telecom led on the downside at -3.22%

The S&P 1500 is up 1.19% in May, up 11.38% quarter-to-date, down 1.63% year-to-date, and down 43.43% from the peak of 356.38 on 10/11/07. Average price per share is $24.52, down 43.28% from the peak of $43.23 on 6/4/07.

Percent over 10-sma: 30.4%. 13-Week Closing Highs: 27. 13-Week Closing Lows: 11.

Put/Call Ratio: 0.807. Kaufman Options Indicator: 1.00.

P/E Ratios: 66.95 (before charges), 14.47 (continuing operations), 15.85 (analyst estimates).
*P/E Yield 10-year Bond Yield Spreads: **-57% (earnings bef. charges),** 100% (earnings continuing ops), and 83% (projected earnings).*

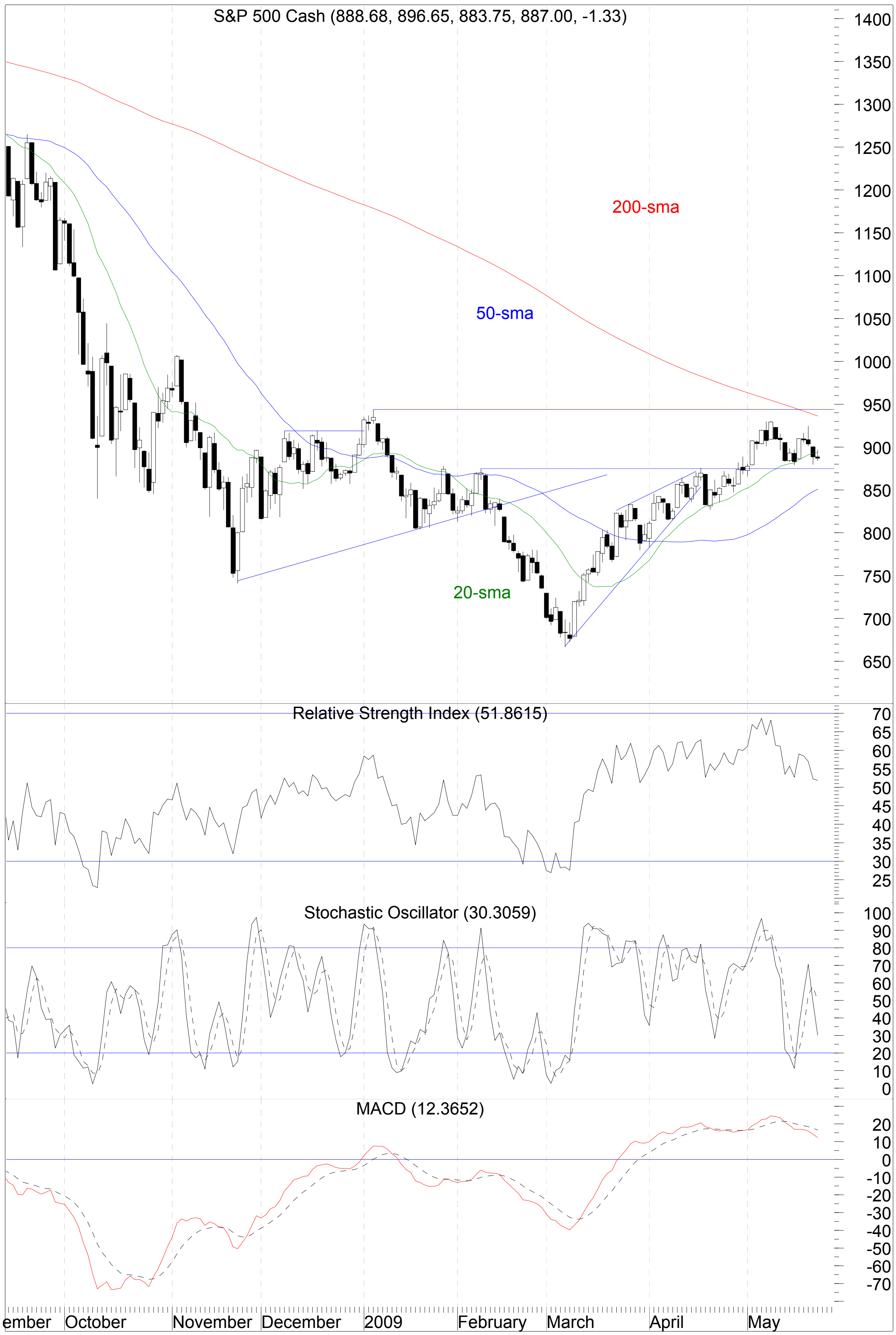
Aggregate earnings before charges for the S&P 1500 peaked in August 2007 at $19.18 and are now at $3.01, a drop of 84.91%. Aggregate earnings from continuing operations peaked at $19.95 in September 2007 and are now $13.93, down 30.18%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $12.72, a drop of 42.06%.

486 of the S&P 500 have reported 1st quarter earnings. According to Bloomberg, 67.8% had positive surprises, 7.2% were in line, and 24.9 % have been negative. The year-over-year change has been -33.5% on a share-weighted basis, -23.2% market cap-weighted and -34.7% non-weighted. Ex-financial stocks these numbers are -33.0%, -22.6%, and -31.1 %, 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 76.1% that the Fed will *leave rates unchanged* on August 12th, a probability of 16.3% of cutting 25 basis points to 0.0%, and a probability of 7.6% of *raising 25 basis points*.

IMPORTANT DISCLOSURES

I, Wayne S. Kaufman, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.



On Thursday the S&P 500 closed below the 20-sma for the first time since 3/11. It is trying to hold support at the 878 - 875 zone.

Our momentum indicators are at neutral levels with the stochastic and MACD on sell signals.

We have been discussing the 200-day moving average coming into play, and on the weekly chart the almost identical 40-week average highlights the point.

The stochastic is on a sell signal on the weekly chart.

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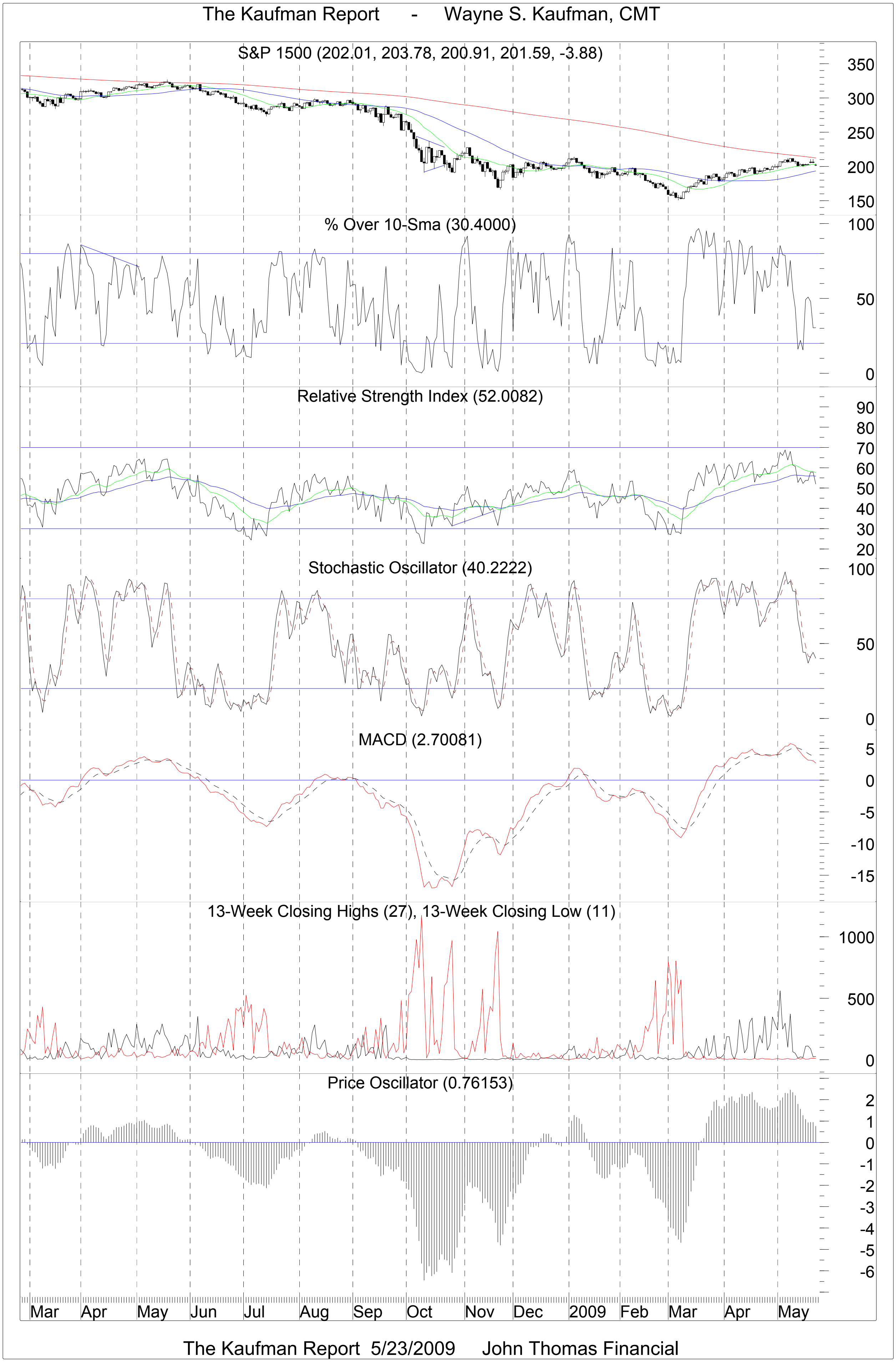
The Nasdaq 100 is hanging on to its 200-sma. Support is the 5/13 low of 1339.82 and thereafter the rising 50-sma, currently at 1320. A break of the 5/13 low would target 1327 on a measured move basis.

Our momentum indicators are at neutral levels, with the stochastic and MACD on a sell signals.

The weekly chart of the Nasdaq 100 clearly shows the recent price resistance with long shadows at the top of the weekly candles.

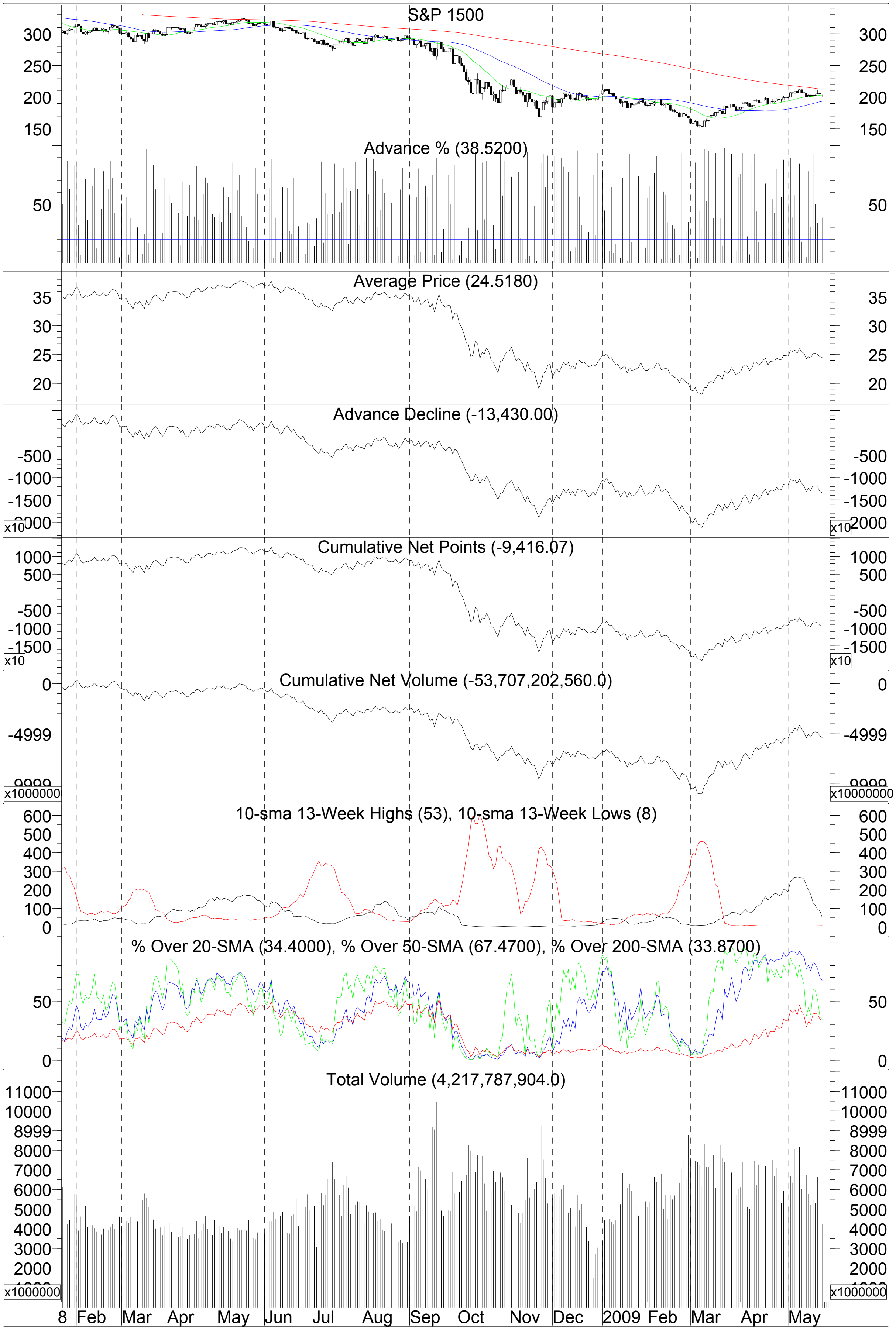
Our weekly momentum indicators remain at high levels with the stochastic showing a negative crossover in the overbought zone.

The ADR Index continues to outperform the S&P 500 and the Nasdaq Composite.



Our momentum indicators are no longer at high levels on the daily chart, but they have room to move lower before getting oversold.

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



After Monday's 93% of stocks advancing this indicator has been weak.

The Advance Decline line, a leading indicator,has fallen below the May lows.

Only 34.4% of stocks are below their 20-sma.

Volume has been drying up recently, showing a lack of conviction by both bulls and bears.

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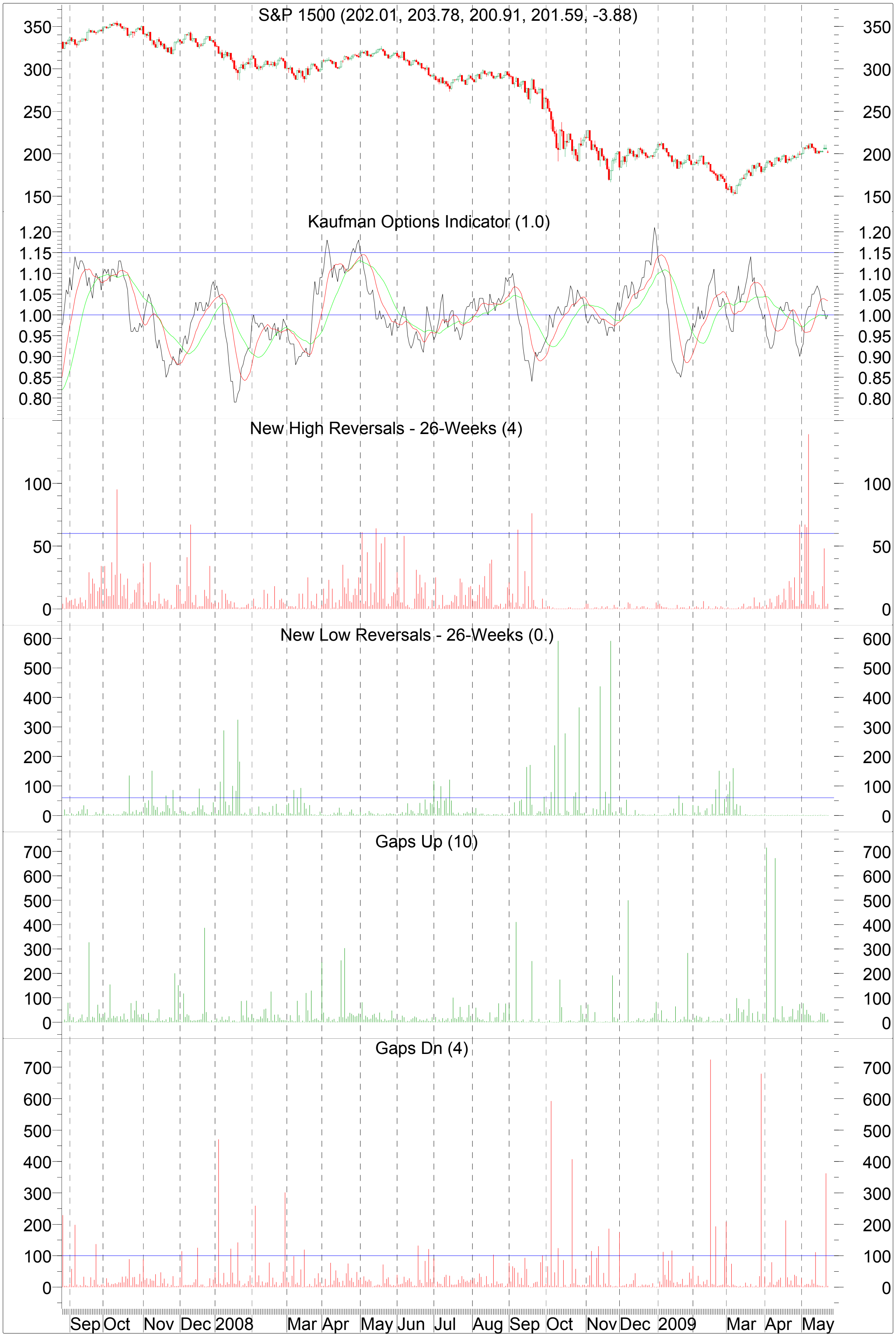
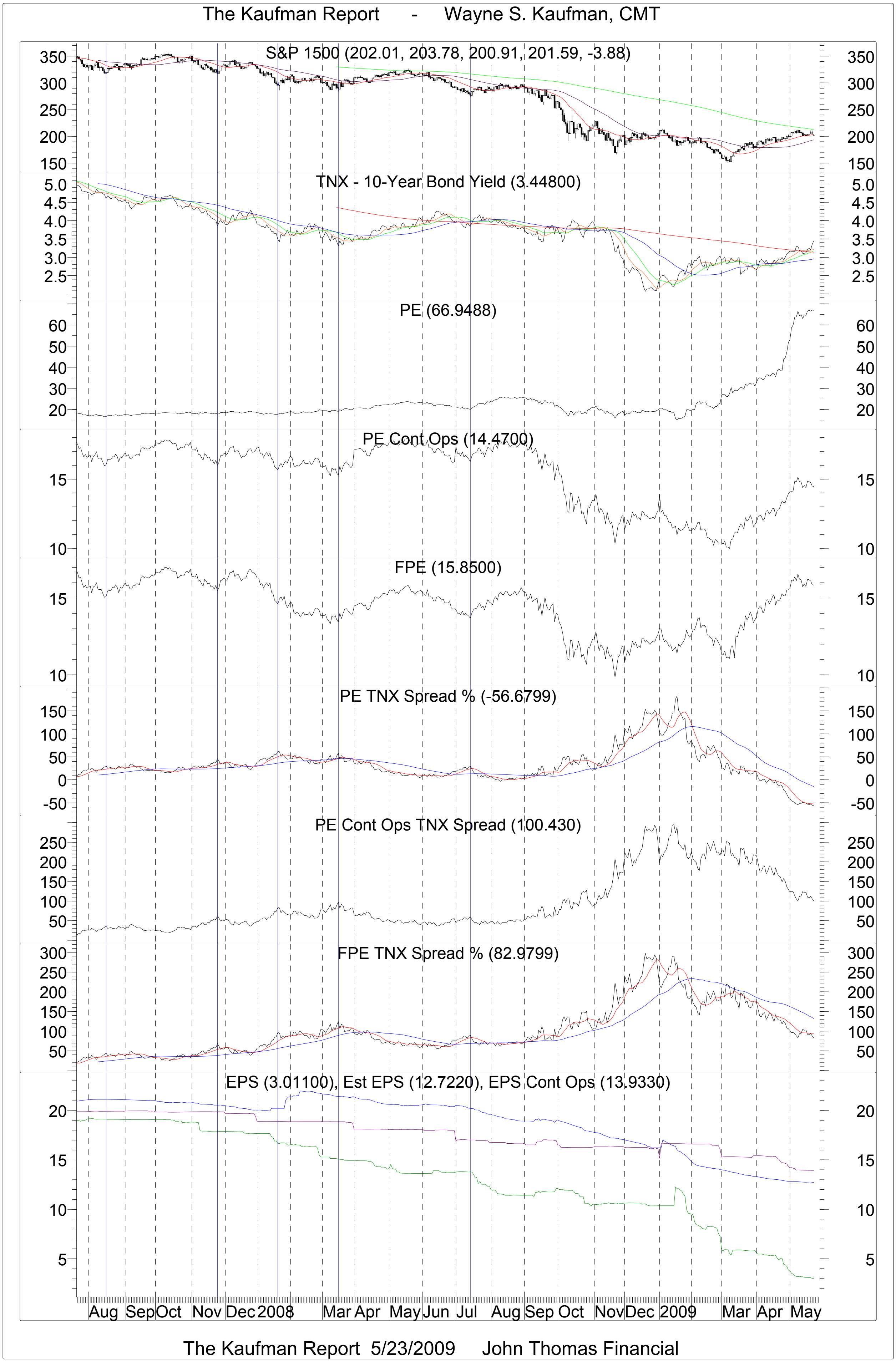


Our proprietary options indicator is neutral.

Last week we pointed out some negative crossovers in our statistics of supply (red) versus demand(green). It is easily seen that the recent weakness is more due to a withdrawal of demand than a big increase in supply. Still, lack of demand at these levels leaves stocks vulnerable to a further decline.



Bond yields are breaking out.

Spreads between bond yields and earnings yields have moved down as bond yields rise and earnings continue their inexorable move lower.

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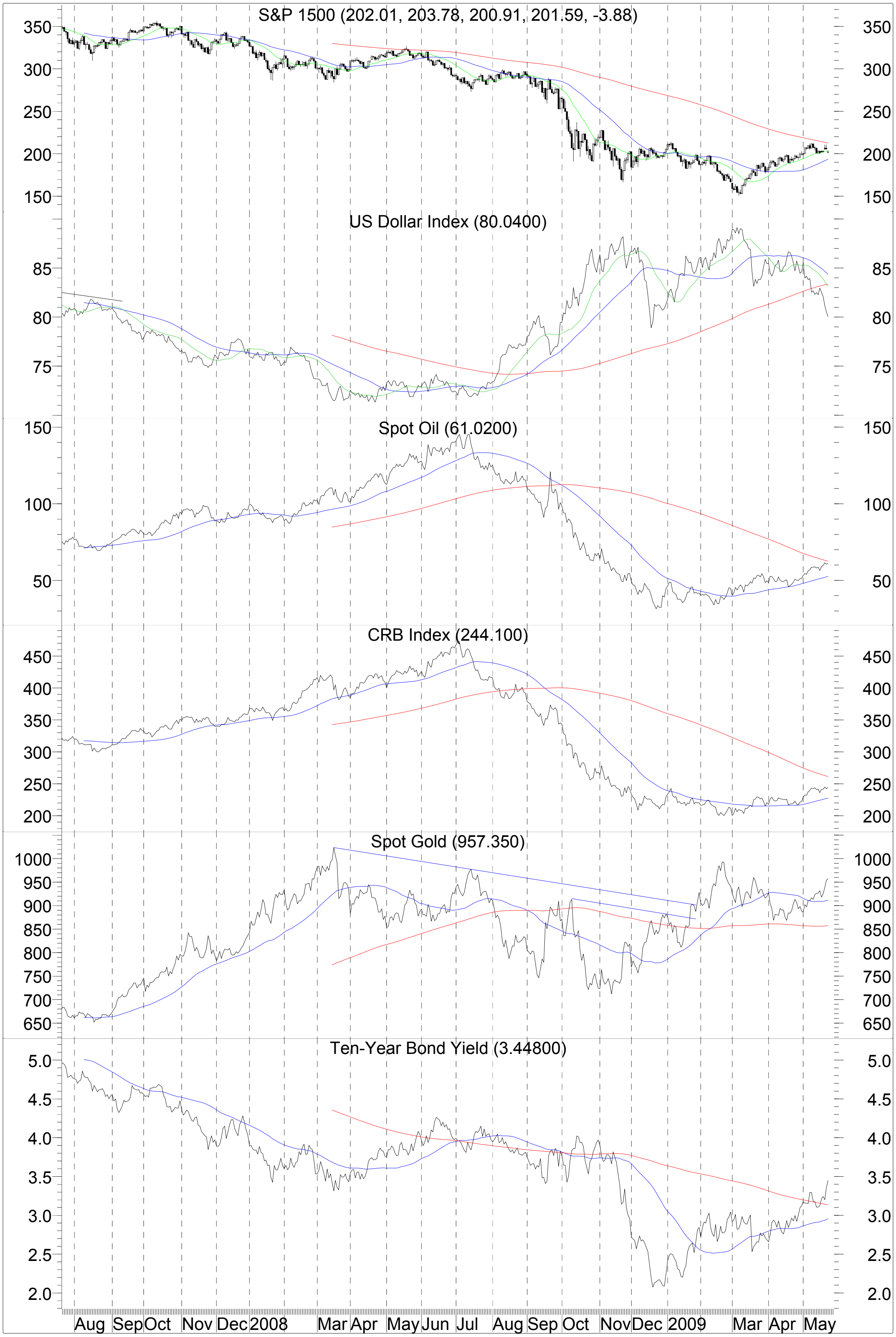

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We have been calling for a move down in the U.S. Dollar. It is getting short-term oversold, so a bounce is likely soon, but we expect further weakness after that.

Oil has had a terrific rally and is getting overbought. A pullback here would coincide with a bounce in the U.S. Dollar.

Gold looks like it will top out shortly, but after a pullback we expect higher prices.