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The Kaufman Report

Trade what you see, not what you think.

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Monday May 5, 2008 **Closing prices of May 2, 2008**

Climbing a Wall of Worry?

It seems like a long time since December 16th, when we wrote our essay on "the slippery slope of hope." The S&P 1500 was at 331.06, only 7.1% off its all-time high set in October. We had been issuing warnings about deteriorating market conditions, including our November 23rd discussion of the Dow Theory sell signal which had taken place. However, most investors were clinging to various reasons why the market should rally, such as being in the best seasonal period for stocks, hopes for a Fed sparked rally, and hopes for a year-end rally. We reminded investors that bear markets slide down the slippery slope of hope, and by January 22nd, less than six weeks later, the S&P 1500 was down 13.2%.

The mirror image platitude which corresponds to the slippery slope of hope is that "bull markets climb a wall of worry." With the positives that have occurred recently in the stock market we think it is timely to remind everyone of this old saying. As we reported recently, we have had a Dow Theory buy signal. Thursday's rally created 289 closing highs in the S&P 1500, the most since June 4th. Over 72% of the stocks in the index are now over their own 50-day moving averages, the most since October 10th. The major indexes have broken through their down trend lines from their October highs, and are now challenging their 200-day moving averages. Should they decisively surpass those 200-day averages, they will officially be back in long-term up trends. April closed up 4.95% for the month, breaking a five-month losing streak.

More good news is the loss of down side leadership. All markets, bull or bear, must have leaders. This bear market was led down by Financials and Homebuilders. They are each currently outperforming the S&P 500, with Homebuilders up 17.66% year-to-date, Financials up 10.85% quarter-to-date, and broker/dealers up 18.24% quarter-to-date. With first quarter earnings season almost 80% over, we just don't see a resumption of downside leadership taking place anytime soon.

In the short-term we are expecting a pull back. Our proprietary options indicator is showing too much bullishness. There are negative divergences on some breadth indicators. Major indexes are now at or near down-sloping 200-day moving averages or near other resistance. On Friday there were 61 stocks in the S&P 1500 that had down closes after making new 26-week intra-day highs. In the past 60 or more reversals has been a warning of impending weakness.

Our strategy for some time has been to buy leading stocks while watching for sector rotation and being prepared for the down trend to resume. We continue to follow that course of action while hoping that after a brief pull back stocks will strengthen and successfully challenge the last barriers that prevent us from changing our mammalian description of this market from one with claws to one with horns.

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Monday May 5, 2008 **Closing prices of May 2, 2008**

The S&P 1500 rallied again Friday and closed at its highest level since January 3rd. However, breadth was negative and the average price per share actually declined. There are some warnings signs appearing, and we are about to leave a seasonally strong period for stocks.

There has been dramatic sector rotation as the U.S. Dollar has rebounded smartly, and maintaining their historic inverse relationship with the Dollar commodities and commodity based stocks have dropped. Former laggards like technology, financials, and Asian stocks have been the best performers the last couple of weeks.

Federal Funds futures are pricing in an 84% probability that the Fed will *leave rates at 2.00%,* and a 16% probability of *cutting another 25 basis points to 1.75* when they meet again on June 25th.

So far 393 companies have reported first quarter earnings. According to Bloomberg 62.6 % have had positive surprises, 10.4% have been in line, and 27.0% have been negative. The year-over-year average change has been -12.7% on a share-weighted basis, +2.3 % market cap-weighted, and -9.1% non-weighted.

The S&P 1500 (319.92) was up 0.282% Friday. Average price per share was down 0.11%. Volume was 102% of its 10-day average and 103% of its 30-day average. 42.25% of the S&P 1500 stocks were up on the day. Up Dollars was 69% of its 10-day moving average and Down Dollars was 84% of its 10-day moving average. For the week the index was up 1.103% on flat but below average weekly volume.

Options expire May 16th. The FOMC meets June 25th.

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The S&P 1500 printed a bearish shooting star candle at a resistance area as shown on the next chart.

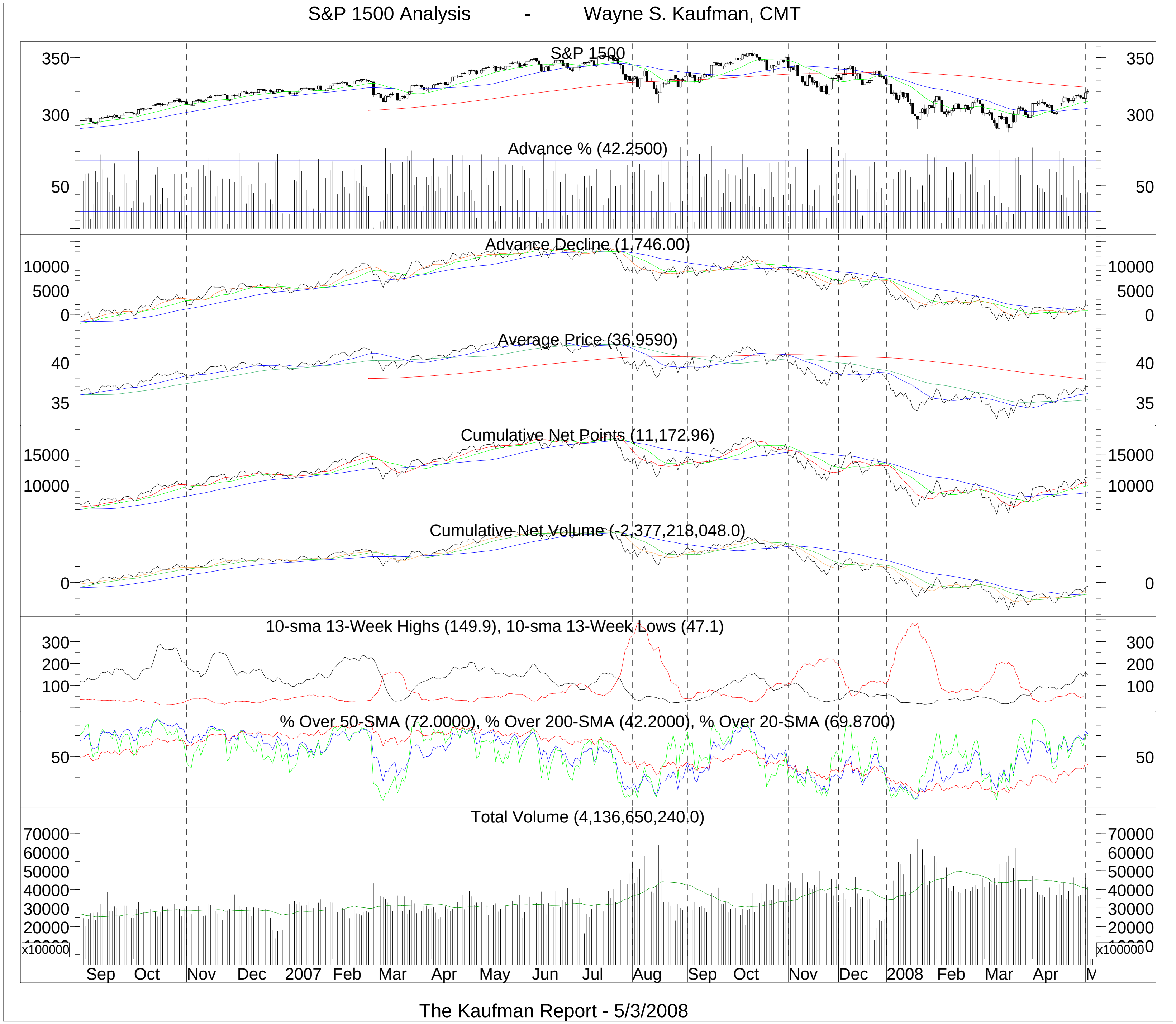
Our oscillators are at high levels but not extremes.

There is a negative divergence on the percent over 10-sma.

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

S&P 1500 Analysis - Wayne S. Kaufman, CMT

The S&P 1500 broke out of a reverse head & shoulders pattern recently with a price target in the 339 area. Unfortunately the down sloping 200-sma (red) is not far above, and the index has formed a bearish rising wedge pattern (Purple). The upper line of the wedge is resistance. Friday's close was also just under the 50% retracement (320.36) of the move down from the October high. Friday's price action formed a shooting star, which is a candle seen at tops.



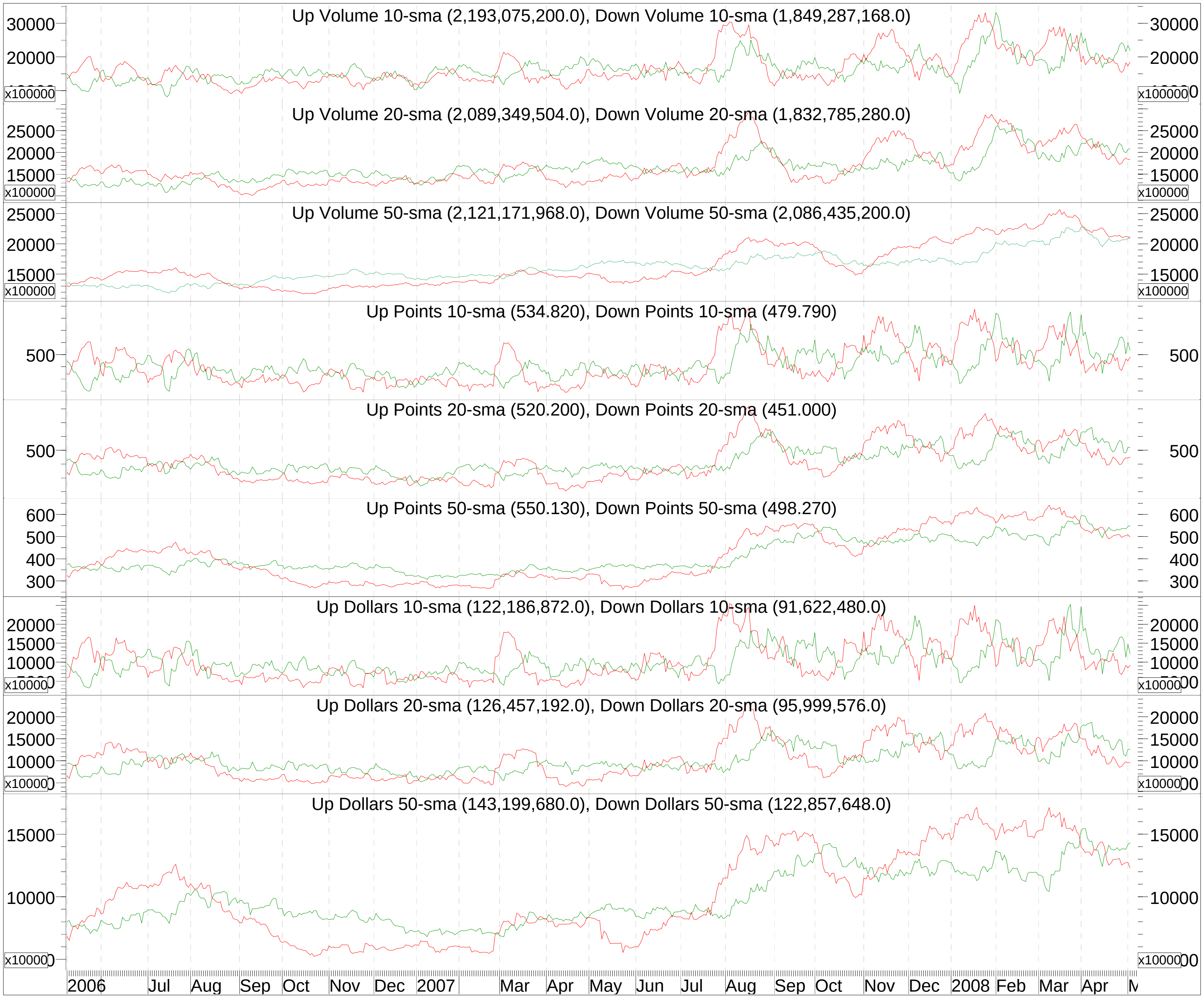
The AD line did not confirm the recent break-out in the index.

The percent of stocks over the longer-term moving averages has improved dramatically.

Our proprietary options indicator remains at high levels showing optimism among options buyers. Too much bullishness leaves stocks vulnerable to pull backs.

On Friday there were 61 stocks making 26-week intra-day highs but closing lower on the day. This is a high number and usually precedes a pull back. Sometimes there is a second day with a number over 60 within a few days, and then there is a pull back. Either way it shows an increased desire on the part of investors to take profits.

S&P 1500 Analysis - Wayne S. Kaufman, CMT



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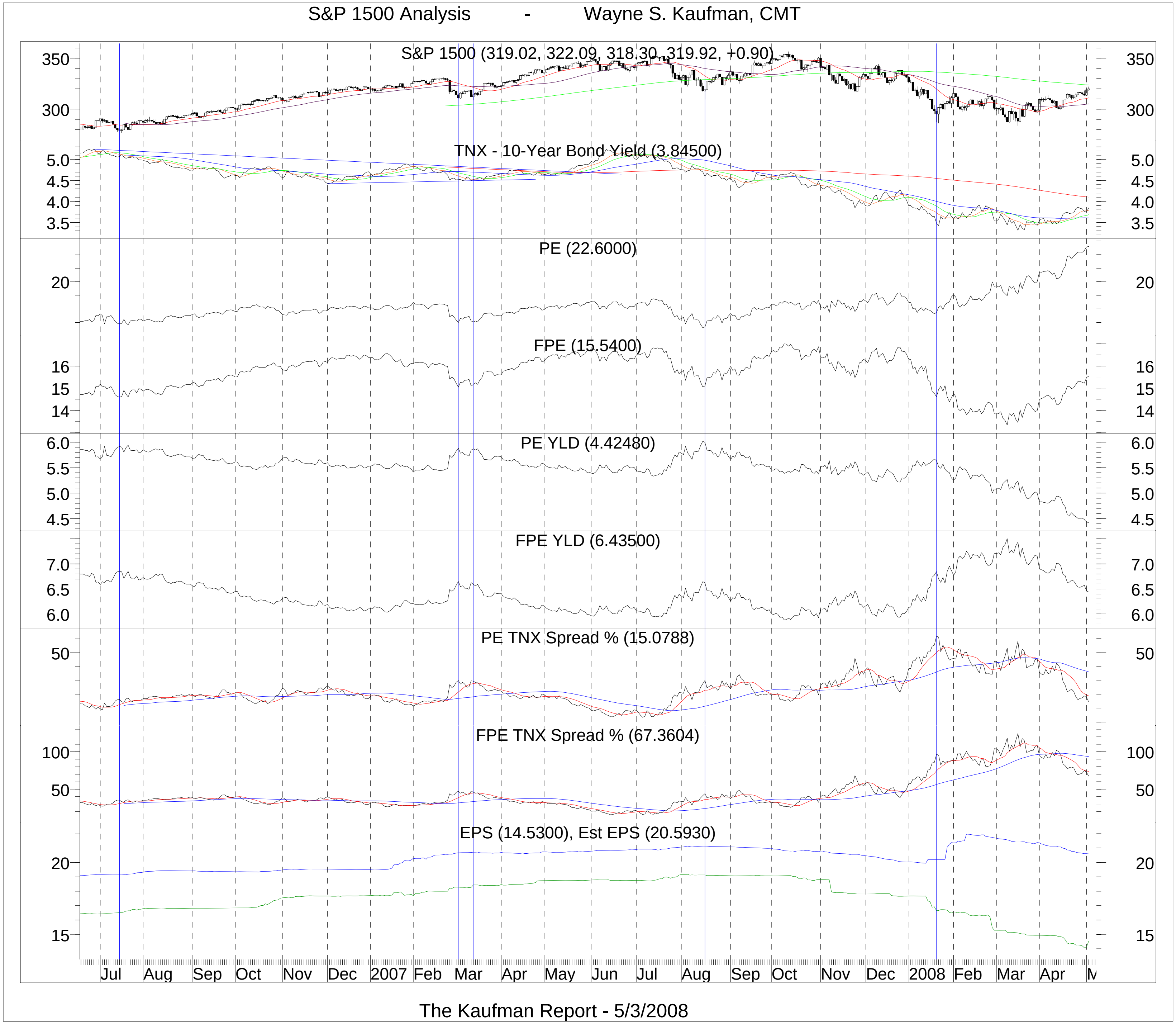
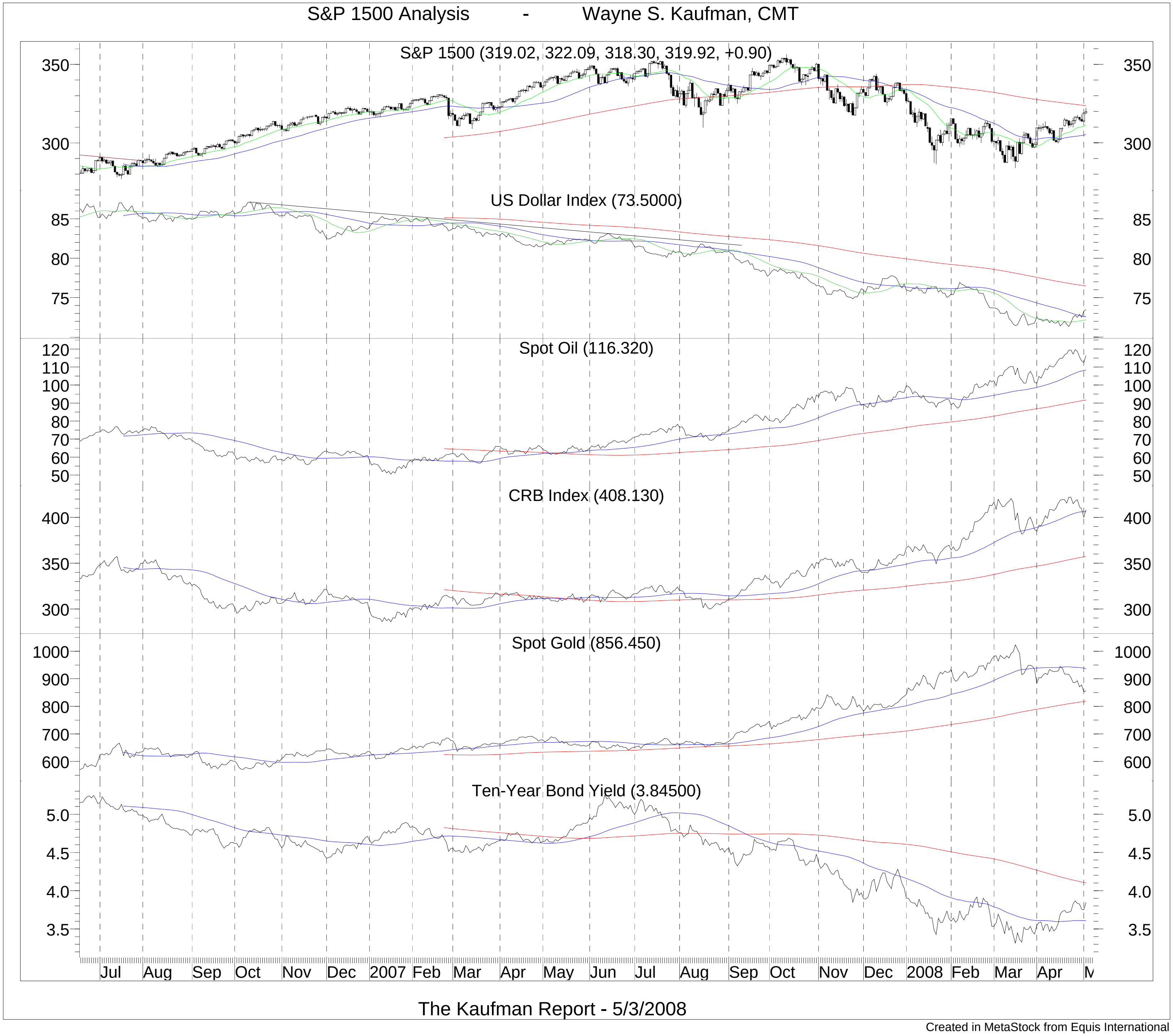
All of our statistics of supply (red) and demand (green) are positive for all time frames. However, a good deal of this is from sellers stepping to the sidelines. Unless buyers become more enthusiastic, an increase in the desire to sell will easily send prices back down.



10-year bond yields are now in an intermediate-term up trend, and are not yet overbought.

The P/E ratio, already the highest since 2004, continues to rise ominously higher.

The spread between the equity yield based on current P/E and bond yields is no longer in a very attractive area. The spread based on forward earnings is. However, current and projected earnings need to stop their relentless march lower.



The U.S. Dollar Index has rebounded from an over-sold condition to move into an intermediate-term up trend. It is not yet overbought.

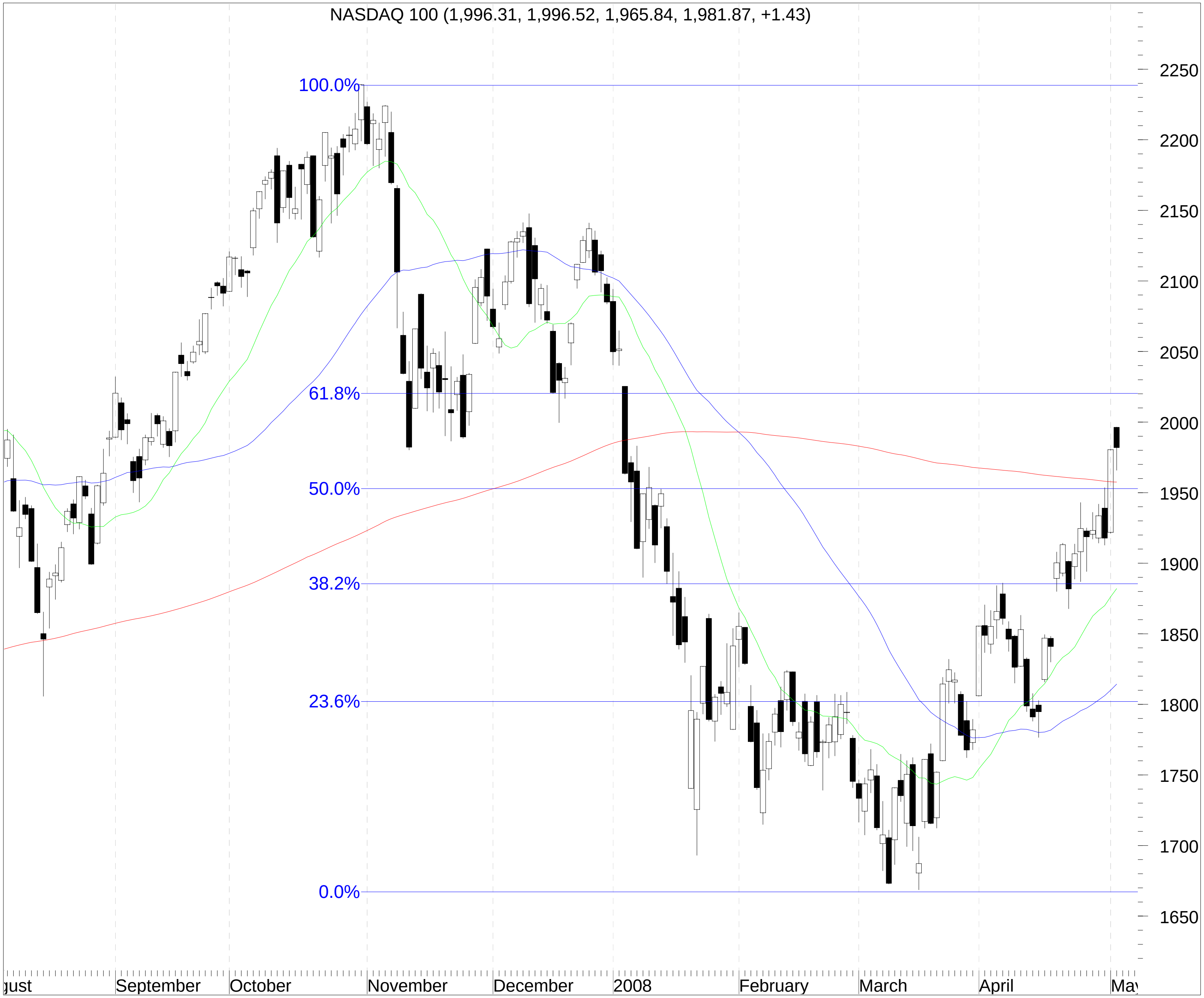
Crude oil is still hanging tough in spite of strength in the U.S. Dollar. If it does not succumb soon it increases the odds of new highs in oil shortly.

The commodities index may be putting in a double top. It needs to drop below 380 to confirm it.

Gold has followed its classic inverse relation-ship to the U.S. Dollar. It is trying to find support at current levels and may be due for a rally.

S&P 1500 Analysis - Wayne S. Kaufman, CMT

The DJIA is at the 200-sma. The last candle on the chart should not be there, it is a data error. However, Friday's real candle is a shooting star so the index may be ready for a breather.



The Nasdaq 100 has exceeded the 50% retracement of the move down from its October highs. This is a sign of strength.

The ADR Index has broken through one resistance level and is back above its 200-sma.

The ADR Index is outperforming the S&P 500 but not the Nasdaq Comp.