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The Kaufman Report

Trade what you see, not what you think.

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Monday November 3, 2008 **Closing prices of October 31, 2008**

Last Sunday night we discussed various bearish factors that had occurred in the prior week and which pointed to lower prices to come, such as all the major indexes making new closing lows that Friday, and the Dow Transports confirming the new closing low in the Dow Industrials. We also pointed out positive divergences which had been developing, very wide spreads between bond and earnings yields, and said a sharp relief rally could begin at any time. We also said that the last week of October cathartic plunge that many market watchers were hoping would flush out the last of the sellers seemed unlikely to us because the market is rarely so accommodating as to follow a game plan hoped for by so many.

The S&P 1500 began the week lower Monday but stayed just above the lows of October 10th. A strong rally Tuesday was the start of a move that sent the S&P 500 to its best week in 34 years. Of course, it still left October as the worst month since the crash of October 1987, but we're happy to end the month this way. The S&P 1500 closed the week up 10.84% and moved over its 20-day moving average for the first time since September 19th. It also pushed the percentage of stocks over their own 10-day moving average to 84.33%, getting to the overbought (over 80%) level for the first time since August 11th. We have been stressing for many weeks that markets that do not respond to oversold levels are dangerous, so hitting the 84% level can be viewed as a positive for the near-term.

That said, a pull back from short-term overbought levels is likely. Add to that the tendency of stocks to move to neutral levels ahead of important events, and it wouldn't be a surprise to see some weakness early in the week. Some of last week's rally can be attributed to end-of-month window dressing, and our statistics show there has been a decrease in the intensity of selling as opposed to any big increase in demand.

Earnings season is nearing an end as 72% of the S&P 500 have reported. Unfortunately earnings and projections keep moving down, although the results after subtracting the financial stocks are not as terrible as one might have thought. Still, the P/E ratio of the S&P 1500 is almost back to 21. Spreads between equity and bond yields are narrowing sharply. Options buyers are becoming bullish again, with Thursday's Put/Call ratio hitting 0.80 right after Wednesday's 0.79. We are watching all of these numbers carefully and will be alert if they near levels where prior weakness in stocks has occured.

In the meantime, we continue to be hopeful that the recent price action proves to be a successful retest of the lows of October 10th, giving us at least a multi-week rally. It is possible that most of the bad news regarding the current earnings season and the upcoming election are already in stock prices, and that forced liquidations have subsided for the time being. Sellers have become less aggressive, and there is a strong chance that no matter who wins the election investors will become more optimistic about the future. Therefore, we are trying to trade what may become a good rally, while keeping alert for signs of weakness and distribution which could mean the resumption of the downtrend. Until proven otherwise, we need to view any rally as being of the bear market variety.

IMPORTANT DISCLOSURES

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The S&P 1500 (219.52) was up 1.738% Friday. Average price per share was up 3.08% as small-caps had a big day. Volume was 101% of its 10-day average and 96% of its 30-day average. 83.37% of the S&P 1500 stocks were up on the day, with up volume at 70.8% and up points at 88.5%. Up Dollars was 94.7% of total dollars, and was 130% of its 10-day moving average while Down Dollars was 8% of its 10-day moving average. The index was down 17.46% in October, 33.76% year-to-date, and 38.4% from the peak of 356.38 on 10/11/07. Average price per share is down 40.68% from the peak of $43.23 on 6/4/2007. For the week the index was up 10.84% on increasing and above average weekly volume.

The Put/Call Ratio was 0.957. The Kaufman Options Indicator was 1.02.

The spread between the reported earnings yield and 10-year bond yield is 20.52% and 104.29% based on projected earnings.

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $10.50, a drop of 45.26%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $17.81, a drop of only 18.86%. Analysts have obviously been very late in lowering estimates, and have also been way too optimistic. *If investors had any confidence in current earnings estimates stocks would be much higher than they currently are.* The earnings numbers jumped up recently as Lehman, Fannie and Freddie were unceremoniously kicked out of the S&P indexes, highlighting the old expression that sometimes less is more. We are waiting for GM to be kicked out of the Dow.

360 companies in the S&P 500 have reported third quarter earnings. According to Bloomberg, 61.0 % have had positive surprises, 10.6% have been in line, and 28.4% have been negative. The year-over-year change has been -10.5% on a share-weighted basis, +6.3% market cap-weighted, and +4.6% non-weighted. Ex-financial stocks these numbers are 16.1%, 26.6%, and 23.2%, respectively.

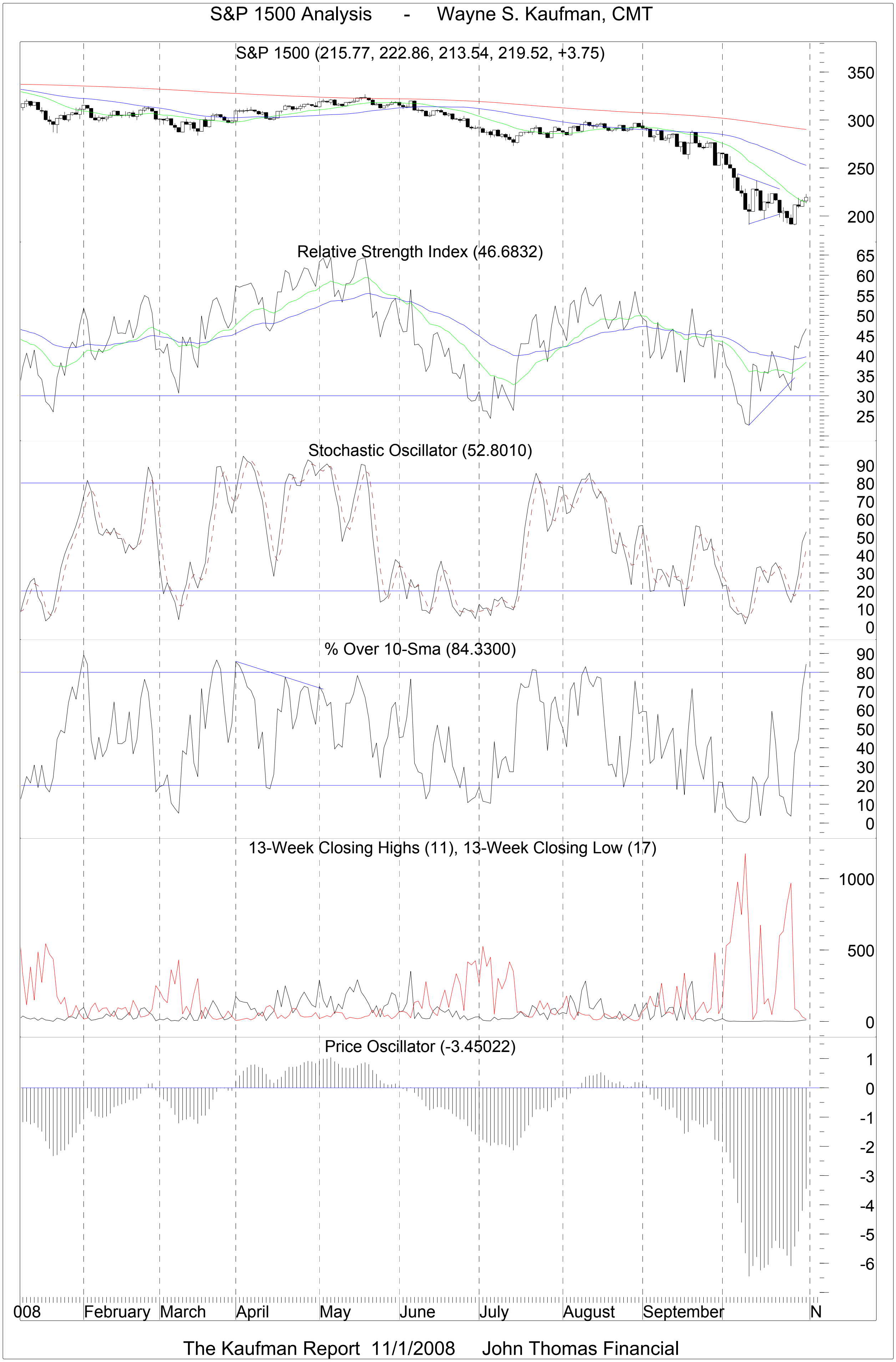
Federal Funds futures are pricing in a 55.3% probability that the Fed will *cut rates 50 basis points to 0.50%,* and a 44.7% probability of *cutting 25 basis points to 0.75%* when they meet on December 16th. They are pricing in a 49.3% probability that the Fed will *cut rates 25 basis points to 0.75%* on January 28th, and a 31.4% probability of *cutting 50 basis points to 0.50%.*

The short-term trend is up, while the intermediate and long-term trends are down. We reiterate that this continues to be a bifurcated, opportunistic trader's market, with adept traders able to take advantage long or short, but the longer-term downtrends must be respected. Investors need to be alert to sector rotation and should not hesitate to move out of lagging sectors and stocks and into leaders.

Options expire November 21st. December options expire the 19th.

IMPORTANT DISCLOSURES

The S&P 1500 rallied for the third time in four sessions Friday and closed above the 20-sma for the first time since September 19th. The 5-sma (not shown) is above the 10-sma (not shown) for the first time since September 2nd.

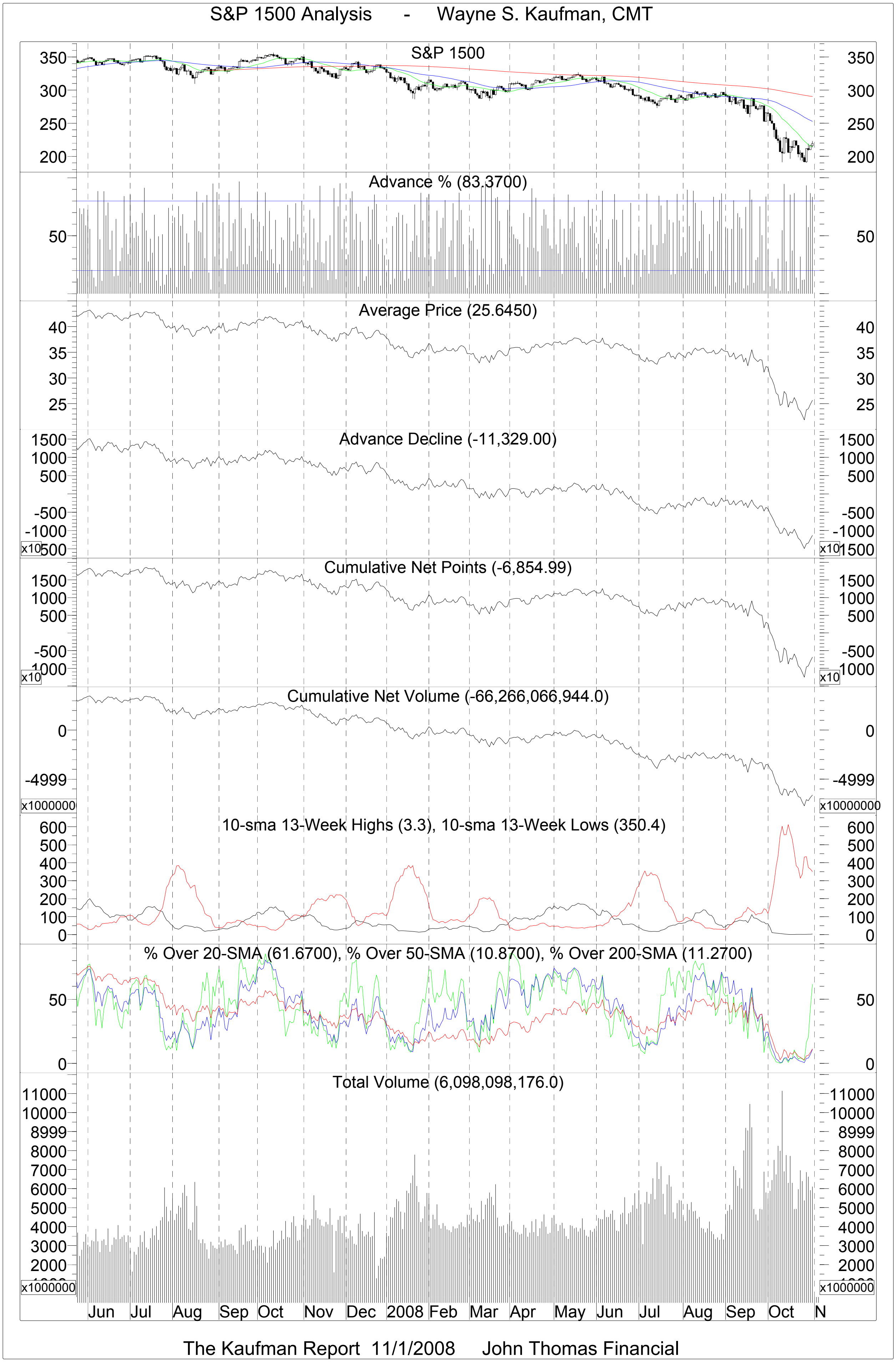


The positive divergence on the RSI gave us an indication an overdue rally was ready to occur.

The percent over 10-sma is in the overbought zone. While a pullback will occur, this is a positive sign. We have been warning that a market that doesn't respond to oversold conditions is dangerous, and this is the first decent response in a while.

New closing lows was another positive divergence.

Our price oscillator is still in negative territory, but is moving in the right direction after hitting very extreme levels.

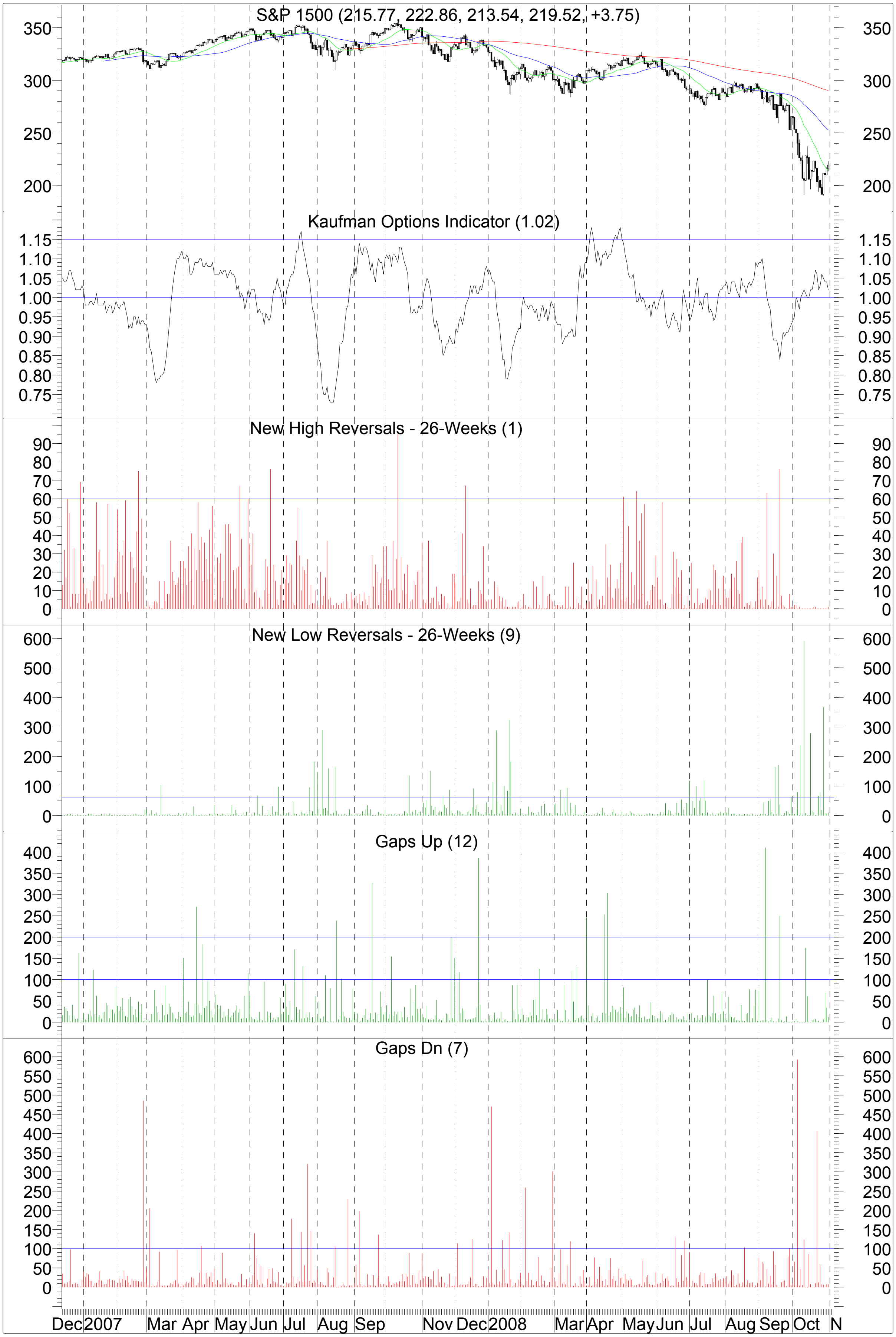


83.37% of the S&P 1500 traded higher Friday.

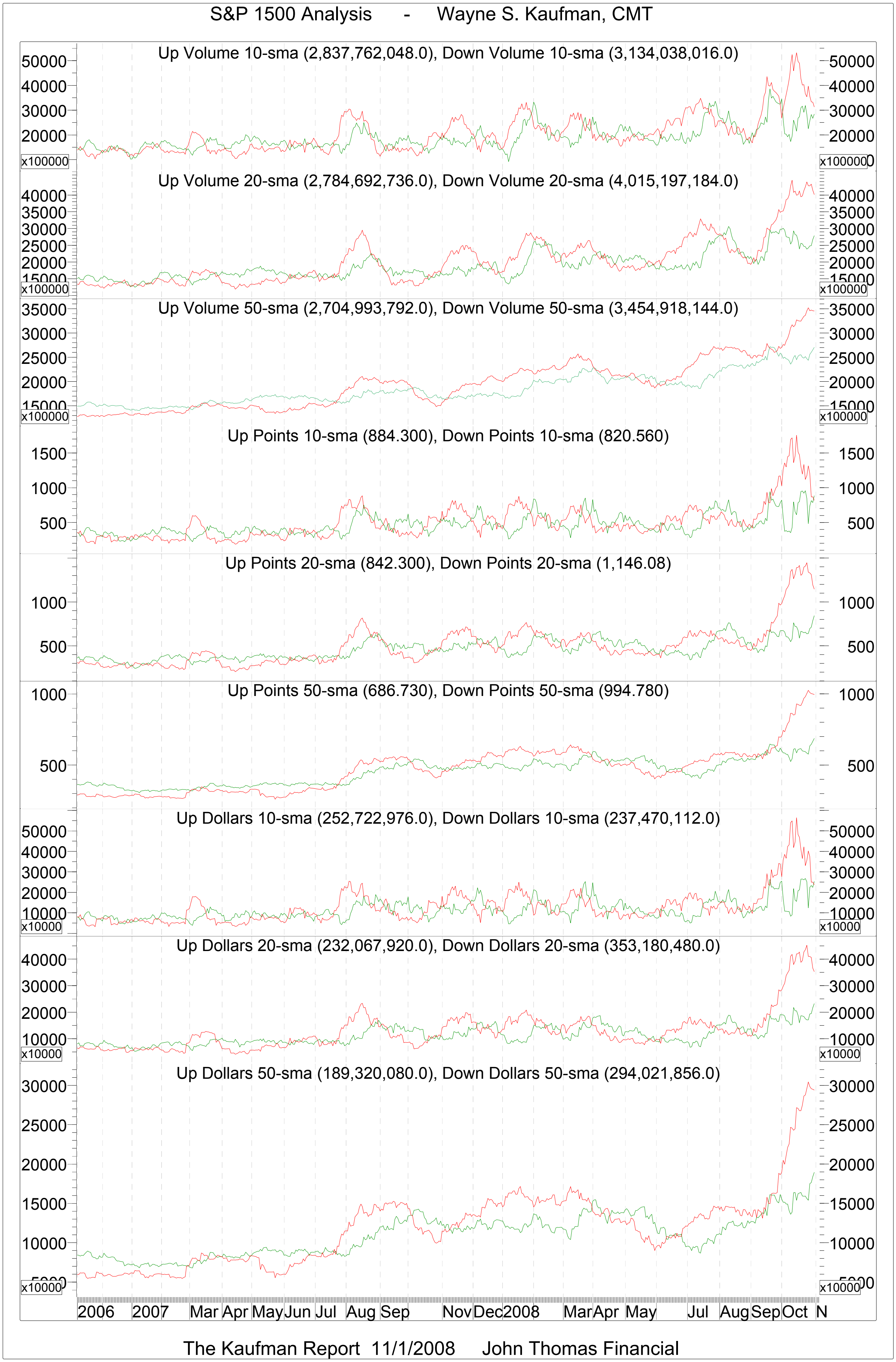
The percent of stocks over their 10 and 20-day moving averages has finally popped up, but the number over the longer-term averages is still extremely low.

Volume was about flat Friday versus Thursday and was about average.

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



Our proprietary options indicator is showing slight bullishness.



Based on the 10-day statistics of supply (red lines) versus demand (green lines) the recent rally is due more to a contraction in supply than a big pickup in demand. Maybe more buyers will step off the sidelines if sellers remain less aggressive than they have been through most of October.

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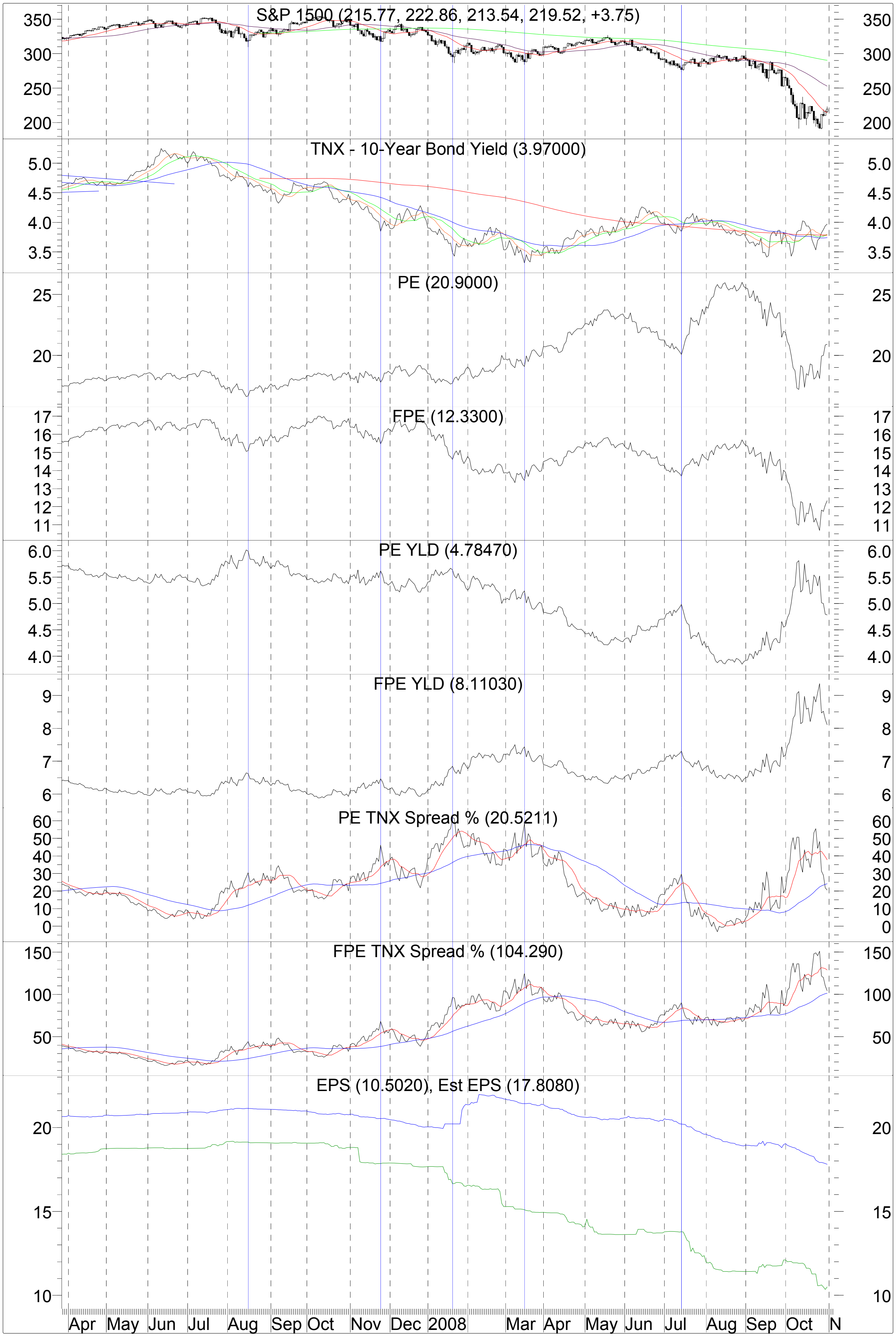

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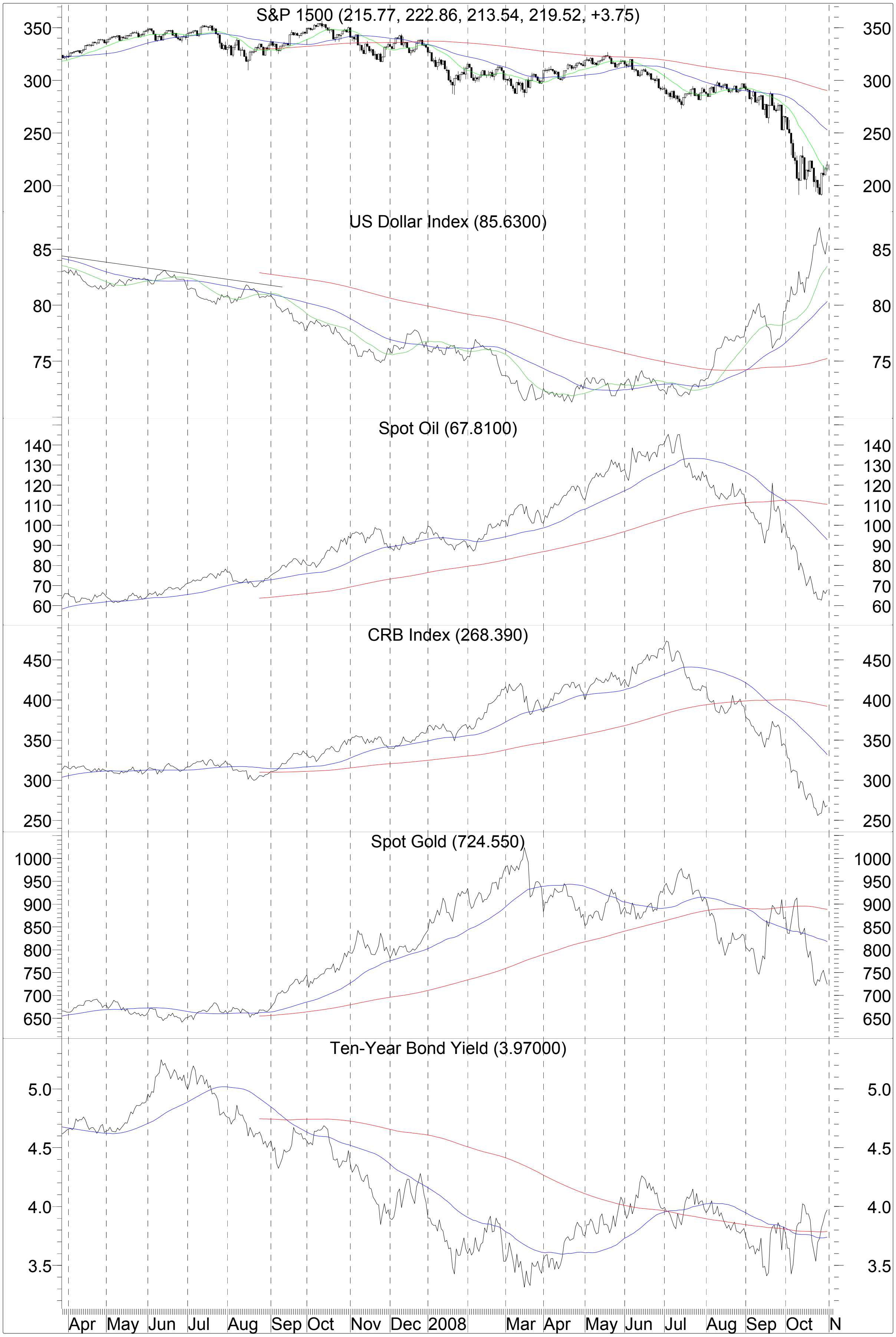
10-year bond yields are in an up trend and are not yet overbought.

The P/E ratio is rising again.

Spreads between bond and equity yields are plunging as stocks and bond yields rise in tandem.

Earnings (green) and projected earnings continue their inexorable move lower.

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



The U.S. Dollar Index ran into resistance at the 88 area and pulled back. It is in an up trend and not overbought.

Crude oil is bouncing from oversold levels.

Gold has support at the 700 area.