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The Kaufman Report

Trade what you see, not what you think.

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Monday October 13, 2008 **Closing prices of October 10, 2008**

On Friday stocks capped the Dow's worst week ever with the biggest one-day swing ever. It was also the S&P 500's worst week since 1933 in what is poised to be the worst year since 1937. *Simply put, we are experiencing the crash of 2008.* For the week the S&P 1500 was down a flabbergasting 17.98%.

On 9/28 we said there was the possibility of a market crash. Since then, only ten trading sessions later, the S&P 1500 is down a staggering 25.91% to the lowest level since May 2003. Before Friday's afternoon rally it was down 30.81% to the lowest level since April 2003. Year-to-date the index is down 38.19%, and since the peak last October 11th it is down an inconceivable 42.5%.

Stocks plunged Thursday sending the S&P 1500 down 7.6%. After finding intra-day support at the 960 level on the S&P 500, which is the Fibonacci 76.4% retracement level of the entire bull market from 2002 - 2007, stocks broke the 960 level at about 2:50 pm and accelerated downward. We said Thursday night this greatly increased the possibility of a 100% retracement of the entire five-year bull market. Incredibly, it looked like the market wanted to do just that on Friday alone.

Everyone knows stocks are at historically oversold levels, so we won't belabor the point by going into all the breadth statistics here because they no longer matter. Search all you want for the magic technical indicator, they are all showing the same extreme condition. Suffice it to say we are in unchartered waters.

Valuations based on spreads between equity and earnings yields are at ridiculous levels, but as we have said many times recently *valuations don't matter when liquidations are forced*.

A sharp rebound relief rally is due at any time. When it takes place we will be skeptical of it being "the" bottom as long as our options indicator is not showing the kind of bearishness seen at prior important bottoms. The only exception to that would be if we somehow see extreme demand for stocks resurface.

We have entered earnings season for the third quarter, and we can't remember one that had such little attention paid to it. Maybe this can be the catalyst for the short-term bottom we have been hoping to see this week.

The short, 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 primary downtrend 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.

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Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $11.91, a drop of 37.9%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $18.67, a drop of only 14.94%. 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.

37 companies in the S&P 500 have reported third quarter earnings. According to Bloomberg, 67.6% have had positive surprises, 7.2% have been in line, and 25.2% have been negative. The year-over-year change has been -22.8% on a share-weighted basis, -40.0% market cap-weighted, and +14.6% non-weighted. Ex-financial stocks these numbers are 4.3%, 5.0%, and 93.1%, respectively.

Federal Funds futures are pricing in an 72.0% probability that the Fed will *cut rates 25 basis points to 1.25%,* and a 28.0% probability of *cutting 50 basis points to 1.00%* when they meet on October 29th. They are pricing in a 46.9% probability that the Fed will *cut rates 25 basis points to 1.25%* at the meeting on December 16th, and a 43.3% probability of *cutting 50 basis points to 1.00%.*

The S&P 1500 (204.84) was down 0.881% Friday. *Average price per share was up 1.11% due to strength in small-caps*. Volume was 155% of its 10-day average and 169% of its 30-day average. 54.62% of the S&P 1500 stocks were up on the day. Up Dollars was 181% of its 10-day moving average and Down Dollars was 32% of its 10-day moving average. For the week the index was down 17.98% on increasing and well above average weekly volume.

Options expire this week on October 17th. November options expire November 21st.

IMPORTANT DISCLOSURES

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OPINION – the following opinions are those of the editor, and are not necessarily held by the owners of John Thomas Financial.

This is a frightening time for Americans, and for many around the world. Sadly, our political leaders have failed us miserably. They have been incompetent and dishonest. Unfortunately, part of their dishonesty comes from the sad fact that Americans don't want to be told the truth. We continually elect people who tell us what we want to hear, not what we need to hear.

Who has been incompetent? Paulson, Bernanke, Bush, Pelosi, Dodd, Frank, the list is endless. Paulson and Bernanke have told Americans for the last two years that the sub-prime mess wouldn't spill over into the rest of the economy. At the FOMC meeting of September 16th the Committee was still talking about upside risks from inflation. When these two bumblers finally realized there was a crisis, they cobbled together a formless bailout plan and expected everyone to just sign on at a moments notice. Competent managers would have been aware of the problem months ago, structured a plan, and ahead of time would have gotten a consensus among legislators should an emergency plan need to be enacted. Instead we got a two-week circus that damaged the little credibility Paulson and Bernanke had left.

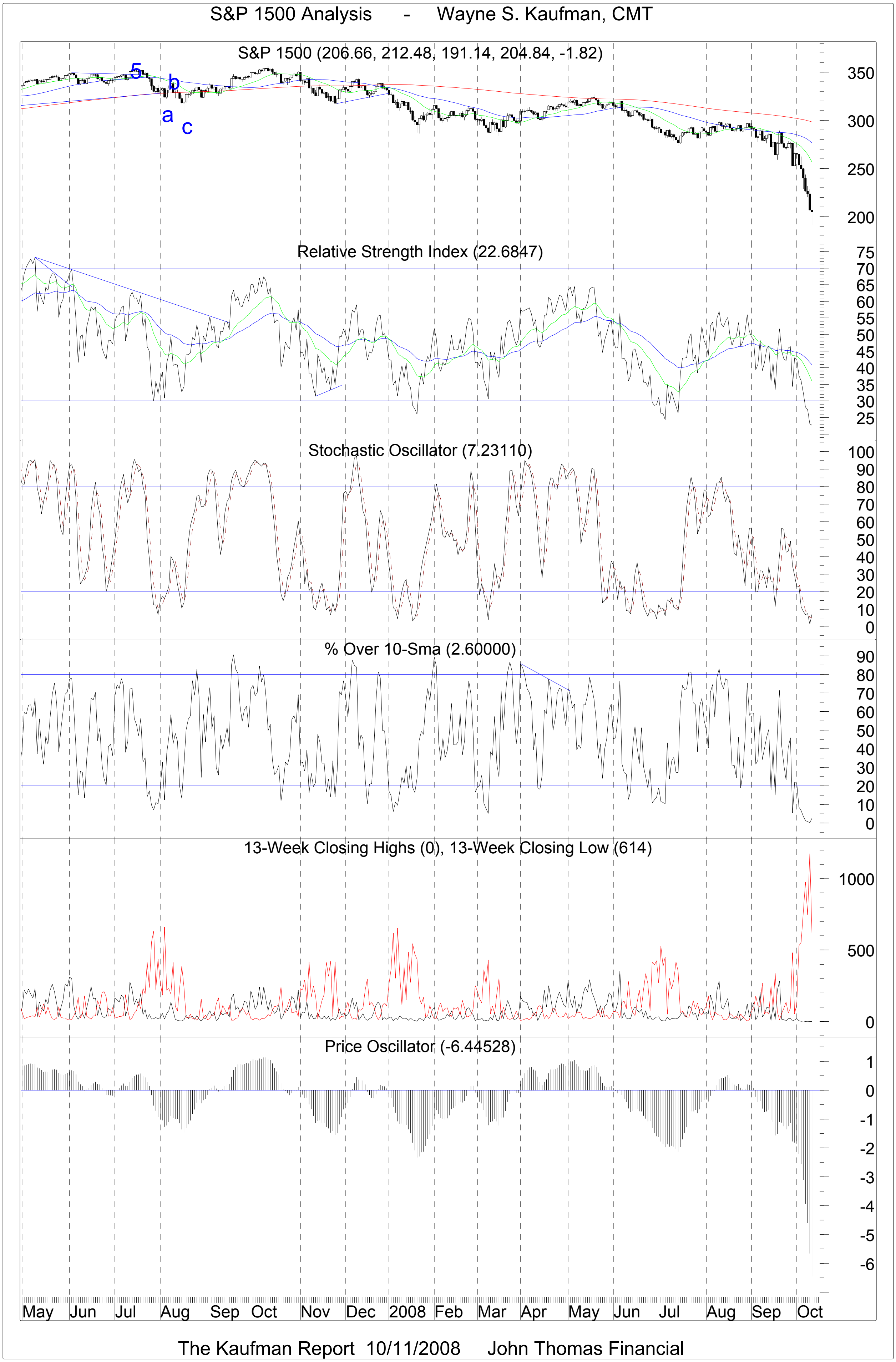
We got an emergency inter-meeting rate cut on October 8th. Why didn't Bernanke cut rates September 16th? Either he didn't see the risks, or he believed the soon to be unveiled bailout plan was going to be enough to re-instill confidence in the financial markets. We actually hope it was the latter. It's too scary to think he was so clueless that he never saw this coming. Still, how naïve and slow to react is this guy if he thought just unveiling a vague bailout plan would stop the carnage?

Who has been dishonest? Pelosi, Dodd, Frank, Reid, Obama, and others who for years stood in the way of fixing the problems at the festering sores known as Fannie Mae and Freddie Mac. Has there ever been as repulsive a display of lying as these "public servants" have displayed as they not only denied responsibility but pointed fingers at those who were trying to fix the problem? It is a matter of public record that these Democratic leaders ran interference against multiple efforts since 2001 to have greater regulation of Fannie and Freddie. It is well known that Senator Dodd has been the number one recipient of campaign contributions from Fannie Mae, to the tune of $160,000. Barack Obama is number two. However, Obama got his $120,000 during his short time as a senator, making him the number one recipient by far of Fannie Mae contributions over the last three years. This is change we can believe in? No, it's blatant dishonesty.

There is another form of dishonesty on the part of our leaders, and it's our own fault. They tell us what we want to hear, not what we need to hear. They don't tell us it is a global marketplace and that Americans have got to compete on a level field with the rest of the world. They don't tell us that traditional American values of hard work, competition, innovation, saving, and planning for the future are what is needed to fix our problems. Instead they help create a sick, leveraged economy by promising things which haven't been earned, as if all are entitled by virtue of merely living in this country. They do it by enabling Americans to mortgage the future. Until we as citizens face up to the realities of life in the 21st century, we are doomed to have demagogic politicians like Barack Obama who thrive on class warfare and blame the American dream for the world's problems. Will we ever see a politician with the guts to tell us the truth, and would Americans have the guts to elect such a person?

IMPORTANT DISCLOSURES

Take a good look at the worst waterfall decline ever! Let's hope we don't see another like it in our lifetimes. Since September 28th, when we said it was possible for stocks to crash, the S&P 1500 dropped as much as 30.81% at Friday's low, and 25.91% at the close. This devastation took place in only ten sessions. The last week alone it was down 17.98%. The candle printed on the daily chart is a high wave spinning top. It shows a tug-of-war between buyers and sellers, and that the down trend may be coming to an end soon.



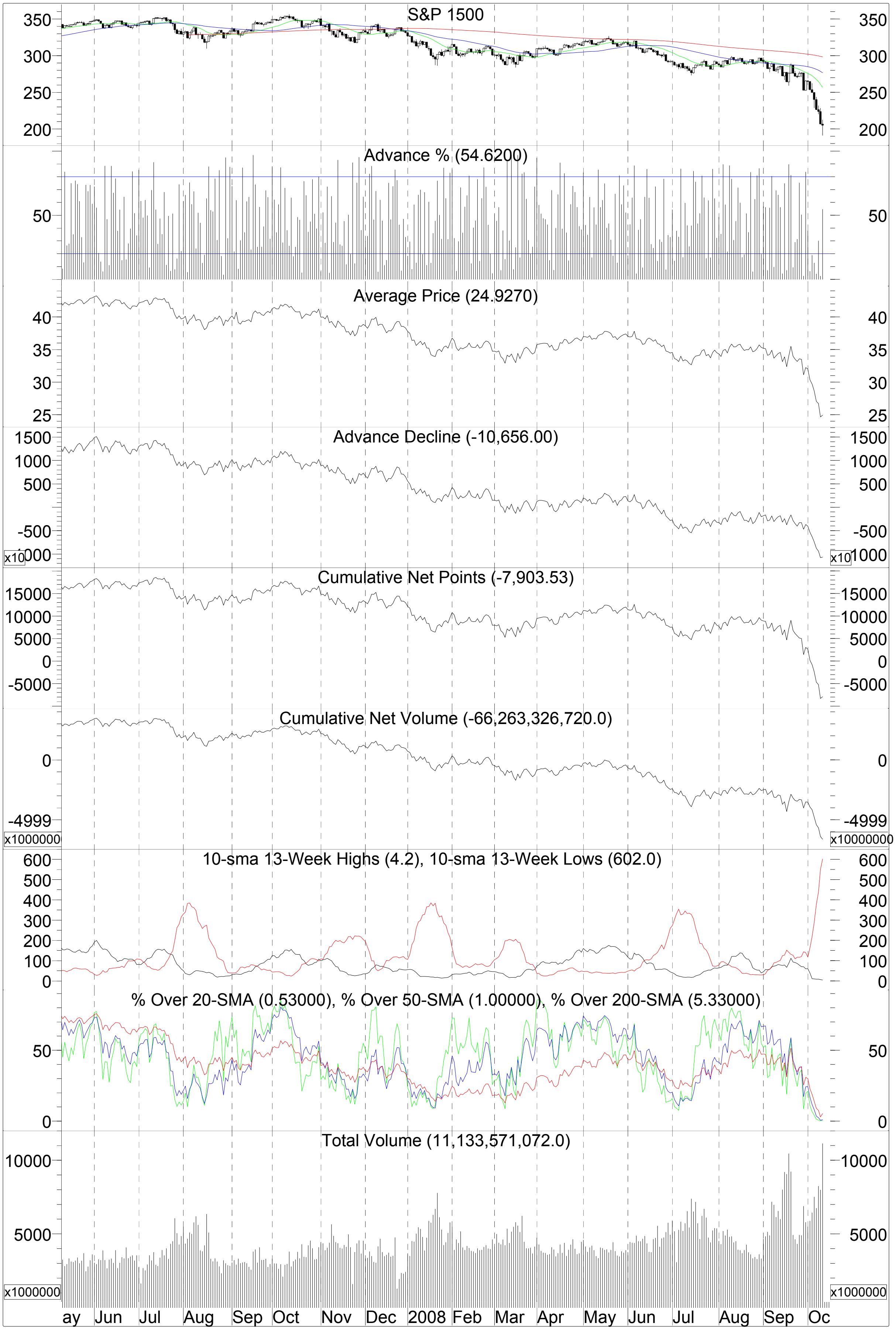
Our oscillators are at deeply oversold levels.

The percent over 10-sma is 2.6% after being less than 1%.

New lows exploded to record numbers last week. We would like to see a positive divergence before we believe a real bottom is in.

Our price oscillator is at extreme oversold levels. This tells us nothing more than all the other breadth indicators which are all at record oversold levels.

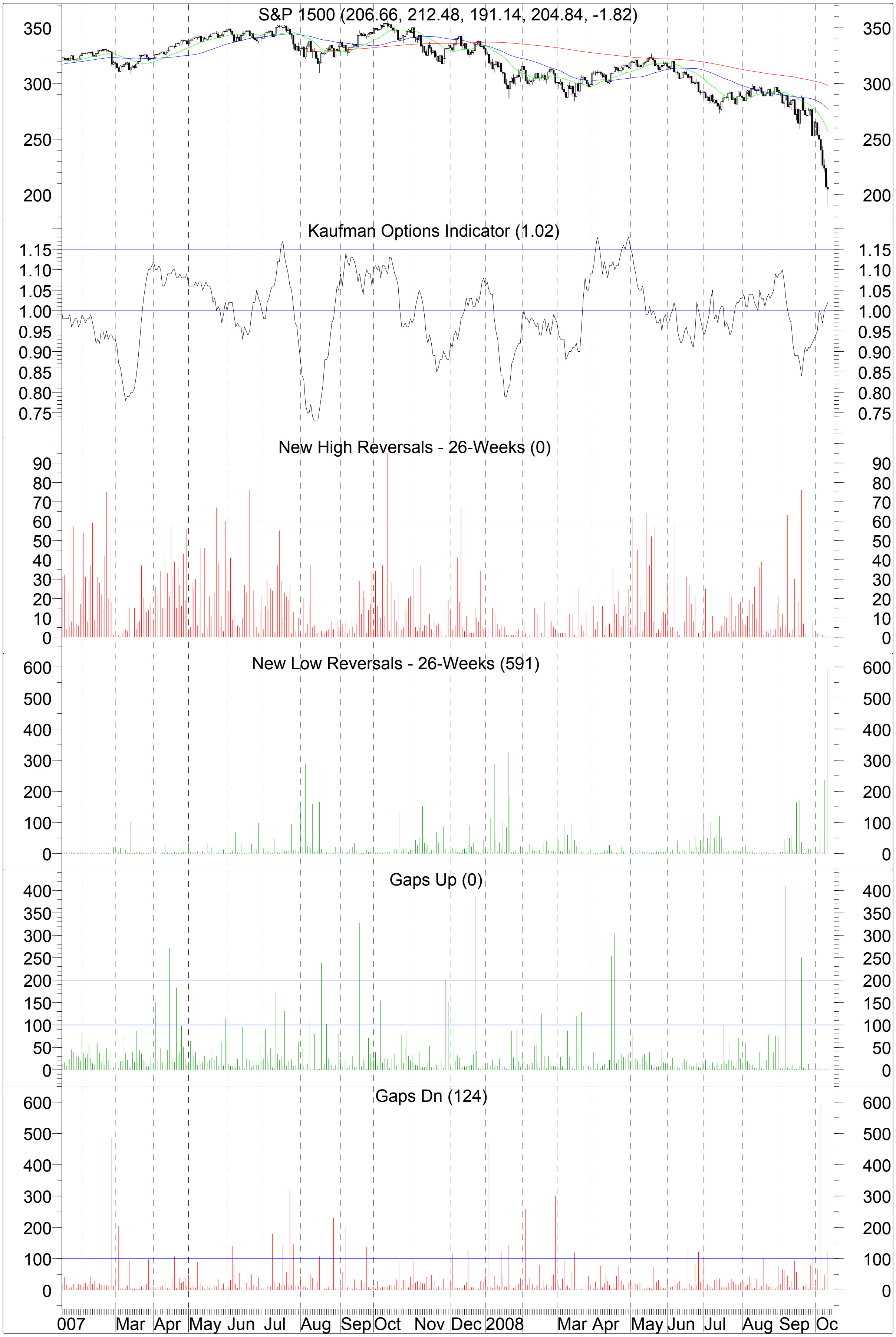
S&P 1500 Analysis - Wayne S. Kaufman, CMT



54.62% of stocks traded higher Friday due to strength in small-caps.

Volume was an all-time record on Friday.

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



Incredibly, our proprietary options indicator is in positive territory. If options buyers get too bullish during any relief rally it will be short-lived.

Friday's 591 new low reversals was the most we have ever recorded. That is usually bullish for the short-term.

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

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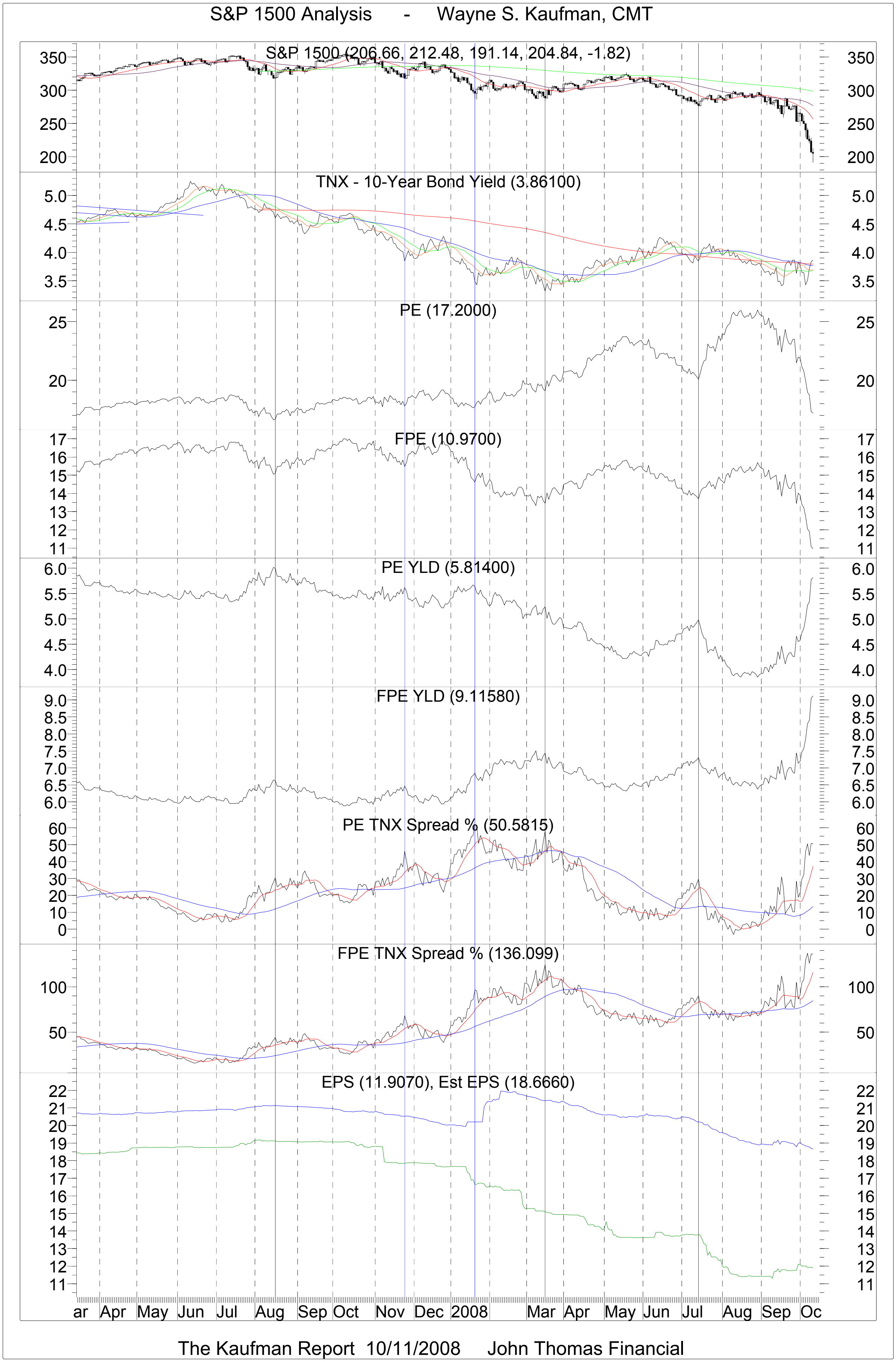
Nothing new here. As we have been saying for quite a while, supply (red lines) has been overpowering demand (green lines). The 10-day numbers show that buyers have run screaming for the exits.



Ten-year bond yields are back above 20, 50, and 200-day moving averages. They are currently at resistance.

The P/E ratio is the lowest since 8/2007, which at the time was the lowest in years.

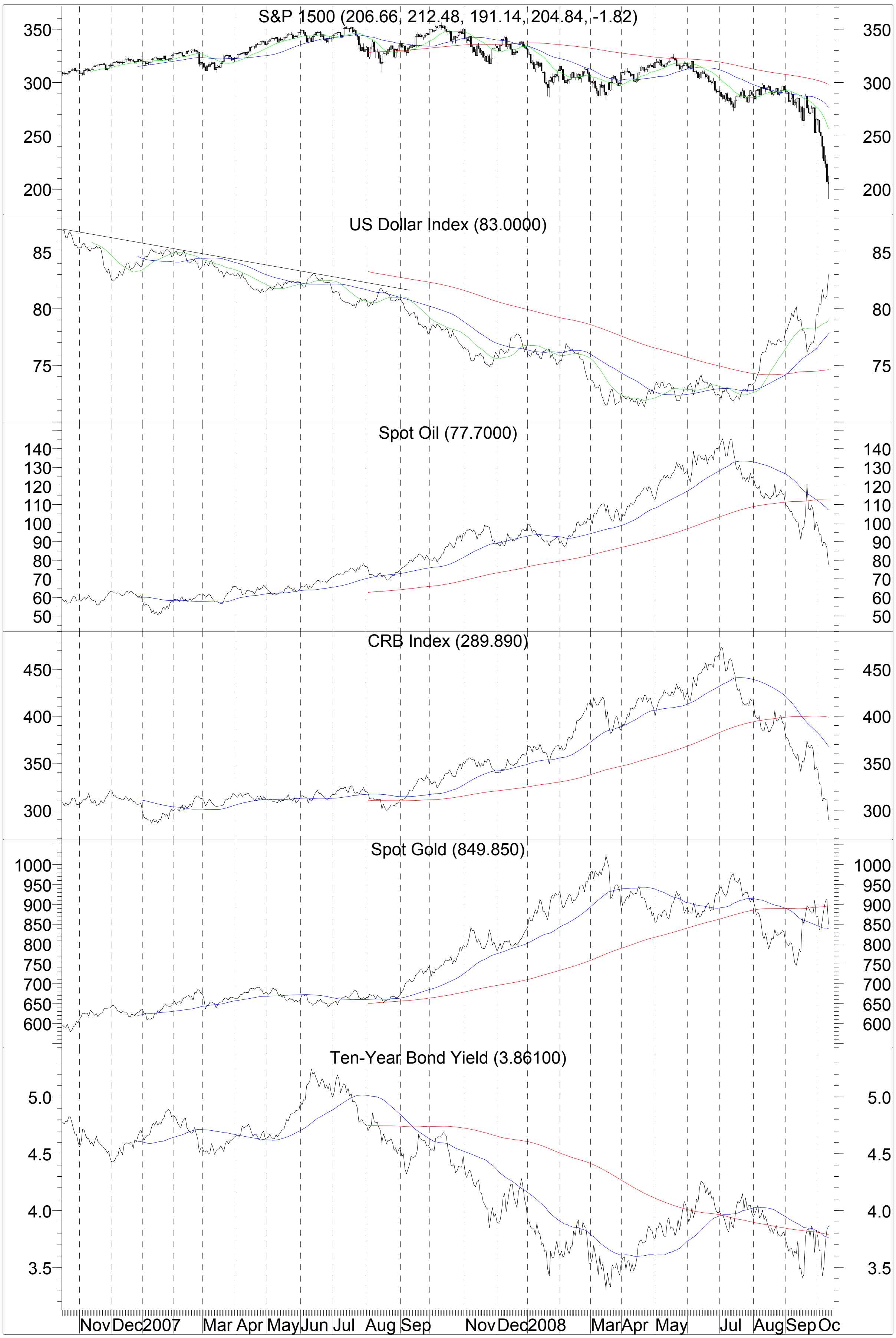
The forward P/E is the lowest in years.

Earnings yields are skyrocketing.

Spreads between earnings yields and 10-tear bond yields have widened to extremely wide levels where stocks should be very attractive.

Earnings and forecasts, which had been flat lining, have started to move lower again now that third quarter numbers are being reported.

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

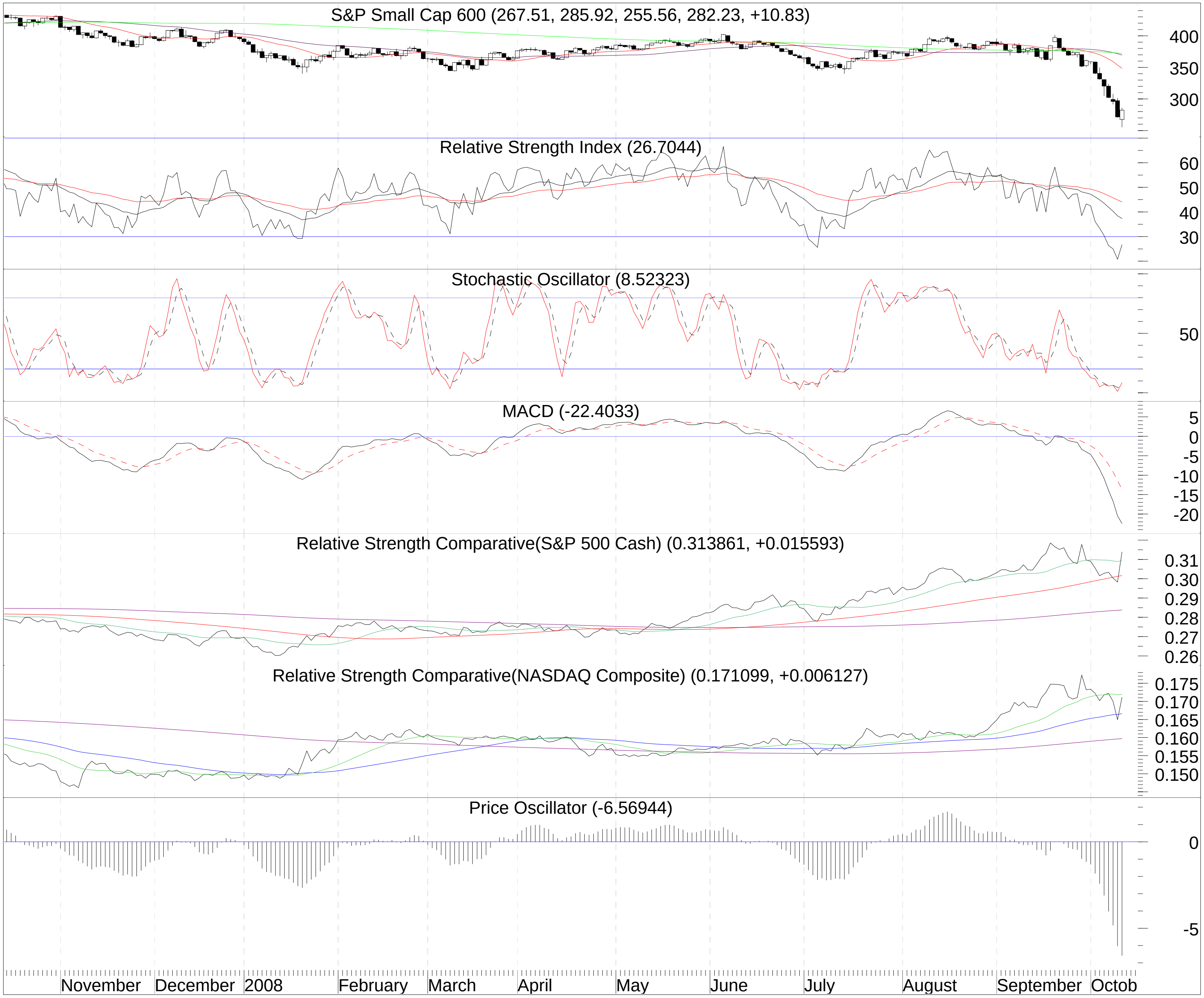


The U.S. Dollar Index continues its new up trend as it benefits from its safe haven status. It is nearing resistance but is not yet overbought.

Oil continues is plunge and is in a long-term down trend. There is strong resistance at 86 - 89. It is at the lowest level since January 2006.

The commodities Index has also collapsed.

Gold traded at its highest level since July, but like other assets it is being liquidated. It has held up better than other commodities.



The S&P Small-Cap Index is outperforming the S&P 500 for 20, 50, and 200-day time periods. It is also outperforming the Nasdaq Composite for all except the 20-day period. Historically small-caps lead the way out of recessions.