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The Kaufman Report

Trade what you see, not what you think.

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Monday October 20, 2008 **Closing prices of October 17, 2008**

Stocks rallied last week for their best weekly gains since 2003. They did it unconventionally as Monday was the best day in seven decades and Wednesday was the worst day since 1987. For the week the S&P 1500 was up 4.14%. This welcome bounce comes right after the flabbergasting 17.98% plunge of the prior week. As we said last week, *<u>we are experiencing the crash of 2008.</u>* We will find out shortly if October 10th marked the bottom.

On 9/28 we said there was the possibility of a market crash. Ten trading sessions later the S&P 1500 was down a staggering 25.91%, hitting the lowest level since May 2003 intra-day. Year-to-date the index is down 35.63%. When the index broke below the 213.6 level, which was the 76.4% Fibonacci retracement level of the 2002 to 2007 bull market, we said it greatly increased the possibility of a complete 100% retracement of the five-year bull market. That is still a possibility.

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. *<u>We have cautioned many times in recent months that markets that don't respond to oversold conditions are dangerous!</u>*

Valuations based on spreads between equity and earnings yields are at levels where stocks should be very attractive, but as we have said many times recently *<u>valuations don't matter when liquidations are forced</u>*. Unfortunately, hedge fund and mutual fund liquidations may be ongoing. Also, reported and forecast earnings continue to move inexorably lower, so valuations are in question. We are in earnings season we can't remember one that had such little attention paid to it.

On October 12th we said a sharp rebound relief rally was due at any time, and we would be skeptical of it being "the" bottom as long as our proprietary options indicator was not showing the kind of bearishness seen at prior important bottoms. Not only hasn't our indicator hit the bearish levels seen at prior important bottoms, it is actually showing slight bullishness currently. Maybe the indicator is losing its effectiveness due to the recent popularity of inverse ETFs. Or, maybe there are too many people who are bullish at this time and another move lower for stocks is coming. At the very least any rally from this point wouldn't have too much upside based on this indicator.

The scenario of another move down is supported by triangle patterns which are forming on the daily charts. These triangles look like fourth waves of classic five-wave structures. *<u>If this is the case, investors need to be on guard for another sharp move lower as wave 5 unfolds.</u>*

<u>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.</u>

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One of the issues commonly discussed at this time is why there is such a lack of confidence on the part of investors. Exactly what is there that they should be confident about?

There is no leadership in the stock market. Recent leading sectors energy and basic materials have been getting killed. Famous names like Merrill Lynch, Bear Stearns, Lehman Brothers, and others no longer exist! Others, like Fannie Mae and AIG trade under five dollars after breathtaking waterfall declines in their stock prices. This and runs on banks hardly inspires confidence.

There are no major themes. Emerging markets are now submerging markets as the famous story of the addition of millions (billions?) of new middle class consumers in China, India and other countries hasn't kept commodities prices from plunging or global growth from slowing. In the 90s we had the PC revolution, Windows 95, the incredible growth of the internet and all the hardware that went along with it, cell phones, compact discs, satellite television, video games, amazing drugs and biotech discoveries, and many other innovations too numerous to mention. Is there anything like that on the horizon now?

If we don't have leading sectors in the stock market, how about actual leaders? Can investors have confidence in Mr. Bernanke and Mr. Paulson? Of course not. These bunglers have gotten the sub-prime mess completely wrong as we outlined last week. Should investors have confidence in the bailout plan? Hard to say, but the head of the TARP (Troubled Asset Relief Program) is Neel Kashkari, a former Goldman Sachs Vice-President who has been a senior advisor to Paulson at the Treasury Department for the last two years. Was Mr. Kashkari given the role of running TARP because he had been warning Paulson about these problems for the last two years and nobody listened, or was he one of the ones, like Bernanke and Paulson, who repeatedly said that the sub-prime mess would not spread to the rest of the economy? We can see how that would deserve a promotion.

How about leaders of industry? Investors have just seen at least eighteen top executives selling huge stakes in their companies after getting margin calls. If the theoretical "smart money" like Aubrey McClendon (Chesapeake Energy), Sumner Redstone (Viacom), Tom Ward (SandRidge Energy), Bruce Smith (Tesoro), Howard Lester (Williams-Sonoma) and others are upside down with their investments in their own companies, investors can't be faulted for not having the confidence to follow insiders.

How about our Presidential candidates? Should there be confidence that McCain or Obama will lead us out of this mess? At this time it looks like our next President is going to be a radical social engineer hell-bent on wealth redistribution above all other concerns. Obama's economic guru is Austan Goolsbee, who says it's okay to raise taxes on the "rich" because those higher tax rates will only be the same level as those used in the nineties. Why is that the benchmark? As discussed above, the nineties was a time of remarkable innovation and growth. Can Mr. Goolsbee, who has spent his entire career as an academic and an advisor to Senator Obama (forgive us for being suspicious of those who have never spent a day in the real world economy) guarantee that type of growth in the future? If so, those tax hikes are okay with us. However, we are skeptical that Mr. Goolsbee would make such a guarantee. The bottom line is that investors have no reason to be confident regarding the financial markets, and we believe the only cure for that is time and free markets. Maybe investors feel the same way.

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Tuesday October 14, 2008 **Closing prices of October 13, 2008**

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $11.62, a drop of 39.42%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $18.38, a drop of only 16.26%. Analysts have obviously been very late in lowering estimates, and have also been way too optimistic. *<u>If investors had any confidence in current earnings estimates stocks would be much higher than they currently are.</u>* 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. <u>We are waiting for GM to be kicked out of the Dow.</u>

97 companies in the S&P 500 have reported third quarter earnings. According to Bloomberg, 56.7% have had positive surprises, 17.5% have been in line, and 25.8% have been negative. The year-over-year change has been -35.4% on a share-weighted basis, -19.0% market cap-weighted, and +2.3% non-weighted. Ex-financial stocks these numbers are 10.5%, 16.6%, and 33.8%, respectively.

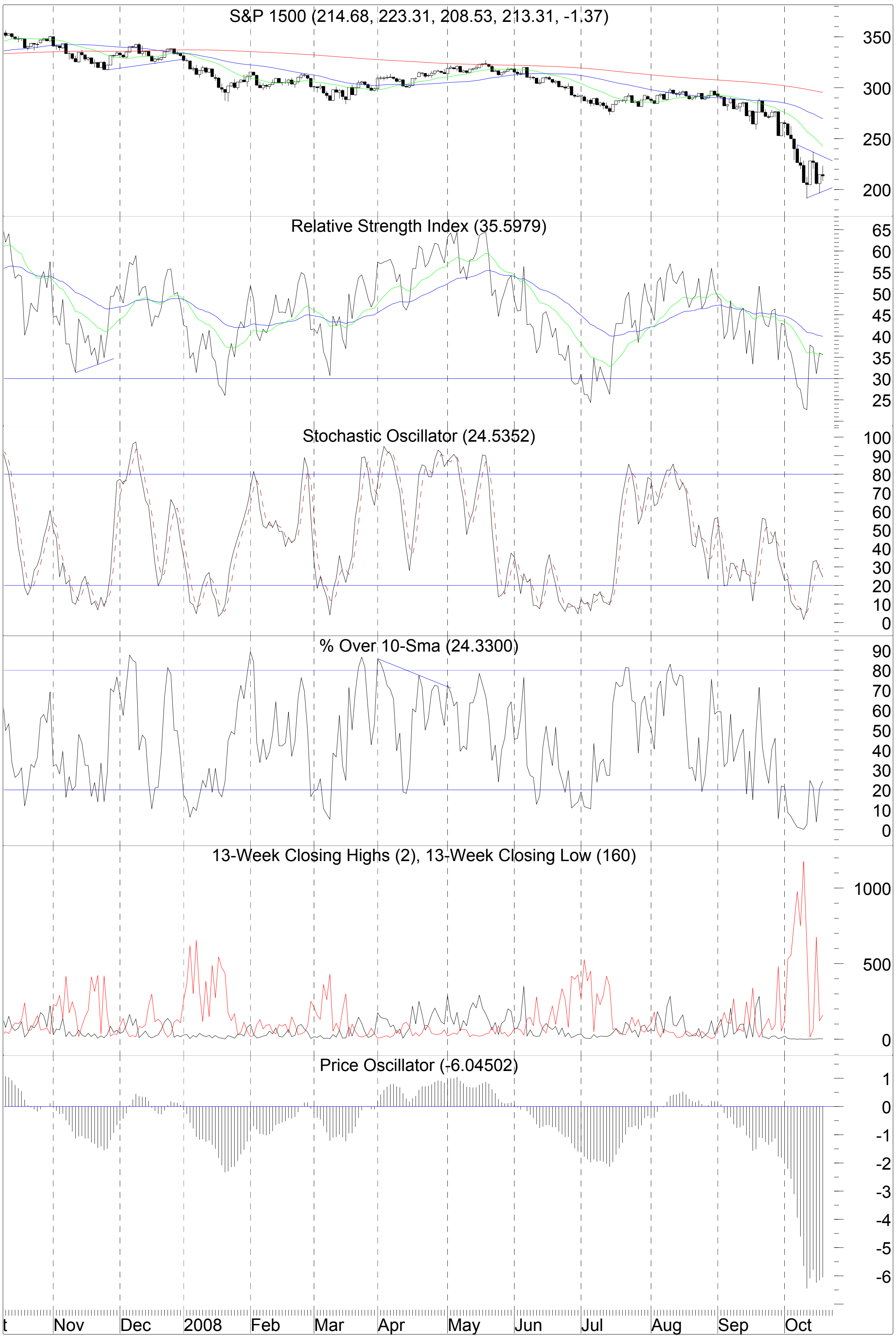
Federal Funds futures are pricing in an 62.0% probability that the Fed will *<u>cut rates 25 basis points to 1.25%,</u>* and a 38.0% probability of *<u>cutting 50 basis points to 1.00%</u>* when they meet on October 29th. They are pricing in a 52.4% probability that the Fed will *<u>cut rates 25 basis points to 1.25%</u>* at the meeting on December 16th, and a 41.7% probability of *<u>cutting 50 basis points to 1.00%.</u>*

The S&P 1500 (213.31) was down 0.638% Friday. Average price per share was down 0.85%. Volume was 82% of its 10-day average and 90% of its 30-day average. 37.1% of the S&P 1500 stocks were up on the day. Up Dollars was 23% of its 10-day moving average and Down Dollars was 31% of its 10-day moving average. For the week the index was up 4.135% on decreasing but above average weekly volume.

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

The S&P 1500 is forming a triangle on the daily chart. The trend is obviously down, and triangles are continuation patterns. Last Monday was a wide-ranging day which so far has acted as the boundary for closing prices. Investors need to be aware that a downside break of this bearish pennant formation could lead to a sharp move lower.

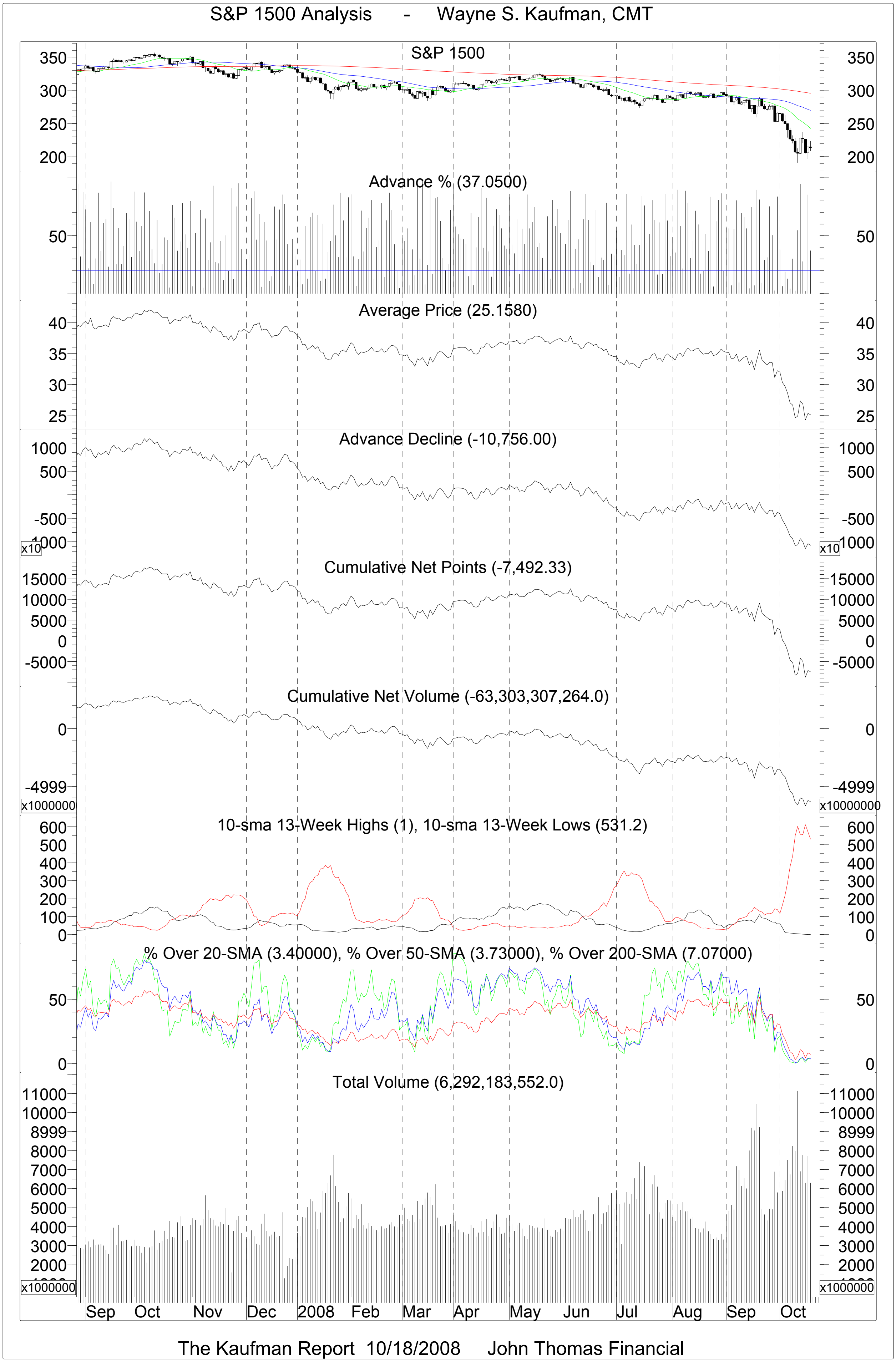
S&P 1500 Analysis - Wayne S. Kaufman, CMT



It is possible that the triangle is wave 4 of a five-wave move down.

Our momentum indicators remain at low levels. We have cautioned many times in recent months that a market that doesn't respond to oversold conditions is dangerous.

Our price oscillator, a good indicator of trends, seems locked at extreme oversold levels.

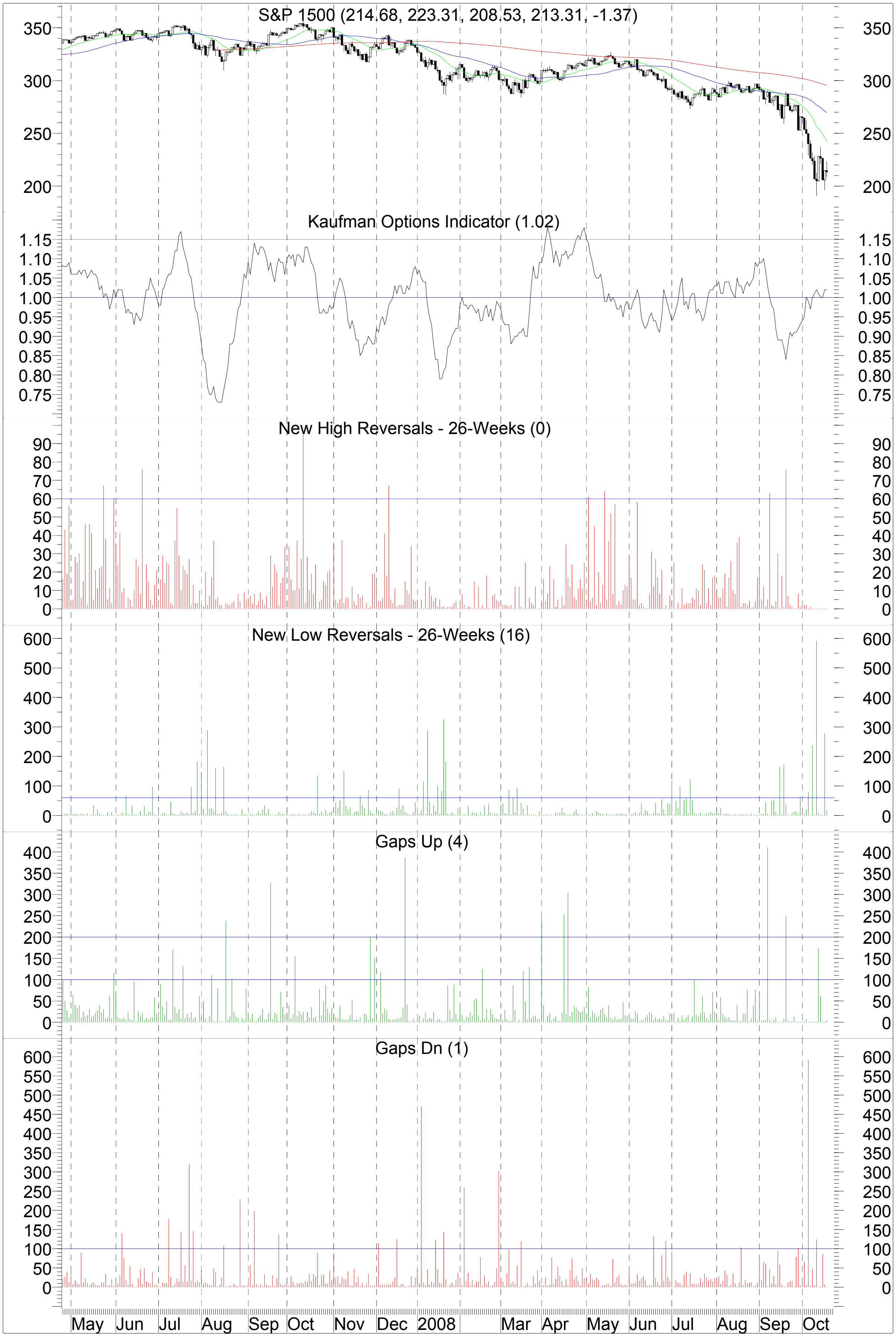


37.05% of the S&P 1500 traded higher Friday.

The 10-sma of 13-week highs exploded higher in October.

Only 7.07% of the S&P 1500 are above their own 200-day moving average. 3.73% are above their 50-dma. These are unusually extreme numbers.

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

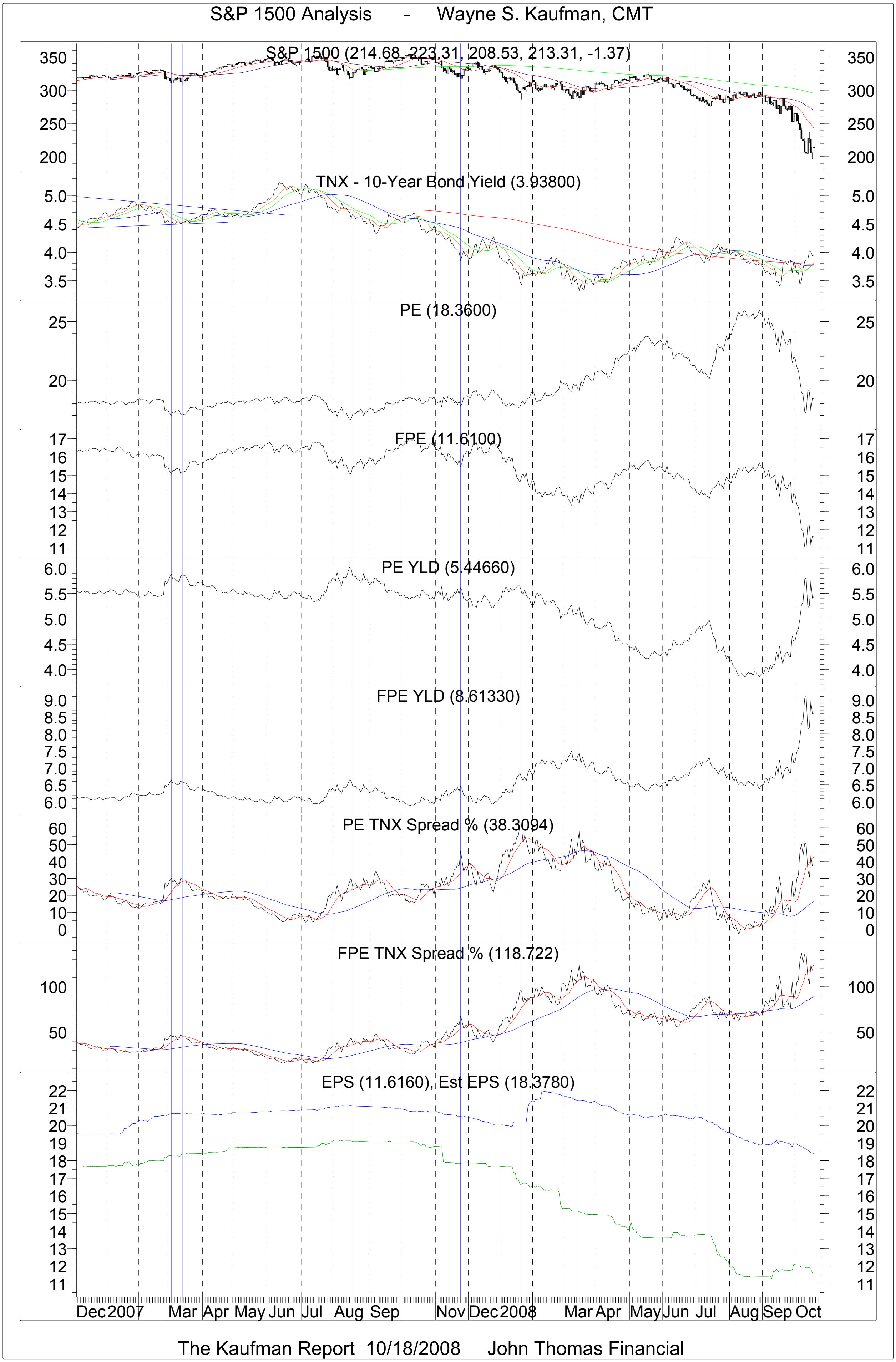


Our proprietary options indicator is in positive territory. We have been warning recently that it was not at the negative, or bearish levels we have seen at important bottoms. Perhaps the recent popularity of inverse ETFs has made this indicator less effective, but if not more downside is possible at this time, and any rally from here will be limited.

So far the huge number of new low reversals from 10/10 has helped put in a short-term bottom. This amount of bottom fishing has usually been bullish in the intermmediate-term also.

This enlarged chart of our proprietary options indicator shows the slight bullishness of options buyers. If this indicator is working as well as it has in the past, a bottom is not in and any further rally will not have much upside.

Our statistics of supply (red lines) versus demand (green lines) show that sellers are still very active, but buyers, who had been completely on the sidelines, have been stepping back into the market.



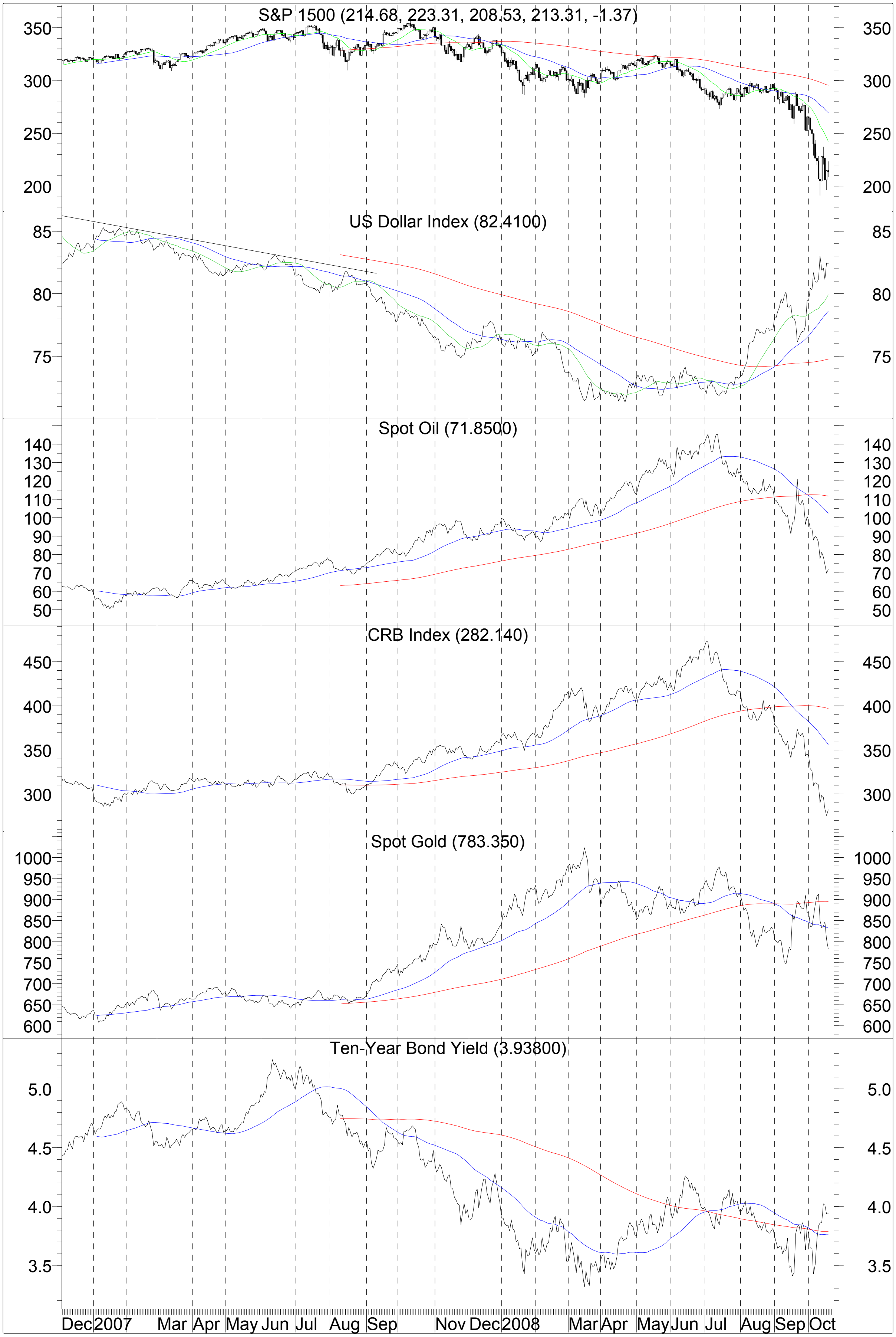
10-year bond yields are in an up trend with the next resistance at the 4.3% area.

The P/E ratio is at a low level for this decade.

The forward P/E is at the lowest level since the 1980s. Unfortunately the estimates the number is based on keep moving lower.

Spreads between equity and bond yields are in an area where stocks should be attractive.

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



The U.S. Dollar Index remains in an up trend.

Oil and commodities are getting oversold.

10-year bond yields are in an up trend, with the next resistance at the 4.3% area.