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The Kaufman Report

Trade what you see, not what you think.

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Wednesday October 22, 2008 **Closing prices of October 21, 2008**

Stocks slumped broadly Tuesday as the S&P 1500 fell 3.08%. All ten S&P sectors were down, led by materials, information technology, and energy, which were each down over 4%. Volume was light again, and the put/call ratio was 0.87, the second day in a row where options buyers were very bullish. Our options indicator is nearing worrisome levels.

Our strategy is as follows: we are buying stocks breaking out of recent oversold ranges while keeping in mind the primary down trend of the market. We are aware of the bearish triangle which is forming and the possibility of another move down, and if triggered we will enter short using inverse ETFs as a hedge. With many market statistics having recently reached historic oversold levels, valuations at the best levels in years, and governments around the world carpet bombing financial markets with liquidity, we do not want to miss what could become a meaningful rally. However, good entry points, stop losses, and selectivity are important. *Aggressive traders can enter short if we rally near the top border of the triangle, or on a break through the bottom*.

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $11.27, a drop of 41.24%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $18.29, a drop of only 16.67%. 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.

142 companies in the S&P 500 have reported third quarter earnings. According to Bloomberg, 56.3% have had positive surprises, 12.0% have been in line, and 31.7% have been negative. The year-over-year change has been -29.7% on a share-weighted basis, -15.7% market cap-weighted, and -2.0% non-weighted. Ex-financial stocks these numbers are 8.1%, 14.4%, and 22.6%, respectively.

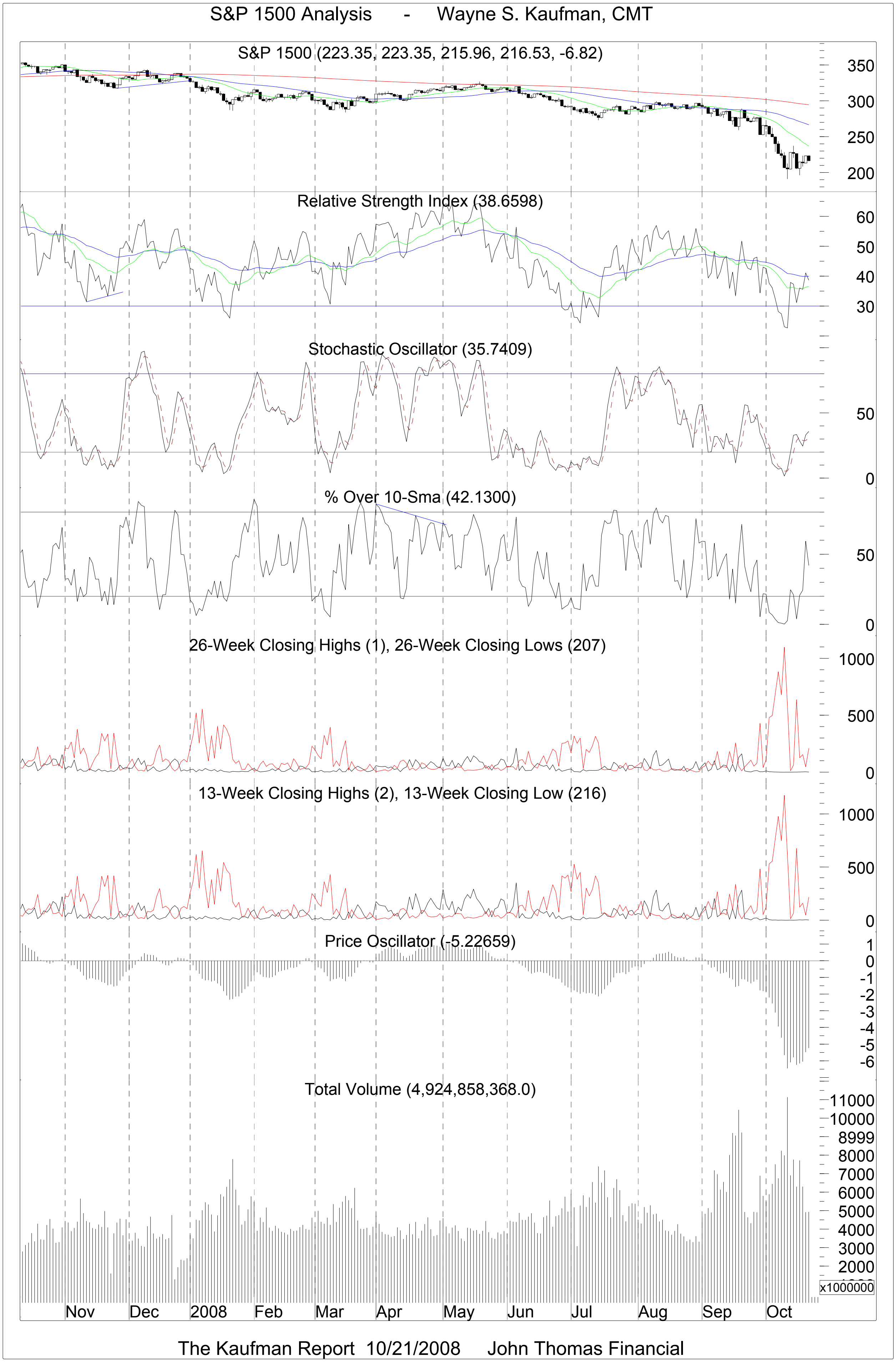
Federal Funds futures are pricing in an 64.0% probability that the Fed will *cut rates 25 basis points to 1.25%,* and a 36.0% probability of *cutting 50 basis points to 1.00%* when they meet on October 29th. They are pricing in a 59.7% probability that the Fed will *cut rates 25 basis points to 1.25%* on December 16th, and a 30.4% probability of *cutting 50 basis points to 1.00%.*

The S&P 1500 (216.53) was down 3.05% Tuesday. Average price per share was down 2.95%. Volume was 68% of its 10-day average and 72% of its 30-day average. 13.7% of the S&P 1500 stocks were up on the day. Up Dollars was 2% of its 10-day moving average and Down Dollars was 104% of its 10-day moving average. The Put/Call Ratio was 0.873.

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.

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

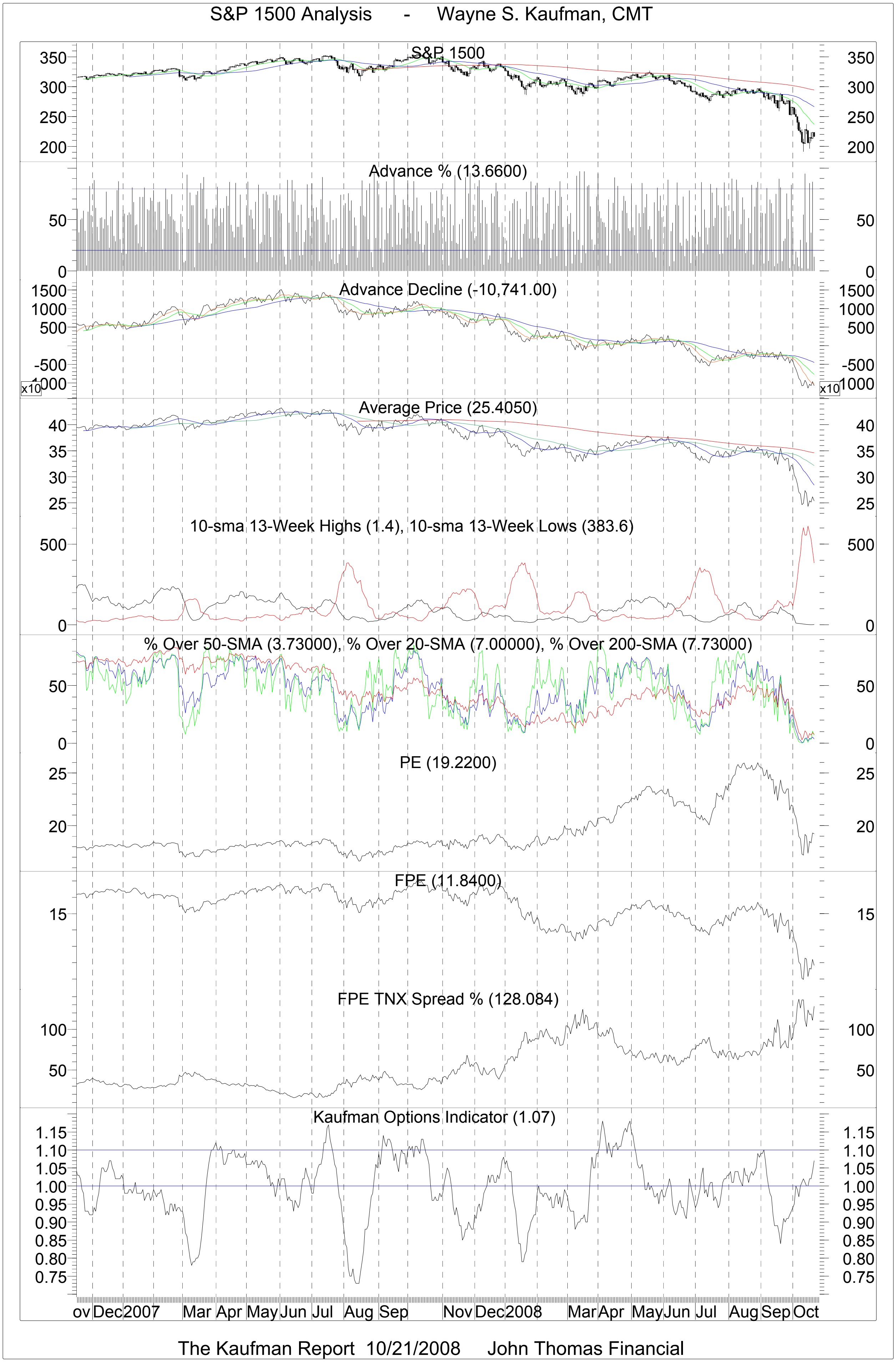
The S&P 1500 continues forming a triangle with its closing prices bound by the high and low of the wide-ranging day of 10/13. Triangles are continuation patterns, so the odds favor a downside resolution. It would also fit as the fifth wave of a five-wave bear market structure. However, we are prepared to play a breakout in either direction. Should a fifth wave appear it will probably move down sharply and quickly.



Our oscillators remain at neutral levels.

Our price oscillator remains at deeply oversold levels. As we have said many times, a market that doesn't respond to oversold conditions is dangerous.

Volume has been low the last two sessions.



13.66% of the S&P 1500 traded higher Tuesday.

These numbers remain at pathetic levels.

The P/E ratio has moved higher as earnings and forecasts continue to move down.

The forward P/E is very low, but can we trust projections?

Spreads between bond and earnings yields are at levels where stocks should be very attractive.

Our proprietary options indicator is starting to get to worrisome levels of optimism. We need pessimism in order to put in a solid bottom.