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The Kaufman Report

Trade what you see, not what you think.

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Thursday October 23, 2008 **Closing prices of October 22, 2008**

Stocks plummeted again Wednesday on increasing volume as the S&P 1500 fell 6.06% in another panic-selling 90% down day. All ten S&P sectors were down again, with energy down 10.3% and materials down 8.3%. We said yesterday we were concerned that our options indicator was showing too much optimism, and one would think the put/call ratio would be higher than Wednesday's 1.217. Simply put, the crash of 2008 continues until proven otherwise.

Valuations based on spreads between bond and earnings yields are the highest we have ever seen. However, we have stressed many times recently that valuations don't matter when liquidations are forced, and that a market that doesn't respond to an oversold condition is dangerous.

Aggressive traders can continue to play the down trend. However, the forced liquidations can end at any time and there can be a vicious relief rally. Investors can buy stocks that break out of oversold ranges while keeping in mind the primary down trend of the market. 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, a meaningful rally should come soon.

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 $18.25, a drop of only 16.86%. 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.

174 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 -29.0% on a share-weighted basis, -11.0% market cap-weighted, and -4.4% non-weighted. Ex-financial stocks these numbers are 7.8%, 15.2%, and 19.1%, respectively.

Federal Funds futures are pricing in an 80.0% probability that the Fed will *cut rates 50 basis points to 1.00%,* and a 20.0% probability of *cutting 25 basis points to 1.25%* when they meet on October 29th. They are pricing in a 59.1% probability that the Fed will *cut rates 50 basis points to 1.00%* on December 16th, and a 27.9% probability of *cutting 75 basis points to 0.75%.*

The S&P 1500 (203.40) was down 6.064% Wednesday. Average price per share was down 5.52%. Volume was 85% of its 10-day average and 87% of its 30-day average. 4.1% of the S&P 1500 stocks were up on the day. Up Dollars was 1/5 of 1% of its 10-day moving average and Down Dollars was 186% of its 10-day moving average. The Put/Call Ratio was 1.217.

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.

IMPORTANT DISCLOSURES

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

A new closing low for the S&P 1500 as the bottom of the triangle held on a closing basis.

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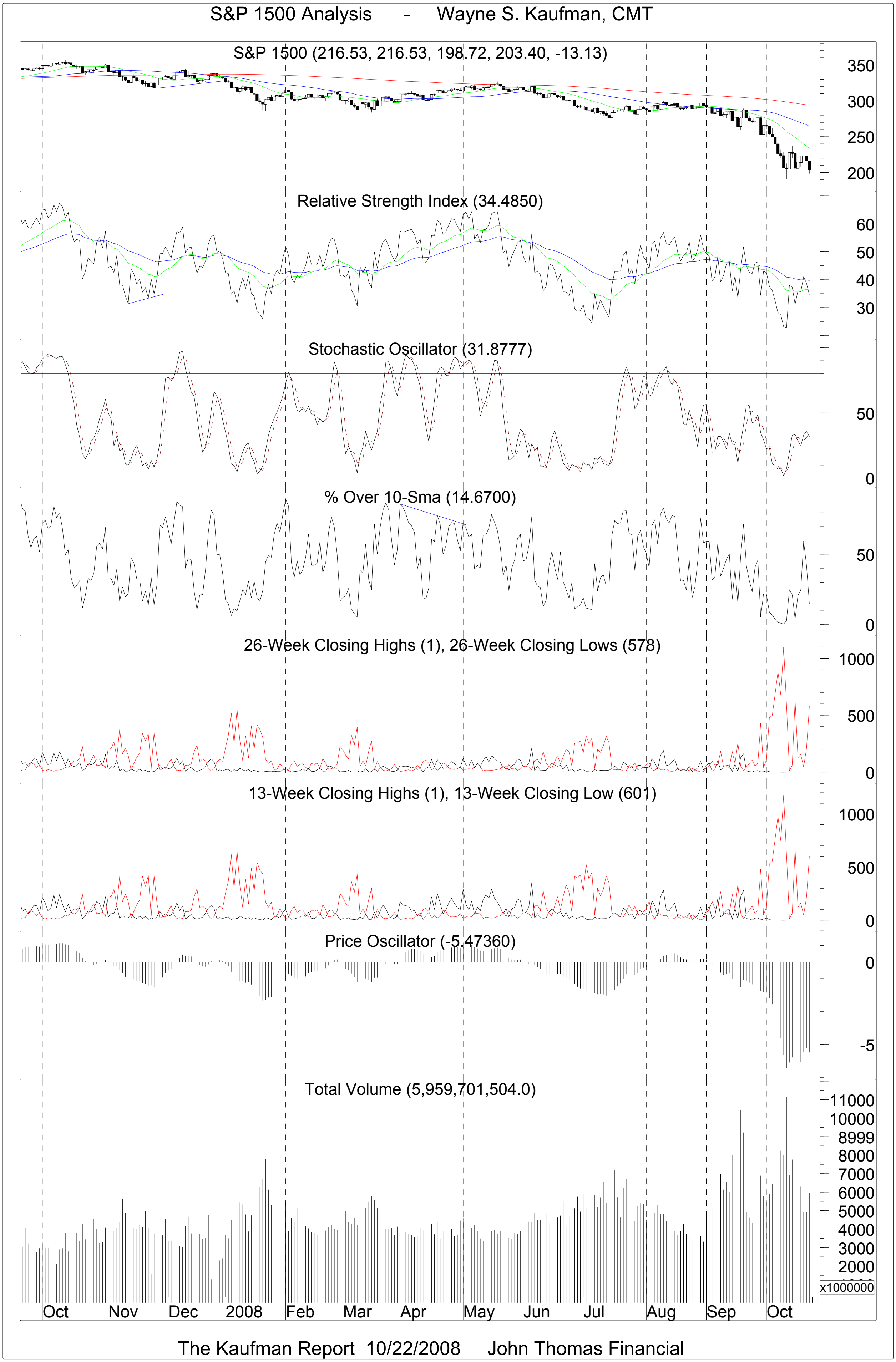
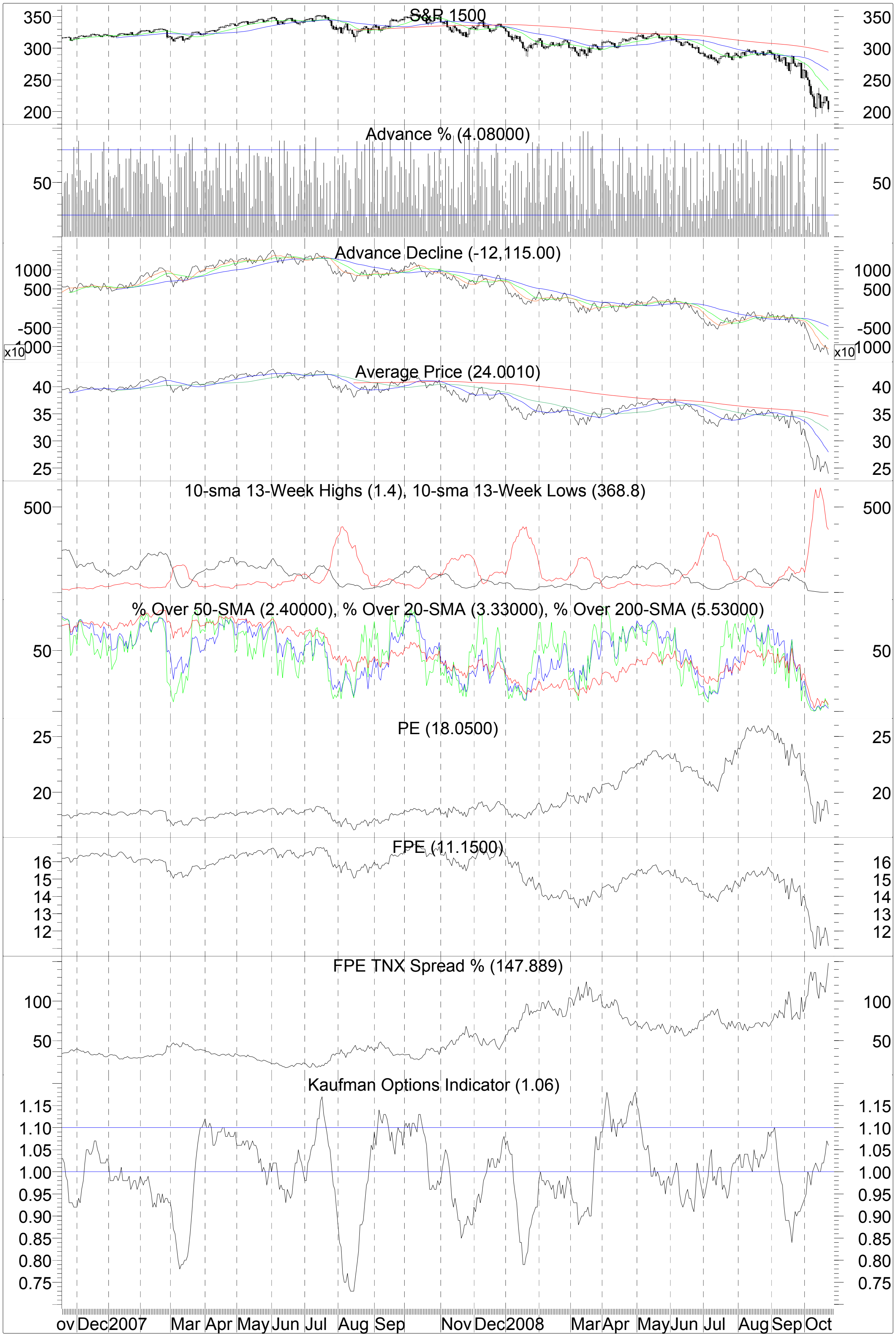


Some positive divergences are finally showing up. In spite of a new closing low our indicators are not making new lows.

Volume expanded on Wednesday's big down day.

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



4.08% of the S&P 1500 traded higher Wednesday.

The AD line is making new lows, which points to lower prices in the future. So did average price per share and cumulative net volume.

The unprecedented bad breadth continues.

Spreads between bond and earnings yields are at amazing levels, possibly all-time highs.

Our proprietary options indicator is still showing too much bullishness on the part of options buyers.