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The Kaufman Report

Trade what you see, not what you think.

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Tuesday October 28, 2008 **Closing prices of October 27, 2008**

As we have said for weeks, *<u>we are experiencing the crash of 2008.</u>* All of the major indexes recorded new closing lows Monday, which is obviously bearish and points to more lows in the future. Many have taken out their 10/10 intra-day lows. The S&P 1500 closed at its lowest level since April 2003. Followers of Dow Theory should take note that the Dow Transports made a new closing low, confirming the closing low in the Dow Jones Industrials. However, with stocks at historic oversold levels, and valuations based on spreads between bond and earnings yields at silly levels, a sharp relief rally can begin at any time.

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%, to the lowest level since May 2003 intra-day. When the index broke 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, which would take us to 169.45, another 11.5% lower from here. <u>That is still a possibility</u>.

Monday's weak close points to more lows in the near-term as indexes continue to follow through to the downside after recently breaking down out of triangle patterns. We remain very concerned about our proprietary options indicator, which still shows optimism, and not the extreme level of pessimism which has marked important bottoms in the past.

Last December we wrote an essay we called "The Slippery Slope of Hope." We listed the numerous reasons investors were bullish on the markets, even as we gave warnings about weakening market internals. In January, well ahead of most market observers, we said it had become a bear market. We see the same kind of whistling past the graveyard at this time. Current hopes which might be making a slippery slope include the following: the end of October will bring a cathartic selloff which will mark the bottom; the selling is irrational, not based on fundamentals, and will end soon as forced liquidations stop; there is uncertainty about who will be elected, which will end after the election; seasonality becomes positive as November brings the start of the best three-month period of the year for stocks; and lastly, but maybe most important of all, the bailout will work.

Regarding the end of October plunge, even though we have been warning about it ourselves, the market is rarely so accommodating as to follow a game plan hoped for by so many. The selling may be irrational, but we find it interesting that the S&P 1500 is down 46.26% from its peak while reported earnings are down 44.89% from their peak. The election will end the uncertainty of who will be elected, but will it end the uncertainty about the coming policies and their effects? Positive seasonality is the all-time classic hope, especially at this time of year, and actually could help create a tradable rally. Lastly, on the hope that the bailout plan will work, we say that the government cannot legislate prosperity, and economic cycles must run their course.

A bottom may be near based on the guests seen in the financial media. During bull markets the fundamental analysts get top billing as they sell the dream of individual stocks. As markets slide technical analysts are brought out to discuss broken and approaching support levels, which also end up breaking. Then the economists are brought out with their inevitable, usually incorrect, predictions of a soft landing. Fund managers and market strategists tell everyone things will be fine but they need to have a three to five year outlook. Lastly, things get so ugly the market historians are trotted out with bear market stats, what prior bottoms looked like, how things will get better eventually, and why we should bottom soon. That's where we are now.

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The S&P 1500 (191.52) was down 3.3% Monday. Average price per share was down 3.99%. Volume was 86% of its 10-day average and 79% of its 30-day average. 12.04% of the S&P 1500 stocks were up on the day, with up volume at 14.12% and up points at 5.79%. Up Dollars was 9/10 of 1% of total dollars, and was 3.2% of its 10-day moving average while Down Dollars was 114% of its 10-day moving average. It is down 27.99% in October, 42.20% year-to-date, and 46.26% from the peak of 356.38 on 10/11/07. Average price per share is down 49.49% from the peak of $43.23 on 6/4/2007.

The Put/Call Ratio was 1.158. The Kaufman Options Indicator was 1.06.

The spread between the reported earnings yield and 10-year bond yield is 48.08% and 150.86% based on projected earnings.

Valuations based on spreads between bond and earnings yields are the best levels 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.

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $10.57, a drop of 44.89%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $17.91, a drop of only 18.41%. 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.

247 companies in the S&P 500 have reported third quarter earnings. According to Bloomberg, 60.2% have had positive surprises, 11.8% have been in line, and 28.0% have been negative. The year-over-year change has been -22.5% on a share-weighted basis, -8.2% market cap-weighted, and -0.3% non-weighted. Ex-financial stocks these numbers are 8.1%, 14.4%, and 18.4%, respectively.

Federal Funds futures are pricing in a 66.0% probability that the Fed will *cut rates 50 basis points to 1.00%,* and a 34.0% probability of *cutting 75 basis points to 0.75%* when they meet on October 29th. They are pricing in a 45.5% probability that the Fed will *cut rates 50 basis points to 1.00%* on December 16th, and a 43.9% probability of *cutting 75 basis points to 0.75%.*

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, assuming leaders show up at some time in the future.

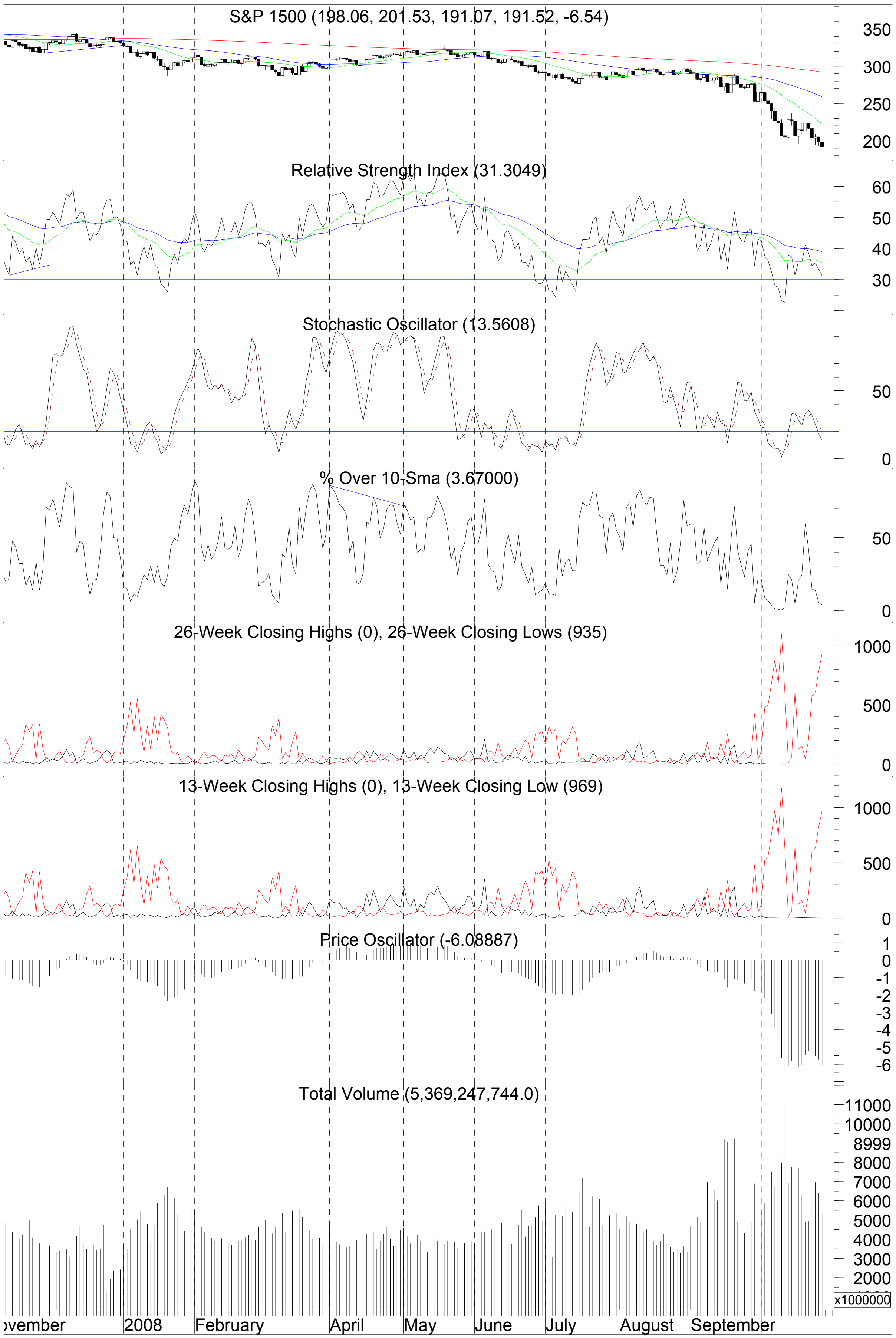
Options expire November 21st. December options expire the 19th.

IMPORTANT DISCLOSURES

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

The S&P 1500 made another closing low as it continues its move lower after breaking down from the triangle pattern. The low for the day was a fraction above the intra-day low of 10/10.

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



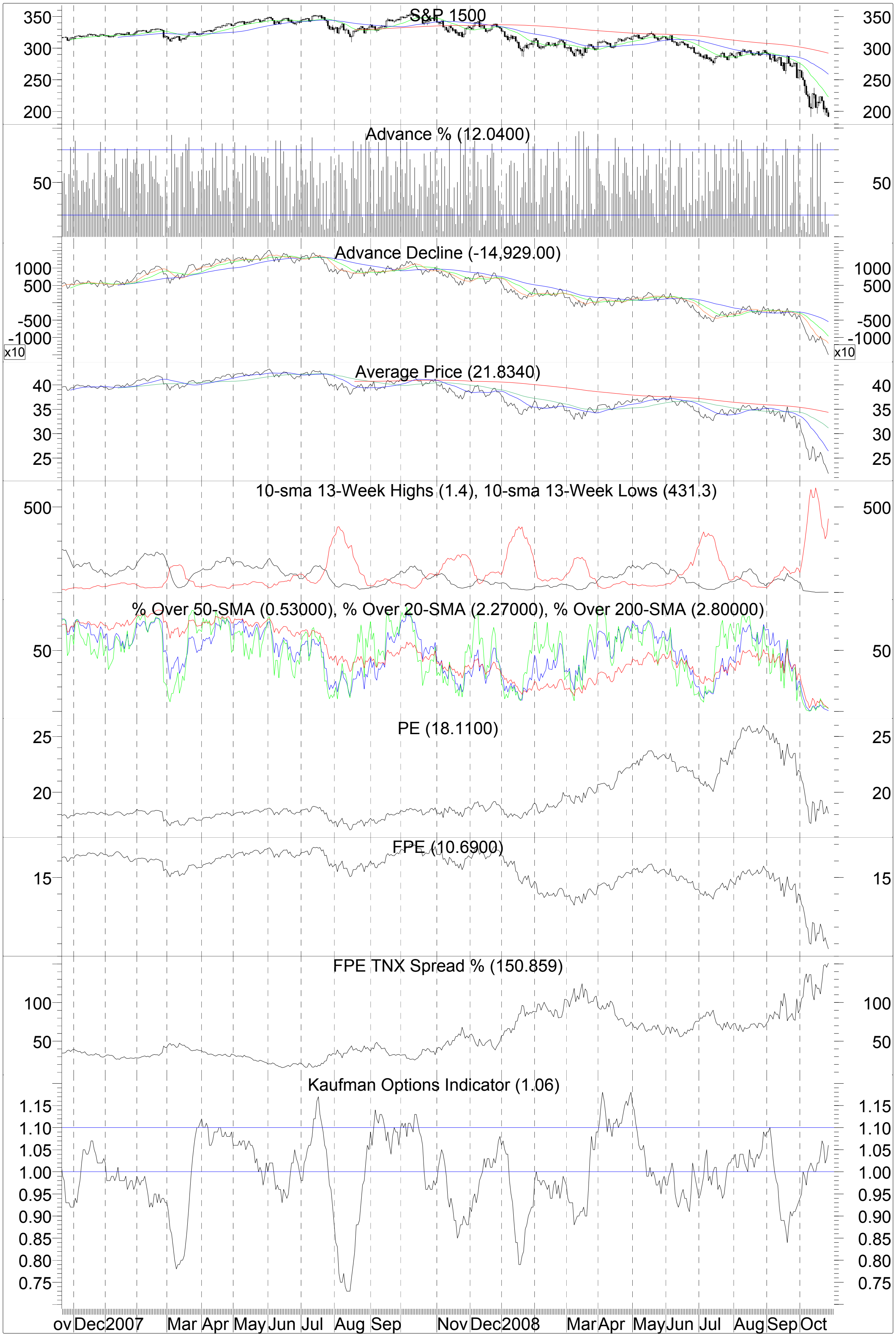
Our momentum oscillators are at low levels or oversold.

New lows are rising but are still below the level of 10/10.

Our price oscillator remains at extremely oversold levels. We have warned for quite a while that markets that do not respond to oversold conditions are dangerous.

Volume decreased on Monday.

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



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12.04% of stocks traded higher Monday.

These numbers are amazing.

The P/E ratio is moving sideways while the forward P/E makes new lows.

This spread is moving higher and is already at decade high levels where stocks should be attractive.

Our proprietary options indicator is showing optimism, not the kind of pessimism which has been present at prior important bottoms.