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The Kaufman Report

Trade what you see, not what you think.

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Wednesday October 29, 2008 **Closing prices of October 28, 2008**

Yesterday we said that with stocks at historic oversold levels, and valuations based on spreads between bond and earnings yields at silly levels, a sharp relief rally could begin at any time. After Monday's weak close we didn't expect a rally so quickly, but Tuesday was a panic-buying 90% up day similar to the explosive rally of October 13th. The S&P 1500 was up 10.51%, with all ten S&P sectors up a minimum of 7.51%, led by Telecom and Consumer Discretionary, up 13.28% and 13.1% respectively. Large-caps led versus mid and small-caps.

We are hopeful that this becomes a successful retest of the lows of October 10th, giving us at least a multi-week rally. It is possible that most of the bad news regarding the current earnings season and the upcoming election are already in stock prices, and that forced liquidations are subsiding for the time being. We noted Sunday that sellers were becoming less aggressive, and that some positive divergences had emerged. Therefore, we are trying to trade what may become a good rally, while keeping alert for signs of weakness and distribution which could mean the resumption of the downtrend.

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The S&P 1500 (211.65) was up 10.51% Tuesday. Average price per share was up 8.94% as small-caps lagged the major indexes. Volume was 111% of its 10-day average and 103% of its 30-day average. 93.32% of the S&P 1500 stocks were up on the day, with up volume at 96% and up points at 97.6%. Up Dollars was 99.95% of total dollars, and was 469% of its 10-day moving average while Down Dollars was 1/8 of 1% of its 10-day moving average. It is down 20.42% in October, 36.13% year-to-date, and 40.61% 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 1.01. The Kaufman Options Indicator was 1.05.

The spread between the reported earnings yield and 10-year bond yield is 31.28% and 121.66% based on projected earnings.

<u>Valuations based on spreads between bond and earnings yields dropped from the best levels we have ever seen, but are still at levels where stocks should be attractive. 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.</u>

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $10.62, a drop of 44.63%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $17.92, a drop of only 18.36%. 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>

266 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 -20.0% on a share-weighted basis, -5.5% market cap-weighted, and +5.6% non-weighted. Ex-financial stocks these numbers are 10.1%, 16.7%, and 24.4%, respectively.

Federal Funds futures are pricing in a 62.0% probability that the Fed will *<u>cut rates 50 basis points to 1.00%,</u>* and a 38.0% probability of *<u>cutting 75 basis points to 0.75%</u>* when they meet on October 29th. They are pricing in a 45.2% probability that the Fed will *<u>cut rates 50 basis points to 1.00%</u>* on December 16th, and a 44.5% probability of *<u>cutting 75 basis points to 0.75%.</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, assuming leaders show up at some time in the future.</u>

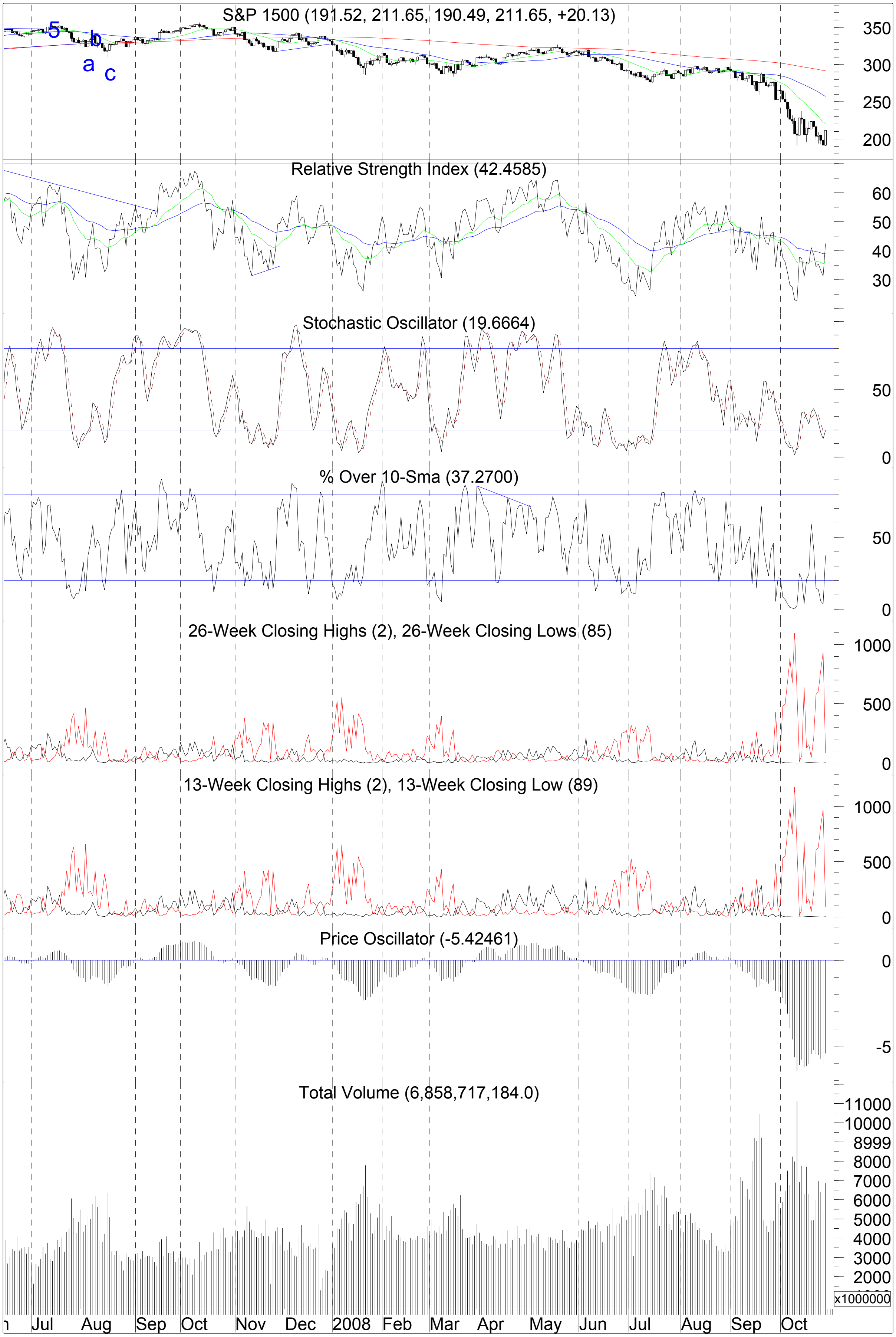
Options expire November 21st. December options expire the 19th.

IMPORTANT DISCLOSURES

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

The S&P 1500 printed a bullish engulfing candle on Tuesday in what was a 90% up day similar to the one on 10/13.

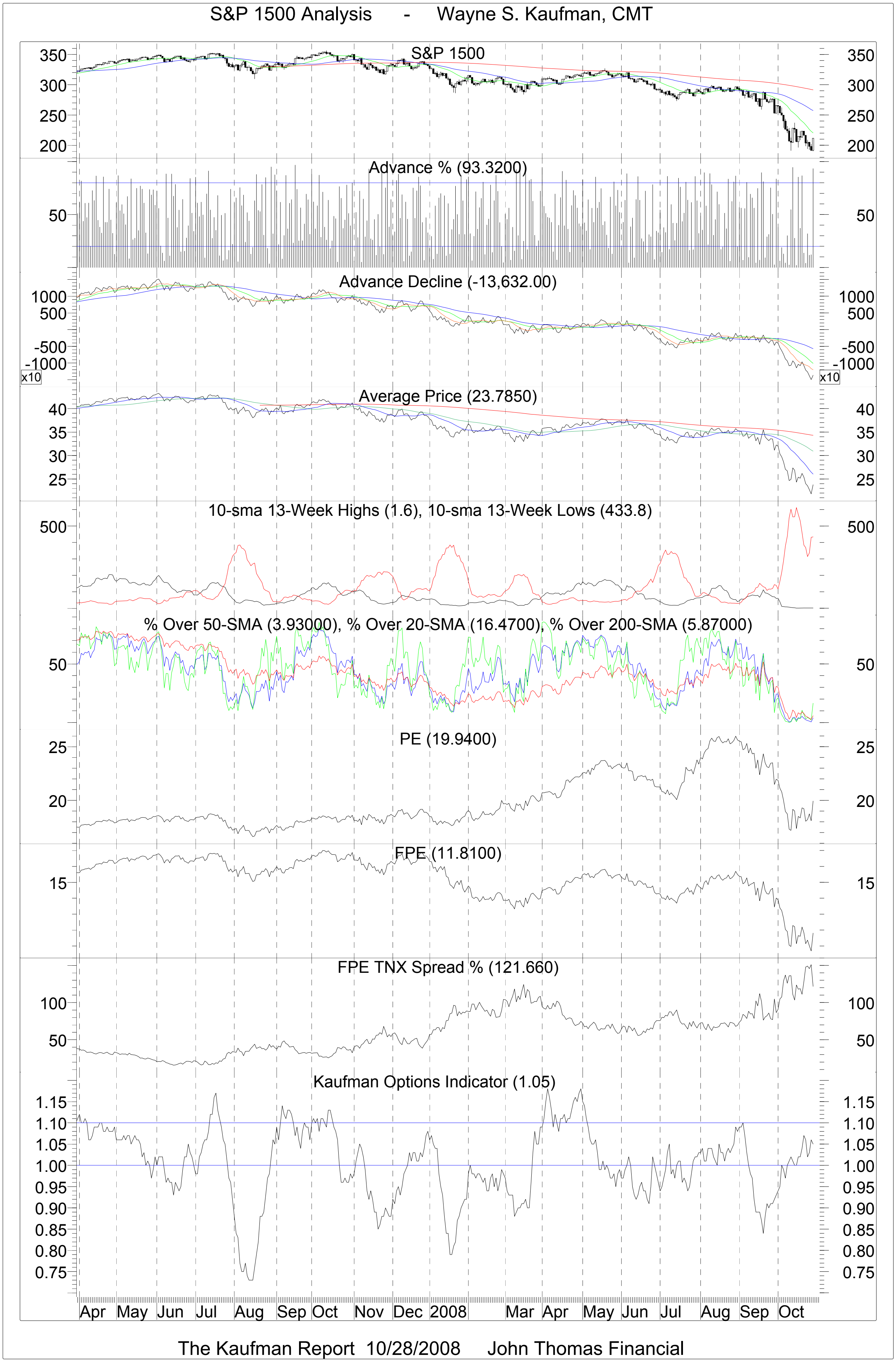
S&P 1500 Analysis - Wayne S. Kaufman, CMT



Our oscillators are still at low levels. They recently formed positive divergences.

Our price oscillator is still at extremely oversold levels.

Volume increased during Tuesday's rally.



93.32% of the S&P 1500 traded higher Tuesday.

Our options indicator shows optimism, not the pessimism we have seen at important bottoms.