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The Kaufman Report

Trade what you see, not what you think.

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Monday October 6, 2008 **Closing prices of October 3, 2008**

Last week we said there was the possibility of a market crash. That is exactly what happened as the S&P 1500 plunged 9.67% for the week to the lowest level since October 2004. Most of the damage came on Monday when the S&P 500, the large-cap component of the S&P 1500, lost 8.8%, the second worst day in its history behind October 1987. The S&P 1500 has crashed 13% since September 19th. Year-to-date the index is down 24.64%, and since the peak last October 11th it is down 29.93%.

The inmates are now running the asylum, if they haven't been already. The bailout just passed by the government calls for $700 billion to buy toxic assets from financial institutions. Legislators wouldn't pass the bill initially, causing the market conniption Monday, and then they decided that the addition of another $150 billion or so in tax breaks made it much more effective in its goal of saving the financial system. For those not keeping score, add to the bailout number another $85 billion doled out to AIG, and an almost imperceptible by comparison $25 billion for the auto companies.

We said last week our problem with the bailout plan is that Chairman Bernanke and Secretary Paulson haven't done one thing in the past two years to prove to anyone that they really have a handle on this situation. How many times did each of them say the sub-prime mess would not spread to the rest of the economy, or make other overly optimistic pronouncements? <u>In fact, the desperate fire drill aspect of this entire exercise is an indictment of both of these incompetent public servants.</u>

The only thing that makes us angrier than the Bernanke/Paulson bungling is the dishonesty on the part of so many politicians as they point fingers at others in transparent attempts to deflect criticism from themselves. There is plenty of blame to go around, but our greatest disdain is towards the three politicians who have attempted to make the greatest political hay from the situation, Nancy Pelosi, Barney Frank, and Barack Obama. Americans deserve far better legislators than these abject liars.

As far as the bailout itself, the best defense for it we have heard is that it is better than nothing, and that something had to be done. Maybe so, but we think those who believe the government will turn a profit from it will be proven wrong. Time will tell, but we think the government will end up paying a lot more for these securities than they will ever be worth.

However, stocks are extremely oversold, many indicators are at levels where rallies have occurred in the past, and there could be some type of euphoric bounce as the government carpet bombs the markets with all kinds of liquidity. Of course, reality may set in quickly as we are only a week or so away from a third quarter earnings season which promises to keep investors hopping.

<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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Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $12.01, a drop of 37.4%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $18.88, a drop of only 13.99%. 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.

499 companies in the S&P 500 have reported second quarter earnings. According to Bloomberg, 67.6% have had positive surprises, 7.2% have been in line, and 25.2% have been negative. The year-over-year change has been -23.3% on a share-weighted basis, -23.3% market cap-weighted, and -12.3% non-weighted. Ex-financial stocks these numbers are 3.9%, 7.2%, and 4.8%, respectively.

Federal Funds futures are pricing in an 84.0% probability that the Fed will *cut rates 50 basis points to 1.50%,* and a 16.0% probability of *cutting 75 basis points to 1.25%* when they meet on October 29th. They are pricing in a 58.0% probability that the Fed will *cut rates 50 basis points to 1.50%* at the meeting on December 16th, and a 37.1% probability of *of cutting 75 basis points to 1.25%.* They are pricing in a 53.6% probability that the Fed will *cut rates 50 basis points to 1.50%* at the meeting on January 28th, and a 30.3% probability of *decreasing 75 basis points to 1.25%.*

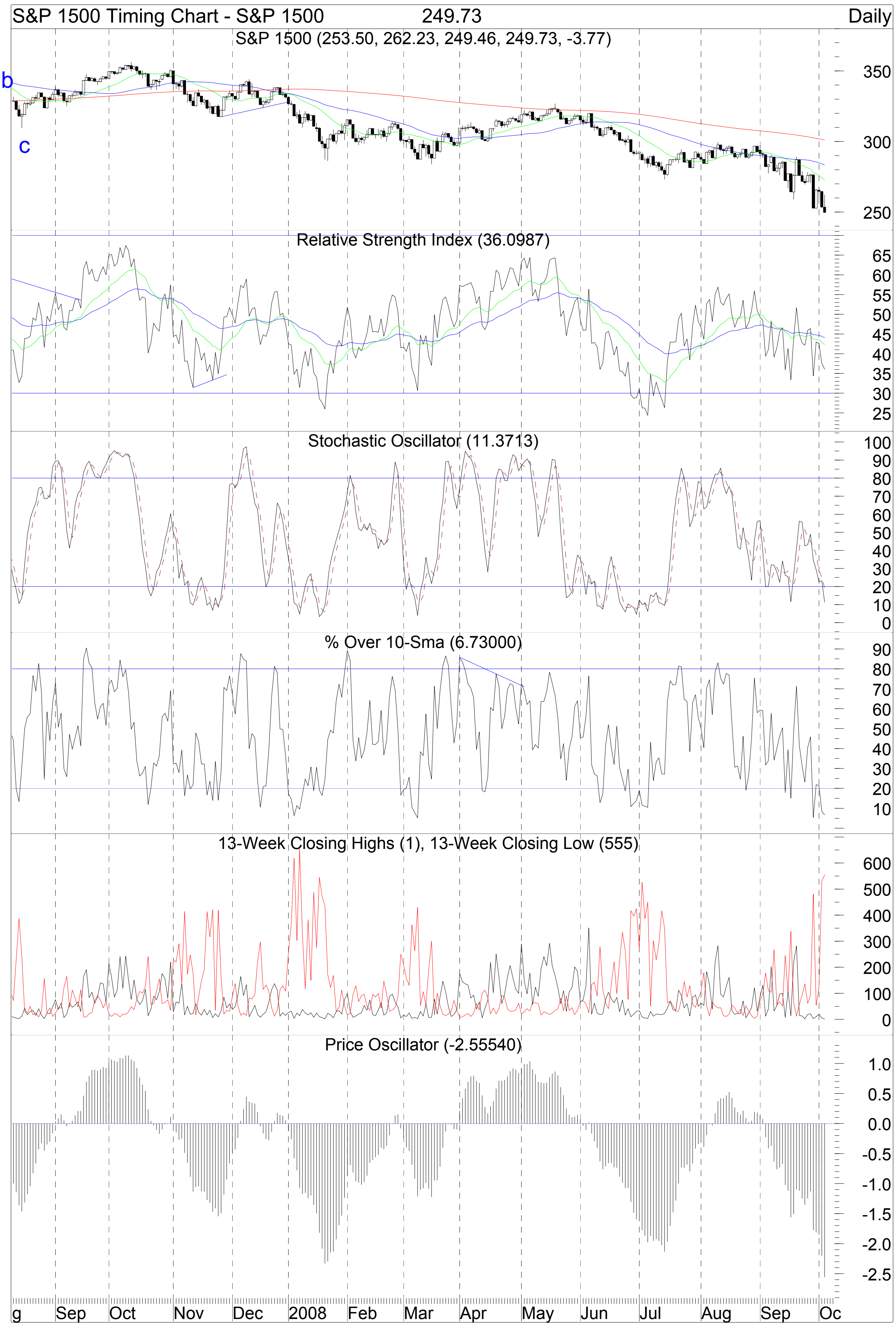
The S&P 1500 (276.46) was down 1.487% Friday. Average price per share was down 2.08%. Volume was 119% of its 10-day average and 112% of its 30-day average. 18.8% of the S&P 1500 stocks were up on the day. Up Dollars was less than 18% of its 10-day moving average and Down Dollars was 72% of its 10-day moving average. For the week the index was down 9.67% on increasing and above average weekly volume.

Options expire October 17th. November options expire November 21st.

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

The S&P 1500 plunged to the lowest level since October 2004. It was down 9.67% for the week, and has crashed 13% since September 19th. An inverted hammer was printed on the daily chart, and some indicators are at extreme oversold levels, so some type of relief rally soon is very likely.

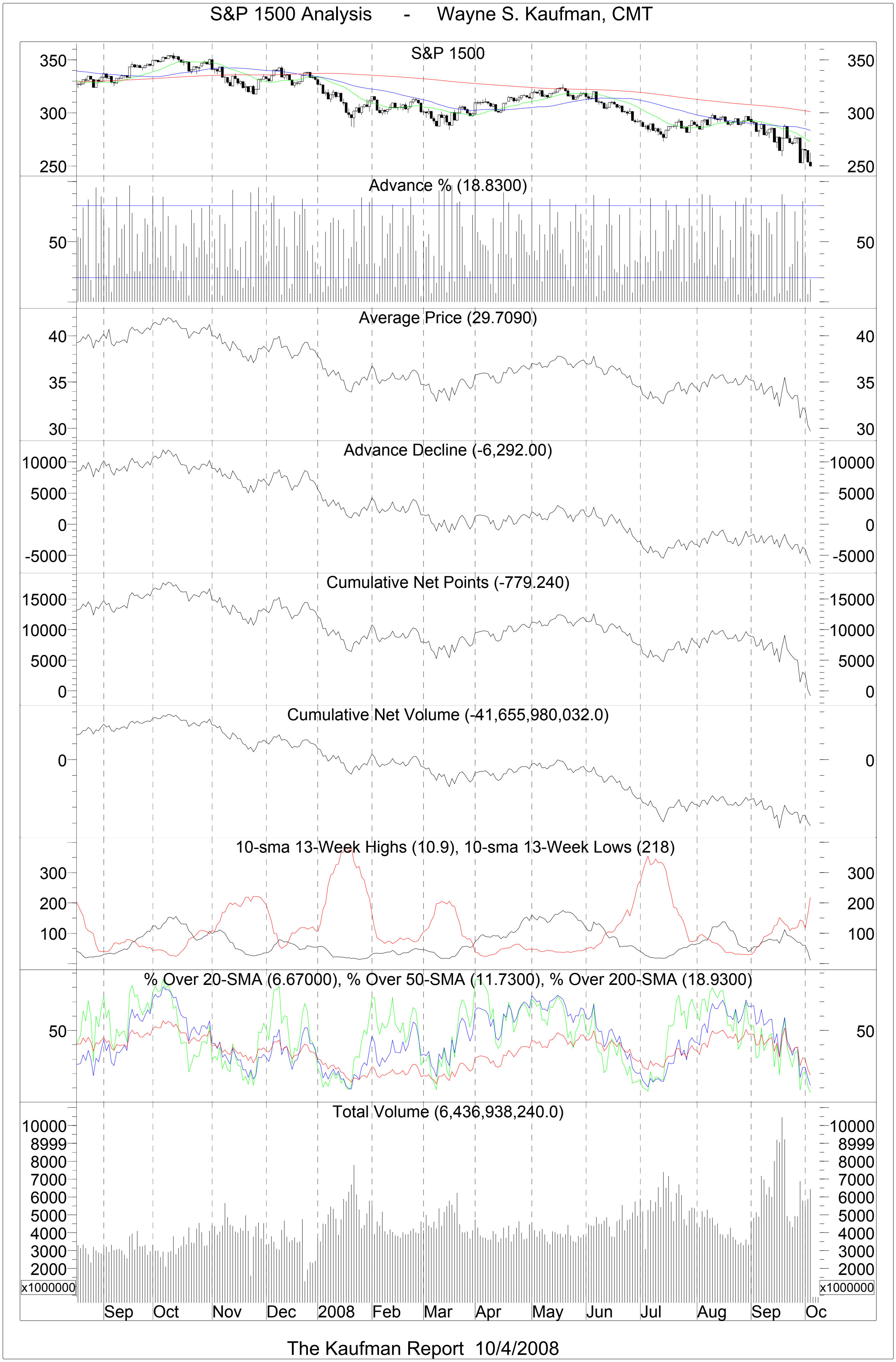
S&P 1500 Analysis - Wayne S. Kaufman, CMT



Two of our oscillators are at oversold levels, and the RSI is showing a positive divergence. This means some kind of bounce is likely soon.

New lows have exploded to levels seen at or near prior bottoms.

Our price oscillator is at an extreme oversold level.



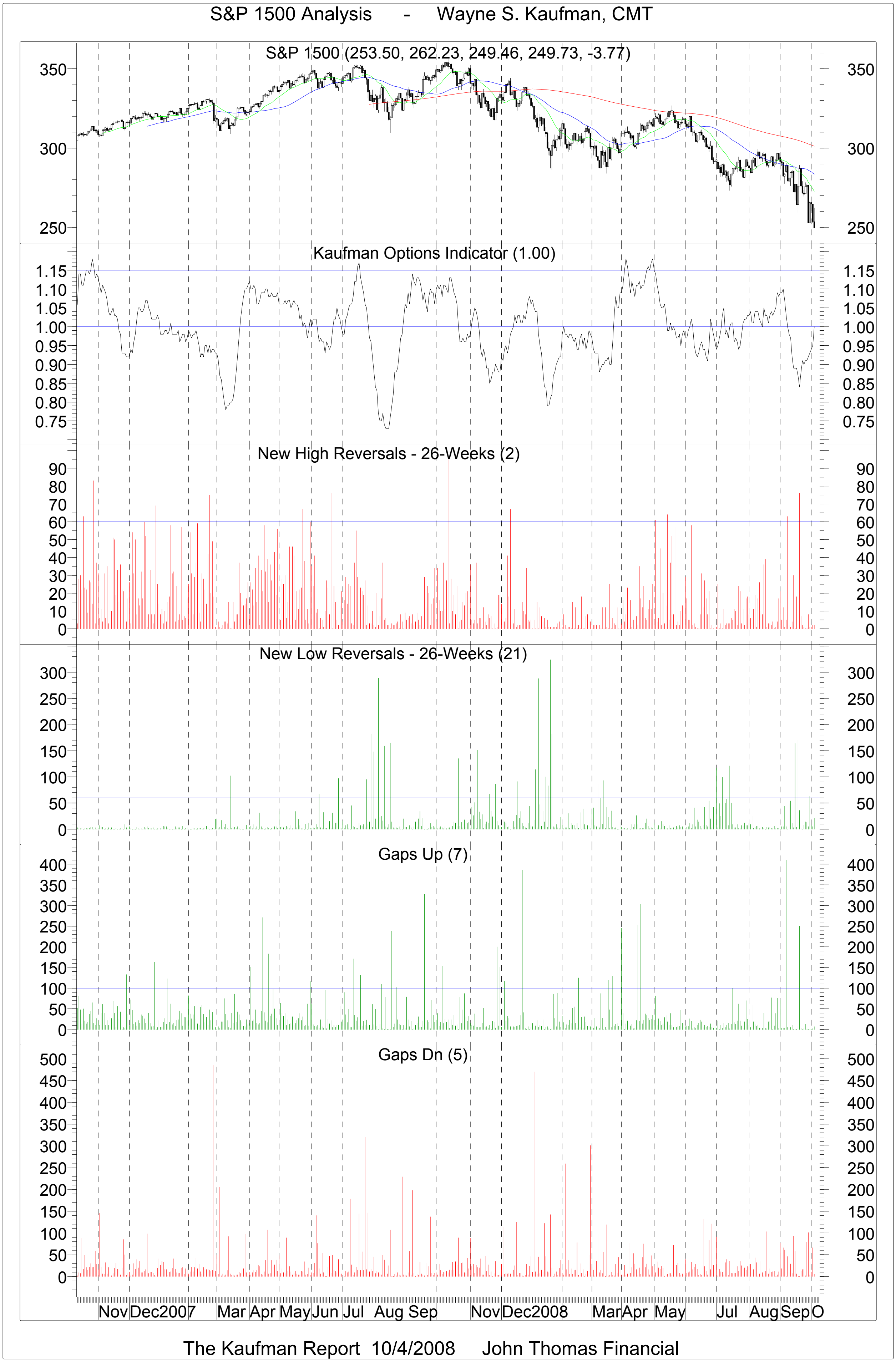
18.83% of the S&P 1500 traded higher Friday.

Our statistics of market breadth are making new lows except for a positive divergence in net volume. The AD line is also holding up well, showing a certain degree of selectivity in the recent selling.

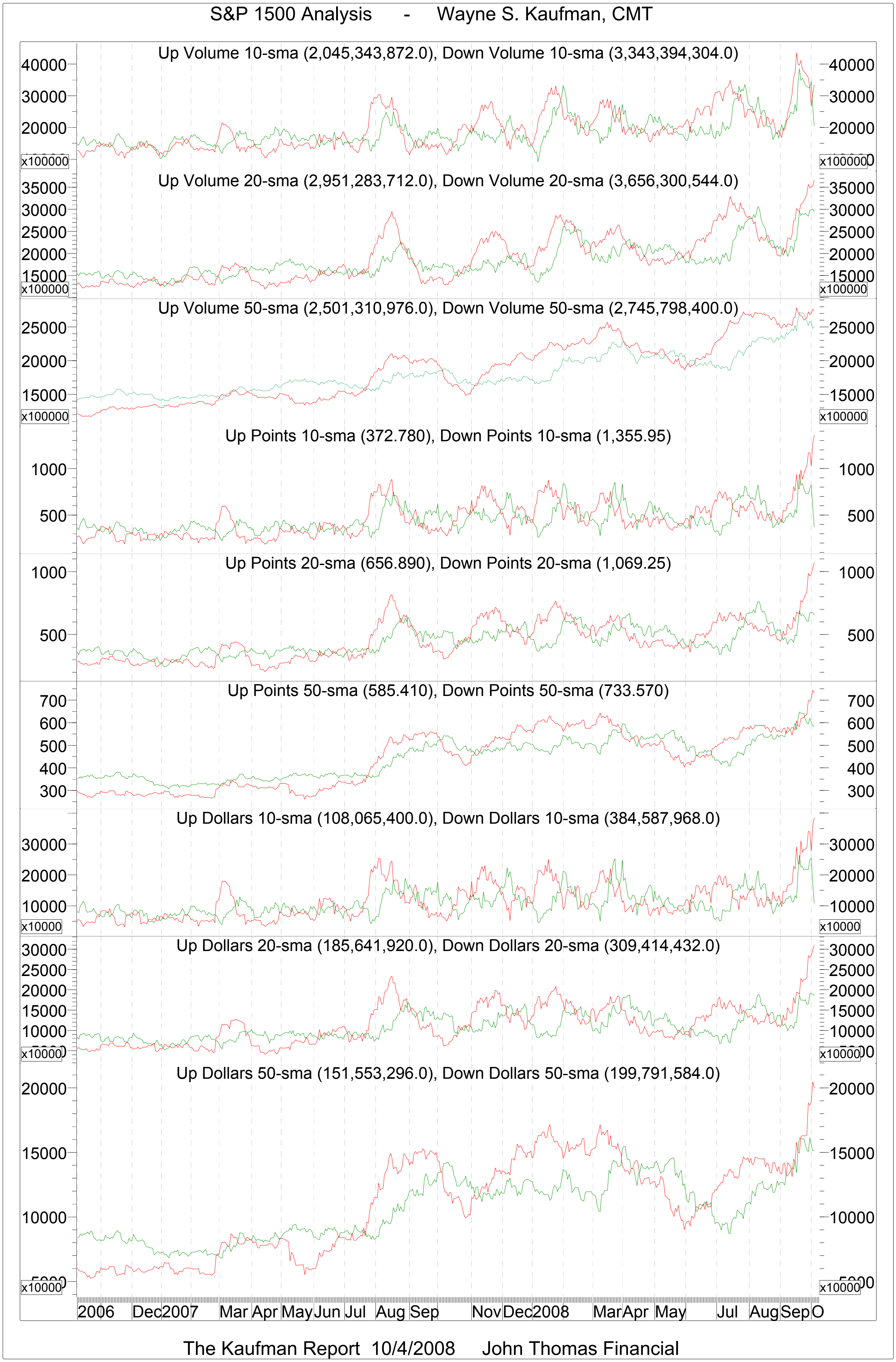
The 10-sma of 13-week lows is still well under levels of prior bottoms.

The percent of stocks over various moving averages is at extreme low levels.

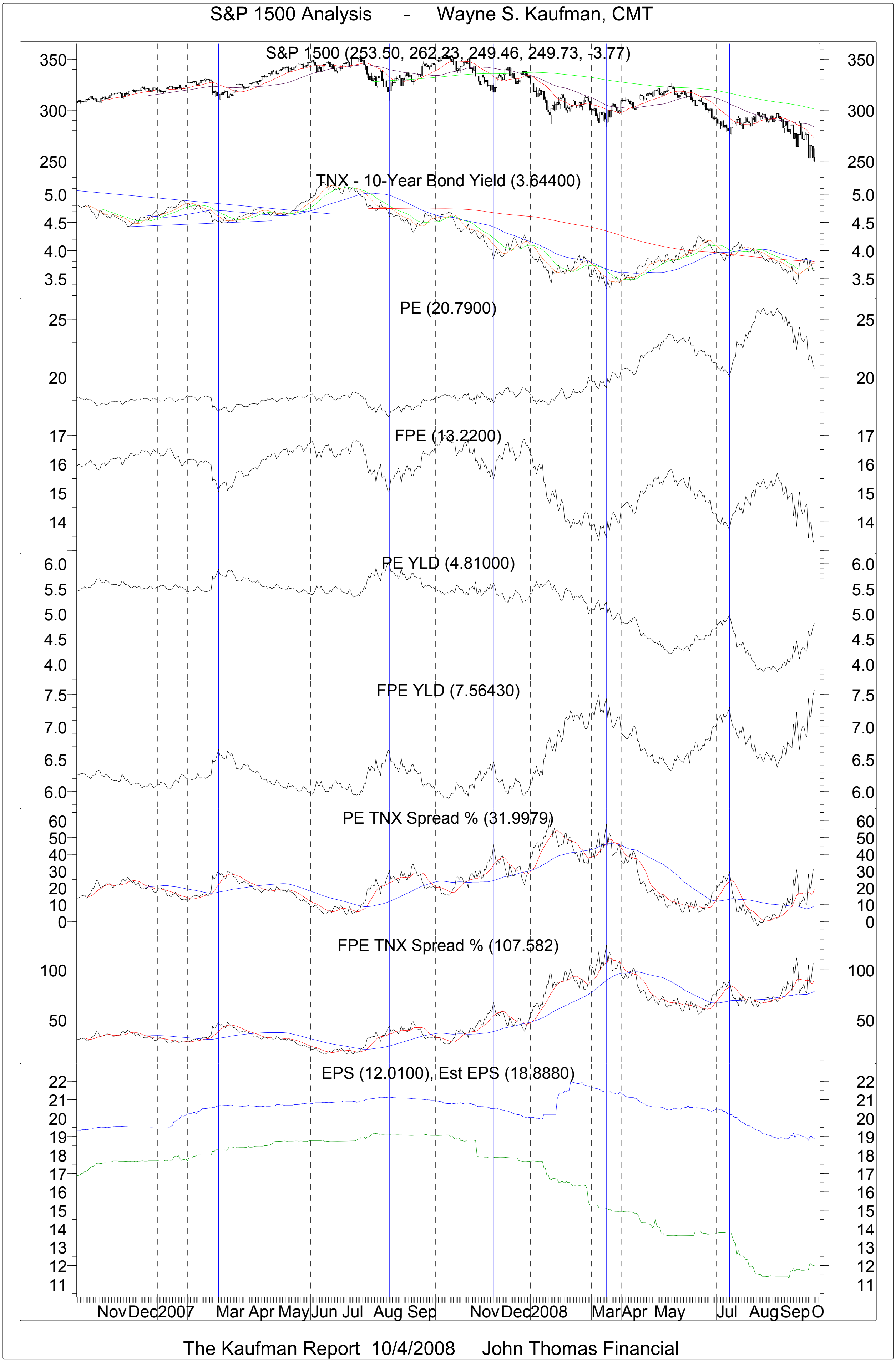
Volume has expanded on down days, not a good sign.



Our proprietary options indicator is neutral, which is very surprising. We would like to see far more bearishness in order for us to believe this is an important bottom.



Our statistics of buying and selling tell a simple story. Supply (red lines) has been swamping demand (green lines). Buyers have fled to the sidelines.



The 10-year bond yield has resumed its down trend with strong resistance at the 3.8% to 3.9% area.

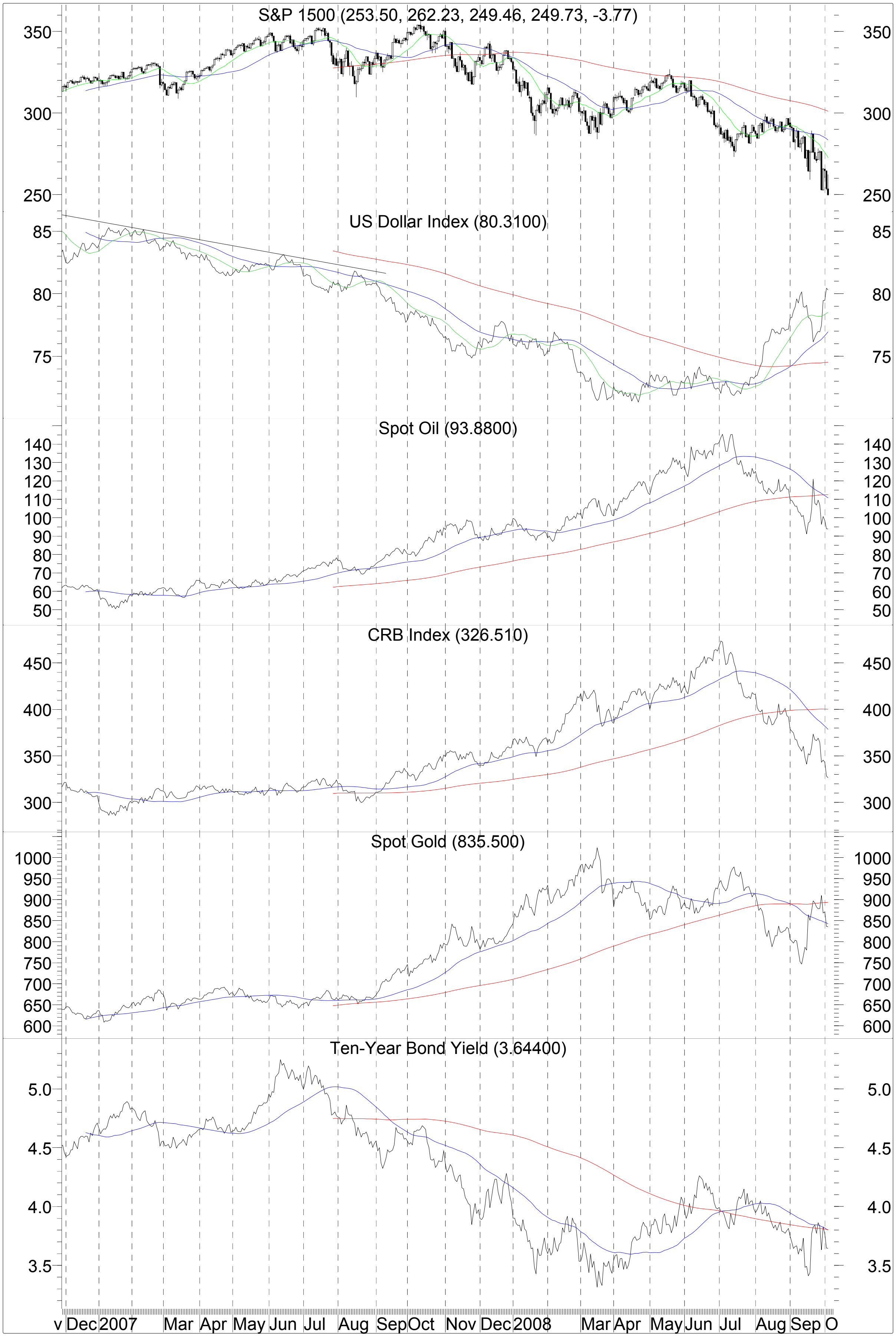
The P/E ratio is at the lowest level since the July bottom for stocks.

The forward P/E is at the lowest in years.

Spreads between earnings yields and the 10-year bond have widened dramatically and are at levels where stocks have bottomed multiple times.

We said earnings and forecasts would flat line due to lack of reports and that has happened. Third quarter earnings season will begin in a week or so.

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



The U.S. Dollar Index continues to show strength, helping commodities, already weak from slowing global demand, to be even weaker. There is a negative RSI divergence, so it should pause soon.

Oil is in a down trend near support.

There may be a little more weakness in gold before we get a good entry point long.