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The Kaufman Report

Trade what you see, not what you think.

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Monday September 29, 2008 **Closing prices of September 26, 2008**

Stocks had a rough week last week, with the S&P 1500 down 3.71% for the week. So far September has lived up to its reputation and the S&P 1500 is down 5.55% for the month. Year-to-date the index is down 16.57%, and since the peak on October 11th it is down 22.43%. <u>It was the lowest weekly close since November 2005</u>.

The good news is we are entering October, which in spite of its scary reputation has a history of being the end of many bear markets. There have been some notable crashes in October, and with the current problems in the financial markets still being attended to that possibility exists at this time. However, our intrepid legislators are tirelessly working on the solution, and of course doing so without any hint of political grandstanding, so perhaps markets will stabilize in short order.

Our problem with the $700 billion 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 other overly optimistic pronouncements?

The debate rages over whether or not this bailout money is actually an investment which will yield taxpayers a profit or if the next thing we hear will be that familiar flushing sound. There are some high profile supporters of the bailout, including Bill Gross, who runs the world's largest bond fund for Pimco. He is quoted in Barron's as saying the government will make money on the deal, and that "we can do a granular analysis of any mortgage security or package in 10 to 15 minutes to determine their fair value."

This is great news, because we keep hearing that the problem with these mortgage securities is it has been impossible for anyone to value them. It begs the question of how can Pimco do it so easily while financial managers all over the world are completely flummoxed? Mr. Gross estimates the government will pay 65 cents on the dollar and end up with a 7% to 8% profit. With Pimco's superior ability to value these securities, they will obviously front-run the government's purchases and are probably racing even as we type to pay twice as much as the 22 cents on the dollar Lone Star Funds paid Merrill Lynch in July for $31 billion worth of debt. As legendary art dealer Edward Duveen used to say "top dollar for something priceless is a bargain!"

We shouldn't be so cynical about the government's ability to fix this mess. It's not like they had anything to do with causing it. Hopefully the bailout will unfreeze the credit markets and investors can focus once again on the more traditional issues of company earnings and forecasts now that we are a mere two weeks away from third quarter earnings season.

<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 $11.76, a drop of 38.7%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $18.91, a drop of only 13.85%. 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 a 68.0% probability that the Fed will *cut rates 25 basis points to 1.75%,* and a 32.0% probability of *cutting 50 basis points to 1.50%* when they meet on October 29th. They are pricing in a 49.5% probability that the Fed will *cut rates 25 basis points to 1.75%* at the meeting on December 16th, and a 41.8% probability of *of cutting 50 basis points to 1.50%.* They are pricing in a 48.7% probability that the Fed will *cut rates 25 basis points to 1.75%* at the meeting on January 28th, and a 38.1% probability of *decreasing 50 basis points to 1.50%.*

The S&P 1500 (276.46) was up 0.225% Friday. Average price per share was down 0.21%. Volume was 70% of its 10-day average and 91% of its 30-day average. 50.34% of the S&P 1500 stocks were up on the day. Up Dollars was less than 43% of its 10-day moving average and Down Dollars was 32% of its 10-day moving average. For the week the index was down 3.77% on decreasing and below average weekly volume.

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

The weekly chart of the S&P 500 shows the obvious long-term down trend. The candle two weeks ago is a hammer, which is a bottoming candle. The momentum indicators are at neutral to low levels. We have been calling this a bear market since January when the index crossed below the 80-week moving average, which equates roughly to the 400-day moving average. This was the lowest weekly close since 11/2005.

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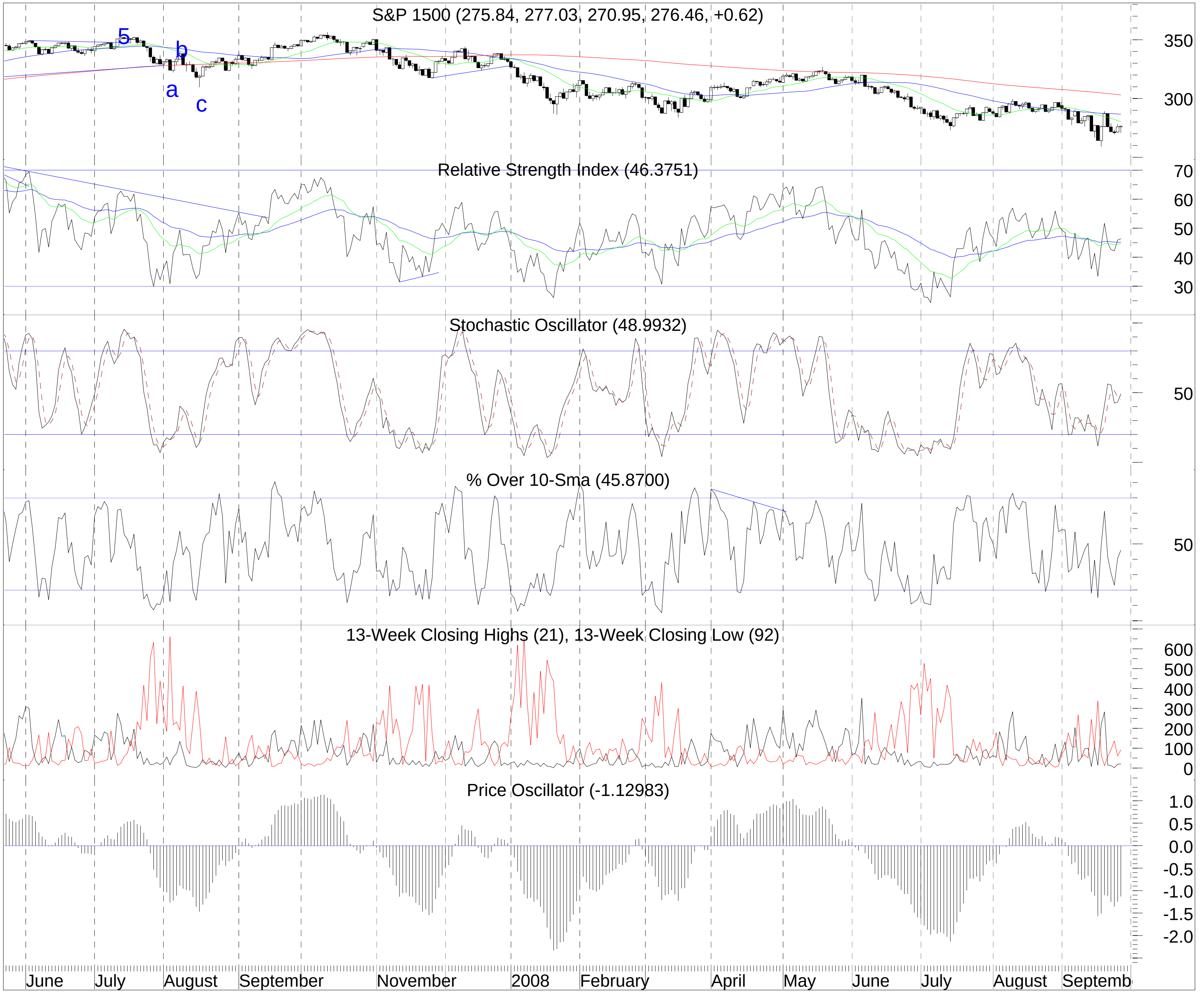
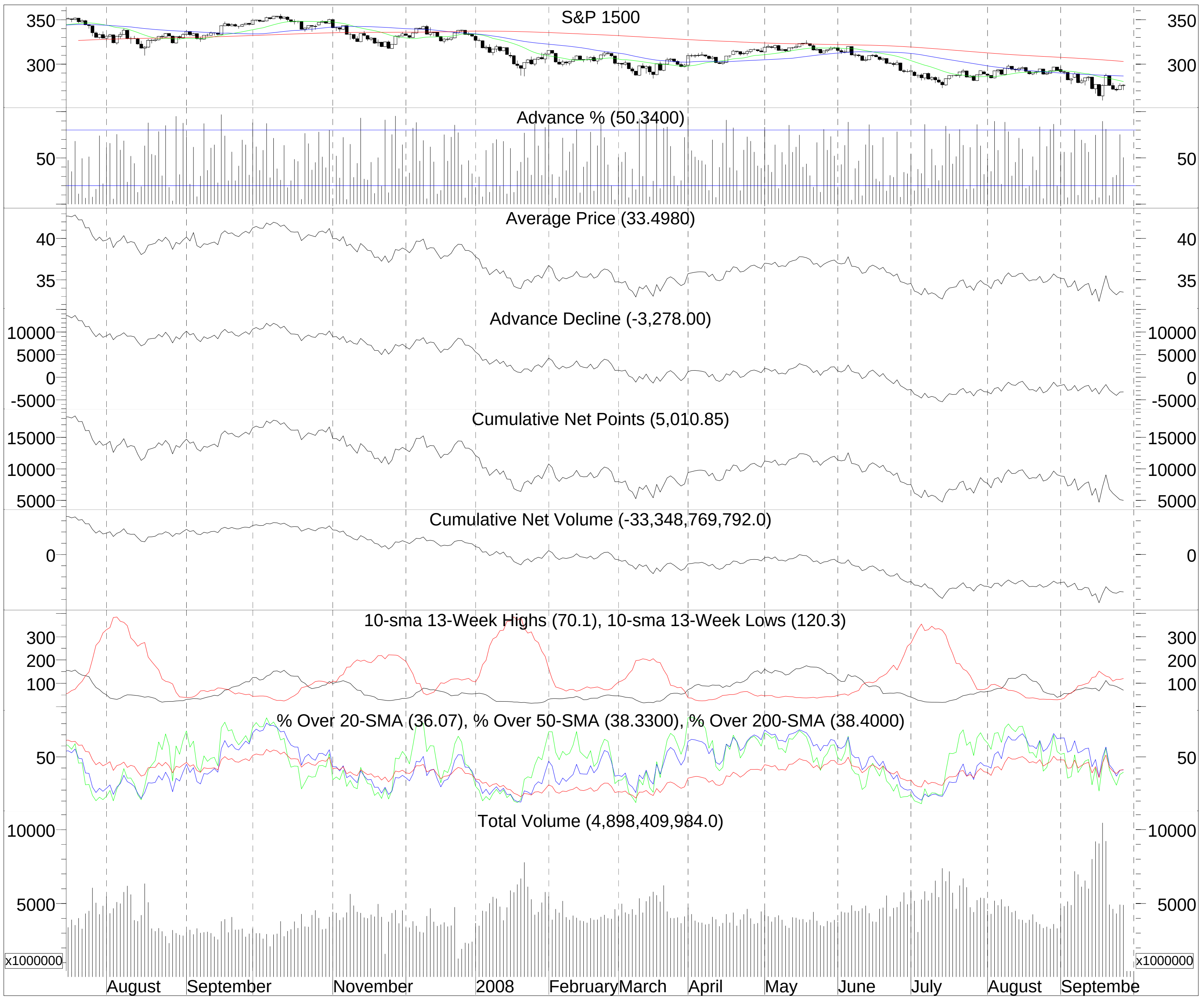
The S&P 1500 remains in a down trend and is below the 20, 50, and 200-sma. In spite of the negative headlines last week, so far the low of 9/18 is holding. Unfortunately the weekly chart shows the lowest weekly close since 11/2005.



Our oscillators are neutral.

There were more lows than highs Friday.

Our price oscillator, a good indicator of trends, remains decidedly negative.

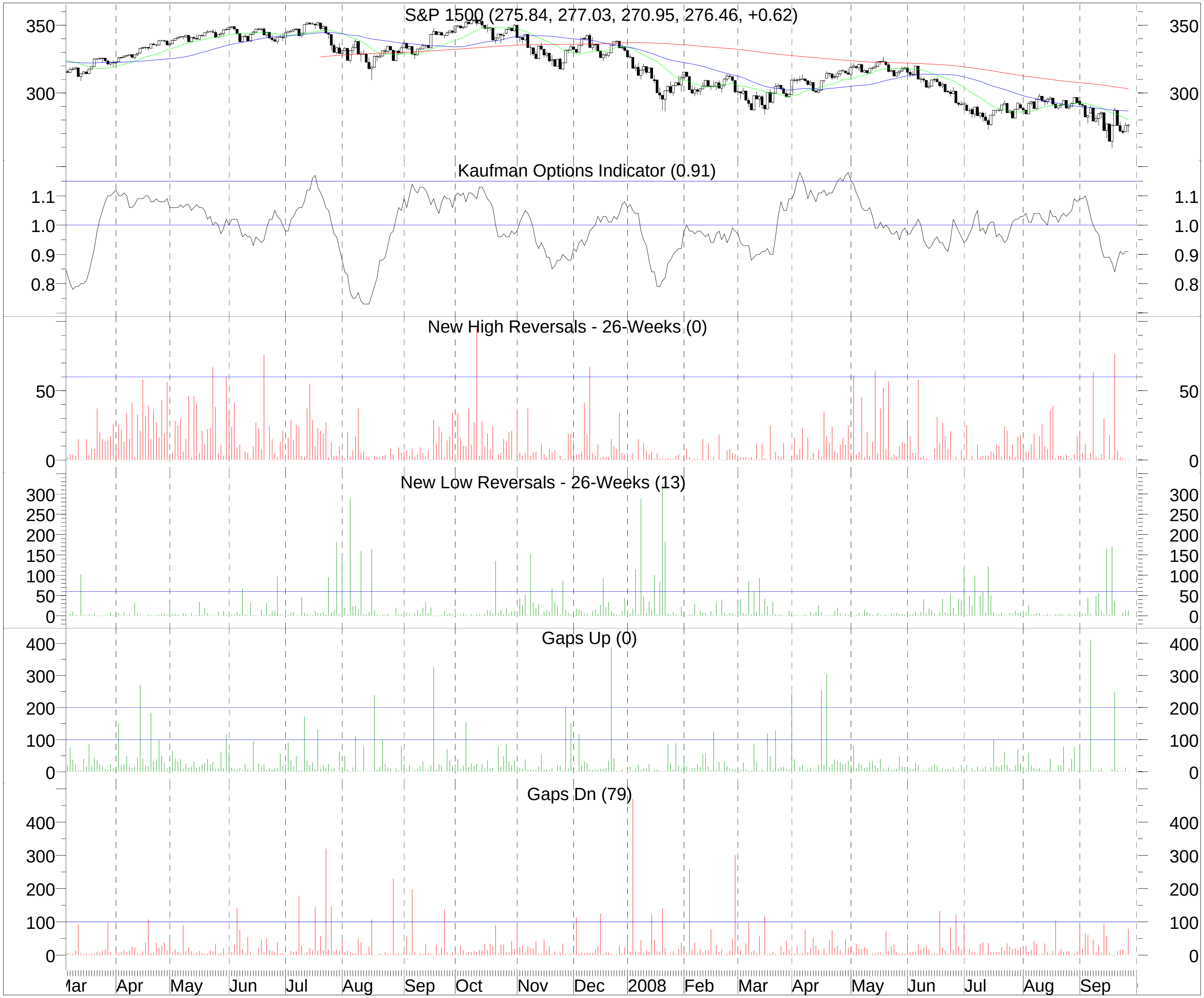


50.34% of stocks traded higher Friday.

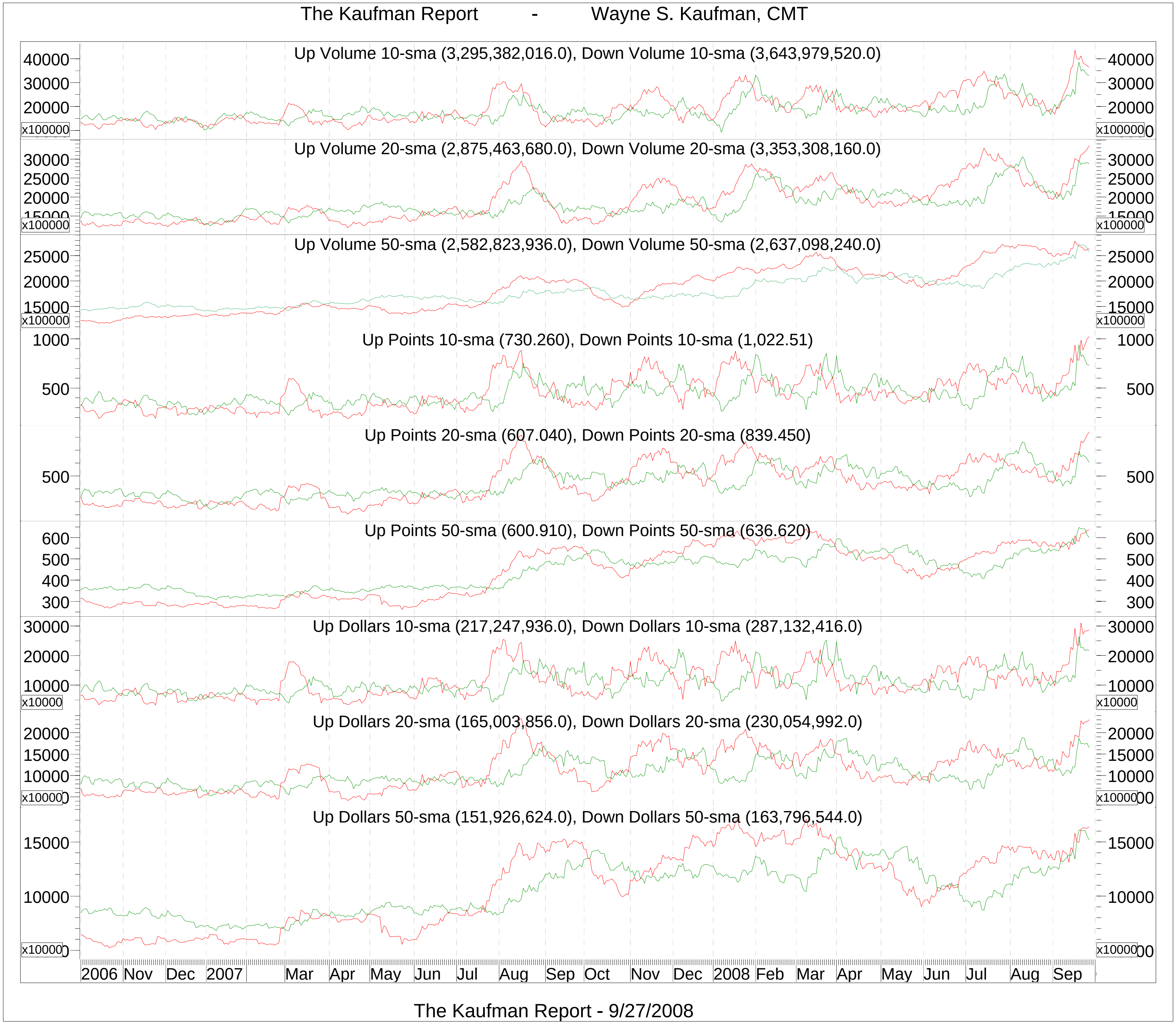
The AD line is holding up so far.

The 10-sma average of new 13-week closing highs is decreasing while new lows is increasing.

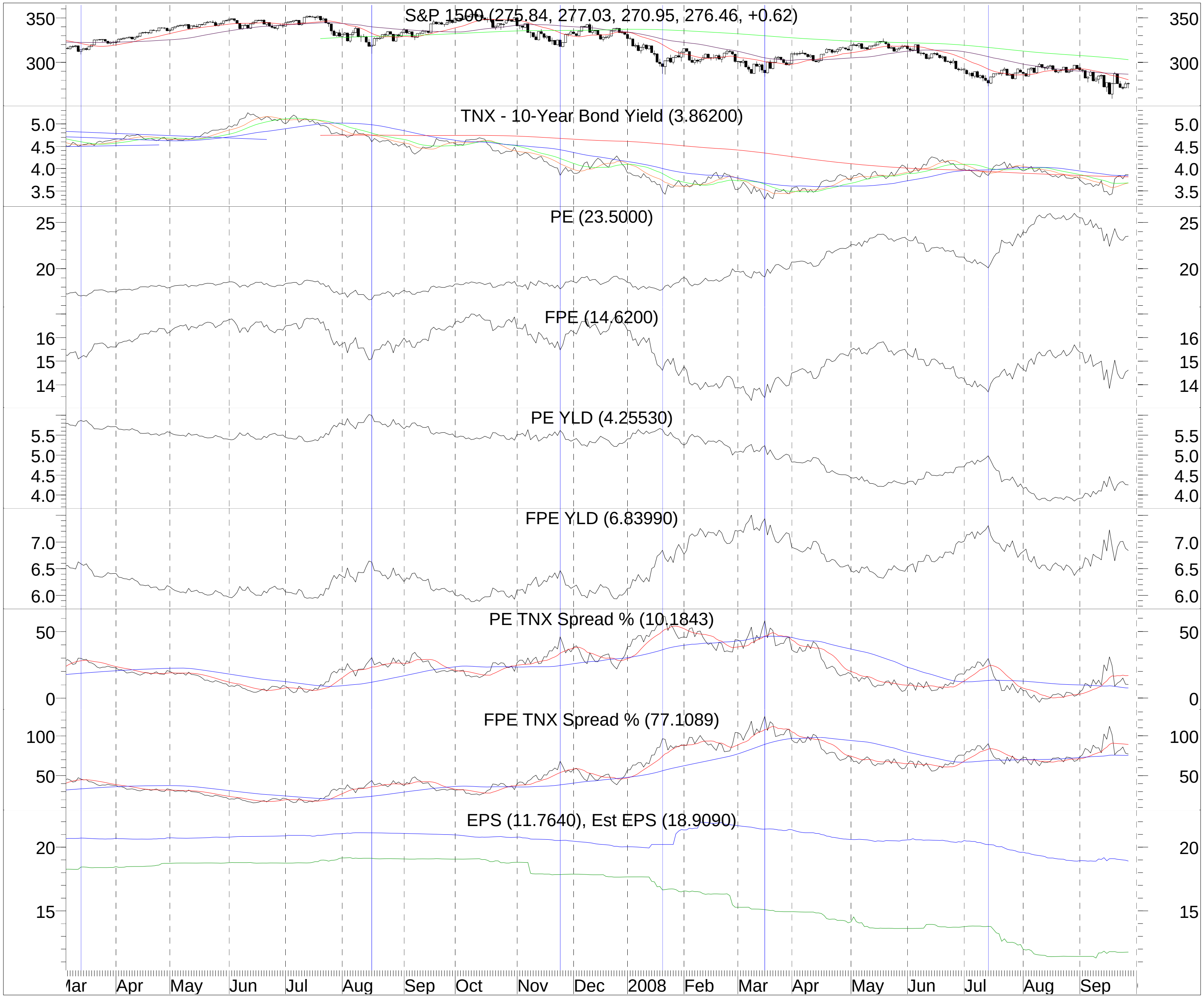
Only a little more than one-third of stocks are above important moving averages.



Our proprietary options indicator is in negative territory, showing that options buyers have become pessimistic. Stocks can go higher or lower while the indicator is at these levels, but downside should be limited.



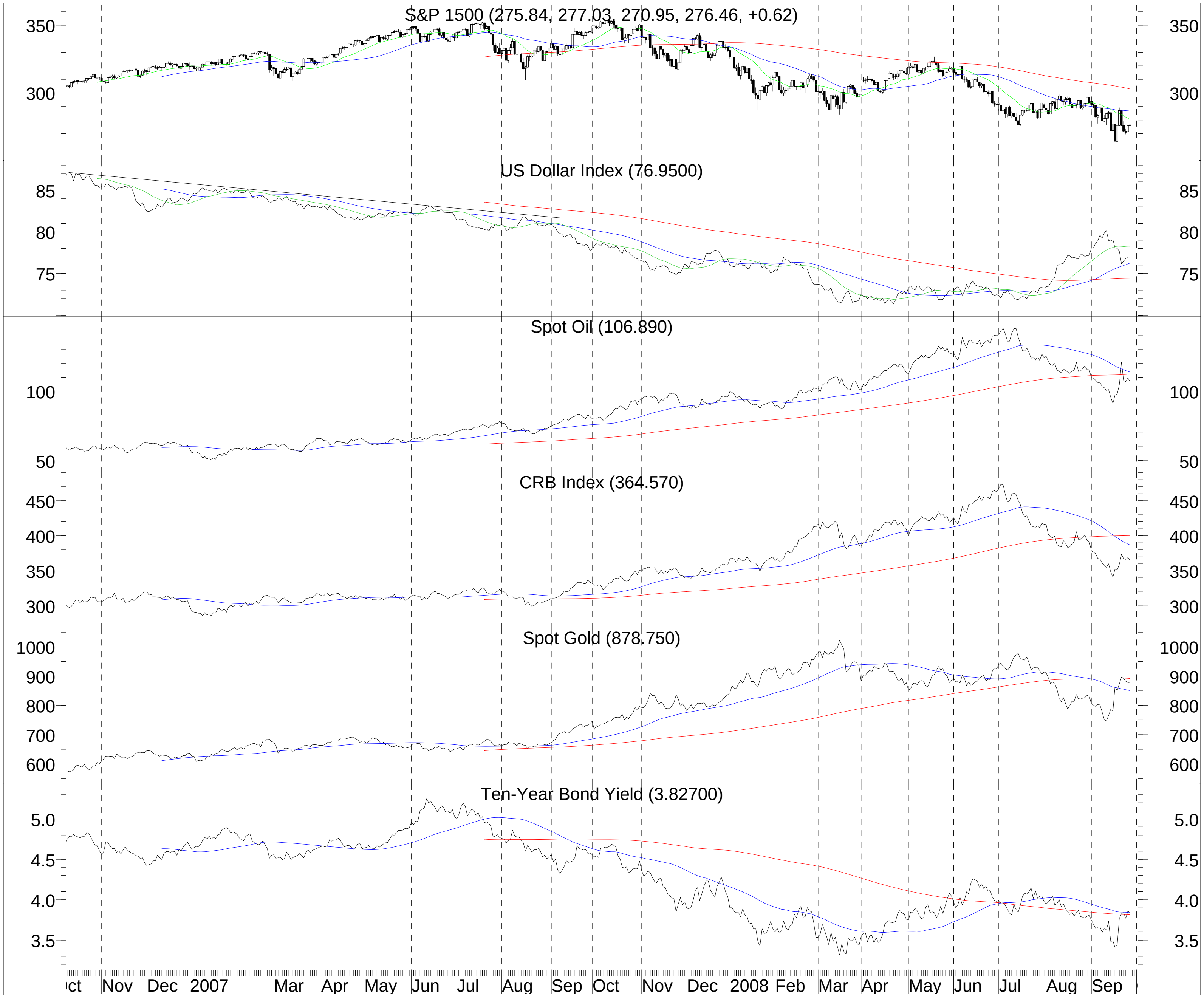
Our statistics of supply (red lines) versus demand (green lines) are showing negative crossovers, or simply put, supply has been swamping demand.



After a flight to safety drove bond yields to low levels, they rebounded sharply. They have resistance in the 3.905 area, but they seem destined to go higher based on the daily and weekly charts.

Spreads between bond and earnings yields have narrowed and don't leave much room for stocks to trade higher in the short-term.

Earnings and projections have been flat lining as we said they would a few weeks ago. This is due to a lack of earnings reports at this time and will change in October.



The U.S. Dollar Index has pulled back from over-bought levels after hitting resistance at the 80 area. That is also the neckline of a scary head and shoulders pattern on the monthly chart which we have been talking about for quite a while.

Crude oil is in a down trend. There is some support at the 106 area, and after that the low 90s. It is neutral short-term relative to over-bought or oversold.

Gold is fighting the 200-sma. If it breaks above it it should trade a lot higher.