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The Kaufman Report

Trade what you see, not what you think.

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Monday September 8, 2008 **Closing prices of September 5, 2008**

Last Monday we warned that investors should be on high alert for the possibility that equities could be about to make another leg down, and the S&P 1500 thereafter plunged 3.18% for the week. The catalysts for the sharp drop were bad economic news in the form of higher than expected Jobless Claims and worse than expected Unemployment Report, and weak forecasts issued by companies like Nokia, Corning, MEMC, Altera, Terex, and Ciena.

Thursday was a panic-selling 90% down day. Friday was a bungee jump kind of day as stocks dropped sharply in the morning and rallied in the afternoon to close higher on the day. They had an oversold bounce after reaching a level just above the July 15th close, and also managed to put in a weekly close just above the prior weekly closing low of 282.24, which remains the lowest weekly close since July 2006.

We have been highlighting the spreads between 10-year bond yields and the earnings yields of the P/E and forward P/E of the S&P 1500. Stocks bottomed Friday when the earnings yield of the forward P/E became 90% higher than the 10-year bond yield. *This was the exact level of the spread when stocks bottomed on July 15th.* The spread based on current reported earnings is still well below the levels of July 15th. This shows the discrepancy in the way reported earnings have plunged versus the slower descent of earnings estimates.

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $11.42, a drop of 40.45%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $18.91, a drop of only 13.86%. 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.*

Time will tell how much lower earnings projections will actually go, but for the time being it is one of many variables where there is a lack of visibility for investors. Some of the other variables with little or no visibility are the slowing global economy, the political landscape, energy and commodities prices, real estate valuations, and the ongoing lack of liquidity in the credit markets.

In the very near-term, with earnings season essentially over, reported and projected earnings could flat line for a little while, which may prevent stocks from plunging too much lower as long as interest rates, which are oversold, don't move up too much. However, we are in a seasonally weak time of the year, there is a triple-witching options expiration coming shortly, bad news continues to dominate, and investors still need to be on the alert for further deterioration in equities.

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

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So far 496 companies in the S&P 500 have reported second quarter earnings. According to Bloomberg, 67.4% have had positive surprises, 7.3% have been in line, and 25.3% have been negative. The year-over-year change has been -23.4% on a share-weighted basis, -23.4% market cap-weighted, and -12.4% non-weighted. Ex-financial stocks these numbers are 3.9%, 7.2%, and 4.7%, respectively.

Federal Funds futures are pricing in an 98.0% probability that the Fed will *leave rates at 2.00%,* and an 2.0% probability of *raising 25 basis points to 2.25* when they meet on September 16th. These are the same probabilities for the following meeting on October 29th.

The S&P 1500 (283.42) was up 0.429% Friday. Average price per share was up 0.36%. Volume was 122% of its 10-day average and 112% of its 30-day average. 55.71% of the S&P 1500 stocks were up on the day. Up Dollars was less than 91% of its 10-day moving average and Down Dollars was 33% of its 10-day moving average. For the week the index was down 3.18% on increasing weekly volume.

Options expire September 19th.

IMPORTANT DISCLOSURES

The S&P 1500 followed through to the downside After Thursday's panic-selling 90% down day. It then had an oversold bounce just above the closing price of July 15th. It also managed to close for the week just above the weekly closing low of 282.24, which itself was the lowest weekly close since July 2006. During the session it also hit a downside target we published on August 4th of 279.83, which we calculated from a negative reversal which had shown up on the RSI. The oversold bounce caused a hammer candle to be printed on the daily chart. Hammers are bottoming candles.

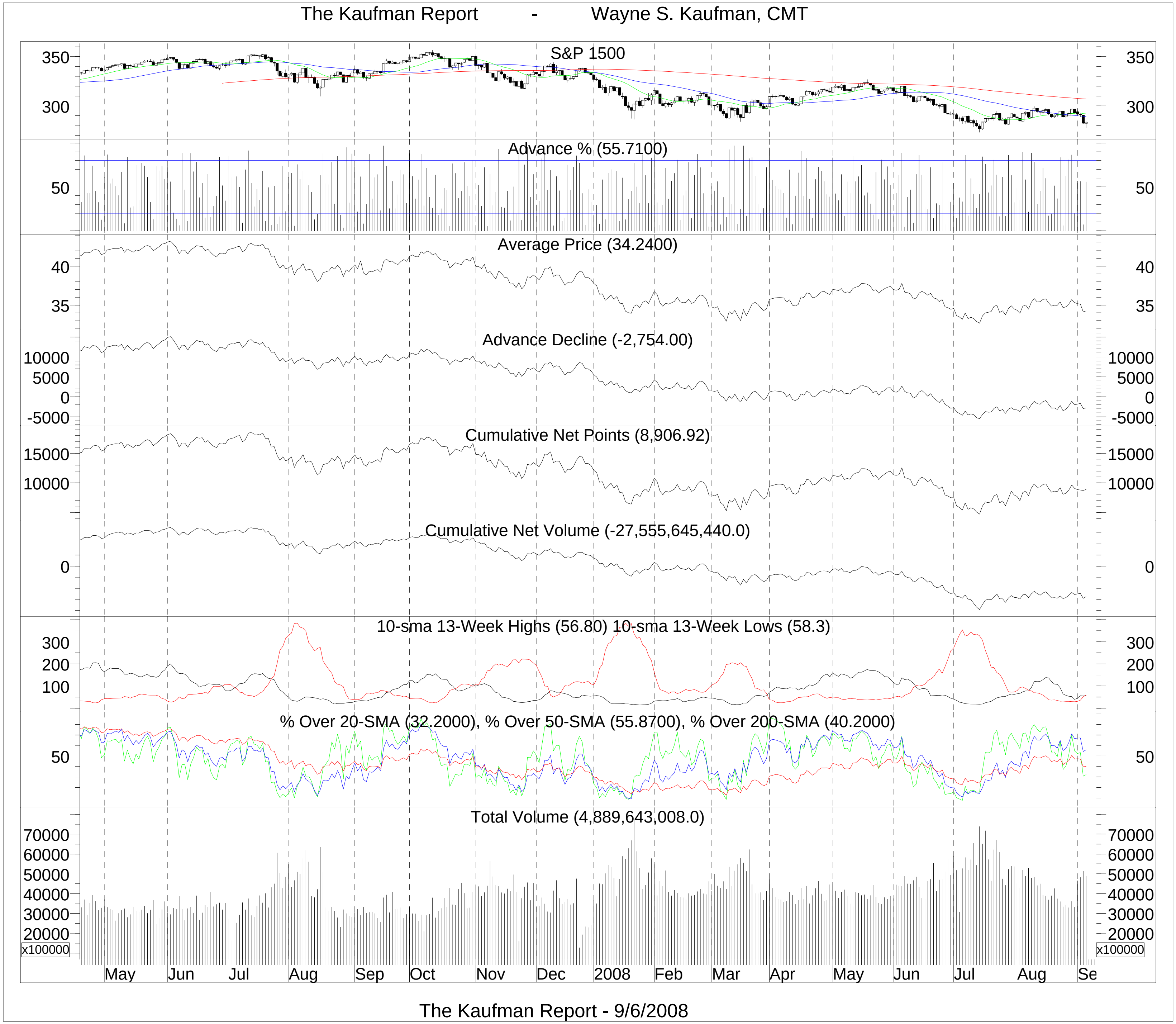
Last week we noted the stochastic sell signal given from an overbought condition. There is still room for it to move down, but the other oscillators are at low levels already, although not extremely oversold.

Our daily oscillators are not oversold, although the stochastic is close. The RSI is at the 40 level which is support during up trends.

There is a positive divergence in the percent over 10-sma.

New lows have begun to expand again.

Our price oscillator, a good indicator of trends, turned negative Thursday.

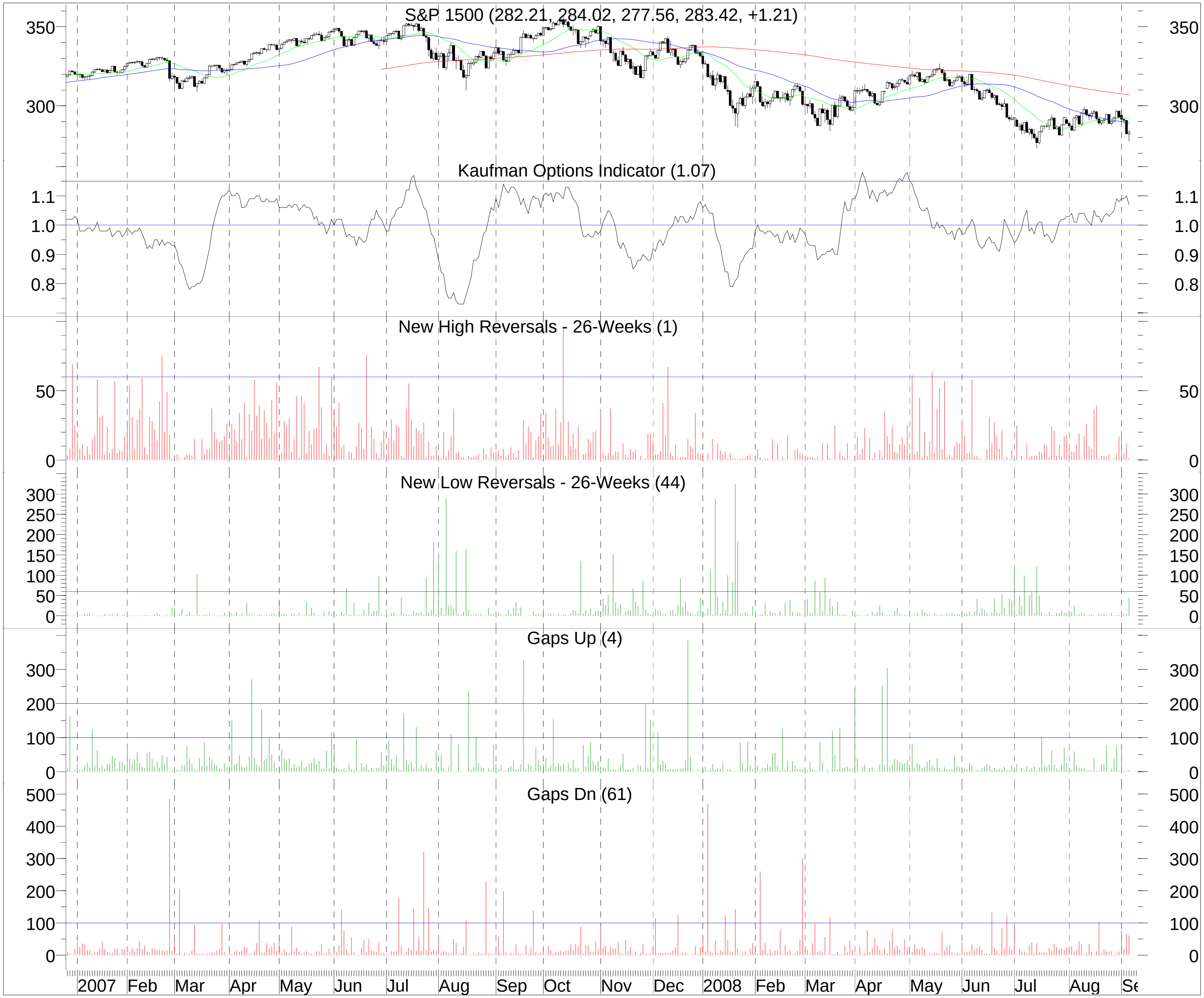


55.71% of stocks traded higher Friday.

Some of Our statistics of market breadth are not yet breaking down, in particular the AD line. This shows the recent strength in small-caps.

After turning positive August 8th, the 10-sma of 13 week highs versus lows has turned negative. The 10-sma of 26-week highs versus lows (not shown) is still positive.

Volume has picked up in September after a lackluster August.



We have been warning that our proprietary options indicator was showing bullishness that left equities vulnerable to a sharp drop. It has pulled back some, but it is still much higher than where it has been during important bottoms in the past.

New low reversals jumped up Friday due to bottom fishers and short-covering. More than one day of this type of activity is usually needed to make a bottom.

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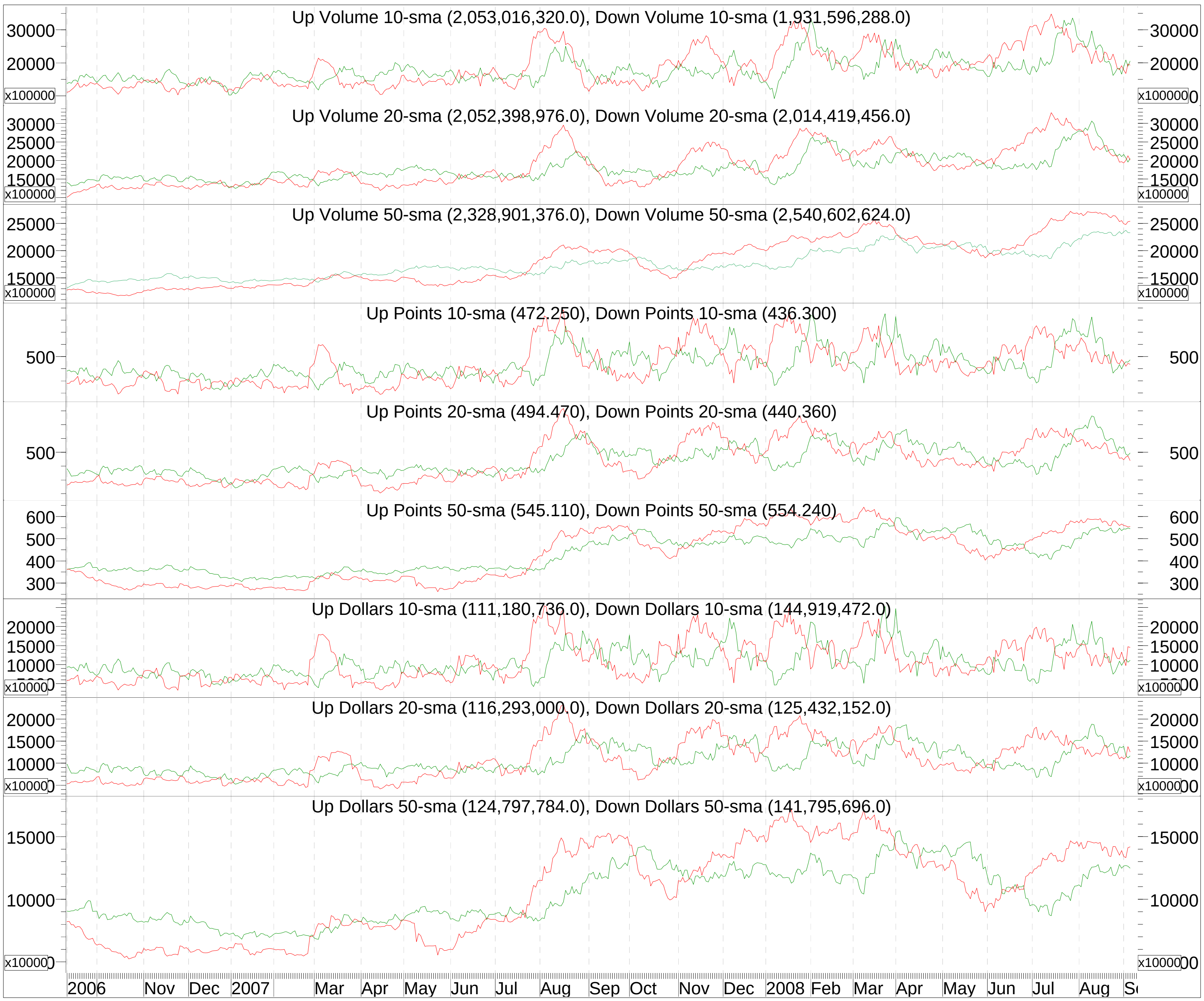

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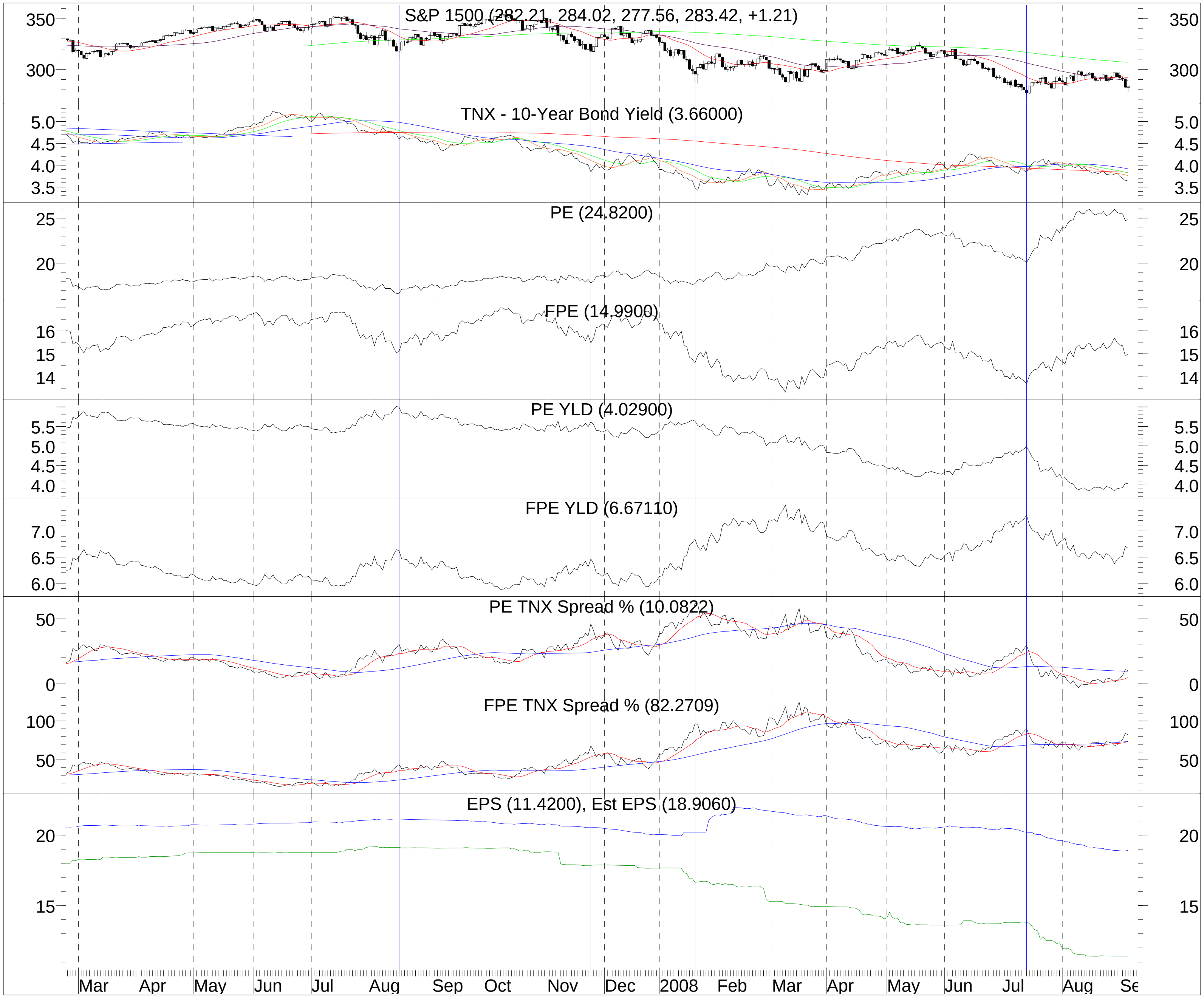
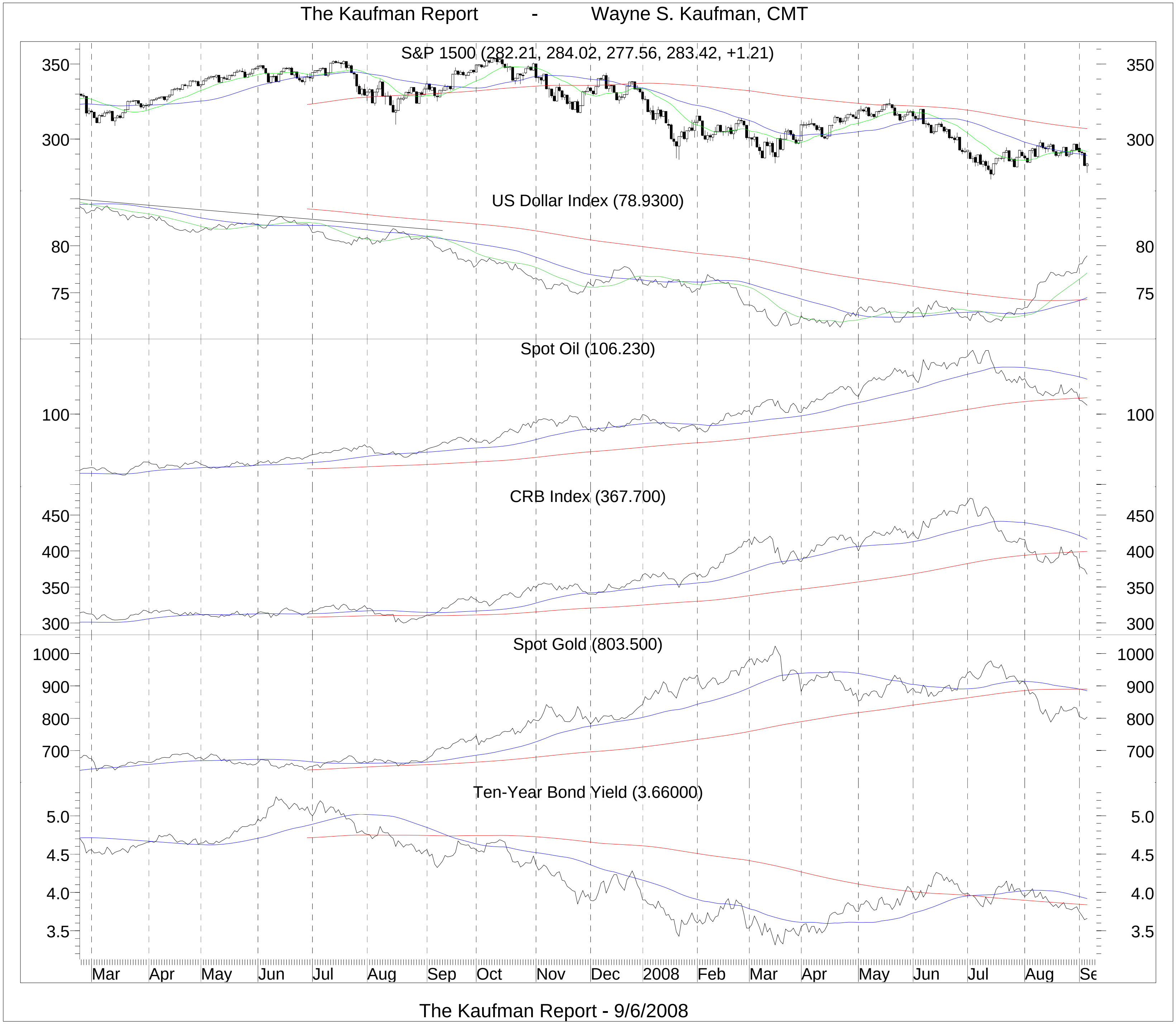
Our statistics of supply (red lines) versus demand (green lines) are actually positive for volume and points. Dollars remain negative. This shows the recent outperformance of small caps over large and mid-caps.



The P/E ratio is coming down after hitting multi-year highs.

The forward P/E is coming down after reaching the same area where stocks topped in May.

Spreads between earnings yields and 10-year bond yields have improved, with the spread based on the forward yield in an area where stocks should be attractive. This could put a floor under stocks in the near-term since earnings season is over, and reported and forecast earnings could flat line for a while.



The U.S. Dollar Index is in an up trend after reaching the highest levels in over a year. It is overbought with a negative RSI divergence.

Crude oil is in a down trend, with the next price support at 100. There is a positive RSI divergence.

Commodities are like oil, in a down trend with a positive RSI divergence.

Gold is trying to put in a bottom with an inverted hammer (not shown). It was very oversold on 8/15 with a positive RSI divergence.

10-year bond yields are almost oversold with a hammer on the daily chart.