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The Kaufman Report

Trade what you see, not what you think.

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Monday July 28, 2008 **Closing prices of July 25, 2008**

The S&P 1500 followed through early last week after finding a bottom on July 15th. It reached the 38.2% Fibonacci retracement level of the May – July plunge before pulling back a little. The 50% Fibonacci level is about 4.5% higher at the 300 area, which if reached will be stronger resistance, with the 50-day moving average also coming into play at that point.

So far the end of the week pullback is in the range of what's normal, but any big increase in selling may set the stage for an August decline. We are still of the opinion that until proven otherwise this is a bear market rally.

We are very concerned about the P/E ratio, which at 22.88 is back at high levels and not far from the 23.73 which marked the top for stocks on May 19th. It has been rising in spite of weakness in stocks because aggregate current earnings have taken a precipitous plunge recently. Projected earnings have not dropped as sharply, but have remained in a down trend. Therefore, the spreads between bond yields and earnings yields have narrowed dramatically, with the spread based on the current P/E now back at uncomfortably narrow levels.

This situation will be exacerbated by a further increase in interest rates, which have been rising and are now above important moving averages. We present a chart of the Philadelphia Stock Exchange Utility Index, which has a head and shoulders pattern forming on the weekly chart. It is currently at support, but a breakdown would coincide with a move higher in bond yields, which would be very damaging to the spreads between bond and earnings yields, and would probably result in a new leg down for stocks.

The short-term trend is up (tenuously), but the intermediate and long-term trends are down, and we reiterate that this continues to be a bifurcated, opportunistic trader's market, with adept traders able to take advantage long or short. Investors need to be alert to sector rotation and should not hesitate to move out of lagging sectors and stocks and into leaders.

So far 256 companies in the S&P 500 have reported second quarter earnings. According to Bloomberg, 71.1% have had positive surprises, 5.5% have been in line, and 23.4% have been negative. The year-over-year change has been -24.3% on a share-weighted basis, -25.6% market cap-weighted, and -11.9% non-weighted. Ex-financial stocks these numbers are 12.1%, 15.8%, and 13.3%, respectively.

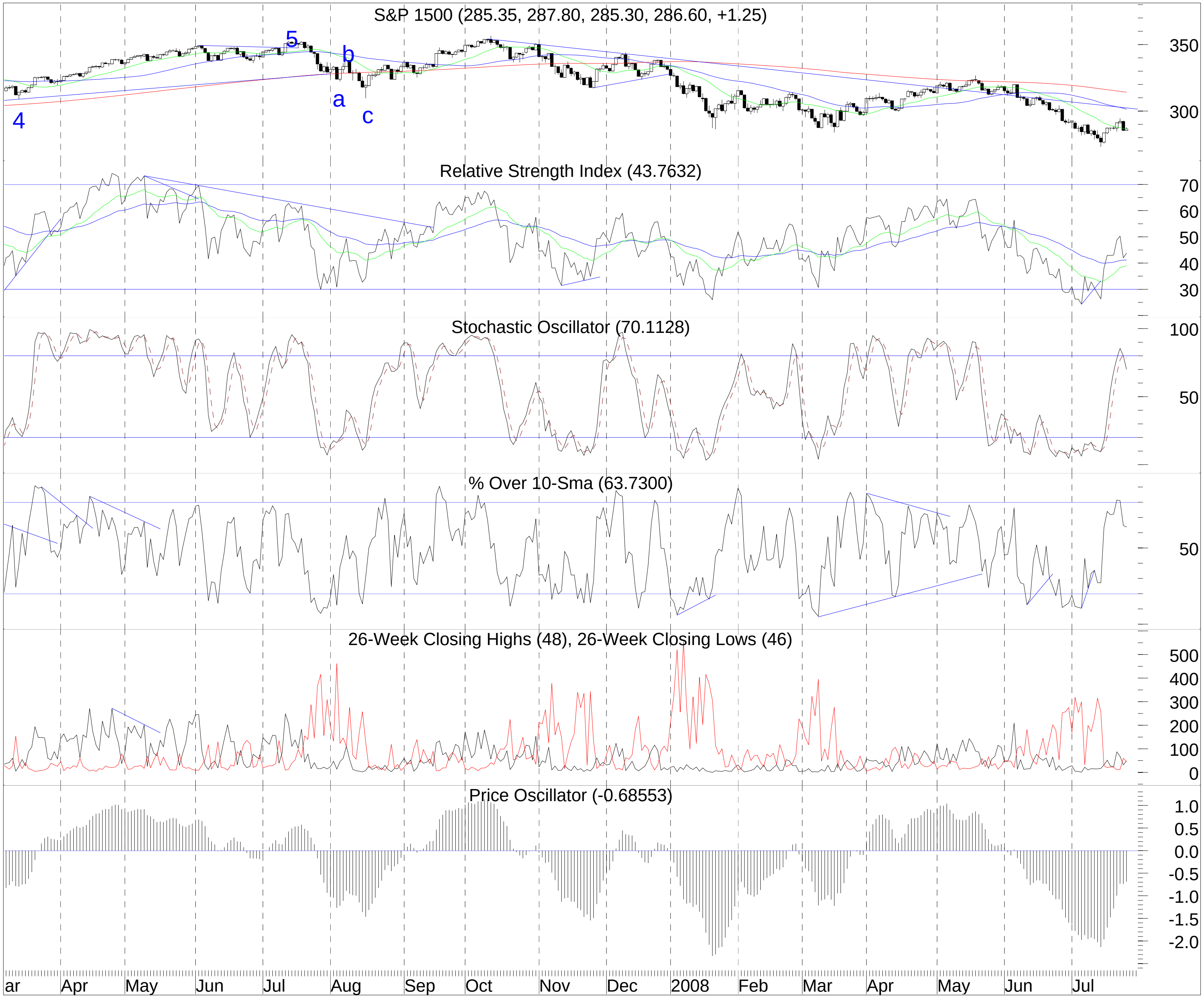
Federal Funds futures are pricing in a 93.1% probability that the Fed will *leave rates at 2.00%,* and a 6.9% probability of *raising 25 basis points to 2.25* when they meet on August 5th.

The S&P 1500 (286.6) was up 0.438% Friday. Average price per share was up 0.65%. Volume was 78% of its 10-day average and 89% of its 30-day average. 61.39% of the S&P 1500 stocks were up on the day. Up Dollars was 75% of its 10-day moving average and Down Dollars was 34% of its 10-day moving average. For the week the index was down 0.188% on decreasing but above average weekly volume.

Options expire August 15th.

IMPORTANT DISCLOSURES

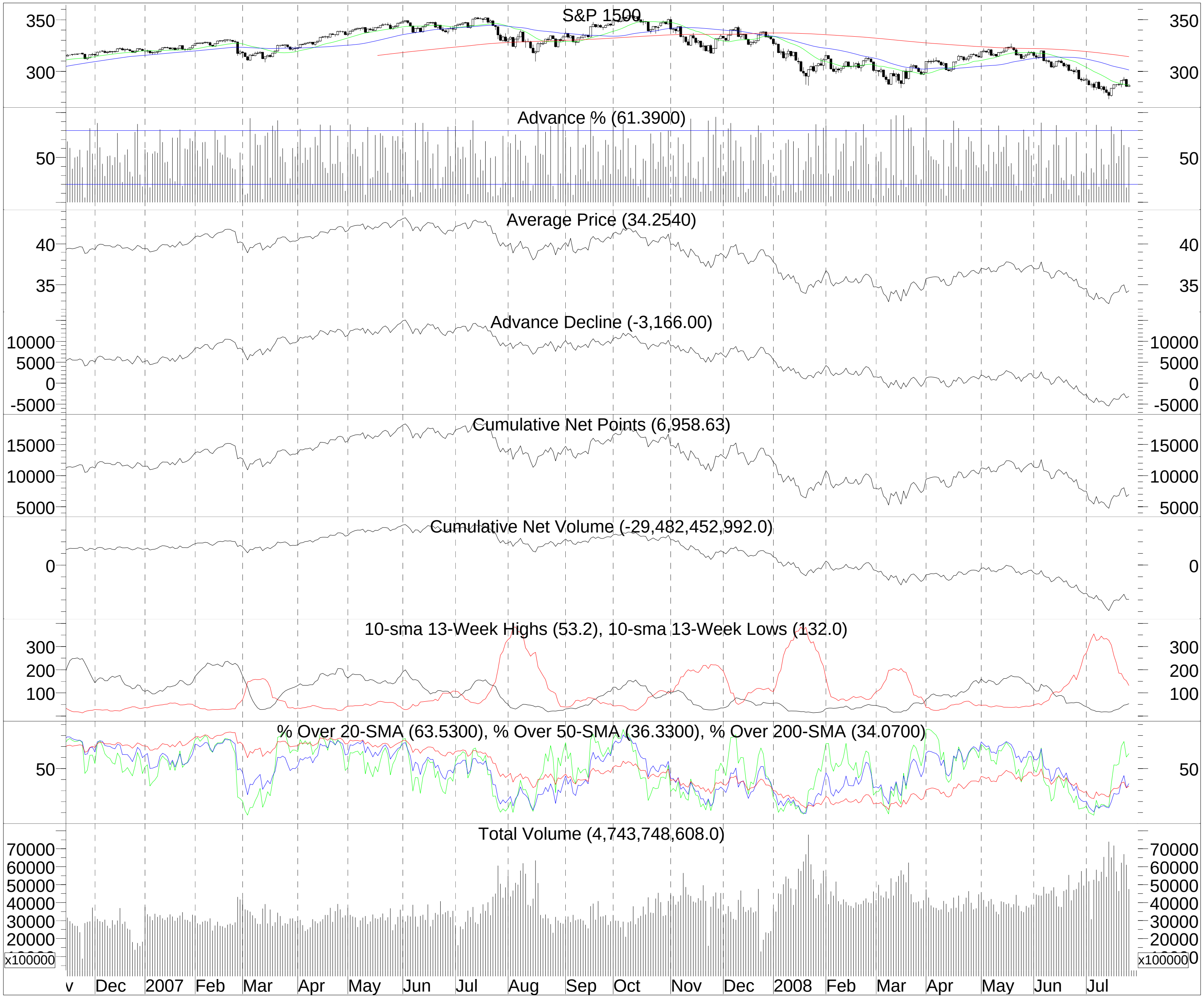
The S&P 1500 bounced from oversold conditions up to the 38.2% Fibonacci retracement level and then pulled back. The next important level is 50%, or the 300 area, which will provide even greater resistance due to the 50-sma coming into play at that time. The index is currently at the 20-sma, and so far this pullback is normal. Any big increase in selling puts the recent rally in jeopardy and sets the stage for another leg down in August.



Two of our oscillators are pulling back from over-bought levels, while the RSI is neutral.

New highs and lows were about the same Friday.

Our price oscillator is still in negative territory.

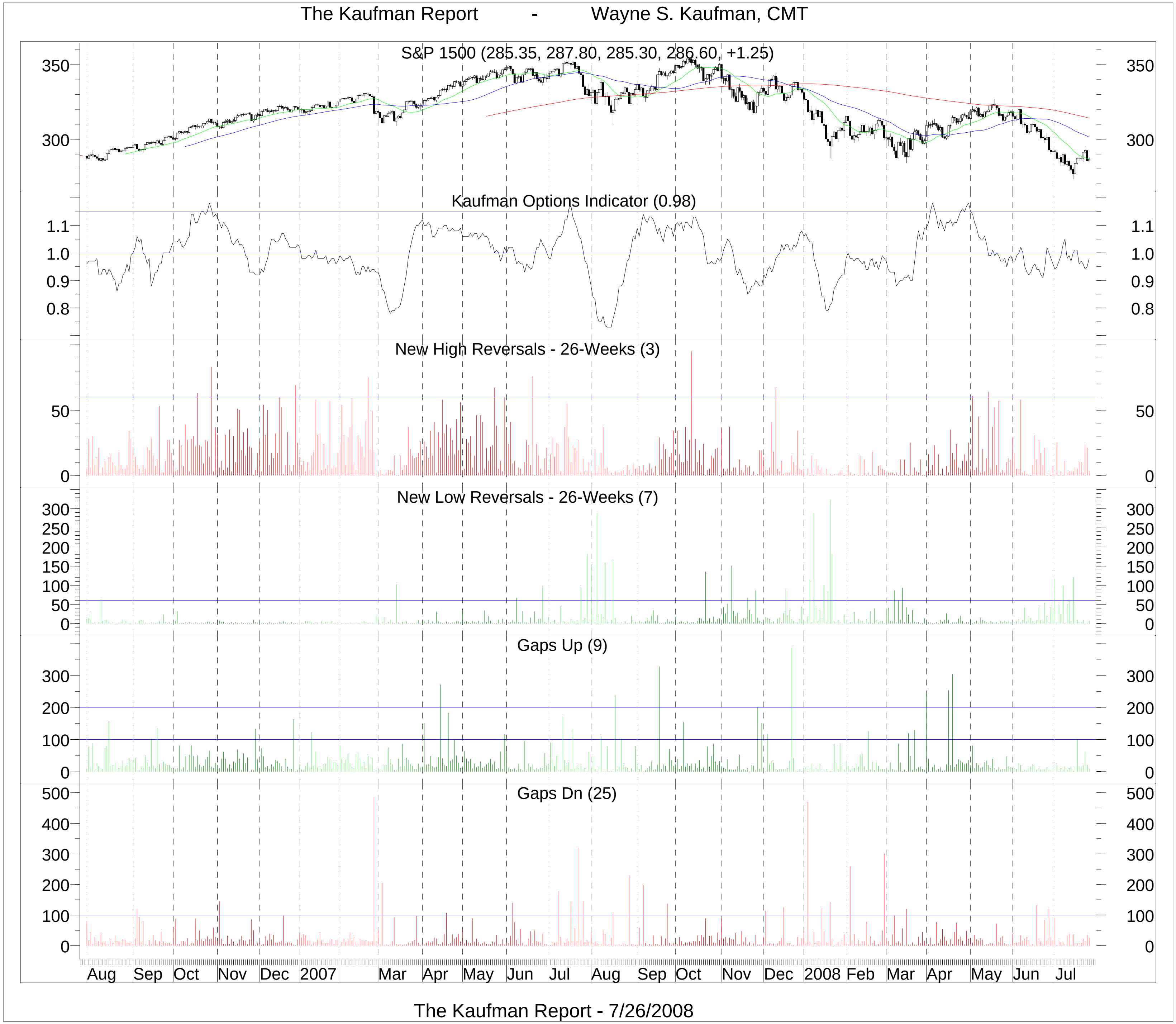


61.39% of the S&P 1500 traded higher Friday.

The AD line is above levels of ten days ago, which is positive.

63.53% of the S&P 1500 are above their own 20-sma.

Volume decreased and was below average Friday.



Our proprietary options indicator is in negative territory, which is good, but it hasn't reached the levels of bearishness seen at prior important bottoms.

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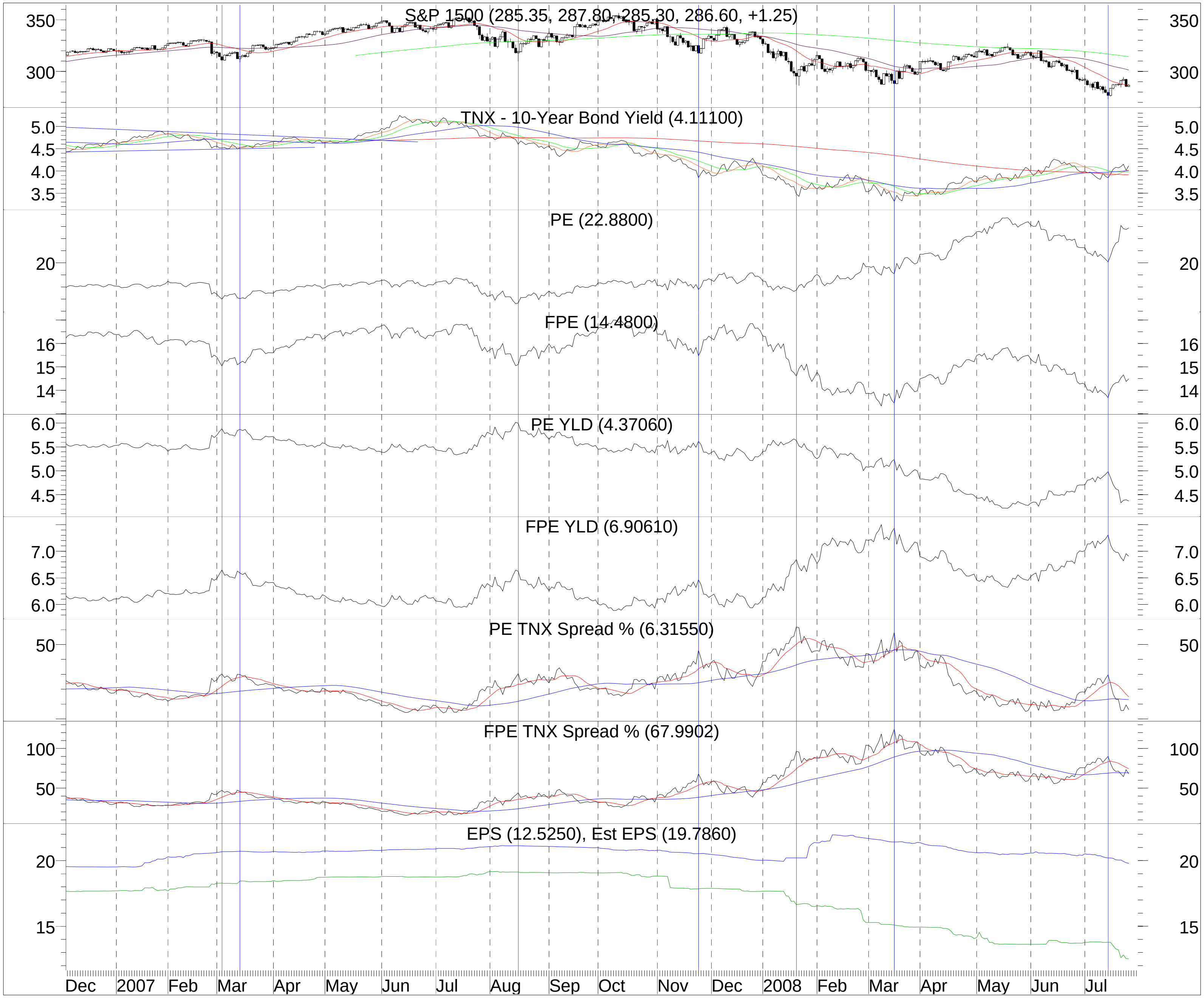
Our 10-day averages of demand (green) are above the 10-day averages of supply (red). Our other time periods still are showing inverted averages, meaning supply is still greater than demand.

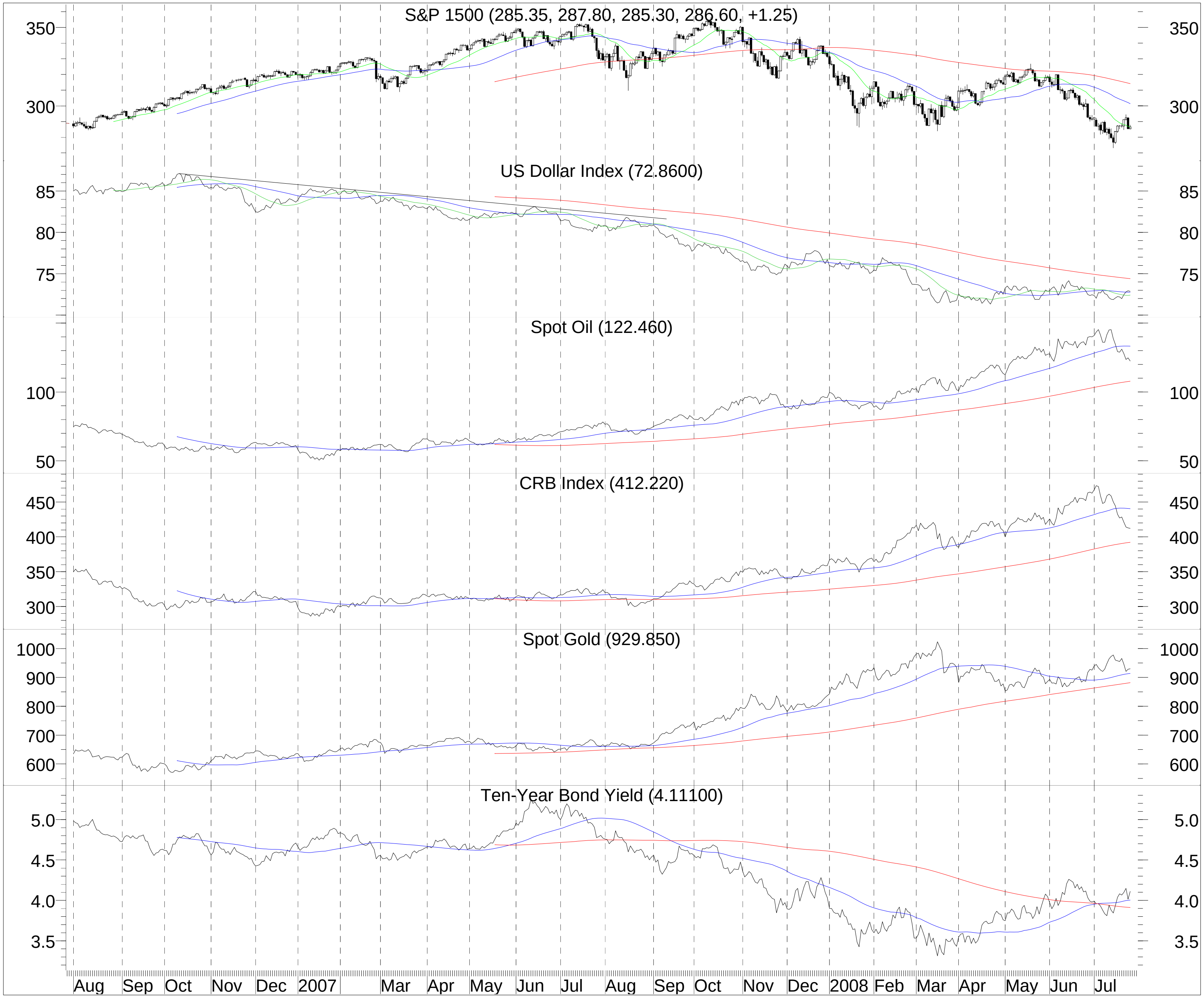


10-year bond yields are above all the important moving averages. Further strength will be damaging to spreads between equity and bond yields.

The P/E ratio is at a high level, not far under the level where stocks topped in May.

The forward P/E is still at reasonable levels.

The spread between the 10-year bond yield and equity yield of the current P/E is at very low levels, in the area where stocks have made tops in the past. The spread based on the forward P/E is still at levels where equities should be attractive. Unfortunately projected earnings have continued their move lower, while current earnings have made a sharp move down.

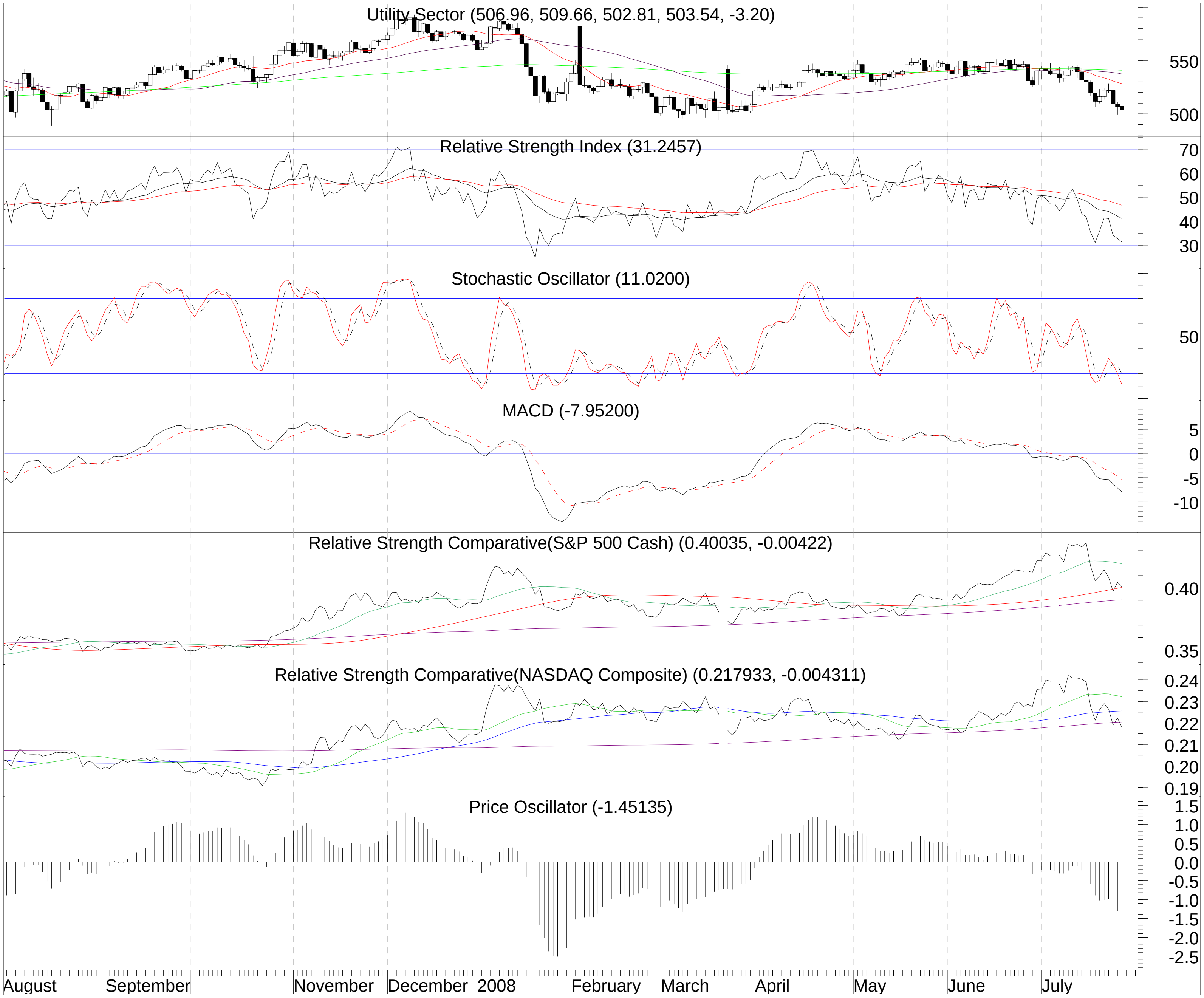


The U.S. Dollar Index has been trading is a tight range since March. It is trading just above the 20 and 50-sma. Soon the down sloping 200-sma (red) will come into play, at which time the long-term trend will change to up, or the index will start to make another leg down.

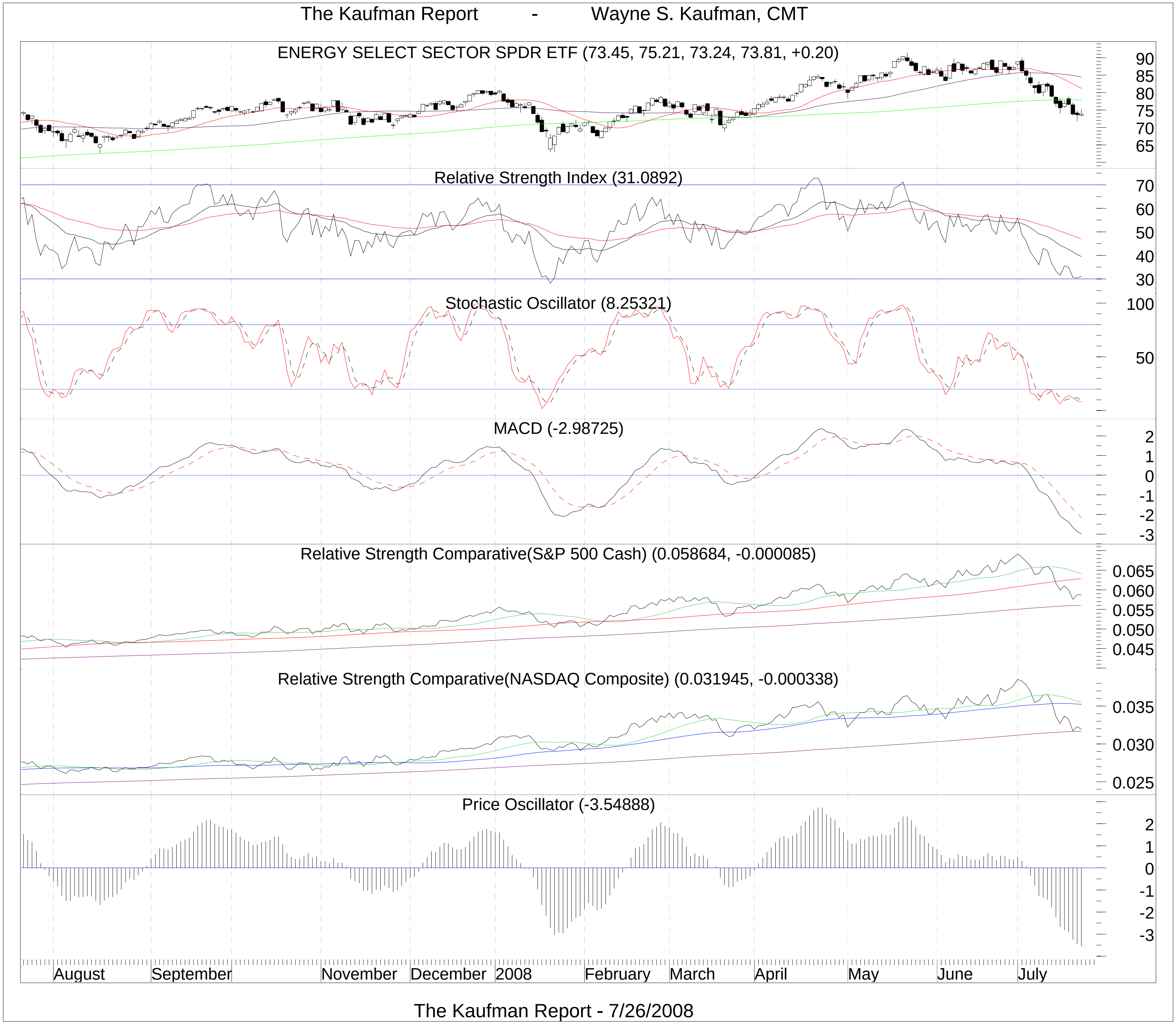
Crude oil put in a double top and is trying to hold support at the 122 - 123 area. There is important support at the 110 - 112 area.

Gold has pulled back after hitting our target in the high 900s. It is sitting just above the 50-sma. It may have some more weakness before moving higher again.

All the important weekly moving averages are sloping downward.



The Utility Index is oversold and under-performing the S&P 500 and Nasdaq Composite. It also has a head & shoulders pattern on the weekly chart (not shown). A breakdown in this pattern should coincide with a sharp move up in interest rates.



The energy sector is oversold. It is under-performing the S&P 500 and the Nasdaq Composite for 20 and and 50-day periods, and just hanging on for the 200-day period.