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The Kaufman Report

Trade what you see, not what you think.

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Monday October 27, 2008 **Closing prices of October 24, 2008**

Last Sunday we warned that investors needed "to be on guard for another sharp move lower." Thereafter the S&P 1500 plunged 7.15% for the week, with Friday threatening to become a historic day as the futures started out limit down, meaning they weren't allowed to go any lower. However, cooler heads (Paulson?) prevailed, and stocks rallied off the opening lows making investors ecstatic to have "only" a 3.42% drop on the day. As we have said for weeks, *we are experiencing the crash of 2008.* We will find out shortly if October 10th marked the bottom.

All of the major indexes recorded new closing lows Friday, which is obviously bearish and points to more lows in the future. The S&P 1500 closed at its lowest level since April 2003. Followers of Dow Theory should take note that the Dow Transports made a new closing low, confirming the closing low in the Dow Jones Industrials. However, with stocks at historic oversold levels, and valuations based on spreads between bond and earnings yields at silly levels, a sharp relief rally can begin at any time.

On 9/28 we said there was the possibility of a market crash. Ten trading sessions later the S&P 1500 was down a staggering 25.91%, hitting the lowest level since May 2003 intra-day. When the index broke below the 213.6 level, which was the 76.4% Fibonacci retracement level of the 2002 to 2007 bull market, we said it greatly increased the possibility of a complete 100% retracement of the five-year bull market. That is still a possibility.

Last December we wrote an essay we called "The Slippery Slope of Hope." We listed the numerous reasons investors were bullish on the markets, even as we gave warnings about weakening market internals. In January, well ahead of most market observers, we said it had become a bear market. We see the same kind of whistling past the graveyard at this time. Current hopes which might be making a slippery slope include the following: the end of October will bring a cathartic selloff which will mark the bottom; the selling is irrational, not based on fundamentals, and will end soon as forced liquidations stop; there is uncertainty about who will be elected, which will end after the election; seasonality becomes positive as November brings the start of the best three-month period of the year for stocks; and lastly, but maybe most important of all, the bailout will work.

Regarding the end of October plunge, even though we have been warning about it ourselves, the market is rarely so accommodating as to follow a game plan hoped for by so many. The selling may be irrational, but we find it interesting that the S&P 1500 is down 44.43% from its peak while reported earnings are down 44.89% from their peak. The election will end the uncertainty of who will be elected, but will it end the uncertainty about the coming policies and their effects? Positive seasonality is the all-time classic hope, especially at this time of year, and actually could help create a tradable rally. Lastly, on the hope that the bailout plan will work, we say that the government cannot legislate prosperity, and economic cycles must run their course.

A bottom may be near based on the guests seen in the financial media. During bull markets the fundamental analysts get top billing as they sell the dream. As markets slide technical analysts are brought out to discuss broken and coming support levels, which also end up breaking. Then the economists are brought out with their inevitable, usually incorrect, predictions of a soft landing. Lastly, things get so ugly the market historians are trotted out with bear market stats, what prior bottoms looked like, etc. That's where we are now. (cont'd)

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The S&P 1500 (198.05) was down 3.421% Friday. Average price per share was down 3.43%. Volume was 100% of its 10-day average and 93% of its 30-day average. 11.6% of the S&P 1500 stocks were up on the day, with up volume at 13.5% and up points at 7.5%. Up Dollars was 9/10 of 1% of total dollars, and was 1.6% of its 10-day moving average while Down Dollars was 120% of its 10-day moving average. For the week the index was down 7.152% on decreasing but above average weekly volume. It is down 25.53% in October, 40.23% year-to-date, and 44.43% from the peak of 356.38 on 10/11/07. Average price per share is down 47.4% from the peak of $43.23 on 6/4/2007.

The Put/Call Ratio was 1.224. The Kaufman Options Indicator was 1.03.

The spread between the reported earnings yield and 10-year bond yield is 44.34% and 145.68% based on projected earnings.

Valuations based on spreads between bond and earnings yields are the highest we have ever seen. 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.

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $10.57, a drop of 44.89%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $17.99, a drop of only 18.04%. 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. We are waiting for GM to be kicked out of the Dow.

236 companies in the S&P 500 have reported third quarter earnings. According to Bloomberg, 56.3% have had positive surprises, 12.0% have been in line, and 31.7% have been negative. The year-over-year change has been -23.3% on a share-weighted basis, -8.6% market cap-weighted, and -1.5% non-weighted. Ex-financial stocks these numbers are 8.2%, 14.6%, and 18.1%, respectively.

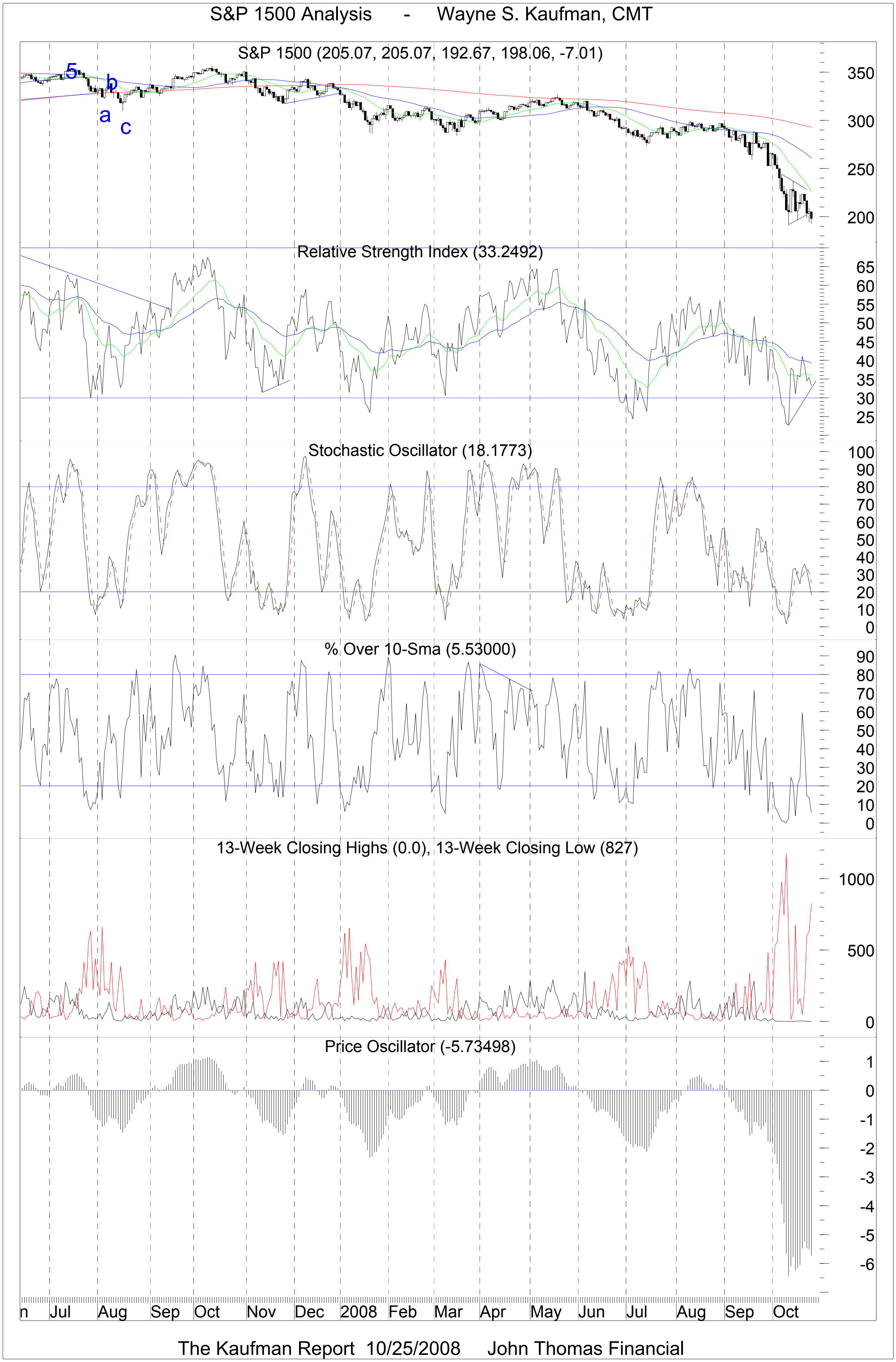
Federal Funds futures are pricing in a 74.0% probability that the Fed will *cut rates 50 basis points to 1.00%,* and a 26.0% probability of *cutting 75 basis points to 0.75%* when they meet on October 29th. They are pricing in a 48.2% probability that the Fed will *cut rates 50 basis points to 1.00%* on December 16th, and a 42.7% probability of *cutting 75 basis points to 0.75%.*

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.

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

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

The S&P 1500 made a new closing low Friday, the lowest since April 2003. It has broken down through the triangle pattern and on Friday was retesting the intra-day low of October 10th.



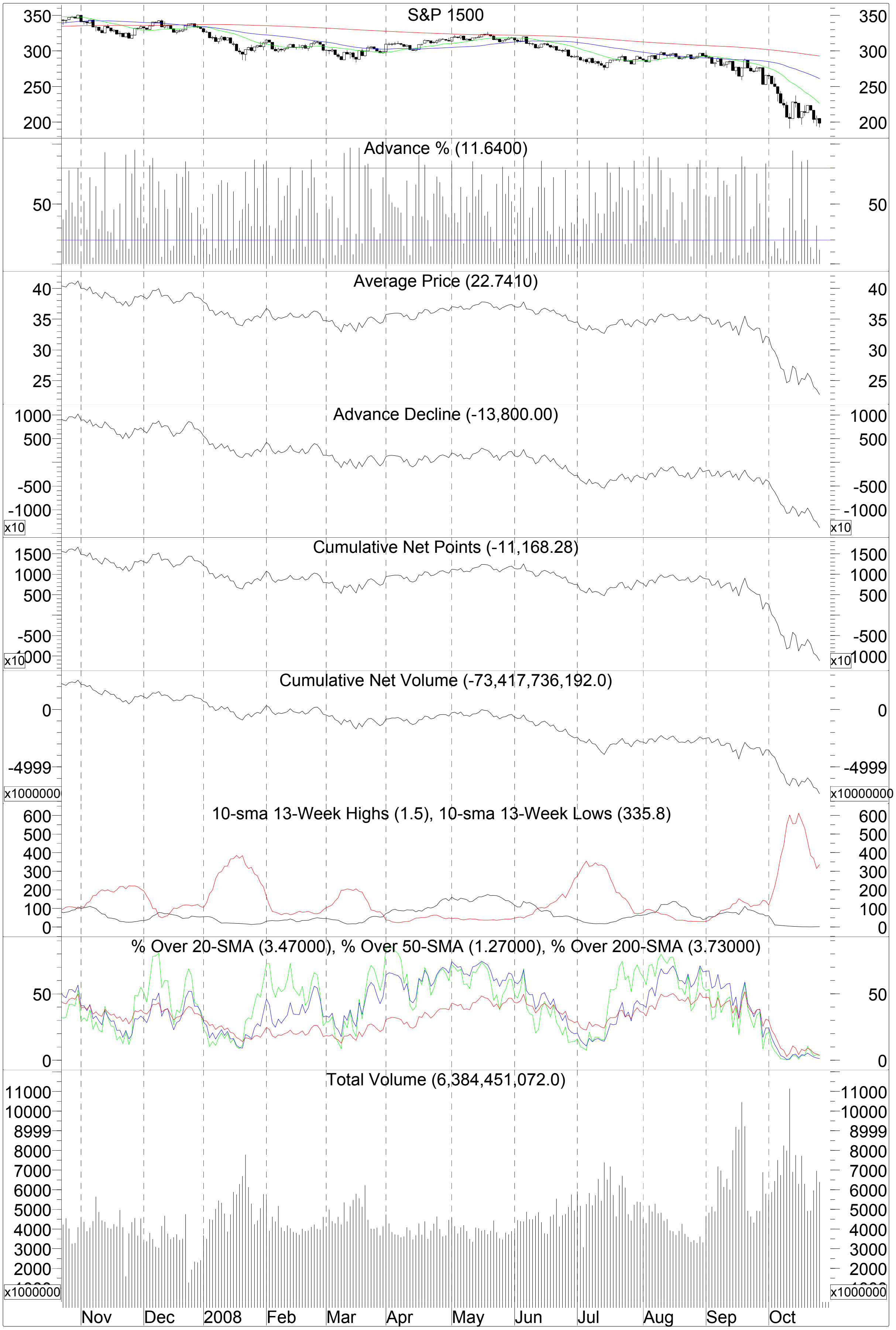
The RSI has a positive divergence.

Only 5.53% of stocks are above their 10-day moving average.

New lows expanded Friday, but was still well below the number seen October 9th.

Our price oscillator remains deep in oversold territory. We have warned many times that a market that does not respond to oversold conditions is dangerous.

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



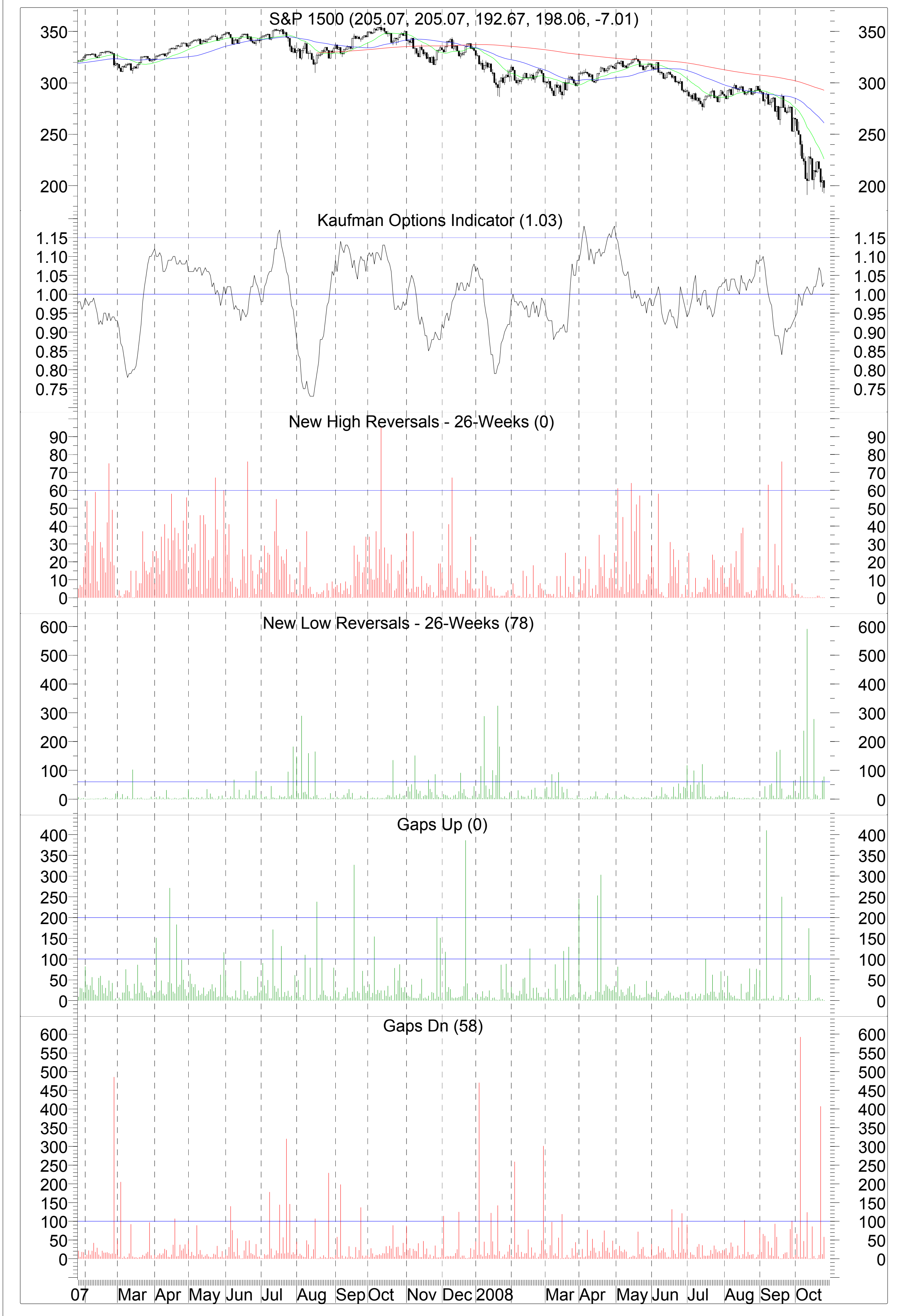
11.64% of stocks traded higher Friday.

All of our statistics of market breadth are confirming the new closing low by making their own new lows. This points to lower prices in the future.

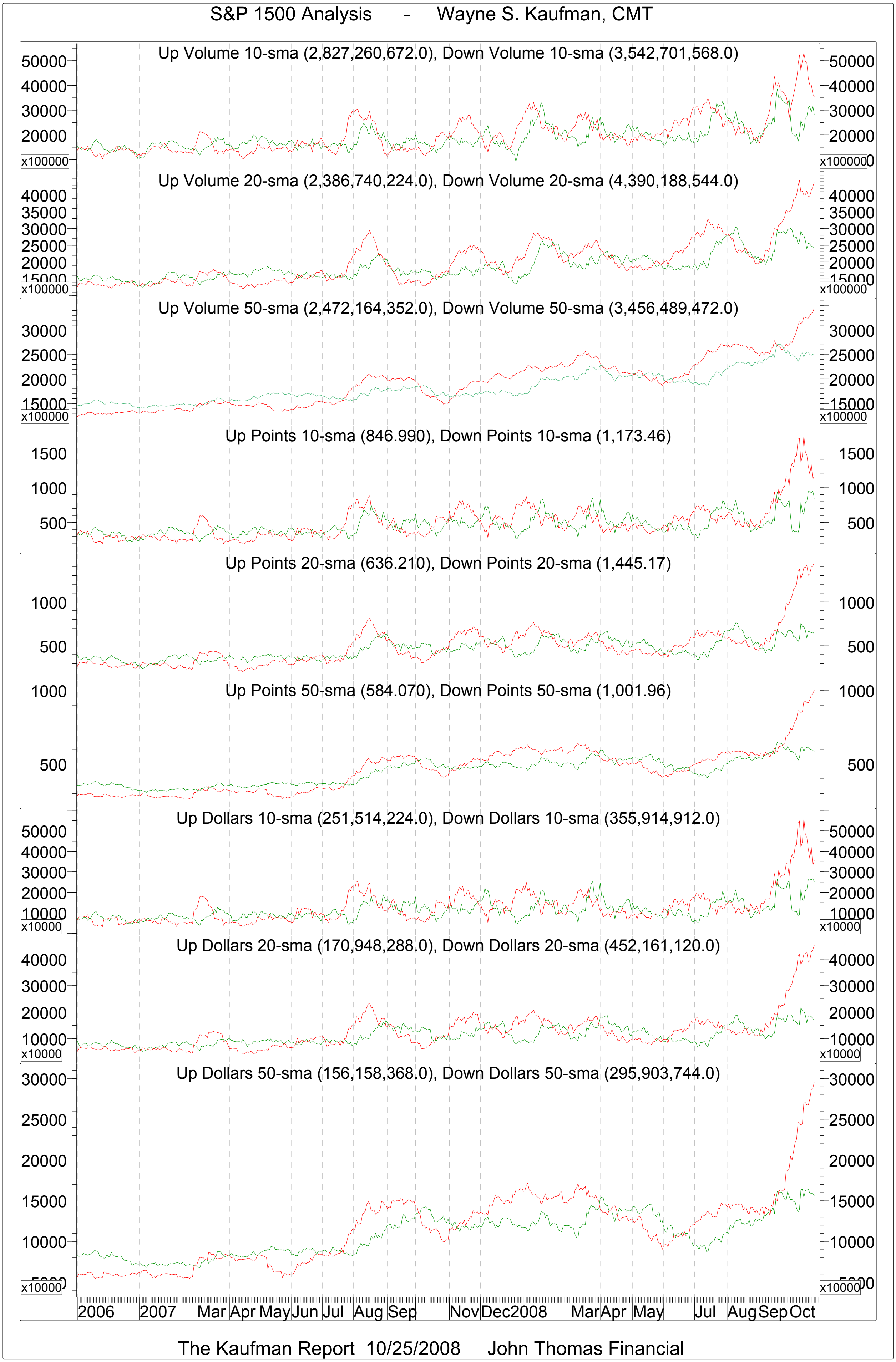
These percentages of stocks over longer-term moving averages are incredible.

Surprisingly volume receded a little Friday. Maybe sellers are getting exhausted for the time being.

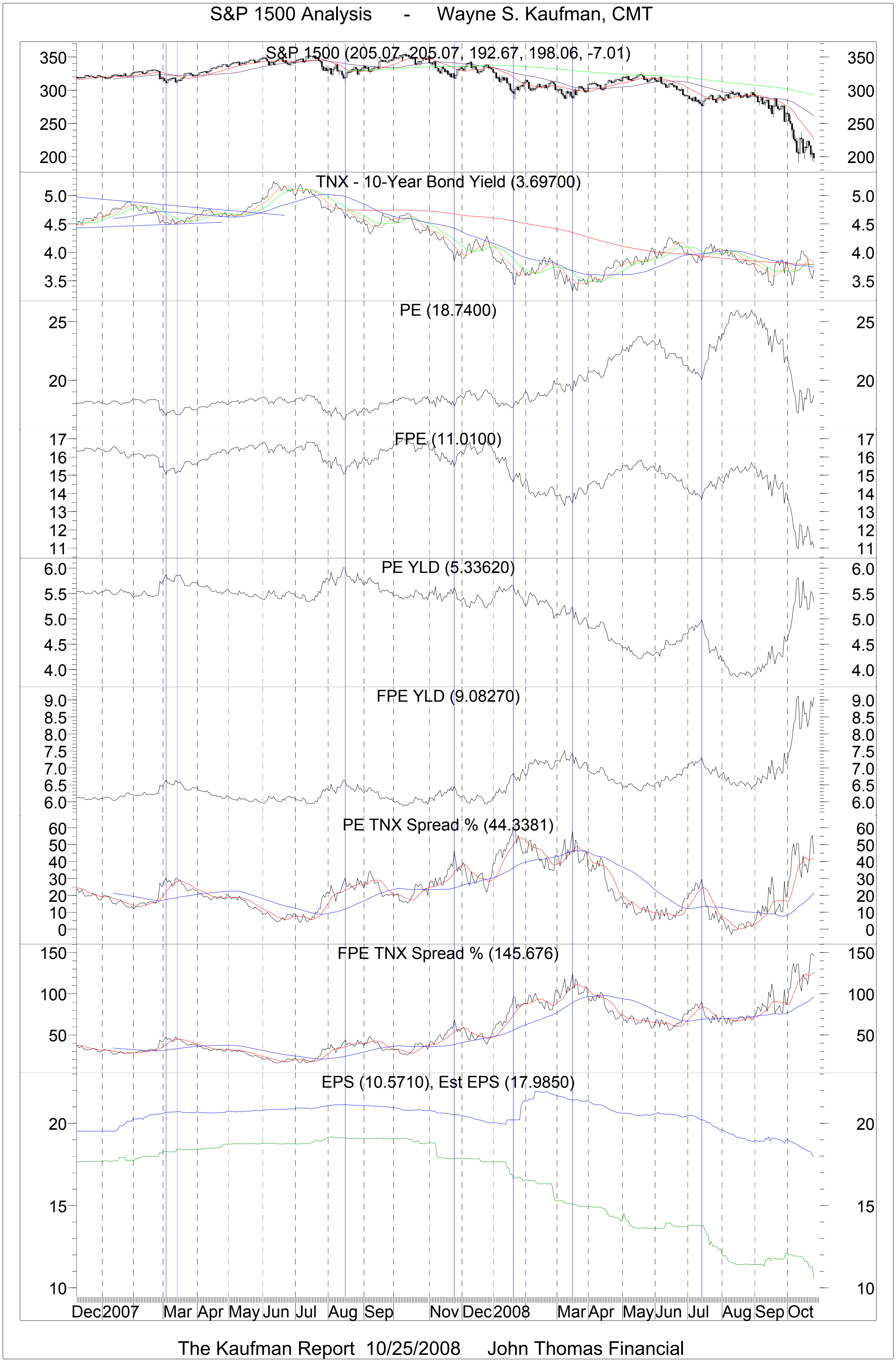
S&P 1500 Analysis - Wayne S. Kaufman, CMT



We have warned recently that our options indicator was showing too much optimism for stocks to have put in a bottom. It is still in positive territory, no where near the levels of pessimism that have marked important bottoms.



All of our statistics of supply (red lines) versus demand (green lines) are negative for all time frames. However, a glance at the 10-day statistics shows that sellers are starting to lighten up on their sales.



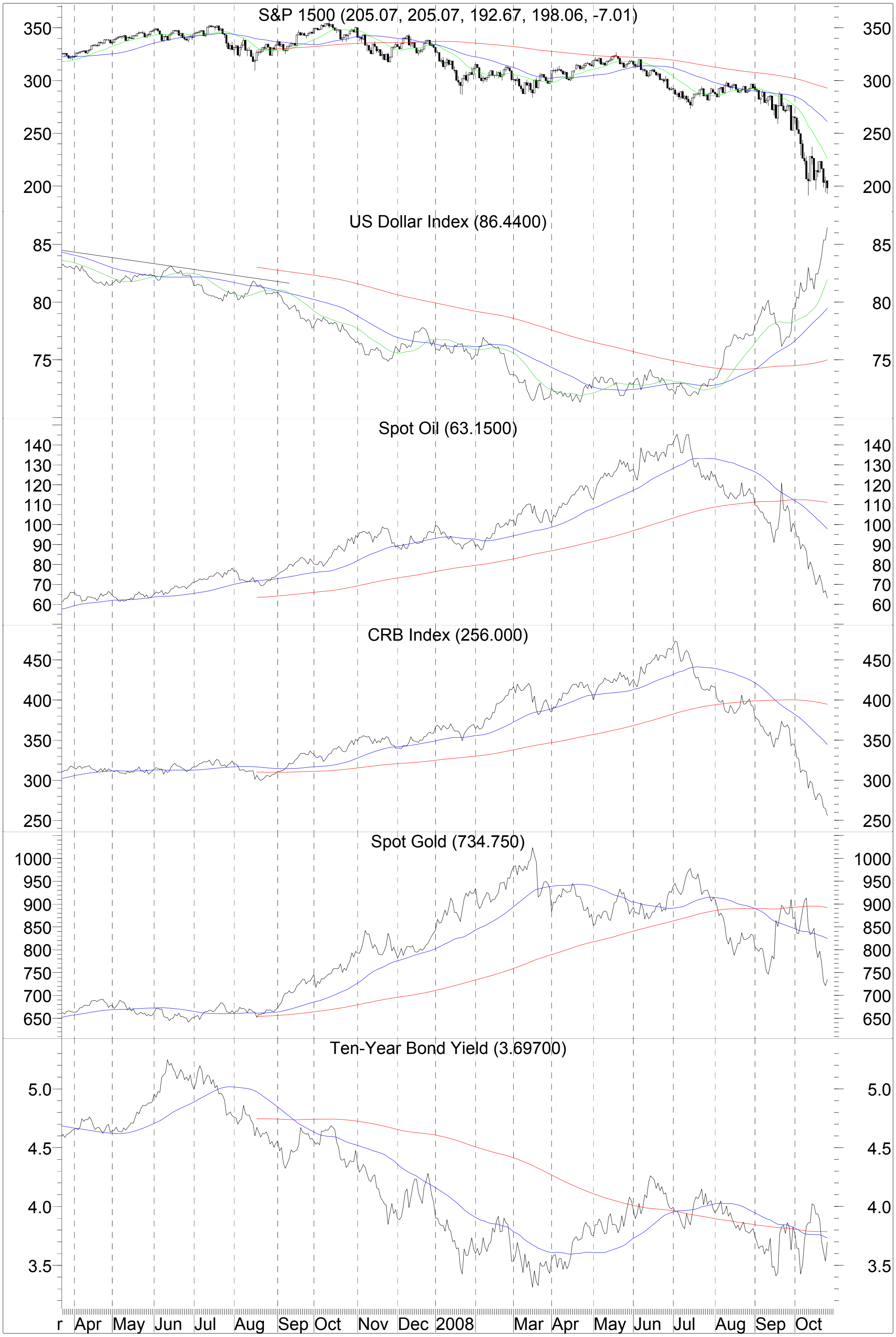
Interest rates jumped up Friday. There is resistance up to the 3.83% area.

The P/E ratio has dropped dramatically, but is still not at bargain levels.

The forward P/E is very low, at the level where stocks bottomed on 10/10. Unfortunately estimates continue to drop.

Spreads between bond and equity yields are at levels where stocks should be very attractive. Again, as seen just below, reported and estimated earnings continue to move inexorably lower.

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



The U.S. Dollar Index is just under resistance and is overbought.

Crude oil and commodities in general are oversold and have overshot their targets based on charts.

On the daily candlestick chart (not shown) gold printed a hammer which was a bullish engulfing candle.