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The Kaufman Report

Trade what you see, not what you think.

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Friday January 2, 2009 **Closing prices of December 31, 2008**

We wish everyone and their families a happy, healthy, and prosperous New Year!

Stocks rallied strongly the last two days of 2008, including a 90% up day on Tuesday, after holding support levels on Monday. Was this just end of the year window dressing, or was it the continuation of the rally off the November lows? The S&P 500 is getting overbought under resistance levels, so some pull back soon is likely. Also, we are concerned about the extreme levels of optimism being shown by options buyers and which can leave stocks vulnerable to a sharp drop. However, a breakout above the resistance levels on good volume would show an increasing demand for equities and argue for a continuation of the rally.

Reasons for optimism for equities would be the calendar change causing money managers to become more aggressive, the huge pile of cash on the sidelines ($8.85 trillion, or about 74% of U.S. stock market value, the highest since 1990), valuation levels which by any metric are very favorable for stocks, and a massive global response by governments to stimulate economies. In addition, the technical picture for stocks has improved greatly with major indexes back above their 50-day moving averages being just one example of indicators turning positive.

Whether or not the recent optimism is justified will be answered shortly as earnings season gets underway. One big problem has been a lack of visibility for investors, which we have discussed for months. It has become so difficult to forecast even the near-term outlook that many companies have completely stopped giving earnings guidance, and of those recently making revisions to their guidance the ratio has been 12 to 1 downward revisions versus upward.

Projections for fourth quarter aggregate earnings call for a drop of 10%. Since reported earnings for the S&P 1500 peaked in August 2007 they are down about 46%. The average price per share is down about 44% from its June 2007 peak. If this one-to-one relationship continues, and if the forecast 10% drop in earnings is accurate, stocks would drop another 10%. If the forecast is accurate and stocks do not go lower, that would argue that they have reached trough valuations, and the recent optimism is justified. If earnings and forecasts come in better than expected, there is the possibility of a very strong snap back rally as the recent flight to safety starts to reverse, and investors assume more risk in their portfolios.

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The S&P 1500 (204.93) was up 1.561% Wednesday. Average price per share was up 2.23%. Volume was 101% of its 10-day average and 71% of its 30-day average. 86.9% of the S&P 1500 stocks were up on the day, with up volume at 79.3% and up points at 94.4%. Up Dollars was 98.68% of total dollars, and was 223% of its 10-day moving average while Down Dollars was 3.6% of its 10-day moving average. The index was up 2.80% month-to-date, down 22.95% quarter-to-date, down 38.16% year-to-date, and down 42.50% from the peak of 356.38 on 10/11/07. Average price per share is $24.24, down 43.93% from the peak of $43.23 on 6/4/2007.

***The Put/Call Ratio was 0.81. The Kaufman Options Indicator is 1.19*. This indicates too much bullishness.**

The spread between the reported earnings yield and 10-year bond yield is 125% and 252% based on projected earnings. These are unheard of levels*. *The dividend yield on the S&P 500 recently moved higher than the 10-year bond yield for the first time since 1958.

Reported aggregate earnings for the S&P 1500 peaked in August 2007 at $19.18 and are now at $10.36, a drop of 45.98%. Estimated aggregate earnings peaked at $21.95 in February 2008 and are now $16.22, a drop of only 26.10%. Analysts have obviously been very late in lowering estimates. *If investors had any confidence in current earnings estimates stocks would be much higher than they currently are.*

498 companies in the S&P 500 have reported third quarter earnings. According to Bloomberg, 58.1% have had positive surprises, 9.7% have been in line, and 32.3% have been negative. The year-over-year change has been -18.3% on a share-weighted basis, +5.3% market cap-weighted and -2.7% non-weighted. Ex-financial stocks these numbers are 10.1%, 23.7%, and 15.8%, respectively.

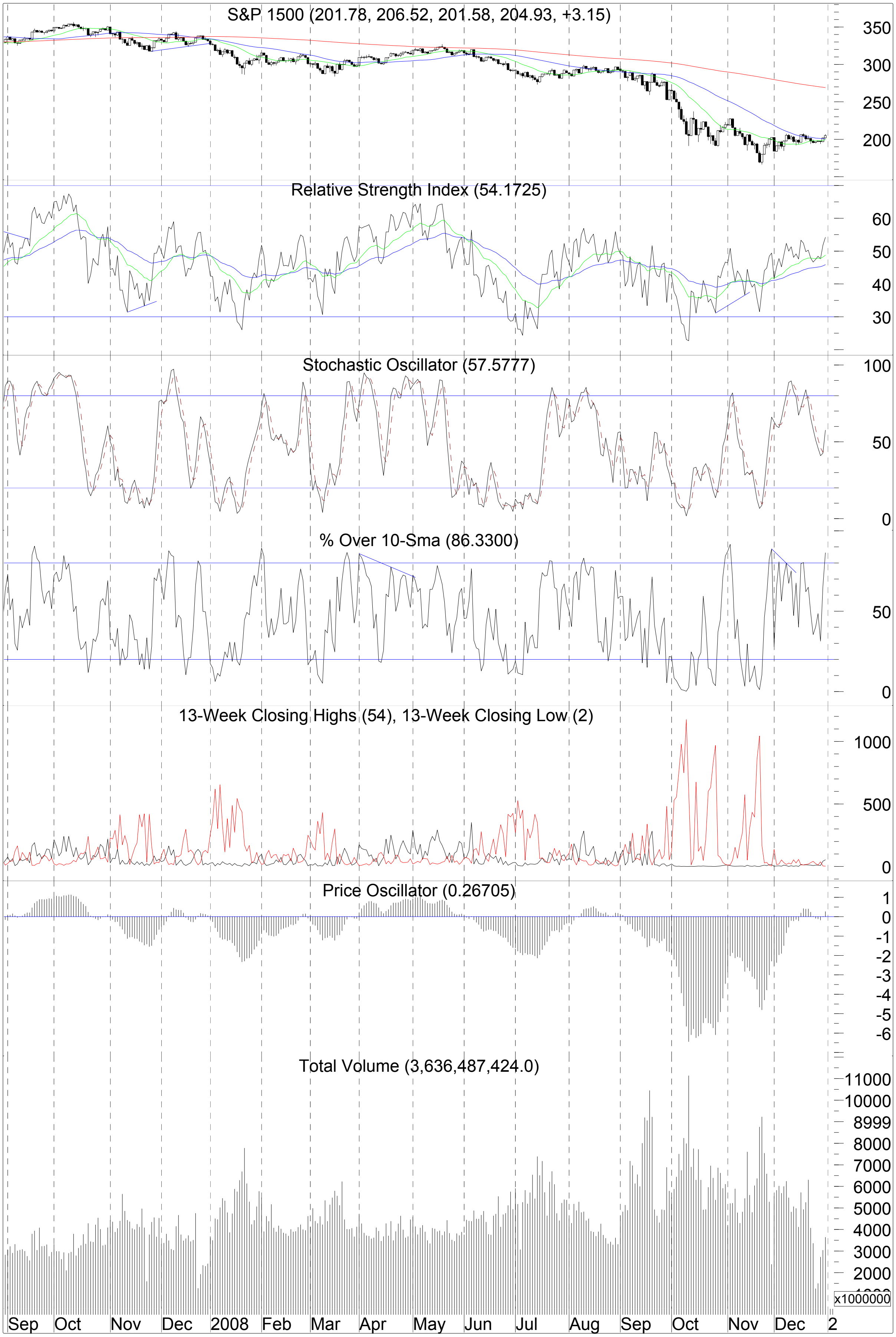
Federal Funds futures are pricing in a probability of 84% that the Fed will *leave rates unchanged,* and a probability of 16.0% of *cutting 25 basis points to 0.00%* when they meet on January 28th. They are pricing in a probability of 75.8% that the Fed will *leave rates unchanged* on March 17th, and a probability 14.1% of *cutting 25 basis points to 0.00%.*

The short-term and intermediate-term trends are now up, but the long-term trend remains down. We reiterate that this continues to be an opportunistic trader's market, with adept traders able to take advantage long or short, but the long-term downtrend must still be respected. Investors should not hesitate to move out of laggard sectors and stocks and into leaders.

IMPORTANT DISCLOSURES

The S&P 500 held support at the 857 area and closed 2008 with two strong days, including a 90% up day on Tuesday. Were these strictly window dressing, or is it the continuation of the rally off the November lows? The index is above the 20-sma (green) and the 50-sma (blue). It is getting overbought just under resistance in the form of the descending trend line and the rally high of 918.85. A break through the resistance on good volume would show demand for stocks increasing, and not just end of year window dressing.

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

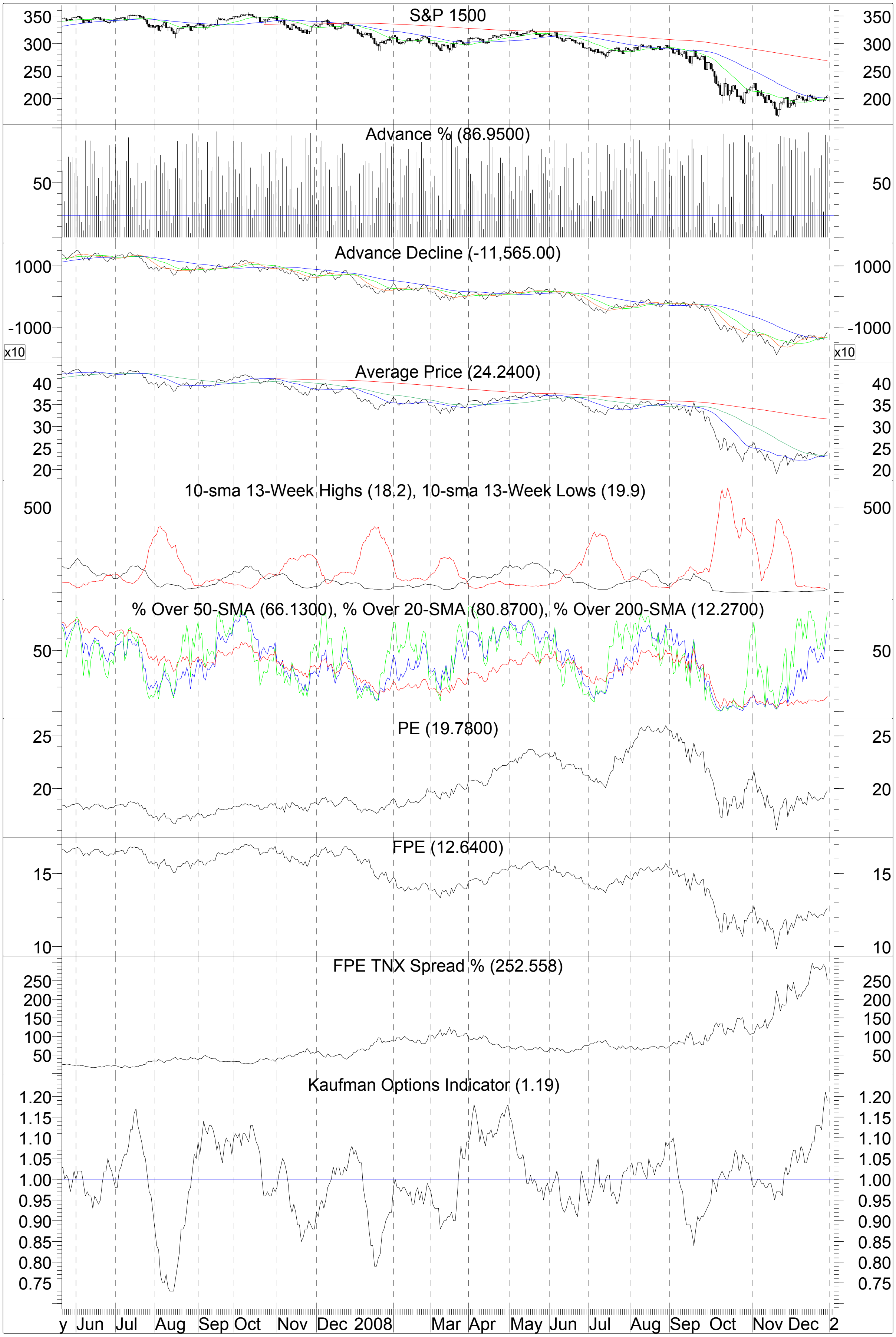


The percent over 10-sma is in the overbought zone at 86.33%.

13-week highs are the most since September 19th.

Our price oscillator is about neutral.

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



86.95% of stocks traded higher Wednesday.

The AD line is breaking out of the recent range.

Two-thirds of stocks are above their 50-day moving averages.

P/E ratios have been range bound but are starting to move higher.

Our proprietary options indicator is showing extreme optimism among options buyers. This can leave stocks vulnerable to a sharp move down.