

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 19, 2008

Issue 64

Market Overview

Summary of Recent Active Studies (see <http://QuantifiableEdges.blogspot.com> for details)

Study Date	Description	Time span	Bias
May 16, 2008	VIX stretch	1-7 days	Bearish
May 16, 2008	Equity P/C Avg Stretch (Letter)	1-5 Days	Bearish
May 13, 2008	1% Rally on Lowest Vol in 20	1-12 days	Bearish
May 12, 2008	5 Lower Lows near 50-day high	1-11 days	Bearish
April 29, 2008	Narrow Range New High < 200	1-20 days	Bearish
February 1, 2008	FTD's Short-Term Implications	long-term	Bearish
March 17, 2008	Consumer Sentiment Stretch	1-12 months	Bullish

*Intermediate-term Outlook (2 weeks – 2 months) – **slightly bearish** – updated 5/12/2008*

The last time I updated the intermediate-term outlook was last weekend. At that time, the S&P had made a lower low for 5 consecutive days. I look at what this may mean in the context of an uptrend vs. a downtrend. What I found was that when 5 lower lows occurred following an intermediate-term high, it typically had bearish connotations moving forward. I also discussed the decline in put/call ratios as of late and the potential bearish implications of that. Lastly I discussed the fact that most of the studies with bullish influence were going to be losing relevance by the end of the week. All of this lead me to move the intermediate-term outlook to “slightly bearish”.

The S&P 500 then followed up my bearish analysis by making 5 higher highs. Of course that isn't as dire as it sounds from my perspective. The Letter entered last week with a few long positions. The run-up allowed profitable exits to be taken on those trade ideas and over the last few days the continued strength has allowed for scaling in on the short side. Five higher highs is notable, though. Just as I did with five lower lows last week, I decided to break down the possible implications of five higher highs this week.

Let's first look at what happens following 5 higher highs and using no additional filters:

S&P makes 5 higher highs. Buy on close. Sell "X" days later. \$100,000 per trade. March 1979-present									
X Days	Net Profit	Trades	% Profitable	Winners	Max Win	Max Loss	Avg Win	Avg Loss	Avg Trade
20	\$56,857.33	137	62.04	85	\$14,045.25	(\$22,295.52)	\$2,851.33	(\$3,567.42)	\$415.02
15	\$72,895.02	147	57.14	84	\$12,387.45	(\$7,927.08)	\$2,527.39	(\$2,212.79)	\$495.88
10	\$31,428.44	165	52.73	87	\$8,961.33	(\$7,631.40)	\$1,904.91	(\$1,721.77)	\$190.48
9	\$40,876.99	170	52.35	89	\$10,112.58	(\$5,363.60)	\$1,929.86	(\$1,615.81)	\$240.45
8	\$19,975.35	172	56.40	97	\$8,417.94	(\$5,408.12)	\$1,547.50	(\$1,735.10)	\$116.14
7	\$11,551.91	179	51.40	92	\$7,911.39	(\$6,521.20)	\$1,612.32	(\$1,572.20)	\$64.54
6	\$6,922.50	181	49.17	89	\$9,237.63	(\$6,059.86)	\$1,553.76	(\$1,427.85)	\$38.25
5	\$714.21	185	50.81	94	\$8,344.26	(\$6,557.14)	\$1,268.84	(\$1,302.82)	\$3.86
4	\$1,142.54	190	50.53	96	\$6,272.01	(\$5,037.78)	\$1,193.42	(\$1,206.65)	\$6.01
3	\$7,580.55	205	53.17	109	\$6,990.39	(\$4,268.80)	\$984.96	(\$1,050.32)	\$36.98
2	\$18,002.19	244	49.18	120	\$5,136.87	(\$4,276.16)	\$926.43	(\$751.37)	\$73.78
1	\$7,323.51	371	49.60	184	\$3,850.37	(\$3,515.37)	\$542.69	(\$500.17)	\$19.74

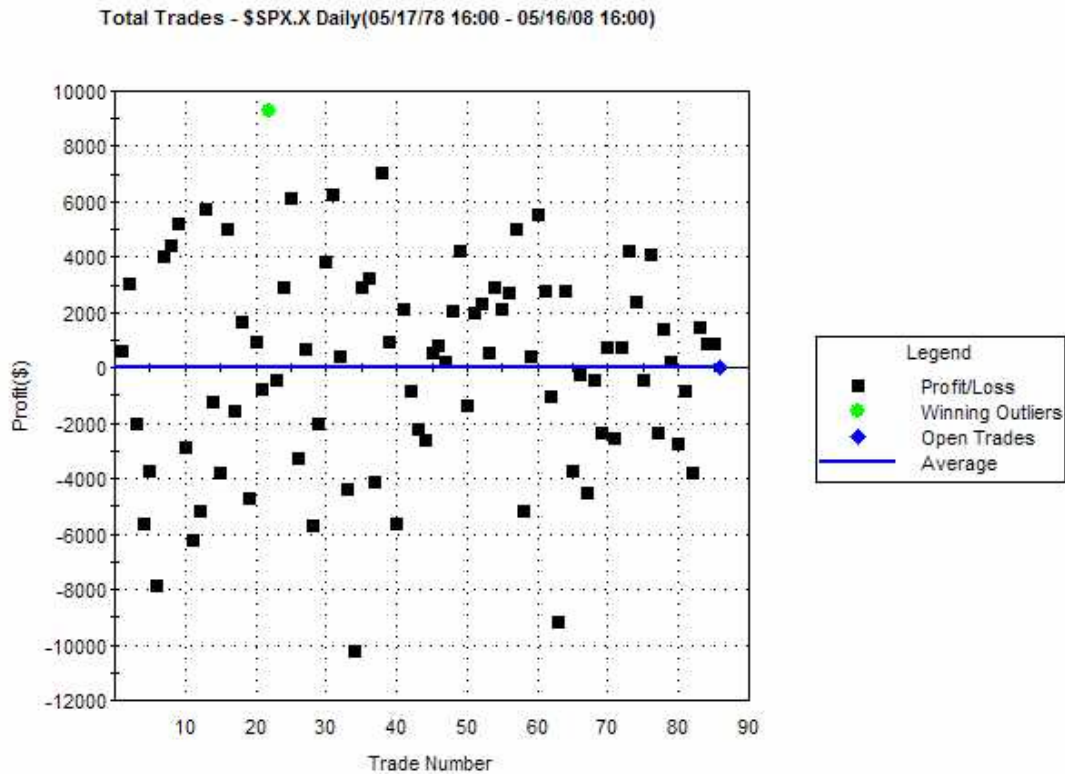
The table above shows that action was generally choppy over the next week before moving higher in a muted fashion. Over the period tested, the average day gained \$56.70, or about 0.06%. So even in the three weeks from day 5 to day 20, the expectation would have been for a rise of about \$850. Under the above scenario it was about half that.

As I demonstrated last week with the lower lows study, these moves can lead to very different conditions depending on the state of the market. Not only did the market make its 5th consecutive high on Friday, it also hit a 50-day high. I looked at all times this occurred below. There were still quite a few occurrences even with this filter.

S&P makes 5 higher highs and today's high is highest in 50 days. Buy on close. Sell "X" days later. \$100,000 per trade. March 1979-present									
X Days	Net Profit	Trades	% Profitable	Winners	Max Win	Max Loss	Avg Win	Avg Loss	Avg Trade
20	\$2,814.78	85	55.29	47	\$9,261.56	(\$10,205.38)	\$2,772.38	(\$3,354.92)	\$33.12
18	(\$6,630.70)	85	47.06	40	\$7,255.60	(\$9,660.84)	\$2,961.68	(\$2,779.95)	(\$78.01)
15	\$9,243.71	87	50.57	44	\$6,576.60	(\$7,927.08)	\$2,503.46	(\$2,346.71)	\$106.25
10	\$5,401.07	91	51.65	47	\$6,448.56	(\$5,262.54)	\$1,862.52	(\$1,866.76)	\$59.35
9	\$6,986.11	94	50.00	47	\$5,146.08	(\$6,305.04)	\$1,927.30	(\$1,778.66)	\$74.32
8	\$20,199.04	96	56.25	54	\$5,055.20	(\$5,493.28)	\$1,655.12	(\$1,647.08)	\$210.41
7	\$13,612.85	102	50.98	52	\$4,679.28	(\$6,521.20)	\$1,681.79	(\$1,476.80)	\$133.46
6	\$9,158.02	102	48.04	49	\$5,043.84	(\$4,438.20)	\$1,645.82	(\$1,348.81)	\$89.78
5	\$6,694.68	104	53.85	56	\$4,044.16	(\$5,907.61)	\$1,249.81	(\$1,318.64)	\$64.37
4	\$740.97	108	50.00	54	\$4,918.88	(\$4,523.06)	\$1,223.52	(\$1,209.80)	\$6.86
3	\$7,460.94	114	54.39	62	\$2,777.04	(\$3,868.48)	\$922.28	(\$956.16)	\$65.45
2	\$17,367.58	140	51.43	72	\$3,376.80	(\$2,295.34)	\$896.53	(\$693.86)	\$124.05
1	\$8,466.23	216	48.61	105	\$2,135.28	(\$1,599.36)	\$542.67	(\$445.09)	\$39.20

In this case the chop lasts more than just a week. Four weeks out the expectancy is still flat.

Below is a scattergraph showing how the trades looked 20 days out:



I also looked to see how the market performed if the 5 higher highs came directly after a 50-day low. While not relevant to our current situation, the results were quite interesting.

S&P makes 5 higher highs after making 50-day low. Buy on close. Sell "X" days later.									
\$100,000 per trade. March 1979-present									
X Days	Net Profit	Trades	% Profitable	Winners	Max Win	Max Loss	Avg Win	Avg Loss	Avg Trade
20	\$23,517.26	15	66.67	10	\$6,258.70	(\$3,808.95)	\$3,177.76	(\$1,652.07)	\$1,567.82
15	\$20,788.14	15	66.67	10	\$8,288.00	(\$4,718.55)	\$2,751.07	(\$1,344.50)	\$1,385.88
10	\$3,536.65	15	60.00	9	\$4,691.28	(\$3,979.50)	\$1,523.05	(\$1,695.14)	\$235.78
9	\$1,306.09	15	53.33	8	\$4,722.08	(\$3,763.80)	\$1,576.23	(\$1,614.82)	\$87.07
8	(\$8,310.44)	15	46.67	7	\$3,781.36	(\$3,905.10)	\$964.57	(\$1,882.80)	(\$554.03)
7	(\$7,137.80)	15	33.33	5	\$2,851.20	(\$3,500.70)	\$1,624.51	(\$1,526.04)	(\$475.85)
6	(\$5,804.14)	15	33.33	5	\$2,954.16	(\$2,551.63)	\$1,694.21	(\$1,427.52)	(\$386.94)
5	(\$10,177.32)	15	26.67	4	\$3,025.44	(\$3,726.00)	\$1,517.60	(\$1,477.07)	(\$678.49)
4	(\$5,316.69)	15	40.00	6	\$3,138.08	(\$3,838.50)	\$1,102.95	(\$1,326.05)	(\$354.45)
3	(\$8,401.62)	15	40.00	6	\$2,742.08	(\$3,130.13)	\$1,060.48	(\$1,640.50)	(\$560.11)
2	(\$2,873.20)	15	46.67	7	\$2,494.32	(\$3,748.50)	\$1,102.30	(\$1,323.66)	(\$191.55)
1	(\$3,941.35)	15	40.00	6	\$1,147.16	(\$2,792.25)	\$413.18	(\$713.38)	(\$262.76)

In this case, rather than just choppy action over the first week, the expectation is strongly negative. Interestingly, that negative expectation only lasts a week and then becomes strongly positive. It appears 5 higher highs off a bottom most often turns into a retest or double bottom type situation before launching higher.

So while the overdone price action seems to be suggesting further upside will be difficult, there remain other more bearish intermediate-term concerns. The VIX is has become stretched from its short-term moving average and is also posting its lowest relative levels to the VXV since late December. The VXV measures 90-day implied volatility while the VIX measures 30-day. If the 90-day is significantly higher than the 30-day that means an increase in volatility is expected by the options market. Most of the time increases in volatility are associated with market selloffs, so this extreme ratio has bearish connotations. As I've discussed in great detail the last week or so, CBOE put/call ratios are now reaching relatively extreme levels. Historically, reading of this magnitude have been associated with future market weakness. Low volume also remains a concern at this point as demonstrated by the May 13th study.

The market seems to have gotten ahead of itself at this point. Whether that leads to choppy sideways trading for a while, or a significant selloff, I just don't know. I do know that I am seeing very little that would suggest strong upside and several studies based on different indicators that suggest downside. Until this changes, I expect the focus of trading to be skewed to the short side.

Short-term Outlook (1-5 days) –bearish – updated 5/19/08

After some morning weakness the market managed to fight its way back to mixed on Friday. The S&P 500 finished higher. Volume was higher across the board. Some of the higher volume may be associated with options expiration though.

In Thursday's blog I revealed a system that would go long the S&P when the VIX became stretched more than 10% below its 10-day moving average and then the stretched condition began to become relieved. This system shows a success rate of about 64% with winners slightly higher than losers at 1.7% vs. 1.5% and the average trade came to about 0.5%. This system would have triggered an entry short at Friday's close.

As of Thursday's close there was a CBOE put/call stretch system that I discussed in Thursday night's letter that also triggered a short entry. The success rate there was about 85% with muted drawdown.

The current Aggregator vs. S&P 500 chart is posted below:



The green Aggregator line is now at its lowest point since the end of February. The Aggregator measures the expected return over the next three days based on the average estimates of all outstanding studies. Additionally, the three day S&P returns (dotted grey line) have outperformed expectations recently. This means the black line (difference between expectations and reality of the last few days) and green line are both stretched in the same direction. This suggests an edge to the short side and I will continue to look for additional exposure there.

I've been scaling in to an S&P 500 index trade and will continue to do so. Between the current active studies, the VIX and CBOE put/call systems and the Aggregator chart, I am becoming more and more convinced that there is a solid edge to the downside in the near term.

Catapult and Capitulative Breadth Statistics

(Catapult Presentation Part 1) (Catapult Presentation Part 2)

Open Catapult Trades

none

Open Big 50 Trades

None

Open Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 0

Sector CBI Breakdown (% of stocks with active catapult triggers within each sector.)

Index	ETF	CBI %	Index	ETF	CBI %
DJ US Broker Dealers	IAI	0.00	DJ US Energy	IYE	1.16
DJ US Insurance Index	IAK	0.00	DJ US Financial	IYF	0.68
DJ US Regional Banks	IAT	0.00	DJ US Financial Services	IYG	0.70
DJ US Utilities	IDU	0.00	DJ US Healthcare	IYH	1.41
DJ US Oil&Gas Expl & Prod	IEO	1.72	DJ US Industrial Sector	IYJ	0.00
DJ US Oil Equip & Svcs	IEZ	0.00	DJ US Consumer Goods	IYK	0.68
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	0.00
DJ US Healthcare Providers	IHF	4.08	DJ US Real Estate	IYR	1.22
DJ US Medical Devices	IHI	0.00	DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	0.00	DJ US Technology Sector	IYW	0.00
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	0.00	Nasdaq 100	QQQQ	0.00

Not much showing up here.

Additional New Trade Ideas

SPY – Short at \$142.66 and \$143.50. I've been scaling into this trade with ¼ allocation at a time. Tomorrow I will look to enter the remaining half. One quarter near yesterday's closing price and the rest about ½% higher.

Other alternatives would be mid-cap indices. The Letter is showing trade ideas in IWP and MDY at the moment. The system for entry was discussed in Friday's Letter. The exit is a cross of the ETF below its 10-day moving average. ETF's that currently qualify for the entry criteria include IJH, IWP and IWR.

Additional Trades Active Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Lo	Stop	Notes
SPY(S)	5/14/2008	\$141.09	\$142.66	-1.11%		
MDY(S)	5/14/2008	\$158.66	\$160.61	-1.23%		exit on close < 10ma
SPY(S)	5/15/2008	\$142.00	\$142.66	-0.46%		
IWP(S)	5/16/2008	\$115.27	\$115.03	0.21%		exit on close < 10ma

Stocks and ETF's on my Radar

COP and *DOW* are both overly extended and could be shortable. With the strength of the recent move I'm preferring ETF's unless the setup is very strong. These are somewhat borderline.

SLM and MA have pulled back strongly. These would both qualify as RSI spread trades as the 14-period RSI is now more than 50 points above the 2-period RSI. This is a system we've used in the Letter several times already – most recently on 5/8 to purchase MCD. Due to my bearish bias I will be passing on these and will not include them among the “official” trade ideas. Those traders that either don't agree with my market analysis or would like some long exposure to hedge current shorts could look here.

Notable S&P 500 stocks outside my “tradable” radar

Oversold

none

Overbought

None

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