

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 20, 2008

Issue 65

## Market Overview

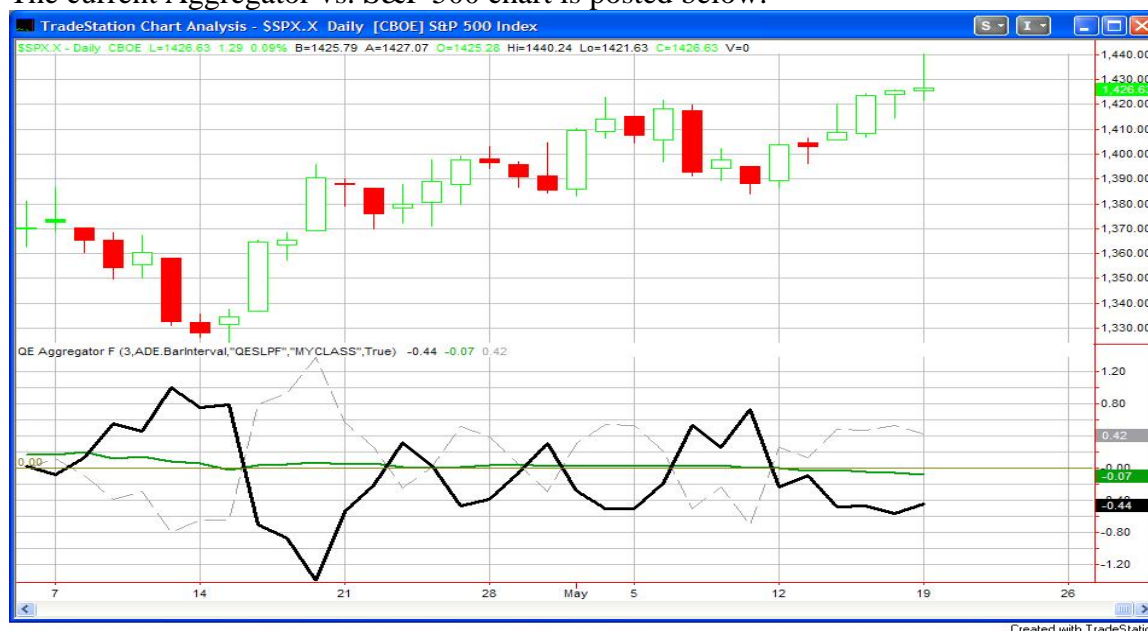
*Summary of Recent Active Studies (see <http://QuantifiableEdges.blogspot.com> for details)*

Study Date	Description	Time span	Bias
May 20, 2008	Failure at 200	1-5 days	Bearish
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

### *Short-term Outlook (1-5 days) –bearish – updated 5/20/08*

After posting strong gains in the morning and probing its 200-day moving average, the S&P failed to hang on to its gains and sold off a bit in the afternoon. In [tonight's blog](#) I discussed the possible ramifications of Monday's action. Generally it has been a slight negative for the short term. Volume was light once again today. The Dow and S&P did manage to close slightly higher, but breadth was negative and the Nasdaq finished lower.

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



Created with TradeStation

The market remains overbought and the Aggregator is still suggesting a selloff. Until at least one of these conditions is relieved I will be looking to remain short. Bearish studies are now swamping bullish ones. Hopefully the pullback comes soon.

**Intermediate-term Outlook (2 weeks – 2 months) – *slightly bearish – updated 5/19/2008***

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:

<b>S&amp;P makes 5 higher highs. Buy on close. Sell "X" days later. \$100,000 per trade. March 1979-present</b>									
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

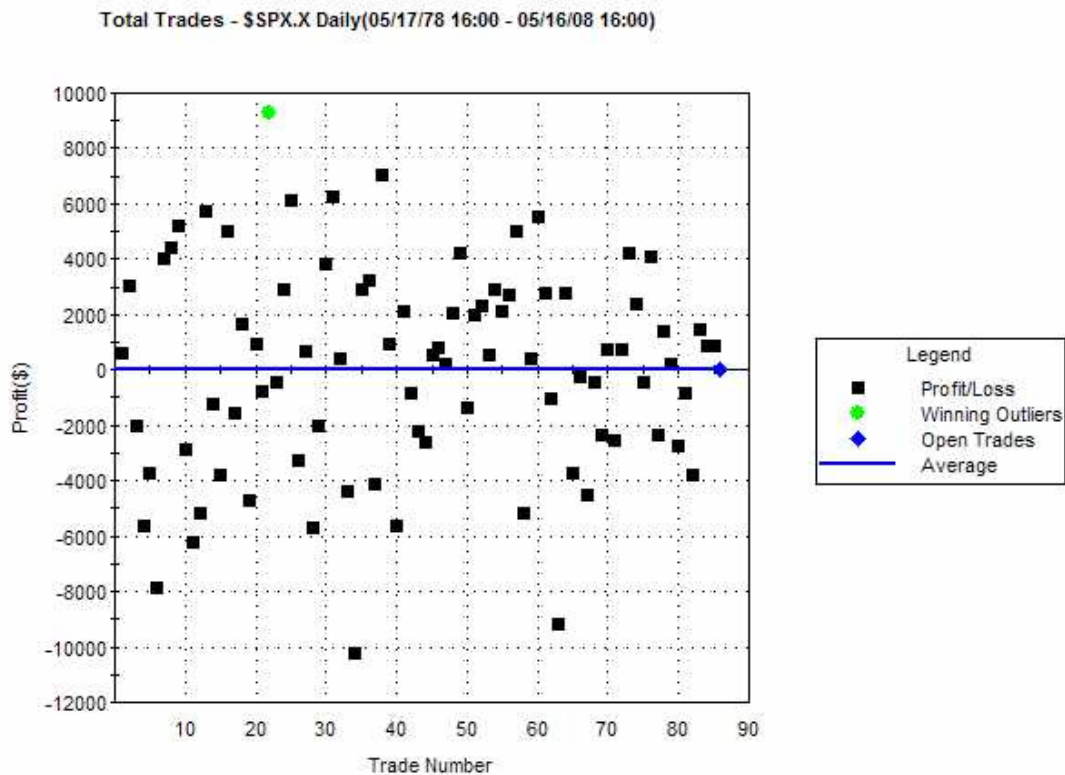
The table above shows that action was generally choppy over the next week before moving higher in a muted fashion. Over the period tested, the average day gained \$56.70, or about 0.06%. So even in the three weeks from day 5 to day 20, the expectation would have been for a rise of about \$850. Under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

<b>S&amp;P makes 5 higher highs after making 50-day low. Buy on close. Sell "X" days later.</b>									
<b>\$100,000 per trade. March 1979-present</b>									
<b>X Days</b>	<b>Net Profit</b>	<b>Trades</b>	<b>% Profitable</b>	<b>Winners</b>	<b>Max Win</b>	<b>Max Loss</b>	<b>Avg Win</b>	<b>Avg Loss</b>	<b>Avg Trade</b>
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 13<sup>th</sup> 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.

### **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	0.00
DJ US Insurance Index	IAK	0.00	DJ US Financial	IYF	0.68
DJ US Regional Banks	IAT	1.25	DJ US Financial Services	IYG	1.40
DJ US Utilities	IDU	0.00	DJ US Healthcare	IYH	1.41
DJ US Oil&Gas Expl & Prod	IEO	0.00	DJ US Industrial Sector	IYJ	0.00
DJ US Oil Equip & Svcs	IEZ	0.00	DJ US Consumer Goods	IYK	0.00
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	0.00
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	0.50
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	2.63
DJ US Consumer Svcs	IYC	0.00	Nasdaq 100	QQQQ	0.00

Not much showing up here.

**Additional New Trade Ideas**

*DELL – Short at \$21.20.* This setup is somewhat similar to one we used to short GE on 3/25. (That trade was good for a small ¼% gain.) Rules are as follows: 1) Must close below its 200-day simple moving average. 2) Must close above upper Bollinger Band for at least the 4<sup>th</sup> day in a row. 3) Must close lower than yesterday. Shorting under these circumstances and covering when the %b closed under 75 would have produced the following results over the last 10 years among the S&P 100 components:

Trades	29
Winners	22
Pct Winners	75.9%
Avg Win	4.17%
Avg Loss	-2.28%
Avg Trade	2.62%
Profit Factor	5.8

Dell has actually has 5 closes above the upper Bollinger. Using 5 days instead of 4 the number of trades is too small to give me much confidence. The results are quite good, though:

Trades	10
Winners	9
Pct Winners	90.0%
Avg Win	3.50%
Avg Loss	-1.92%
Avg Trade	2.96%
Profit Factor	16.5

No stop to start. I'll likely put one in once a swing high is established.

### **Additional Trades Active Table**

<b>Symbol</b>	<b>Entry Date</b>	<b>Entry Price</b>	<b>Current Price</b>	<b>% Gain/Loss</b>	<b>Stop</b>	<b>Notes</b>
SPY(S)	5/14/2008	\$141.09	\$143.01	-1.36%		
MDY(S)	5/14/2008	\$158.66	\$160.61	-1.23%		exit on close < 10ma
SPY(S)	5/15/2008	\$142.00	\$143.01	-0.71%		
IWP(S)	5/16/2008	\$115.27	\$115.03	0.21%		exit on close < 10ma
SPY(S)	5/19/2008	\$142.81	\$143.01	-0.14%		

The SPY trade is now all in at an average price of \$142.35. The whole position is currently about 0.5% underwater.

### **Stocks and ETF's on my Radar**

*COP remains overly extended and could be shortable.* I still feel there are stronger setups, such as the Dell trade discussed above. I'll hold off a little longer on this one.

*MA* still qualifies as a RSI 2/14 spread trade long. I will once again pass. I am not interested in longs with the market so overbought and my studies suggesting a pullback is likely.

### **Notable S&P 500 stocks outside my "tradable" radar**

#### ***Oversold***

*none*

#### ***Overbought***

None

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