QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 21, 2008 Issue 66

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) –slightly bearish – updated 5/21/08

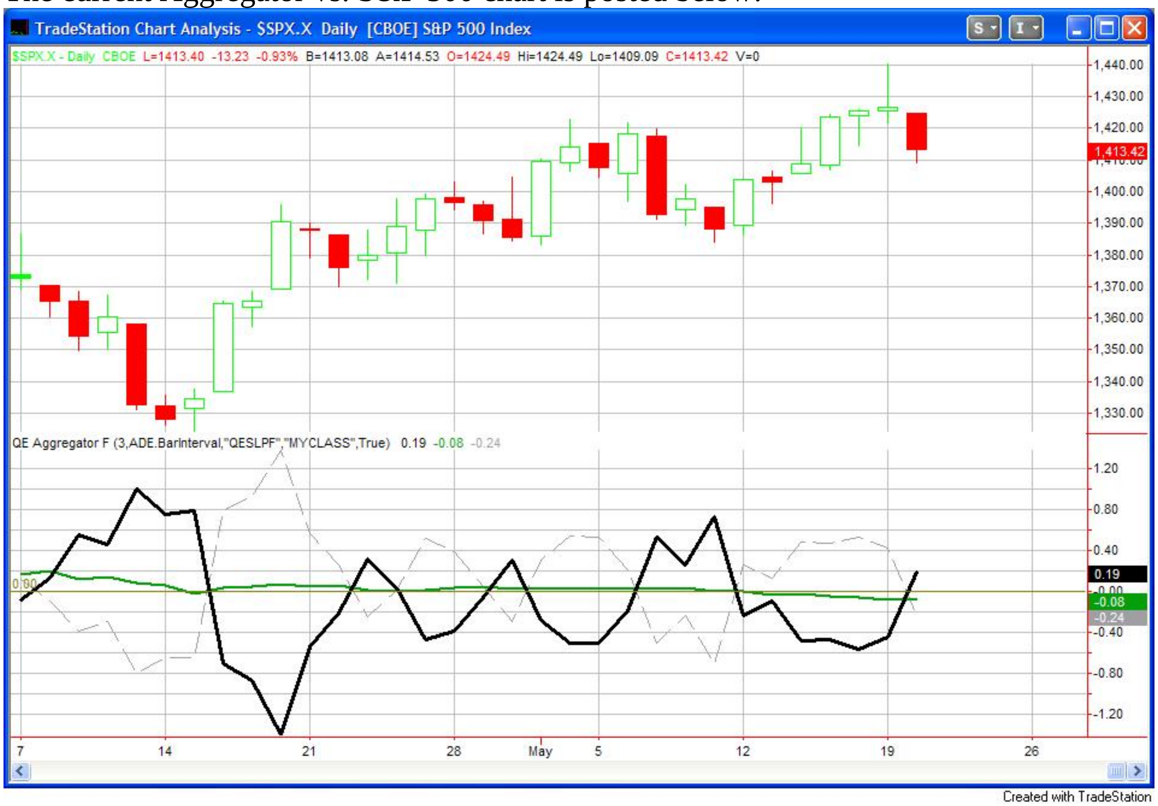
The market had a difficult go of it on Tuesday. It gapped down at the open and never really gained traction. A surge in the last 20 minutes of trading kept the numbers from looking too bad. After trading right near it lows of the day just after 3:30, SPY closed in the upper half of its daily range. Volume came in higher. Breadth was mildly negative. The put/call ratio spiked sharply higher and an exit was triggered in the put/call system I discussed in Friday's (5/16) Letter.

I looked at Tuesday's action about 15 different ways tonight to try and decipher whether the market was more likely to continue lower or to quickly rebound over the next day or two. With a full index SPY short position on I'd like to protect profits but would also like to see profits run a bit if odds continue to favor the downside. I found nothing terribly compelling in tonight's research.

One-day pullbacks from short-term overbought conditions will tend to be a coin flip over the next few days. For example I looked at any time the SPY dropped 0.75% on increased volume after posting a 3-day RSI of greater than 90. There have been 25 instances. 13 positive and 12 negative. Over the next two days the losers were larger than the winners and so the total expectancy was a loss. Using the S&P 500 cash index and looking back 50 years the results were nearly the same.

Another thing to consider about Tuesday is that it was a gap down that never filled. I again looked at SPY for significance here. The criteria was a gap lower that never filled and the SPY closed down at least 0.75% on volume higher than the day before. Over the next 2-3 days we see a slightly better than coin toss situation. The time, though the winners outsize the losers. The average day the next day closed about 0.38% higher. All this means is that today's action isn't helping us to identify a clear edge.

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



No longer severely outperforming expectations, the black line has turned up and is now slightly above the zero line. The Aggregator, as referenced by the green line above, continues to suggest weakness in the days ahead.

I'm willing to be patient and wait for the system exit with the MDY and IWP trades. With SPY, I'd prefer to take some profits while they are on the table and then let the rest ride using house money. I've outlined the target in the active trades section below.

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:

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

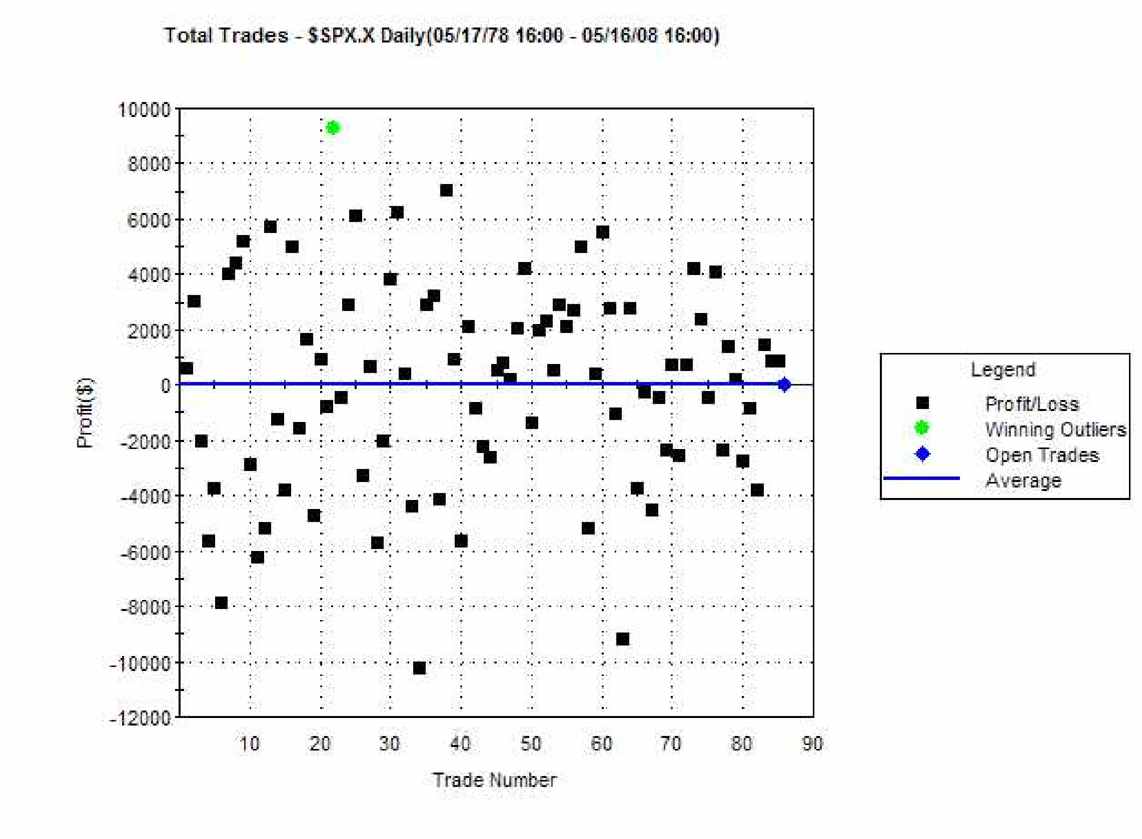
The table above shows that action was generally choppy over the next week before moving higher in a muted fashion. Over the period tested, the average day gained $56.70, or about 0.06%. So even in the three weeks from day 5 to day 20, the expectation would have been for a rise of about $850. Under the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

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	3.45		DJ US Energy	IYE	0.00
DJ US Insurance Index	IAK	0.00		DJ US Financial	IYF	1.37
DJ US Regional Banks	IAT	3.75		DJ US Financial Services	IYG	2.80
DJ US Utilities	IDU	0.00		DJ US Healthcare	IYH	0.70
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	2.04		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	0.44		Nasdaq 100	QQQQ	0.00

Banks and broker dealers staring to show signs of capitulation. I will keep an eye on those areas in the next few days.

Additional New Trade Ideas

VLO – short @ $50.10. VLO is being considered based on the following setup: 1) Close < 200-day moving average. (Long term downtrend) 2) Has closed higher at least 7 days in a row. (Short-term overbought). 3) Today is the lightest volume in 5 days. (The low volume is a clue that the buying enthusiasm is drying up.) Shorting this setup and covering on a close below the 5-day MA in the S&P 100 stocks over the last 10 years would have produced the following results:

Trades	50
Winners	41
Pct Winners	82.0%
Avg Win	2.19%
Avg Loss	2.81%
Avg Trade	1.29%
Profit Factor	3.5

MA – buy @ $277.65. This has now closed 3 days in a row with a 14period RSI over 50 points higher than its 2-period RSI. Buying this setup and selling when the 2-period closed back above the 14-period would have yielded the following results in all S&P 100 stocks over the last 10 yrs:

Trades	71
Winners	55
Pct Winners	77.5%
Avg Win	1.69%
Avg Loss	3.14%
Avg Trade	0.60%
Profit Factor	1.8

Not the greatest system but not bad. I like the reversal bar it put in on Tuesday. Should the price hold above Tuesday's low on Wednesday, I will likely enter a stop near Tuesday's low.

Additional Trades Active Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(S)	5/14/2008	$141.09	$141.89	-0.57%		
MDY(S)	5/14/2008	$158.66	$160.45	-1.13%		exit on close < 10ma
SPY(S)	5/15/2008	$142.00	$141.89	0.08%		
IWP(S)	5/16/2008	$115.27	$113.97	1.13%		exit on close < 10ma
SPY(S)	5/19/2008	$142.81	$141.89	0.64%		
SPY(S)	5/19/2008	$143.50	$141.89	1.12%		

The SPY trade is now all in at an average price of $142.35. I will look to cover ½ of it tomorrow @ $141.50. I will then most likely place a stop on the remaining around $143.00, which is a little above the 200-day moving average. In this way a small gain will be locked in barring gaps and I can let the rest ride for a while to see if the bearish studies play out.

Stocks and ETF's on my Radar

JNJ - Has closed below 10-day moving average for 10 days in a row. Closed at its lowest close in 10 days. Looks to be getting overdone.

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

Oversold

none

Overbought

None