

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 22, 2008

Issue 67

Market Overview

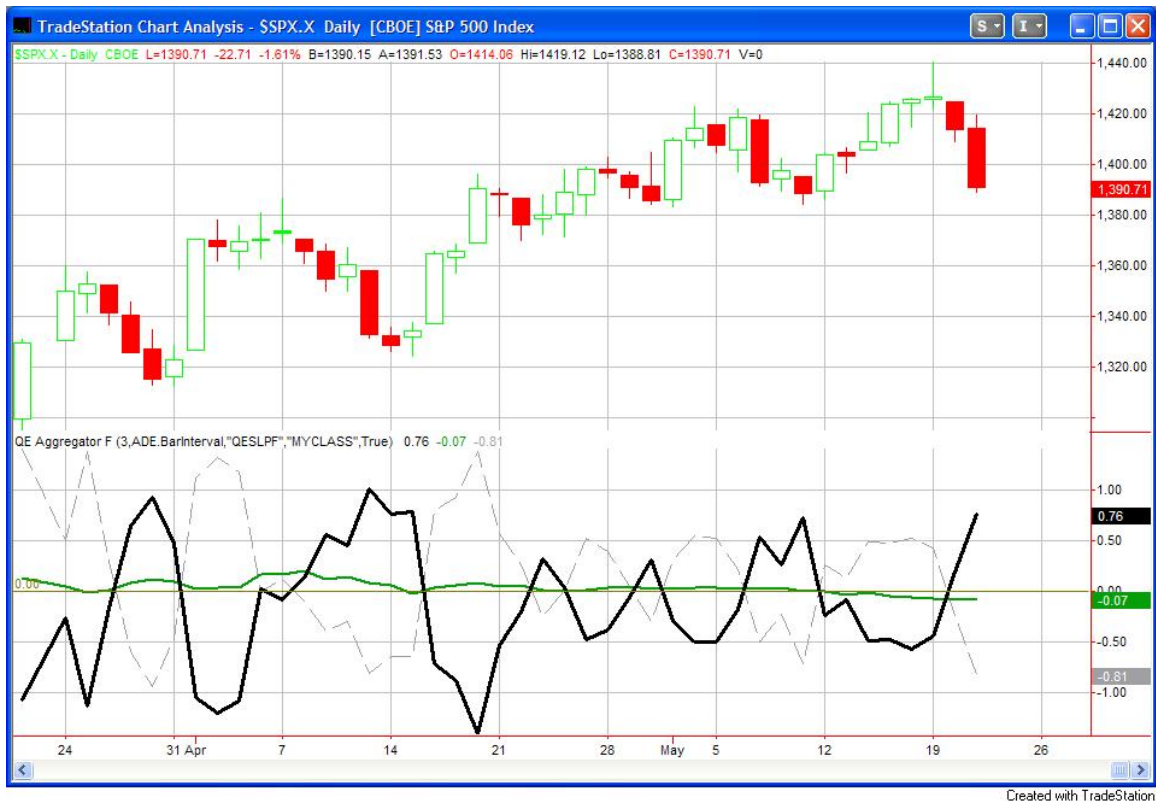
Summary of Recent Active Studies (see <http://QuantifiableEdges.blogspot.com> for details)

Study Date	Description	Time span	Bias
May 20, 2008	Failure at 200	1-5 days	Bearish
May 16, 2008	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 got thumped pretty good today. Fortunately, we've been discussing that this was a likely event for about a week now. Over that time several short-side trade ideas were listed in the Subscriber Letter. They all did well today, with a good number signaling profitable exits. The drop today amounted to about 1.6% for the S&P 500, and 1.8% for the Nasdaq Composite and Dow. It was the highest volume in about 12 days, but not at any extraordinary level. Breadth was poor but not to an extreme. Decliners outnumbered advancers by about 22 to 9 and down volume came in higher than up volume by a ratio of about 4.5 to 1.

In [tonight's blog](#) I looked at other times when the S&P had sold off sharply following a 50-day high. The expectancy was for a brief, weak bounce before some choppy action or a resumption of the selloff. Tonight's Aggregator chart is shown below. The green Aggregator line is still negative as bullish results continue to evade my studies. With the very strong underperformance of the S&P over the last two days, the black line, representing the difference between expectancy and actual return, has shot higher. Index trading opportunities occur when both lines are stretched in the same direction from the zero line as they were a couple of days ago to the downside. Today appears to be a good day for taking short-side profits rather than adding significant exposure.



I went through charts of many price, breadth and sentiment indicators tonight as well. I could find nothing that was signaling a bounce was imminent. The only indicators suggesting the market was oversold were the very shortest-term ones such as 2 or 3-day RSI readings. With all the negative implications my studies have suggested lately, I'm wary of rushing in to long positions based solely on short-term price indicators. A few "systems" I've disclosed in past Letters triggered tonight. I put those ideas in the "Radar" section rather than as official trade ideas. I am not prepared to step in front of this selloff just yet. The one trade I am listing as official is the Catapult trade that triggered. These are legged into in up to three parts, so further selling could allow for averaging down and is not as much of a concern.

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.

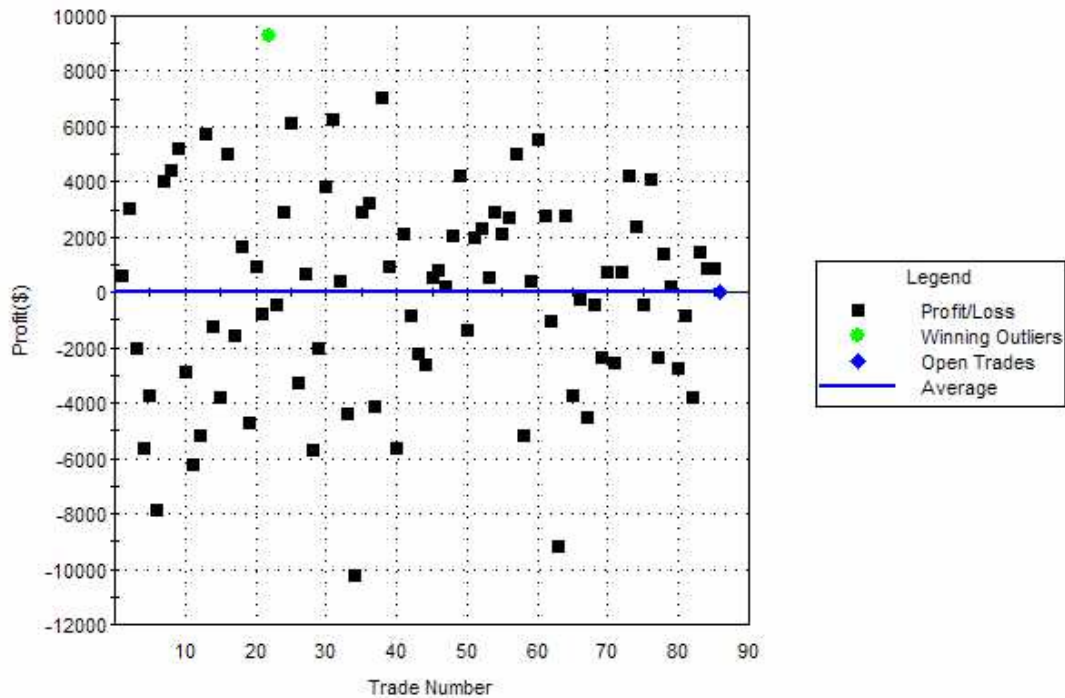
As I demonstrated last week with the lower lows study, these moves can lead to very different conditions depending on the state of the market. Not only did the market make its 5th consecutive high on Friday, it also hit a 50-day high. I looked at all times this occurred below. There were still quite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

Total Trades - \$SPX.X Daily(05/17/78 16:00 - 05/16/08 16:00)



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

F (Ford) – Buy @ \$7.80 limit (1/3 position).

This is the first Catapult trade that has triggered since the March bottom – a record length of time between Catapults since I began trading them in 2005. Recall that Catapult's are scaled in to in up to 3 parts. For a refresher on Catapult's you may refer to the presentation in the links above.

Open Big 50 Trades

None

Open Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 1 (F)

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	3.50
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	0.77
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	2.04	DJ US Real Estate	IYR	0.00
DJ US Medical Devices	IHI	2.44	DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	2.78	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	1.32	Nasdaq 100	QQQQ	1.00

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

None – There are a few system ideas in the “Radar Screen” section. I am not looking to take any new longs yet. I’d prefer to see some evidence that the market is likely to bounce before taking on much long-side exposure.

Additional Trades Active Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(S)	5/14/2008	\$141.09	\$140.83	0.18%		covered
MDY(S)	5/14/2008	\$158.66	\$157.87	0.50%		covered
SPY(S)	5/15/2008	\$142.00	\$140.83	0.82%		covered
IWP(S)	5/16/2008	\$115.27	\$112.10	2.75%		covered
SPY(S)	5/19/2008	\$142.81	\$140.83	1.39%		covered
SPY(S)	5/19/2008	\$143.50	\$139.40	2.86%		
VLO(S)	5/21/2008	\$50.15	\$49.50	1.30%		
MA	5/21/2008	\$277.40	\$278.65	0.45%		

Most shorts were covered. I have left one lot of SPY on. I will likely leave it on while I see how the selloff progresses. With the favorable entry price, I’m willing to sit through a shallow pullback in order to possibly participate in another leg down. Should my studies reveal an imminent bounce is likely, I may quickly switch and take the trade off.

It was fortunate to have both the new trades start off in the right direction.

Stocks and ETF’s on my Radar

GE and RKH – Both have closed below their 10-day ma’s for at least 10 days. Today they hit their lowest low and close further stretched below the 10-ma than any other time during the recent selloff. Yesterday was also stretched the furthest it had been below the 10ma. This system was the basis for our KO (Coke) trade that was good for about 0.95%. The stats published on 5/9 were “Over the last 10 years across all current S&P 100 stocks, buy this setup on the close and selling on a close above the 5-period moving average would have produced the following results:”

Trades	475
Winners	352
Pct Winners	74.1%
Avg Win	3.70%
Avg Loss	-4.93%
Avg Trade	1.55%
Profit Factor	2.3

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

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