

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 23, 2008

Issue 68

Market Overview

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

Study Date	Description	Time span	Bias
April 15 / May 23	WR7/NR7	1-15 days	Bullish
May 22, 2008	Sharp Drop from High	1-13 days	Bearish
May 20, 2008	Failure at 200	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
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 5/23/08

A tight range today as the market quieted down after yesterday's selling. Volume was lighter and breadth was mildly positive. As I showed about a month ago large down bars that immediately quiet the next day provide an upside edge up to 3 weeks out. This is the first bullish study I've produce in a while.

On the other hand I also took a look at Nasdaq new highs vs. new lows today in the blog. The current outsized number of new lows minus new highs in compared to the total issues trading on the Nasdaq is a bit concerning. Since 1994 there have only been three times when this ratio spiked lower when the market was so close to a 4-month higher. All three led to large selloffs. In October of 1999 there was a close call that defied the odds and led to a further rally. While its tough to glean much from just 3 or 4 instances this study may serve as a warning of a potential serious selloff.

The Aggregator chart is below. While the S&P remains significantly overbought as compared to the Aggregator's estimates, no entry is being considered. The aggregator is still suggesting downside so long entries continue to carry elevated risk.



There are a few trade ideas tonight, including a 2nd entry into the Ford catapult trade.

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.

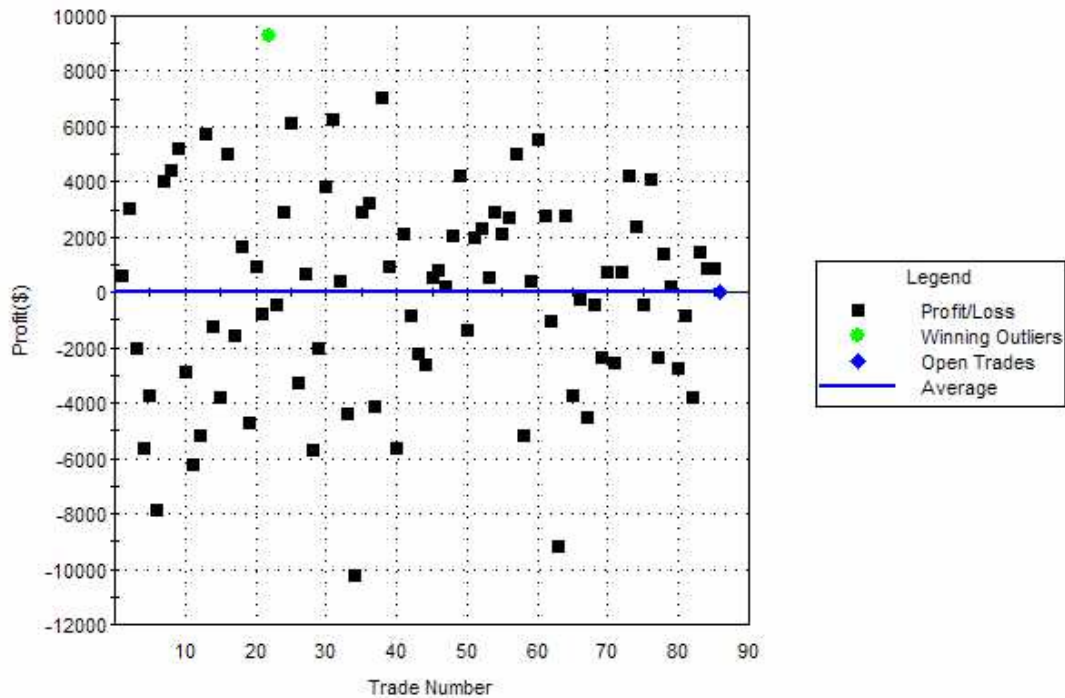
As I demonstrated last week with the lower lows study, these moves can lead to very different conditions depending on the state of the market. Not only did the market make its 5th consecutive high on Friday, it also hit a 50-day high. I looked at all times this occurred below. There were still quite 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) – Bought @ \$7.49 limit (1/3 position).

F – buy @ \$7.16 limit. (1/3 position)

The first trigger in two months looks like a stinker right off the bat. Fortunately, we scale into these rather than taking the whole amount up front.

Open Big 50 Trades

None

Open Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 2/1 (F2)

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 starting to show signs of capitulation. I will keep an eye on those areas in the next few days.

Additional New Trade Ideas

MER – buy@ \$44.50. This is based on the following setup which first was shown in the 4/21 Subscriber Letter:

- 1) Closed down at least 5 days in a row.
- 2) Gapped lower this morning.
- 3) Opened below its lower Bollinger Band.
- 4) Closed above its open.

Over the last 10 years across all current S&P 100 stocks, buy this setup on the close and selling on a close with the %b (Bollinger Band) > 25 would have produced the following results:

Trades	307
Winners	217
Pct Winners	70.7%
Avg Win	3.83%
Avg Loss	-4.90%
Avg Trade	1.30%
Profit Factor	1.9

Other stacks that could be played with this strategy tonight include GS or HD.

JNJ – buy @ \$65.41 - . This is based on the following setup:

- 1) Closed under 10 day ma at least 10 days in a row
- 2) Close above 200ma
- 3) Made a 10-day low.
- 4) Stretched further from the 10-day low than any time in last 10 days.

After meeting the above criteria 2 days in a row the setup is taken. The exit is a close above the 10-period ma.

Over the last 10 years across all current S&P 100 stocks, buy this setup on the close and selling on a close with the %b (Bollinger Band) > 25 would have produced the following results:

Trades	59
Winners	41
Pct Winners	69.5%
Avg Win	3.32%
Avg Loss	-3.05%
Avg Trade	1.43%
Profit Factor	2.6

Additional Trades Active Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(S)	5/19/2008	\$143.50	\$139.51	2.78%		
VLO(S)	5/21/2008	\$50.15	\$49.81	0.68%		
MA	5/21/2008	\$277.40	\$275.90	-0.54%	\$272.00	
F	5/22/2008	\$7.49	\$7.16	-4.41%		

MA has been trying to bounce without much success. I will put a stop a little below yesterday's low.

The SPY may very well bounce over the next few days. Still, downside risk seems much higher than potential upside reward, so I am not going to cover yet. With 3 new long ideas tonight it's also a not bad idea to hold this position as a short-hedge.

Stocks and ETF's on my Radar

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

Oversold

none

Overbought

None

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