

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

June 9, 2008

Issue 78

Market Overview

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

Study Date	Description	Time span	Bias
June 9, 2008	VXO stretch	1-6 days	Bullish
June 5, 2008	SPX down NDX up 1%	1-4 days	Bullish
June 5, 2008	Put/Call 3ma spike (Letter)	1-10 days	Bullish
June 3, 2008	Big drop bad breadth	1-9 days	Bullish
May 30, 2008	3 Up Days - Volume On Rise	1-10 days	Bullish
May 26, 2008	Put/Call 4ma spike (Letter)	1-10 days	Bullish
April 15 / May 23	WR7/NR7	1-15 days	Bullish
May 22, 2008	Sharp Drop from High	1-13 days	Bearish
March 17, 2008	Consumer Sentiment Stretch	1-12 months	Bullish

Short-term Outlook (1-5 days) – neutral – updated 6/9/08

The market imploded on Friday. After posting a 2% gain on Thursday, it wiped that out and more – falling 3% on Friday. Taking the brunt of the blame was the unemployment report along with a spike in oil prices. Volume spiked to its highest level in about a month and a half as traders rushed for the exits. As would be expected, breadth was also strongly negative.

I normally find extreme moves lead to interesting studies. In most cases an edge becomes pretty apparent. So I was expecting to find some interesting results from my research this evening. What I found is that the situation the market finds itself in is somewhat unprecedented. Below are a few examples so you can understand what I was looking at.

The first thing I tested was the 2% rise on Thursday followed by the 3% drop on Friday. I wanted to see how the market had reacted to moves of this size in the past. Looking back 30 years I was only able to find two other instances which a spike and drop of this magnitude. Those dates were October 22, 1987 and March 24, 2003. Both of these dates occurred shortly after significant bottoms – a time when volatility can be unusually high.

I then changed the criteria slightly. Rather than looking for a down day of 3% I simply required it was down enough to wipe out all gains from the previous day. In this case March 24, 2003 was the only date that showed up.

Looking where the days closed within their range rather than worrying about the magnitude of the move I concocted this study:

S&P closes in top 5% of range day 1 and bottom 5% of range day 2. Overall there is a loss for the 2 days.											
Buy at day 2 close. Hold "X" days. Last 30 years. \$100,000 per trade.											
X Days	Net Profit	Trades	Wins	% Profitab	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
10	\$1,126.49	42	24	57.14	\$7,721.96	(\$23,527.65)	\$2,839.68	(\$3,723.66)	0.76	\$26.82	1.02
9	\$3,774.60	42	22	52.38	\$10,875.66	(\$23,553.81)	\$3,170.21	(\$3,298.50)	0.96	\$89.87	1.06
8	(\$4,551.81)	43	22	51.16	\$8,408.28	(\$25,362.12)	\$2,815.09	(\$3,165.90)	0.89	(\$105.86)	0.93
7	\$7,496.11	43	22	51.16	\$8,184.42	(\$18,639.00)	\$2,683.64	(\$2,454.47)	1.09	\$174.33	1.15
6	\$801.88	43	23	53.49	\$7,253.31	(\$18,629.19)	\$2,222.90	(\$2,516.24)	0.88	\$18.65	1.02
5	(\$11,489.04)	43	25	58.14	\$6,803.13	(\$15,319.95)	\$1,628.97	(\$2,900.74)	0.56	(\$267.19)	0.78
4	(\$18,973.12)	43	22	51.16	\$5,247.61	(\$22,363.53)	\$1,553.29	(\$2,530.74)	0.61	(\$441.24)	0.64
3	(\$26,756.50)	43	18	41.86	\$4,438.92	(\$26,287.53)	\$1,822.19	(\$2,382.23)	0.76	(\$622.24)	0.55
2	(\$9,299.92)	44	18	40.91	\$4,388.51	(\$7,367.31)	\$1,346.94	(\$1,290.18)	1.04	(\$211.36)	0.72
1	(\$5,691.48)	44	24	54.55	\$1,681.00	(\$2,334.78)	\$496.35	(\$880.19)	0.56	(\$129.35)	0.68

The “max loss” column skews this one a bit since this pattern occurred 3 days before the Crash of '87. Eliminating the max loss you are still left with choppy results.

The volatility indices (VIX, VXO, VXN, etc.) all spiked on Friday. This type of action is frequently followed by a reversal, but it's no sure thing. See the below study for an example:

VXO close 20% above 10-day moving average. Buy S&P 500 on close. Sell "X" days later. \$100,000 per trade. 1986-present.											
X Days	Net Profit	Trades	Wins	% Profitab	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Fact
10	\$28,809.77	57	38	66.67	\$9,241.60	(\$10,911.23)	\$2,660.96	(\$3,805.61)	0.70	\$505.43	1.40
9	\$28,493.50	59	41	69.49	\$7,602.40	(\$13,385.76)	\$2,497.50	(\$4,105.77)	0.61	\$482.94	1.39
8	\$42,979.01	60	40	66.67	\$8,317.50	(\$17,445.26)	\$2,816.88	(\$3,484.81)	0.81	\$716.32	1.62
7	\$59,729.21	62	41	66.13	\$10,870.00	(\$17,473.50)	\$2,943.44	(\$2,902.47)	1.01	\$963.37	1.98
6	\$81,784.39	65	44	67.69	\$14,240.00	(\$19,425.59)	\$3,220.93	(\$2,854.12)	1.13	\$1,258.22	2.36
5	\$51,274.53	66	41	62.12	\$13,135.00	(\$12,167.91)	\$2,433.38	(\$1,939.77)	1.25	\$776.89	2.06
4	\$41,472.17	69	42	60.87	\$12,657.50	(\$12,157.32)	\$2,352.52	(\$2,123.46)	1.11	\$601.05	1.72
3	\$45,462.73	80	54	67.50	\$7,511.29	(\$11,884.77)	\$1,983.31	(\$2,370.62)	0.84	\$568.28	1.74
2	\$41,376.26	87	61	70.11	\$6,245.15	(\$16,188.58)	\$1,685.86	(\$2,363.88)	0.71	\$475.59	1.67
1	\$32,767.00	117	77	65.81	\$9,089.88	(\$20,424.58)	\$1,421.76	(\$1,917.71)	0.74	\$280.06	1.43

More often than not the market will reverse shortly. Damage prior to the reversal can be extreme, though. Buying this kind of spike and then selling when the VXO dropped back below its 10-day moving average is a fairly high-risk system. You'd get about 70% winners, but the average losing trade is about a 3% loss versus a potential for a 2% gain. Decent, but not great. Especially when dealing with a uniquely difficult market.

Another curious thing about last week's action is that although the major indices all dropped hard, the IBD 100 Index actually finished the week in positive territory. I sometimes like to compare the action of the IBD 100 to the majors since it supposedly represents the “leading” stocks. My data for this index goes back to March of 2004. I looked to see any other time where the S&P dropped at least 2.5% and the IBD 100 finished up for the week. Again, it was rare. The only other occurrence was the week of April 11, 2008.

So the basic story my testing revealed is that we are in somewhat unprecedented territory. When the S&P and other majors put in a 2%+ upside day, it simply is not supposed to be given all back the next day. I am not yet seeing a clear edge with any of the studies. The market is full of uncertainty and it appears the best course of action might be to hold off for a day or two before initiating new positions.

The action in the CBI may help to guide us into some conservative positions or more aggressive index trades over the next several days. On Friday there were no Catapult trades triggered. By breaking down the S&P 100 stocks I was able to find at least 4 that have the potential to trigger in the next day or two. The CBI could very quickly jump from “3” to “10” or higher in the next two to three days if these stocks continue to exhibit Catapult behavior. The four stocks I’ve noted with potential are: Regions Financial (RF), Bank of America (BAC), Wachovia(WB) and Pfizer(PFE).

You’ll note that 3 of the 4 of these are bank stocks. Banks have been getting destroyed lately with the continued worries about the credit crisis. Should we see continued selling in the above stocks, there are a number of ways that traders could consider taking advantage of it.

Normally when the CBI predicts a bounce, some of the stocks that bounce the best off the oversold market condition are the Catapult trades. They are typically the most beaten up and the most volatile and therefore bounce the best – in part due to short covering. As we’ve seen with Ford, though, Catapults carry higher risk.

Therefore, the first and most obvious way to try and take advantage of potential extreme selling conditions is to take small positions in the individual Catapult trades and then possibly supplement these smaller positions with larger ones in S&P 500 index shares.

Another way would be to look to buy the industries that are under the most Capitulative stress. In this case that will likely be banks and financials. The sector breakdown in the CBI section is a way for traders to spot those sectors or etf’s that may be appropriate. This is more conservative than buying individual stocks but more aggressive than a general market allocation.

The last way to try and take advantage of the CBI spike would be to ignore the individual trades and just look to take on index exposure in a more aggressive manner.

I’m getting a day or two ahead of myself here, but I think it’s important for traders to have time to consider how they could best take advantage of a potentially tricky yet fruitful market environment. As I showed above, the market is in somewhat uncharted territory here. Friday’s selloff was harsh but it may be a few days before the real panic sets in. While I’m not averse to buying stocks that are in a freefall, I only do so when there is a quantifiable edge. No edge is apparent, but there appears to be one on the horizon. By anticipating and planning out your trades this week, you stand a better chance of profiting. Don’t buy too soon, but when everyone else is panicking it is normally a good time to step in. That is what I intend to do, and I’ll let the Catapults and CBI be a bit of a guide for me.

Intermediate-term Outlook (1 week – 2 months) – neutral – updated 6/9/2008

The studies are in a bit of an unusual situation right now. While we've had at least 7 of them active at all times since March 18th, the market is beginning to move into uncharted territory. Reasons for my considering it uncharted can be found in tonight's short-term outlook section.

By next Monday there will only be two studies that still remain active. Those are the June 5th Put/Call Spike study and the March Consumer Sentiment study. In other words, from an intermediate-term standpoint, the studies are not revealing much at this point. Rather than try and make long-term predictions in an uncertain market environment, I prefer to shorten my outlook. For the time being, therefore, I am going to keep the intermediate-term outlook at "neutral" and rely almost exclusively on the short-term outlook.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Trades

F (Ford) – Bought @ \$7.49 (1/3 position).

F (Ford) – Bought @ \$6.99 (1/3 position).

F (Ford) – Bought @ \$6.79 (1/3 position).

The CBI is now back to a neutral state at "3/1". It could spike very soon if this selloff worsens.

Open Big 50 Trades

None

Open Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 3/1 (F-3)

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	1.35	DJ US Financial	IYF	2.74
DJ US Regional Banks	IAT	8.75	DJ US Financial Services	IYG	4.90
DJ US Utilities	IDU	1.35	DJ US Healthcare	IYH	1.41
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	2.04
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	5.56	DJ US Technology Sector	IYW	0.50
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	0.44	Nasdaq 100	QQQQ	0.00

Additional New Trade Ideas

none

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
F	5/22/2008	\$7.49	\$6.04	-19.36%		
F	5/23/2008	\$6.99	\$6.04	-13.59%		
F	5/27/2008	\$6.79	\$6.04	-11.05%		
EZA	6/3/2008	\$126.01	\$123.20	-2.23%		exit RSI4 closes > RSI15
ATI	6/6/2008	\$67.73	\$66.19	-2.27%	#####	exit on close > 5ma

The average price in F (Ford) is \$7.09. See the June 5th notes for further explanation of why no stops are used on official Catapult trades.

Stocks and ETF's on my Radar

none

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

None

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