

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

June 30, 2008

Issue 93

Market Overview

Summary of Recent Active Studies (see <http://QuantifiableEdges.blogspot.com> or Letters from listed dates for details)

Study Date	Description	Time span	Bias
June 30, 2008	CBI=6	1-6 days	Bullish
June 27, 2008	Sharp Drop to 50 low w/ time str	1-10 days	Bullish
June 27, 2008	P/C Lackadaisical	1-8 days	Bullish
June 27, 2008	Stocks over 40ma < 15%	1-10 days	Bullish
June 25, 2008	Advancers Exp MA Ratio Study	1-20 days	Bullish
June 11/24	Draggin Breadth	1-10 days	Bearish
June 24, 2008	WR7 High Vol Down / NR7	1-18 days	Bullish
June 23, 2008	SPX under BB VIX not stretched	1-12 days	Bearish
June 23, 2008	Gap & Drop At 50-low	1-19 days	Bullish
March 17, 2008	Consumer Sentiment Stretch	1-12 months	Bullish

Short-term Outlook (1-5 days) –bullish – updated 6/30/08

The market failed to bounce on Friday, adding to recent losses. Breadth was quite negative at nearly 2:1. Volume was extremely high, but the number was skewed by the Russell rebalancing, so I'm not reading anything into it.

After looking at several short-term studies on Thursday, there isn't a whole lot new to look at from a short-term perspective today. One notable change, though, is the spike back up from 3 to 6 in the CBI. It's not just the move in the number that is significant, though. I believe the structure of the CBI is more positive than it has been at any time in the recent selloff.

Last week and the week before I noted that while the CBI was spiking, it was almost entirely dominated by financials. Because of this, I didn't feel the spike was as significant for the broad market as it might normally be on a move up to 6 or 8. We did get a bounce just good enough to reduce the CBI back to a neutral 3 on Wednesday, but that bounce quickly failed. With today's spike we now are seeing participation from a wide variety of industry groups including banks, healthcare, auto, insurance, transportation, and food. This appears to be a truer indication of capitulative breadth than even the move to "8" on Monday the 23rd.

Below is an updated chart with the Quantifiable Edges Studies Aggregator:



As you can see the Aggregator chart remains in prime position for a bounce. The green Aggregator line, showing the aggregated results of all outstanding studies, indicates a strongly positive expectation for the next 3 days. The black line, representing the difference between expectations 3 days ago and actual S&P performance over the last 3 days is showing that the S&P has largely underperformed expectations recently. Large underperformance combined with solidly positive short-term expectations typically suggests a sizable short-term upside edge.

Intermediate-term Outlook (1 week – 2 months) – slightly bullish – updated 6/30/2008

In [March I posted a study on the blog](#) that looked at the steep drop in consumer confidence. The study suggested that the market has historically produced greater than average gains when consumer confidence gets stretched too far to the downside. To measure stretch I threw 10% moving average envelopes around a 10-month moving average of the consumer confidence number.

Since then the market has rebounded but is now testing the March lows. Consumer confidence, on the other hand has not rebounded. Friday it closed at an all-time low of 56.40. The data has been kept going back to 1952, but until 1978 it was only reported quarterly. Since 1978 there has only been one other time when the consumer confidence number has finished below its lower 10% envelope for 5 months in a row. That was in 1990 when it managed to close below it for 6 months in a row. In 1990, though, the confidence number and the S&P 500 both bottomed after 3 months below the envelope. Our current situation is unlike any other in the last 30 years since we've yet to see a

bounce in the number. While we're more extreme at this point the take-away remains the same: when people get this extremely negative, they're normally overreacting.

While consumer sentiment is extremely negative, measures of investor sentiment generally aren't. Two examples of this are the VIX and the CBOE Put/Call Ratio. The VIX is only about 5% above its 10-day moving average. On an absolute basis it remains below the 6/11 peak and substantially below the 30+ readings achieved during the January, March and November selloffs. The CBOE Put/Call short-term averages are very close to the long-term average, suggesting little or no panic among option traders. Panic among market participants often occurs at market bottoms, and it can be a helpful indication when looking for one. I ran studies on both [the VIX](#) and [Put/Call](#) last week to examine whether fear was a *necessary* ingredient for a bounce. It wasn't. While I'd like to see it, I don't believe it would be wise to ignore all the other bullish studies and indications I've observed simply because sentiment isn't cooperating.

While the Nasdaq has fallen rather sharply lately, its still stronger than the NYSE composite based on 10-week relative strength. As [I've discussed in the past](#), Nasdaq relative strength over the NYSE has generally been a positive for the market. I figured I'd look at this in the context of the recent selloff as well.

Nasdaq Closes Down At Least 9% from the high of 4 weeks ago, but still leads NYSE Comp.													
Buy NYSE Comp at close. Sell X weeks later. \$100,000 per trade. 1972-present.													
X Weeks	Net Profit	Gross Profit	Gross Loss	Trades	Wins	Losses	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
20	\$59,271.27	\$59,271.27	\$0.00	5	5	0	\$33,315.66	\$0.00	\$11,854.25	\$0.00	100.00	\$11,854.25	100.00
15	\$50,878.89	\$50,878.89	\$0.00	5	5	0	\$28,419.28	\$0.00	\$10,175.78	\$0.00	100.00	\$10,175.78	100.00
14	\$50,609.22	\$50,609.22	\$0.00	5	5	0	\$30,186.58	\$0.00	\$10,121.84	\$0.00	100.00	\$10,121.84	100.00
13	\$42,250.14	\$42,250.14	\$0.00	5	5	0	\$29,972.36	\$0.00	\$8,450.03	\$0.00	100.00	\$8,450.03	100.00
12	\$33,723.05	\$34,991.85	(\$1,268.80)	5	4	1	\$24,972.36	(\$1,268.80)	\$8,747.96	(\$1,268.80)	6.89	\$6,744.61	27.58
11	\$26,084.58	\$31,745.83	(\$5,661.25)	5	3	2	\$26,797.20	(\$4,094.20)	\$10,581.94	(\$2,830.63)	3.74	\$5,216.92	5.61
10	\$20,108.47	\$27,848.13	(\$7,739.66)	5	2	3	\$25,377.88	(\$5,530.50)	\$13,924.07	(\$2,579.89)	5.40	\$4,021.69	3.60
9	\$21,586.85	\$24,007.99	(\$2,421.14)	5	4	1	\$21,292.54	(\$2,421.14)	\$6,002.00	(\$2,421.14)	2.48	\$4,317.37	9.92
8	\$11,670.16	\$24,356.40	(\$12,686.24)	5	2	3	\$18,714.20	(\$8,809.74)	\$12,178.20	(\$4,228.75)	2.88	\$2,334.03	1.92
7	\$8,205.46	\$18,842.74	(\$10,637.28)	5	2	3	\$12,716.34	(\$6,749.68)	\$9,421.37	(\$3,545.76)	2.66	\$1,641.09	1.77
6	\$14,190.92	\$18,638.00	(\$4,447.08)	5	3	2	\$9,877.70	(\$3,600.43)	\$6,212.67	(\$2,223.54)	2.79	\$2,838.18	4.19
5	\$15,659.17	\$24,322.59	(\$8,663.42)	5	3	2	\$11,935.44	(\$5,063.62)	\$8,107.53	(\$4,331.71)	1.87	\$3,131.83	2.81
4	\$12,760.70	\$19,955.34	(\$7,194.64)	5	3	2	\$9,199.20	(\$6,413.59)	\$6,651.78	(\$3,597.32)	1.85	\$2,552.14	2.77
3	\$4,235.25	\$13,115.03	(\$8,879.78)	5	4	1	\$7,350.80	(\$8,879.78)	\$3,278.76	(\$8,879.78)	0.37	\$847.05	1.48
2	\$814.15	\$7,375.06	(\$6,560.91)	5	3	2	\$2,730.20	(\$4,240.31)	\$2,458.35	(\$3,280.46)	0.75	\$162.83	1.12
1	\$6,587.93	\$6,587.93	\$0.00	5	5	0	\$2,720.82	\$0.00	\$1,317.59	\$0.00	100.00	\$1,317.59	100.00

Most glaring about this study is the low number of trades. This speaks to the relatively unusual market environment. While the 5 instances were somewhat mixed over the short-term, performance once you got out 13 weeks was strongly positive. For those interested, the trigger dates were 12/6/74, 8/8/75, 8/14/98, 8/6/99, and 7/19/02. '74 and '02 basically marked the bottoms. The other instances did some wiggling around before moving smartly higher.

To try and include some more instances, I loosened the “% drop” requirement for the Nasdaq. Lowering it to 5% produced the following results:

Nasdaq Closes Down At Least 5% from the high of 4 weeks ago, but still leads NYSE Comp.													
Buy NYSE Comp at close. Sell X weeks later. \$100,000 per trade. 1972-present.													
X Weeks	Net Profit	Gross Profit	Gross Loss	Trades	Wins	Losses	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
20	\$56,713.63	\$67,471.72	(\$10,758.09)	13	9	4	\$26,148.24	(\$5,427.41)	\$7,496.86	(\$2,689.52)	2.79	\$4,362.59	6.27
15	\$48,579.39	\$62,870.88	(\$14,291.49)	14	11	3	\$12,607.68	(\$9,357.99)	\$5,715.53	(\$4,763.83)	1.20	\$3,469.96	4.40
10	\$57,570.44	\$86,261.21	(\$28,690.77)	17	10	7	\$25,377.88	(\$11,404.11)	\$8,626.12	(\$4,098.68)	2.10	\$3,386.50	3.01
9	\$25,180.36	\$71,514.17	(\$46,333.81)	18	11	7	\$10,152.38	(\$12,464.93)	\$6,501.29	(\$6,619.12)	0.98	\$1,398.91	1.54
8	\$16,949.76	\$63,964.37	(\$47,014.61)	18	11	7	\$7,920.36	(\$17,056.31)	\$5,814.94	(\$6,716.37)	0.87	\$941.65	1.36
7	\$28,845.82	\$71,897.03	(\$43,051.21)	19	12	7	\$11,351.88	(\$20,724.34)	\$5,991.42	(\$6,150.17)	0.97	\$1,518.20	1.67
6	\$23,592.11	\$65,891.31	(\$42,299.20)	19	11	8	\$15,701.64	(\$14,953.55)	\$5,990.12	(\$5,287.40)	1.13	\$1,241.69	1.56
5	\$31,594.08	\$64,800.35	(\$33,206.27)	19	12	7	\$13,686.84	(\$14,704.57)	\$5,400.03	(\$4,743.75)	1.14	\$1,662.85	1.95
4	\$7,048.14	\$50,660.01	(\$43,611.87)	19	10	9	\$9,199.20	(\$13,431.35)	\$5,066.00	(\$4,845.76)	1.05	\$370.95	1.16
3	\$9,405.06	\$49,024.44	(\$39,619.38)	19	11	8	\$11,178.00	(\$11,909.15)	\$4,456.77	(\$4,952.42)	0.90	\$495.00	1.24
2	\$5,551.59	\$43,072.81	(\$37,521.22)	23	11	12	\$9,455.76	(\$11,435.38)	\$3,915.71	(\$3,126.77)	1.25	\$241.37	1.15
1	\$14,648.31	\$54,419.35	(\$39,771.04)	32	21	11	\$13,928.11	(\$12,421.27)	\$2,591.40	(\$3,615.55)	0.72	\$457.76	1.37

Not neatly as positive at the steeper 9% decline, but still very good on a risk/reward basis when looking out 10-20 weeks.

Breadth is at a point where it is so bad, it's good. As discussed in tonight's short-term outlook section, the CBI is back to six and the "B" in CBI is looking better than it has recently. While this is more of a short-term indicator, the "% of stocks closing above their 40-day moving average" is not. Below is one of the studies I showed in Friday's Subscriber Letter which looked at this indicator:

Percent of NYSE stocks closing above their 40ma is <= 15. Buy at close. Sell when % rises above X. \$100,000/trade. 1987 - present													
X% Above	Net Profit	Gross Profit	Gross Loss	Trades	Wins	% Profitable	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Fact
50	\$39,407.77	\$54,843.10	(\$15,435.33)	13	11	84.62	\$15,897.60	(\$10,424.09)	\$4,985.74	(\$7,717.67)	0.65	\$3,031.37	3.55
45	\$36,230.98	\$52,537.12	(\$16,306.14)	13	11	84.62	\$14,585.60	(\$11,836.09)	\$4,776.10	(\$8,153.07)	0.59	\$2,787.00	3.22
40	\$32,097.53	\$50,119.93	(\$18,022.40)	13	11	84.62	\$15,738.88	(\$11,836.09)	\$4,556.36	(\$9,011.20)	0.51	\$2,469.04	2.78
35	\$27,347.87	\$45,494.37	(\$18,146.50)	13	11	84.62	\$15,738.88	(\$12,217.33)	\$4,135.85	(\$9,073.25)	0.46	\$2,103.68	2.51
30	\$19,417.03	\$40,461.97	(\$21,044.94)	14	10	71.43	\$13,377.28	(\$12,217.33)	\$4,046.20	(\$5,261.24)	0.77	\$1,386.93	1.92

The last 10 trades going back to 1991 have been profitable at the higher levels. The biggest loser triggered just prior to the Crash of '87. The average trade in this scenario was about 4-5 weeks.

Other breadth measures similar to this one, such as the McClellan Oscillator and the "% of stocks trading at least 1 standard deviation below their 40-day moving average", which I mentioned last week, are also suggesting the selloff is overdone.

As I also discussed in Friday's Subscriber Letter, price measures are becoming stretched to a point that would suggest a rebound as well.

The biggest problem with the intermediate-term bounce scenario as I see it is the fact that the market is operating to extremes that have rarely if ever been seen before. The consumer confidence study above is one example of this. The persistency of the selloff in Financials is something that has rarely been seen in any industry. They have closed below their 10-day moving averages for 36 days in a row now. I discussed this in some detail in Tuesday's Letter and also briefly in [the June 19th blog](#).

Another example of the historical extremes we're seeing is the poor recent performance of the Catapult trades, which make up the CBI. I also discussed this in Tuesday's Subscriber Letter but it bears mentioning again here. The losses on a few of the trades are historic in that we haven't seen multiple trades get whacked like a few of the recent ones except for when there were some Catapults that triggered just prior to September 11th, 2001. The fact that they've sold off harder and bounced weaker lately than at any time in the past speaks to the uniqueness of the current environment. The contrast can be further exemplified by looking at Catapult results during past selloffs and bear markets. Both the January and March selloffs which saw high CBI spikes were fantastic in terms of Catapult results. When looking back further and into the backtest period, since 1995 the two most profitable years for Catapult trades were 2002 and 2000. A bear market should not eliminate their effectiveness. The fact that they have been so ineffective in June does suggest caution may be warranted as the market environment now appears different than it has in a very long time.

In all, it would appear that based on price, breadth, and consumer sentiment a tradeable low should occur fairly soon, allowing the market to embark on an intermediate-term advance. Since we appear to be in an environment a bit more extreme than others seen in the last 30 years, especially from a persistency standpoint, caution does seem warranted. My stated outlook remains “slightly bullish”. For me to get aggressively bullish I would like to see the market provide price confirmation in the form of a solid reversal pattern. Investor sentiment hitting extreme levels would also provide increased confidence.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Trades

BAC – bought 1/3 position @ \$25.88
 UNH – bought 1/3 position @ \$26.15
 GM – bought 1/3 position @ \$12.76

New Catapult Triggers

AIG – buy 1/3 position @ \$27.75
 FDX – buy 1/3 position @ \$77.25
 KFT – buy 1/3 position @ \$28.39

Open Big 50 Trades

None

Catapult for ETF's Trades

New

DIA – buy @ \$113.46

Broad Market Large Cap CBI – 6/6 (BAC, UNH, GM, AIG, FDX, KFT)

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	12.16	DJ US Financial	IYF	6.16
DJ US Regional Banks	IAT	10.00	DJ US Financial Services	IYG	6.29
DJ US Utilities	IDU	4.05	DJ US Healthcare	IYH	2.82
DJ US Oil&Gas Expl & Prod	IEO	1.72	DJ US Industrial Sector	IYJ	4.21
DJ US Oil Equip & Svcs	IEZ	0.00	DJ US Consumer Goods	IYK	9.52
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	1.35
DJ US Healthcare Providers	IHF	8.16	DJ US Real Estate	IYR	2.44
DJ US Medical Devices	IHI	0.00	DJ US Transportation	IYT	4.76
DJ US Aerospace & Defense	ITA	13.89	DJ US Technology Sector	IYW	2.01
DJ US Home Construction	ITB	4.76	DJ US Telecommunications	IYZ	2.63
DJ US Consumer Svcs	IYC	3.51	Nasdaq 100	QQQQ	2.00

Additional New Trade Ideas

Note the 3 new Catapult trigger and the Catapult for ETF trigger in the Catapult and CBI Section. With all that action, I decided not to leg into another SPY lot just yet. A more substantial CBI spike or hint of a reversal could entice me further in the next few days.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
BAC	6/24/2008	\$25.88	\$24.59	-4.98%		Catapult
UNH	6/24/2008	\$26.15	\$26.01	-0.54%		Catapult
GM	6/24/2008	\$12.76	\$11.55	-9.48%		Catapult
SPY	6/24/2008	\$131.05	\$127.53	-2.69%		
SPY	6/27/2008	\$128.28	\$127.53	-0.58%		

Stocks and ETF's on my Radar

none

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

None

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