

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 3, 2008

Issue 96

## 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
July 2, 2008	CBI=10	1-8 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 7/3/08**

The stock market got whacked again today. The S&P 500 lost 1.8%, the Dow 1.5% and the Nasdaq 2.3%. Volume came in relatively light. Breadth, as has been the case lately, was horrible.

One of the themes I've been touching on recently is that the persistency of the selloff is unlike anything we've seen in recent history. There have been no sharp reversals like those that littered the previous bear market. In [tonight's blog](#) I pointed out that the S&P 500 and Dow have now closed below their 10-day moving averages for 19 days in a row. Looking back to 1960, there were 21 other times this happened in the S&P 500, but only once since 1984.

I devised a simple study that showed what would happen if you bought the S&P on the 20<sup>th</sup> day below the 10-ma and then sold when the S&P closed above it. (\$100,000 per trade.) Results of the study are on the next page. I find the drawdown figures in the last column to be especially notable.

#	Type	Date	Price	Shares/Ctrts	% Profit	Run-up
				Profit/Loss		Drawdown
1	Buy	1/29/1962	\$67.90	1472	1.38%	\$1,383.68
	Sell	1/31/1962	\$68.84	\$1,383.68		\$0.00
2	Buy	4/17/1962	\$67.90	1472	0.54%	\$544.64
	Sell	4/18/1962	\$68.27	\$544.64		\$0.00
3	Buy	5/22/1962	\$62.34	1604	-12.72%	\$0.00
	Sell	6/28/1962	\$54.41	(\$12,719.72)		(\$16,072.08)
4	Buy	6/14/1965	\$84.01	1190	2.06%	\$2,058.70
	Sell	6/17/1965	\$85.74	\$2,058.70		\$0.00
5	Buy	3/15/1966	\$87.35	1144	1.35%	\$1,349.92
	Sell	3/18/1966	\$88.53	\$1,349.92		\$0.00
6	Buy	11/8/1967	\$91.14	1097	1.60%	\$1,601.62
	Sell	11/16/1967	\$92.60	\$1,601.62		\$0.00
7	Buy	2/13/1968	\$89.07	1122	1.98%	\$1,974.72
	Sell	2/20/1968	\$90.83	\$1,974.72		\$0.00
8	Buy	1/10/1969	\$100.93	990	1.24%	\$1,237.50
	Sell	1/16/1969	\$102.18	\$1,237.50		(\$524.70)
9	Buy	6/16/1969	\$98.32	1017	-1.01%	\$0.00
	Sell	6/27/1969	\$97.33	(\$1,006.83)		(\$2,125.53)
10	Buy	12/11/1969	\$90.52	1104	0.10%	\$320.16
	Sell	12/18/1969	\$90.61	\$99.36		(\$1,457.28)
11	Buy	2/6/1970	\$86.33	1158	0.79%	\$787.44
	Sell	2/9/1970	\$87.01	\$787.44		\$0.00
12	Buy	5/1/1970	\$81.44	1227	-8.39%	\$0.00
	Sell	5/28/1970	\$74.61	(\$8,380.41)		(\$14,908.05)
13	Buy	5/27/1971	\$99.40	1006	1.57%	\$1,569.36
	Sell	6/2/1971	\$100.96	\$1,569.36		\$0.00
14	Buy	8/9/1971	\$93.53	1069	1.21%	\$1,207.97
	Sell	8/11/1971	\$94.66	\$1,207.97		\$0.00
15	Buy	2/9/1973	\$114.68	871	1.20%	\$1,201.98
	Sell	2/12/1973	\$116.06	\$1,201.98		\$0.00
16	Buy	11/27/1973	\$95.70	1044	0.85%	\$2,035.80
	Sell	12/7/1973	\$96.51	\$845.64		(\$3,695.76)
17	Buy	4/15/1974	\$92.05	1086	1.75%	\$1,748.46
	Sell	4/16/1974	\$93.66	\$1,748.46		\$0.00
18	Buy	1/31/1977	\$102.03	980	-0.52%	\$499.80
	Sell	2/16/1977	\$101.50	(\$519.40)		(\$1,773.80)
19	Buy	3/14/1980	\$105.42	948	-3.17%	\$284.40
	Sell	3/31/1980	\$102.08	(\$3,166.32)		(\$7,299.60)
20	Buy	2/9/1984	\$155.41	643	1.34%	\$1,343.87
	Sell	2/24/1984	\$157.50	\$1,343.87		(\$2,109.04)
21	Buy	2/12/2003	\$818.68	122	3.97%	\$4,171.18
	Sell	2/18/2003	\$851.17	\$3,963.78		(\$1,511.58)

In most cases the market was pretty well washed out after 20 days of selling. The two big exceptions were May/June 1962 and May 1970, and they were very big exceptions.

Based on most everything I'm seeing, chances remain good that the market is near a bounce.

An updated Aggregator chart is below:



Not much has changed as far as the Aggregator is concerned. Expectations based on the active studies remain positive (green line) and the S&P has continued to underperform expectations. This is normally the kind of setup where the market would bounce. I still believe the edge is to the upside.

***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, it's 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.

<b>Nasdaq Closes Down At Least 9% from the high of 4 weeks ago, but still leads NYSE Comp.</b>													
<b>Buy NYSE Comp at close. Sell X weeks later. \$100,000 per trade. 1972-present.</b>													
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	\$29,260.46	\$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:

<b>Nasdaq Closes Down At Least 5% from the high of 4 weeks ago, but still leads NYSE Comp.</b>													
<b>Buy NYSE Comp at close. Sell X weeks later. \$100,000 per trade. 1972-present.</b>													
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	% Profit	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 19<sup>th</sup> 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 11<sup>th</sup>, 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

AIG – bought 1/3 position @ \$27.51

FDX – bought 1/3 position @ \$77.04

F – bought 1/3 position @ \$4.71

AIG – bought 1/3 position @ \$26.09

C – bought 1/3 position @ \$16.57

F – bought 1/3 position @ \$4.71

NYX – bought 1/3 position @ \$49.51

#### **New Catapult Triggers**

F – buy last 1/3 @ \$4.36 (*play EXTRA light if at all*)

NYX – buy 1/3 position @ \$47.72

BAC – buy 1/3 position @ \$22.54

The risk side of the equation has been ratcheted up with the Catapult trades. This has been discussed in a few recent letters. I’m continuing to take positions smaller than normal. Ford (F) is extra risky since it is trading below \$5. Certainly no way to reduce risk and exposure by using options on such a low-priced stock. I needed to list it to keep a proper CBI count. You don’t need to trade it if you’re not comfortable with it. Since I’m going smaller with my Catapult trades, I am going bigger with my index trades. Again, a matter of preference in a difficult market.

#### ***Open Big 50 Trades***

None

#### ***Catapult for ETF’s Trades***

DIA – bought @ \$113.46

***Broad Market Large Cap CBI – 11/6 ( BAC-2, AIG-2, FDX, F-3, C, NYX-2)***

***Sector CBI Breakdown (% of stocks with active catapult triggers within each sector.)***

Index	ETF	CBI %	Index	ETF	CBI %
DJ US Broker Dealers	IAI	13.79	DJ US Energy	IYE	1.16
DJ US Insurance Index	IAK	13.51	DJ US Financial	IYF	9.25
DJ US Regional Banks	IAT	8.75	DJ US Financial Services	IYG	9.79
DJ US Utilities	IDU	2.70	DJ US Healthcare	IYH	2.82
DJ US Oil&Gas Expl & Prod	IEO	0.00	DJ US Industrial Sector	IYJ	10.73
DJ US Oil Equip & Svcs	IEZ	1.92	DJ US Consumer Goods	IYK	16.33
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	9.46
DJ US Healthcare Providers	IHF	4.08	DJ US Real Estate	IYR	3.66
DJ US Medical Devices	IHI	2.44	DJ US Transportation	IYT	4.76
DJ US Aerospace & Defense	ITA	22.22	DJ US Technology Sector	IYW	4.02
DJ US Home Construction	ITB	9.52	DJ US Telecommunications	IYZ	5.26
DJ US Consumer Svcs	IYC	12.72	Nasdaq 100	QQQQ	5.00

**Additional New Trade Ideas**

*See Catapult section above.*

*I will hold off on entering the last ¼ of the SPY allocation for now.*

**Active Trades Table**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
BAC	6/24/2008	\$25.88	\$22.54	-12.91%		Catapult
UNH	6/24/2008	\$26.15	\$25.12	-3.94%		sell on open
GM	6/24/2008	\$12.76	\$11.22	-12.07%		sold on open
SPY	6/24/2008	\$131.05	\$126.14	-3.75%		
SPY	6/27/2008	\$128.28	\$126.14	-1.67%		
AIG	6/30/2008	\$27.51	\$26.75	-2.76%		Catapult
FDX	6/30/2008	\$77.04	\$74.70	-3.04%		Catapult
KFT	6/30/2008	\$28.39	\$28.72	1.16%		sell on open
DIA	6/30/2008	\$113.46	\$112.20	-1.11%		Catapult for ETF's
F	7/1/2008	\$4.71	\$4.36	-7.43%		Catapult
AIG	7/1/2008	\$26.09	\$26.75	2.53%		Catapult
C	7/1/2008	\$16.57	\$16.84	1.63%		Catapult
SPY	7/1/2008	\$126.52	\$126.14	-0.30%		
F	7/2/2008	\$4.71	\$4.36	-7.43%		Catapult
NYX	7/2/2008	\$49.51	\$47.72	-3.62%		Catapult

Like GM yesterday, UNH shot up today and triggered an intraday exit before falling apart. Subscribers were alerted via email shortly after the open. The KFT exit triggered in the afternoon and subscribers were alerted to that as well.

**Stocks and ETF's on my Radar**

*none*

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

*None*

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