

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 8, 2008

Issue 98

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 10, 2008	VXO Stretch SPX Low	10 days	Bullish
July 7, 2008	5 Weeks Lower	1-10 weeks	Bearish
July 7, 2008	Bounce off 100 day support	1-5 days	Bullish
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 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 7/8

The market continued its relentless slide today. It began with another mid-sized gap up. Buying mid-sized gaps up in a downtrend has historically been a losing day-trade. The last three days buying those gaps up would have been disastrous. As I mentioned yesterday – look for a gap of 0.75% or more in either direction to provide an upside edge. Less than that and your playing with fire. Volume was higher than average but not extraordinary. Breadth once again was heavily skewed to the negative with decliners down volume outnumbering advancers and up volume by more than 2 to 1.

The selloff today did lead to a small spike in the VXO. While not as blatant as the spikes we saw in January and March, it reached levels that more often than not do lead to rebounds. Below I ran a test that looked at buying the SPX when the VXO spiked while the SPX made a new low:

SPX closes at 50-day low and VXO stretches at least 12% > 10-day MA intraday. Buy SPX on close. Sell X days later.									
"X" Days	Trades	% Profitable	Wins	Losses	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
10	47	57.45	27	20	\$3,407.31	(\$2,460.74)	1.38	\$910.26	1.87
9	50	56.00	28	22	\$3,717.20	(\$2,823.08)	1.32	\$839.48	1.68
8	53	60.38	32	21	\$2,975.74	(\$2,583.46)	1.15	\$773.03	1.76
7	55	58.18	32	23	\$2,916.33	(\$2,392.29)	1.22	\$696.36	1.70
6	59	61.02	36	23	\$2,567.93	(\$2,225.23)	1.15	\$699.41	1.81
5	62	61.29	38	24	\$2,334.07	(\$1,628.25)	1.43	\$800.27	2.27
4	69	65.22	45	24	\$1,824.00	(\$2,466.82)	0.74	\$331.54	1.39
3	77	64.94	50	27	\$1,686.70	(\$1,869.40)	0.90	\$439.76	1.67
2	89	61.80	55	34	\$1,720.25	(\$1,608.60)	1.07	\$448.56	1.73
1	124	60.48	75	49	\$1,275.58	(\$1,175.10)	1.09	\$307.17	1.66

If I keep the same entry criteria, but exit the trade when the VXO closes below its 10-day moving average that provides the following results:

TradeStation Performance Summary				Expand ▾
All Trades				
Total Net Profit	\$38,151.29	Profit Factor	2.17	
Gross Profit	\$70,755.84	Gross Loss	(\$32,604.55)	
Total Number of Trades	49	Percent Profitable	75.51%	
Winning Trades	37	Losing Trades	12	
Even Trades	0			
Avg. Trade Net Profit	\$778.60	Ratio Avg. Win:Avg. Loss	0.70	
Avg. Winning Trade	\$1,912.32	Avg. Losing Trade	(\$2,717.05)	
Largest Winning Trade	\$7,500.06	Largest Losing Trade	(\$10,274.88)	
Max. Consecutive Winning Trades	11	Max. Consecutive Losing Trades	2	
Avg. Bars in Winning Trades	5.19	Avg. Bars in Losing Trades	10.17	
Avg. Bars in Total Trades	6.41			
Max. Shares/Contracts Held	224	Account Size Required	\$19,857.38	
Return on Initial Capital	38.15%	Annual Rate of Return	2.20%	
Return Retracement Ratio	0.24	RINA Index	156.84	
Trading Period	14 Yrs, 8 Mths, 18 Dys	Percent of Time in the Market	7.46%	
Max. Equity Run-up	\$47,541.37			

While today's spike may not seem like much compared to the March and January spikes, a 12% intraday stretch does seem to provide a quantifiable edge.

Another measure of sentiment that I've neglected to mention which is in extreme territory is the Investors Intelligence Survey. The bears last week reached 44.7%, which is the highest reading in 12 years. The bulls are at an extremely low level of 31.9%. When this survey hits extremes, it tends to be a decent contrarian signal. The next release of the survey is tomorrow. It will be interesting to see if the extreme readings continue.

Breadth indicators continue to scream "BUY!" Unfortunately, this has been the case for several days now. One indicator I monitor is provided by Worden Bros. It measures the % of Stocks that are trading at least 2 standard deviations below their 40-day moving average (T2116). Rather than looking at stocks that are simply in a downtrend, like the "% of stocks below the 40-day MA", it looks for extreme readings. Of all the commercially available breadth indicators out there, this one most represents the spirit of the CBI. While the criteria are less stringent, it is still looking for somewhat extreme

conditions to measure. Today T2116 hit a new high of 58.1%. The indicator dates back to 1986. I looked back to find all days that had readings higher than today's. It was a short list: 7/23/02, 9/20 & 9/21/01, 8/31/98, and lastly 10/19/87 (Black Monday) through 10/28/87. That's it. If you take a look at those dates you'll find they were very opportune times to buy.

Also of note is the fact that the [McClellan Oscillator](#) dipped below 200 again today. These two breadth indicators are simply confirming what the rest have been saying for several days now: from a breadth standpoint, this selloff is extremely overdone.

The biggest issue right now in my eyes remains the downside persistence. Even so, it appears the market is getting to the point where it is going to need to pop higher soon. I'd be quite surprised if it didn't happen by the end of this week. Most likely I'd expect to see a pop in the next day or two. As I type this around 1am Eastern the futures are getting hit hard. The S&P futures are down about 0.75%, so it's possible that we could get the large gap that might turn into a washout and reversal. Should the large gap happen I will definitely be focusing intraday as well as swing trades on the long side.

Intermediate-term Outlook (1 week – 2 months) -neutral – updated 7/7

The preliminary Michigan Consumer Sentiment Survey is set to come out on Friday the 11th. 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. This is the 1st time in the 30 years that number has been tracked on a monthly basis where it has closed below its lower 10% envelope without bouncing for 5 months in a row. Negative reactions this extreme do tend to be overreactions, so even though we're in uncharted territory I'd still consider this extreme reading a long-term positive. It will be interesting to see whether Friday's release signals a bounce from 56.40 or whether the number will get even more extreme.

The biggest and most prevalent concern I have right now with the market is the persistency of the recent selloff. On Wednesday night I discussed the fact that the S&P and Dow were close to closing below their 10-day moving averages for the 20th day in a row. They accomplished that feat on Thursday. As I showed, this was not uncommon in the 60's, 70's and even early 80's. Since the Crash of '87, though, the S&P 500 has only managed this once. Below again are all the instances ordered by the amount of time each occurrence lasted:

20th Day Below	Total # of Days Below
April 17, 1962	20
February 6, 1970	20
February 9, 1973	20
April 15, 1974	20
January 29, 1962	21
August 9, 1971	21
June 14, 1965	22
March 15, 1966	22
May 27, 1971	22
February 12, 2003	22
January 10, 1969	23
February 13, 1968	24
December 11, 1969	24
November 8, 1967	25
November 27, 1973	27
June 16, 1969	28
February 9, 1984	29
March 14, 1980	30
January 31, 1977	31
May 1, 1970	38
May 22, 1962	45

The May '62 and May '70 occurrences were also the worst in terms of selling from the 20th day forward. In 1962 the market sold off and additional 16% before bouncing. In 1970 it dropped another 14%. The 1980 occurrence saw an additional drop of over 7% before rebounding above the 10ma. All of the other instances dropped less than 4% further before bouncing, with 11 of them never closing below their close on the 20th day.

In many cases the selloff ended with a quick acceleration to the downside. A few ways I looked at the acceleration included a 3-period RSI dropping below 15 or a stretch below the 10-period ma greater than any previous stretch. Nearly every instance saw the 3-period RSI drop and many the 10-ma stretch. The S&P did drop sharply on Wednesday with the 3-day RSI closing at 13, and it's possible that was the acceleration needed to provide a bounce. It's not completely clear, though.

Another example of the selling persistence is one I mentioned in Thursday's blog. Two regional bank ETF's, KBE and RKH have now both closed below their 10-day moving averages for 41 days in a row. I was unable to find any other ETF that has ever done this. Of course most of them have a limited history. I did look back to 1920 to see if the Dow had ever done it and the longest it went below its 10-day moving average was 36 days. The persistence is certainly worrisome.

So the big question is: Is the market environment reverting back to the way it acted prior to 1987 or will the extreme breadth and time readings provide enough energy to force a bounce that will stick?

I go back to the Crash of '87 for a few reasons. First, it was the last time that strong negative breadth readings, such as the % below 40ma and the 10-day Advance/Decline EMA led to further selling, and in a big way. Second, it led to changes in the way the

market is governed and monitored. Some changes, such as the implementation of [trading curbs](#), are well documented. Others, such as the [President's Working Group](#), are clouded in mystery. Whatever the reason, breadth extremes as we've seen recently have consistently marked buying opportunities over the last 20+ years. I'm am not yet convinced that the market is likely to revert to a 60's or 70's type of environment.

Even without such bugaboos as government intervention, there are real reasons why bear market rallies tend to be extremely sharp. When the market gets stretched enough to attract bottom fishers and begins to bounce, this will many times lead to short-covering rallies. The bear market of 2000-2003 was littered with these and we've already seen a few this year. Some times these short-covering rallies will lead to something more and sometimes they will quickly peter out. In either case they tend to be extremely sharp. We're at a point in time where more people are able to short the market than ever before. Abolishment of the uptick rule last summer has received a lot of press, but inverse etf's are a new breed of investment that has changed the landscape as well. With inverse etf's many people are able to short the market in their retirement account that were never able to do so before. The more shorts, the more potentially furious the short covering. We saw this in January and March when the CBI and other measures became stretched and then rebounded with ferocity that has rarely been seen.

Of course the January and March rallies were ignited by the Fed intervention –seemingly as a reaction to a huge drop in the futures. While it seems unlikely that we'll get that kind of intervention this time, it should be recalled that both those “Fed moves” were quickly retraced before the rallies fully launched. This suggests that the rallies may have taken place even if the Fed had not moved exactly when it did. The market perhaps was ready to rally and the rates cutes were used as an excuse to do so.

Enough theory, though. Back to some hard evidence. Below is one last example of why the persistent downtrend has me worried:

S&P 500 closes lower 5 weeks in a row. Buy at close. Sell "X" weeks later. \$100,000 per trade.													
X Weeks	Net Profit	Gross Profit	Gross Loss	Trades	Wins	% Winners	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
20	(\$32,429.11)	\$4,311.39	(\$36,740.50)	8	3	37.50	\$1,672.62	(\$15,842.36)	\$1,437.13	(\$7,348.10)	0.20	(\$4,053.64)	0.12
19	(\$30,561.90)	\$5,961.81	(\$36,523.71)	8	3	37.50	\$3,046.29	(\$17,128.50)	\$1,987.27	(\$7,304.74)	0.27	(\$3,820.24)	0.16
18	(\$19,575.78)	\$7,226.73	(\$26,802.51)	8	2	25.00	\$5,521.20	(\$13,510.48)	\$3,613.37	(\$4,467.09)	0.81	(\$2,446.97)	0.27
17	(\$12,993.99)	\$7,012.38	(\$20,006.37)	8	2	25.00	\$6,497.04	(\$9,904.48)	\$3,506.19	(\$3,334.40)	1.05	(\$1,624.25)	0.35
16	(\$12,998.81)	\$6,279.53	(\$19,278.34)	8	2	25.00	\$4,914.51	(\$11,142.54)	\$3,139.77	(\$3,213.06)	0.98	(\$1,624.85)	0.33
15	(\$22,048.81)	\$8,672.48	(\$30,721.29)	8	2	25.00	\$5,213.04	(\$15,662.06)	\$4,336.24	(\$5,120.22)	0.85	(\$2,756.10)	0.28
14	(\$12,318.68)	\$9,569.25	(\$21,887.93)	8	4	50.00	\$3,434.70	(\$13,065.74)	\$2,392.31	(\$5,471.98)	0.44	(\$1,539.84)	0.44
13	(\$18,405.42)	\$4,637.79	(\$23,043.21)	8	4	50.00	\$2,144.07	(\$14,436.02)	\$1,159.45	(\$5,760.80)	0.20	(\$2,300.68)	0.20
12	(\$28,583.38)	\$7,671.21	(\$36,254.59)	8	3	37.50	\$3,539.70	(\$25,013.62)	\$2,557.07	(\$7,250.92)	0.35	(\$3,572.92)	0.21
11	(\$23,814.06)	\$10,463.07	(\$34,277.13)	8	3	37.50	\$5,072.70	(\$21,888.42)	\$3,487.69	(\$6,855.43)	0.51	(\$2,976.76)	0.31
10	(\$28,458.04)	\$8,960.97	(\$37,419.01)	8	3	37.50	\$7,924.38	(\$15,638.02)	\$2,986.99	(\$7,483.80)	0.40	(\$3,557.26)	0.24
9	(\$31,029.36)	\$11,892.36	(\$42,921.72)	8	2	25.00	\$9,267.96	(\$21,575.90)	\$5,946.18	(\$7,153.62)	0.83	(\$3,878.67)	0.28
8	(\$19,067.00)	\$9,033.31	(\$28,100.31)	8	4	50.00	\$6,498.54	(\$14,099.46)	\$2,258.33	(\$7,025.08)	0.32	(\$2,383.38)	0.32
7	(\$20,347.82)	\$9,207.33	(\$29,555.15)	8	2	25.00	\$8,500.20	(\$13,222.00)	\$4,603.67	(\$4,925.86)	0.93	(\$2,543.48)	0.31
6	(\$24,913.99)	\$6,827.58	(\$31,741.56)	8	1	12.50	\$6,827.58	(\$13,943.20)	\$6,827.58	(\$4,534.51)	1.51	(\$3,114.25)	0.22
5	(\$16,387.24)	\$9,850.21	(\$26,237.45)	8	3	37.50	\$6,297.46	(\$8,990.96)	\$3,283.40	(\$5,247.49)	0.63	(\$2,048.41)	0.38

This test was run from 1960-present. Again, only 8 occurrences makes it difficult to draw any solid conclusions. Still, these numbers are terrible. The maximum gain 20 weeks later is only 1.7%! The average loss is over 7% and the average trade lost over 4%. There were only three occurrences since 1988, but none of them were positive. They were 8/24/90, 10/13/00 and 3/2/01. Downtrend persistence like we're seeing has historically been bearish

To sum up what I'm looking at:

- 1) Breadth is extremely oversold by several measures. Using any of these would have provided traders a long-side edge over the last 20 years. Previous to that, it did not provide an upside edge. Evidence of this can be seen in the [Adv/Decl EMA study](#), which looked back farther than any of the other breadth studies.
- 2) Sentiment from traditional market measures such as Put/Call Ratios and VIX readings is not yet stretched. Many bottoms occur when it is but it is not always necessary. This was shown in the [CBI vs. VXO study](#) and [the Put/Call Study](#). Sentiment from a consumer survey measure is as stretched as it has ever been.
- 3) The persistency of the current move down is troubling and something that has rarely been seen in the last 20 years. Should we be moving into an environment reminiscent of earlier periods, many of the studies that seem to be providing upside edges may be inaccurate. I am not yet convinced this is the case.

I am now neutral on the market from an intermediate-term perspective. It certainly appears a bounce is likely in the near-term. The power and action of that bounce may tell a lot about the intermediate-term. Rather than make intermediate or long-term bets in a precarious environment, I'll defer to the short-term analysis as my best guide.

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
F – bought last 1/3 @ \$4.36
NYX – bought 1/3 position @ \$47.72
BAC – bought 1/3 position @ \$22.54
UNH – bought 1/3 position @ \$22.71
NYX – bought 1/3 position @ \$47.07
BAC – bought 1/3 position @ \$22.54

New Catapult Triggers

CBS – buy @ \$17.73

The risk side of the equation has been ratcheted up with the Catapult trades. This has been discussed in recent letters. I'm continuing to take positions smaller than normal. Under normal circumstances it pays to let the trades run after intraday exit triggers are hit. The recent GM and UNH trades suggest taking profits or tightly trailing stops after the intraday target is achieved is likely the way to go in this environment. I'll continue to send timely emails on any targets hit. 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

MDY – buy @ \$141.67

Broad Market Large Cap CBI – 15/7 (BAC-3, AIG-2, FDX, F-3, C, NYX-3, UNH, CBS)

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

Index	ETF	CBI %	Index	ETF	CBI %
DJ US Broker Dealers	IAI	17.24	DJ US Energy	IYE	6.98
DJ US Insurance Index	IAK	12.16	DJ US Financial	IYF	16.10
DJ US Regional Banks	IAT	13.75	DJ US Financial Services	IYG	13.29
DJ US Utilities	IDU	1.35	DJ US Healthcare	IYH	4.23
DJ US Oil&Gas Expl & Prod	IEO	0.00	DJ US Industrial Sector	IYJ	9.96
DJ US Oil Equip & Svcs	IEZ	13.46	DJ US Consumer Goods	IYK	14.29
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	10.81
DJ US Healthcare Providers	IHF	8.16	DJ US Real Estate	IYR	19.51
DJ US Medical Devices	IHI	2.44	DJ US Transportation	IYT	4.76
DJ US Aerospace & Defense	ITA	16.67	DJ US Technology Sector	IYW	6.53
DJ US Home Construction	ITB	14.29	DJ US Telecommunications	IYZ	7.89
DJ US Consumer Svcs	IYC	14.47	Nasdaq 100	QQQQ	9.00

Capitulation is evident in nearly all groups. Based on the CBI % 's, groups most likely to benefit from a short-term bounce would include Aerospace & Defense, Financial and Real Estate.

Additional New Trade Ideas

See Catapult section above. Note both CBS and the MDY Catapult for ETF's trade.

I will hold off on entering the last ¼ of the SPY allocation for now. While I don't initiate positions via intraday alerts, subscribers should be aware of the large gap studies I referenced in the short-term outlook section. The reason I don't initiate intraday is I prefer subscribers have ample time to consider the trade ideas rather than making snap decisions on them. If not for the MDY trade tonight, I may have considered adding the last piece

I had hoped to have time to review the Catapult trades from June/July this evening and compare them to past bottoms. I will try and do this in the next day or two. Needless to say, this has been the by far the worst I have ever seen them perform. The nature of the selloff has been difficult for these trades due to the incredible persistence and very weak bounces.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
BAC	6/24/2008	\$25.88	\$21.53	-16.81%		Catapult
SPY	6/24/2008	\$131.05	\$125.02	-4.60%		
SPY	6/27/2008	\$128.28	\$125.02	-2.54%		
AIG	6/30/2008	\$27.51	\$25.94	-5.71%		Catapult
FDX	6/30/2008	\$77.04	\$75.00	-2.65%		Catapult
DIA	6/30/2008	\$113.46	\$112.21	-1.10%		Catapult for ETF's
F	7/1/2008	\$4.71	\$4.47	-5.10%		Catapult
AIG	7/1/2008	\$26.09	\$25.94	-0.57%		Catapult
C	7/1/2008	\$16.57	\$16.40	-1.03%		Catapult
SPY	7/1/2008	\$126.52	\$125.02	-1.19%		
F	7/2/2008	\$4.71	\$4.47	-5.10%		Catapult
NYX	7/2/2008	\$49.51	\$46.24	-6.60%		Catapult
NYX	7/3/2008	\$47.72	\$46.24	-3.10%		Catapult
F	7/3/2008	\$4.36	\$4.47	2.52%		Catapult
BAC	7/3/2008	\$22.54	\$21.53	-4.48%		Catapult
NYX	7/7/2008	\$47.07	\$46.24	-1.76%		Catapult
UNH	7/7/2008	\$22.71	\$23.31	2.64%		Catapult
BAC	7/7/2008	\$22.40	\$21.53	-3.88%		Catapult

Stocks and ETF's on my Radar

none

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

None

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