QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 9, 2008 Issue 99

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 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 7/9

I've been expecting a bounce for a few days now and the market finally put one in today. The major indices rose between 1.25% and 2.5%, with the S&P 500 rising 1.7%. Volume came in fairly heavy but not too far above normal. Breadth was positive by about 2 to 1. While is all sounds nice, it really wasn't very impressive overall considering how oversold the market was.

In the blog tonight I followed up on last night's post and showed the 1st day gains following the other times the "% of Stocks 2 Standard Deviations Below Their 40-day MA" rose above 58%. As you can see below, today's move didn't stack up:

October 20, 1987	5.33%
September 1, 1998	3.86%
September 24, 2001	3.90%
July 24, 2002	5.73%
July 8, 2008	***1.71%***

I then looked at the significance of the size of a move coming off a 100-day low. The conclusion was that there seemed to be little or no edge unless you had a move of 3% or greater. Below is a table that breaks down moves of 1%-3% by days held after a 100 day low:

Yesterday S&P 500 makes 100 day low. Today it rises between 1 and 3 percent. Buy at close. Sell "X" days later.										
$100,000 per trade. 1960 - present										
X Days	**Net Profit**	**Trades**	**% Wins**	**Max Win**	**Max Loss**	**Avg Win**	**Avg Loss**	**W/L Ratio**	**Avg Trade**	**Profit Factor**
15	($13,101.95)	37	51.35	$10,450.00	($10,130.38)	$3,217.96	($4,124.62)	0.78	($354.11)	0.82
14	($9,687.90)	38	50.00	$11,460.00	($9,129.90)	$3,141.48	($3,651.37)	0.86	($254.94)	0.86
13	($7,601.64)	39	51.28	$12,387.50	($11,653.64)	$2,977.29	($3,534.07)	0.84	($194.91)	0.89
12	($4,554.55)	40	57.50	$10,667.17	($7,889.28)	$2,705.85	($3,928.78)	0.69	($113.86)	0.93
11	($3,667.77)	41	53.66	$12,198.75	($8,455.68)	$2,893.27	($3,543.14)	0.82	($89.46)	0.95
10	($412.91)	42	52.38	$11,451.25	($8,888.10)	$2,829.26	($3,132.83)	0.90	($9.83)	0.99
9	$20,694.06	45	57.78	$14,141.40	($7,615.20)	$3,025.53	($3,051.03)	0.99	$459.87	1.36
8	$2,559.94	47	61.70	$13,208.26	($7,017.00)	$2,560.15	($3,982.47)	0.64	$54.47	1.04
7	$5,083.55	48	47.92	$11,043.76	($9,893.00)	$3,383.61	($2,909.58)	1.16	$105.91	1.07
6	$6,206.21	48	52.08	$11,794.12	($8,645.00)	$2,803.50	($2,777.45)	1.01	$129.30	1.10
5	$12,038.34	49	53.06	$10,340.00	($6,045.00)	$2,767.20	($2,604.73)	1.06	$245.68	1.20
4	($4,722.21)	52	53.85	$5,870.01	($6,162.00)	$1,984.88	($2,512.45)	0.79	($90.81)	0.92
3	($8,084.49)	54	50.00	$5,794.56	($5,738.56)	$1,695.89	($2,072.06)	0.82	($149.71)	0.85
2	$7,349.78	54	48.15	$4,983.16	($4,145.45)	$1,749.62	($1,362.16)	1.28	$136.11	1.19
1	$12,384.08	54	53.70	$3,184.32	($2,723.75)	$1,023.55	($691.96)	1.48	$229.33	1.72

I ran tests about 20 different ways tonight looking at possible effects, including putting breadth and volume into the mix. It didn't seem to make much difference what I did unless the initial bounce day was a move of 3% or more. Results like those above were typical. Pretty much every test showed the same early pattern with some edge for at least day 1 and 2 before petering out and bouncing around with mixed results. This may suggest a slight upside edge for at least tomorrow.

Below is an updated Aggregator chart:

Created with TradeStation

The green Aggregator line remains in positive territory, suggest the current studies still favor upside. The black differential line has now dipped below 0 though, indicating performance over the last 3 days was slightly better than expected. This is normally a formation where I might look to take profits in index trades. I'm going to hold out another day, though.

The CBI remains fairly high at 8, the study above suggests we may be better off waiting one more day, and Catapult for ETF's trades in MDY and DIA did not yet trigger exits. Also, the market is coming off of some incredibly oversold readings and the rally didn't really kick in until near the end of the day. It seems there's a good chance of some follow-through tomorrow or the next day. Therefore, I'm planning on giving it a little more time.

Should we get further upside tomorrow, I'll likely begin to aggressively scale out of the long index trades, perhaps just leaving a small portion on after that.

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	($24,913.98)	$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. Downside persistence like we're seeing has historically been bearish

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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
NYX – bought 1/3 position @ $49.51
NYX – bought 1/3 position @ $47.72
BAC – bought 1/3 position @ $22.54
UNH – bought1/3 position @ $22.71
NYX – bought 1/3 position @ $47.07
BAC – bought 1/3 position @ $22.54
CBS – bought 1/3 position @ $17.59

Open Big 50 Trades

None

Catapult for ETF's Trades

DIA – bought @ $113.46
MDY –bought @ $141.67

Broad Market Large Cap CBI – 8/4 (BAC-3, 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	13.79		DJ US Energy	IYE	10.47
DJ US Insurance Index	IAK	5.41		DJ US Financial	IYF	10.62
DJ US Regional Banks	IAT	10.00		DJ US Financial Services	IYG	9.09
DJ US Utilities	IDU	1.35		DJ US Healthcare	IYH	2.11
DJ US Oil&Gas Expl & Prod	IEO	1.72		DJ US Industrial Sector	IYJ	6.51
DJ US Oil Equip & Svcs	IEZ	17.31		DJ US Consumer Goods	IYK	6.80
DJ US Pharmaceuticals	IHE	0.00		DJ US Basic Materials	IYM	9.46
DJ US Healthcare Providers	IHF	6.12		DJ US Real Estate	IYR	13.41
DJ US Medical Devices	IHI	2.44		DJ US Transportation	IYT	4.76
DJ US Aerospace & Defense	ITA	0.00		DJ US Technology Sector	IYW	5.53
DJ US Home Construction	ITB	9.52		DJ US Telecommunications	IYZ	5.26
DJ US Consumer Svcs	IYC	11.40		Nasdaq 100	QQQQ	8.00

Last night I wrote the following, "*Based on the CBI %'s, groups most likely to benefit from a short-term bounce would include Aerospace & Defense, Financial and Real Estate.*" Today Aerospace & Defense rose 2.9%, Financial rose 5.9%, and Real Estate rose 7.24%. When the CBI percentages get as high as they were last night (16%-20%) and the market is suggesting a bounce is in order, it is normally a good bet that the groups with the biggest CBI%'s are going to get the best bounce. Normally I stick to the individual stocks and the broad indices, but this is certainly another way to play the Catapult and CBI trades. I discuss it some in the Catapult Presentation as well.

Additional New Trade Ideas

None tonight. Let's see how the bounce plays out over the next day or two. Hopefully we can take some profits and then begin to position for the next move.

I still plan to review the most recent Catapult cluster and will hopefully get to it tomorrow.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
BAC	6/24/2008	$25.88	$23.54	-9.04%		Catapult
SPY	6/24/2008	$131.05	$127.20	-2.94%		
SPY	6/27/2008	$128.28	$127.20	-0.84%		
AIG	6/30/2008	$27.51	$27.40	-0.40%		sell on open
FDX	6/30/2008	$77.04	$77.49	0.58%		sell on open
DIA	6/30/2008	$113.46	$113.87	0.36%		Catapult for ETF's
F	7/1/2008	$4.71	$4.90	4.03%		sell on open
AIG	7/1/2008	$26.09	$27.40	5.02%		sell on open
C	7/1/2008	$16.57	$17.39	4.95%		sell on open
SPY	7/1/2008	$126.52	$127.20	0.54%		
F	7/2/2008	$4.71	$4.90	4.03%		sell on open
NYX	7/2/2008	$49.51	$47.36	-4.34%		Catapult
NYX	7/3/2008	$47.72	$47.36	-0.75%		Catapult
F	7/3/2008	$4.36	$4.90	12.39%		sell on open
BAC	7/3/2008	$22.54	$23.54	4.44%		Catapult
NYX	7/7/2008	$47.07	$47.36	0.62%		Catapult
UNH	7/7/2008	$22.71	$23.28	2.51%		Catapult
BAC	7/7/2008	$22.40	$23.54	5.09%		Catapult
CBS	7/8/2008	$17.59	$17.81	1.25%		Catapult
MDY	7/8/2008	$141.67	$145.26	2.53%		Catapult for ETF's

What a difference a day makes. A lot of yesterday's losers are currently in the green. BAC came within a few cents of its exit trigger. Basically any higher close tomorrow will trigger an exit. A decent move up intraday would do it as well. I'll send out an intraday update with a target in the morning.

Stocks and ETF's on my Radar

none

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

None