

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

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July 11, 2008

Issue 101

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## 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	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	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 7/11***

The manic market continued Thursday. The major indices all closed higher, with the Dow and S&P changing direction for the 6<sup>th</sup> day in a row. Volume was slightly higher than yesterday, but still a little below average. Breadth was barely positive.

The market didn't tell us a whole lot on Thursday. Buying conviction was not there. While the market went up there was no hint of panic on the part of bears. No scramble to cover shorts. Mediocre breadth and volume don't build a strong case.

One notable is that while the S&P hit a new low, the number of NYSE stocks hitting new lows was significantly lower than a few days ago. According to my data provider there were 454 today compared with 578 on the Monday the 7<sup>th</sup>. I tested this and found a slight edge to the upside. I need to analyze the data a bit more so I'll likely release the findings in full tomorrow. In short, though, this divergence seems to be at least a mildly bullish indication.

The fact that the price moved up a rather meek 0.7% for the S&P 500 is not good news. I looked at weak bounces from lows a few weeks ago in the blog. The results were not promising. Looking at bounces off of longer-term lows like 200-days rather than 20-days the results were no longer negative. They were still subpar compared to a random entry, though.

Tonight's Aggregator chart is below:



While performance over the last few days has been basically flat, the green Aggregator line is still indicating that the studies suggest more upside.

Some of the big news tomorrow will likely be GE's earnings. A strong rally could indicate a momentum follow through into next week. A weak rally could lead to shorting opportunities next week. In my eyes, today is basically a "wait and see" day. I imagine tomorrow's action may provide a clearer edge..

### ***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 11<sup>th</sup>. 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 1<sup>st</sup> 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 20<sup>th</sup> 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:

<b>20th Day Below</b>	<b>Total # of Days Below</b>
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 20<sup>th</sup> 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 20<sup>th</sup> 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	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. Downside 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**

NYX – bought 1/3 position @ \$49.51

NYX – bought 1/3 position @ \$47.72

UNH – bought 1/3 position @ \$22.71

NYX – bought 1/3 position @ \$47.07  
 CBS – bought 1/3 position @ \$17.59  
 EP – bought 1/3 position @ \$18.91

***New Catapult Triggers***

***Open Big 50 Trades***

None

***Catapult for ETF's Trades***

*MDY* –bought @ \$141.67

***Broad Market Large Cap CBI – 6/4 ( NYX-3, UNH, CBS, EP)***

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

<b>Index</b>	<b>ETF</b>	<b>CBI %</b>	<b>Index</b>	<b>ETF</b>	<b>CBI %</b>
DJ US Broker Dealers	IAI	17.24	DJ US Energy	IYE	10.47
DJ US Insurance Index	IAK	6.76	DJ US Financial	IYF	10.27
DJ US Regional Banks	IAT	11.25	DJ US Financial Services	IYG	9.79
DJ US Utilities	IDU	1.35	DJ US Healthcare	IYH	2.11
DJ US Oil&Gas Expl & Prod	IEO	3.45	DJ US Industrial Sector	IYJ	4.98
DJ US Oil Equip & Svcs	IEZ	13.46	DJ US Consumer Goods	IYK	5.44
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	5.41
DJ US Healthcare Providers	IHF	6.12	DJ US Real Estate	IYR	10.98
DJ US Medical Devices	IHI	0.00	DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	0.00	DJ US Technology Sector	IYW	6.03
DJ US Home Construction	ITB	9.52	DJ US Telecommunications	IYZ	5.26
DJ US Consumer Svcs	IYC	9.21	Nasdaq 100	QQQQ	5.00

**Additional New Trade Ideas**

*None tonight. Let's see how the "wait and see" day plays out.*

**Active Trades Table**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
BAC	6/24/2008	\$25.88	\$21.62	-16.46%		sold on open
SPY	6/24/2008	\$131.05	\$125.30	-4.39%		
SPY	6/27/2008	\$128.28	\$125.30	-2.32%		
DIA	6/30/2008	\$113.46	\$111.61	-1.63%		sell on open
SPY	7/1/2008	\$126.52	\$125.30	-0.96%		
NYX	7/2/2008	\$49.51	\$43.82	-11.49%		Catapult
NYX	7/3/2008	\$47.72	\$43.82	-8.17%		Catapult
BAC	7/3/2008	\$22.54	\$21.62	-4.08%		sold on open
NYX	7/7/2008	\$47.07	\$43.82	-6.90%		Catapult
UNH	7/7/2008	\$22.71	\$22.58	-0.57%		Catapult
BAC	7/7/2008	\$22.40	\$21.62	-3.48%		sold on open
CBS	7/8/2008	\$17.59	\$17.47	-0.68%		Catapult
MDY	7/8/2008	\$141.67	\$143.96	1.62%		Catapult
EP	7/10/2008	\$18.90	\$19.74	4.44%		Catapult

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

There are a few "Big 50" trades triggering. If you're looking for possible bounce candidates these could be playable. I won't be officially tracking them as I'd prefer to be extra conservative and just focus on standard Catapults at the moment. Possible trade candidates include:

NVDA  
VLO

(ATI from yesterday has already begin to bounce.)

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

*None*

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