

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 23, 2008

Issue 108

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 22, 2008	Breadth 3:2 +, SPX dn after high	1-10 days	Bullish
July 22, 2008	Low Vol in ST uptrd LT dntrd	1-5 days	Bearish
July 21, 2008	3 Up Days NR7 off 50 low < 200	1-5 days	Bullish
July 18, 2008	Big Volume Big Gain Under 200	1-18 days	Bullish
July 18, 2008	2% then 1% gains under the 200	1-19 days	Bullish
July 16, 2008	Net New Lows	1-4 days	Bullish
July 15, 2008	Failed Gap Up in Downtrend	1-7 Days	Bullish
July 7, 2008	5 Weeks Lower	1-10 weeks	Bearish
June 25, 2008	Advancers Exp MA Ratio Study	1-20 days	Bullish
March 17, 2008	Consumer Sentiment Stretch	1-12 months	Bullish

Short-term Outlook (1-5 days) –neutral – updated 7/23

After gapping down the major indices all posted strong gains of over 1% on higher volume today. Breadth was positive as both advancers and up volume made up about 70% of total issues and total volume.

Under Investors' Business Daily's new rules, which require a 1.7% advance, tonight did not qualify as a Follow Through Day. It did qualify under the original 1% thrust rules. There are a couple of things to note when the market puts in an "Original Follow Through Day". First, based on the 64 FTD's I found in my study between 1971 and January of 2008, the expectation over the next week was positive. Second, however the market moved over course of the next week was a predictor of the success or failure of the FTD about 2/3 of the time. [You may refer here](#) for more details on these statistics.

The strong breadth in the last week has been reflected in the McClellan Oscillator, as is has spiked over 250 points in that time. I could find only 10 other times since 1986 where the McClellan Oscillator spiked this much within a week. Seven of the 10 times it was trading lower 4 days later. The average trade would have lost about 0.9%. Especially notable is that the last six instances have all occurred since 2006 and all six were losers.

An Aggregator chart is below:



Today's move up kept the S&P in a formation where it has been outperforming expectations over the last 3 days. The green Aggregator line is still positive but has pulled back significantly over the last week. I'd like to see a market pullback and a continuation of positive expectations in order to buy aggressively here. The fact that we remain somewhat overbought is keeping me neutral.

Intermediate-term Outlook (1 week – 2 months) -neutral – updated 7/21

The big question on most traders' minds is not the immediate future, but whether the market may have established an intermediate-term low. Will there be further downside or will the market embark on a significant rally? While it's a bit soon to know there are some interesting things to consider.

First, I've noted for the last couple of weeks how the S&P had spent an inordinate amount of time below its 10-day moving average. The streak ended at 28 days with Thursday's move up. This was the longest amount of time since 1984. Prior to that, it happened 5 other times since 1960. I decided to run a test to see whether moves above the line after spending so much time below it typically led to a change in trend. Both short and long-term results were basically 50/50 when using a baseline of 25 days. The

winners were significantly larger than the losers but no indication was evident as to whether it would become a winner or loser.

One metric that suggest an intermediate-term edge to the upside is the fact that breadth had become so extremely negative. Normally breadth measures as bad as we recently saw signify the market has been washed out to the point that an intermediate-term rally is likely to have either begun or is soon to begin. An example is the [Net New Lows study](#) I showed in the blog on Wednesday. Taking oversold net new low conditions like we saw last week and combining that with a bounce of at least 5% over the next 2 days from low to high I devised the following study:

NYSE (New lows - new highs) / Totals Issues > 33% two days ago. SP-500 jumps over 5% from low of 2 days ago.										
Buy on close. Sell X Days later. \$100,000 per trade. 1970 - present										
X Days	Net Profit	Trades	Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
200	\$126,785.17	5	5	\$39,771.20	\$0.00	\$25,357.03	\$0.00	100.00	\$25,357.03	100.00
120	\$84,134.33	5	5	\$26,589.64	\$0.00	\$16,826.87	\$0.00	100.00	\$16,826.87	100.00
100	\$57,372.77	5	5	\$22,879.23	\$0.00	\$11,474.55	\$0.00	100.00	\$11,474.55	100.00
80	\$40,115.13	5	5	\$19,286.30	\$0.00	\$8,023.03	\$0.00	100.00	\$8,023.03	100.00
40	\$14,612.71	5	3	\$9,760.63	(\$5,959.80)	\$7,798.80	(\$4,391.84)	1.78	\$2,922.54	2.66
20	(\$138.92)	5	2	\$6,025.04	(\$4,965.21)	\$4,857.94	(\$3,284.93)	1.48	(\$27.78)	0.99

Over the next month there is mixed results, but the longer you go out the stronger they get. While the number of instances is too low for accurate estimation, the results are impressive – an average return of nearly 17% over the next 6 months and 25% over the next 200 days. While in all cases an intermediate-term low was near, it wasn't always already established. Below are all the results of a 120-day (about 6 month) holding period, along with some notes on each occurrence.

(New lows - new highs) / Totals Issues > 33% two days ago.				
Market jumps over 5% from low of 2 days ago.				
Buy on close. Sell 120 trading days later. 1970 - present.				
Date	Signal	Price	% Profit	Note
5/28/1970	Buy	\$74.61	11.57%	Low never tested.
11/16/1970	Sell	\$83.24		
9/17/1974	Buy	\$67.38	26.08%	<i>Low undercut by about 5% 2-3 weeks later before rally took off.</i>
3/10/1975	Sell	\$84.95		
3/31/1980	Buy	\$102.09	26.60%	Low never tested.
9/19/1980	Sell	\$129.25		
10/21/1987	Buy	\$258.38	5.10%	Low was tested but not undercut
4/13/1988	Sell	\$271.55		1 1/2 months later.
8/27/1990	Buy	\$321.44	14.81%	<i>Low was undercut by 4% a couple of times</i>
2/15/1991	Sell	\$369.06		<i>over the next 2 months before rally stuck.</i>

Over the next few days and weeks I'll be looking for further signs of confirmation that the rally may have staying power. One sign that many traders will be looking for is a Follow Through Day (FTD). Popularized by William O'Neil the FTD is a high-volume rally that comes 4 or more days after the low. While no rally back to 1970 has occurred without a FTD of at least 1%, they are not terribly accurate. There has been about a 54% success rate according to my research. Traders who wish to learn more about the quantitative value of FTD's may read the [research I posted in the blog](#) in January and February. I plan to do a review of them in the blog in the next day or so, but here's a few interesting facts in the meantime:

- 1) FTD's coming more than 10 days after the low have been better at predicting rallies, not worse, as Investors Business Daily frequently suggests.
- 2) While the FTD is only 54% accurate, success or failure can be predicted about 2/3 of the time by how the market performs in the 1st five days following a FTD.

In 2002, [Lowry's research published a terrific paper](#) which looked at market bottoms. One key that they found to new market rallies were "90% days" – essentially days when 90% of the volume and 90% of the points gained or lost on the NYSE went in one direction. While the moves down frequently consisted of a series of 90% downside days, successful rallies occurred when there was one or more 90% upside days following a low. I did some research last fall that suggested two or more 90% upside days within a close proximity following a low increased the odds of success even more.

In summary, while downside breadth has been poor enough that an intermediate-term bottom seems likely in the near future, it is not yet clear whether that bottom has been reached. Clues to look for would include FTD's and 90% Days. I'll continue to monitor the market and evaluate it based on historical precedents in an effort to better assess the chances of a successful rally. At this point I'm moving the bias up to slightly bullish over the intermediate-term. Further confirmation could turn me solidly bullish.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Trades

CBS – bought 1/3 position @ \$17.59

CBS –bought 1/3 position @ \$16.71

Open Big 50 Trades

None

Catapult for ETF's Trades

none

Broad Market Large Cap CBI – 2/1 (CBS-2)

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

Index	ETF	CBI %	Index	ETF	CBI %
DJ US Broker Dealers	IAI	0.00	DJ US Energy	IYE	1.16
DJ US Insurance Index	IAK	2.70	DJ US Financial	IYF	0.68
DJ US Regional Banks	IAT	0.00	DJ US Financial Services	IYG	0.70
DJ US Utilities	IDU	0.00	DJ US Healthcare	IYH	0.00
DJ US Oil&Gas Expl & Prod	IEO	1.72	DJ US Industrial Sector	IYJ	0.77
DJ US Oil Equip & Svcs	IEZ	1.92	DJ US Consumer Goods	IYK	1.36
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	0.00
DJ US Healthcare Providers	IHF	0.00	DJ US Real Estate	IYR	0.00
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	0.00
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	0.88	Nasdaq 100	QQQQ	0.00

Additional New Trade Ideas

None – see the radar section for an informal idea

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
CBS	7/8/2008	\$17.59	\$17.30	-1.65%		Catapult
EP	7/10/2008	\$18.90	\$18.72	-0.95%		sold on open
SPY	7/15/2008	\$121.80	\$125.00	2.63%	\$125.00	stop hit
CBS	7/15/2008	\$16.71	\$17.30	3.53%		Catapult
DBA	7/21/2008	\$36.76	\$35.84	-2.50%		sell on close > 10ma
UNG	7/22/2008	\$47.57	\$47.28	-0.61%		sell on close > 10ma

CBS came within about 3 cents of hitting its end-of-day target. In other words, any close higher tomorrow should trigger an exit. Also, it should take too much to reach its intraday target. I will send out a note in the morning with the intraday target for CBS.

Horrible stop-out for SPY. Incredibly frustrating when that happens.

Stocks and ETF's on my Radar

GOOG – GOOG has triggered a system trade based on the following from the 4/11/2008 Subscriber Letter:

1) Made a 50-day low today. 2) Closed at least 1% higher. Buying the close and selling on a cross of the 10-sma over the last 10 years in all S&P 100 stocks would have produced the following results:

Trades – 1098

Winners – 779 (71%)

Avg gain – 3.8%

Avg Loss – 5.5%

Avg Trade – 1.15%

Profit Factor – 1.73

I believe the reversal follow such a large gap down the other day should provide a decent edge as well. I didn't have time tonight to test and quantify it, though.

I would take this trade using the above exit criteria. The 10-period MA is too far away. Some discretionary judgment will be needed.

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

None

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