

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 24, 2008

Issue 109

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 7, 2008	5 Weeks Lower	1-10 weeks	Bearish
March 17, 2008	Consumer Sentiment Stretch	1-12 months	Bullish

Short-term Outlook (1-5 days) –neutral – updated 7/24

The market gapped up in the morning, wiggled around most of the day and managed to hold on to decent gains. The Nasdaq led the way, rising over 1%. Breadth was positive by about 3:2. Volume rose and was fairly strong.

The Aggregator chart is below.



The green Aggregator line has slipped substantially over the last several days. It now stands at 0.04 – which is about equal to the long-term drift of the market. I typically consider 0 – 0.04 neutral. Meanwhile the market is a bit extended short-term. I believe the likelihood of a pullback occurring in the indices over the next few days appears pretty good.

I looked into the possibility of shorting SPY based on the fact that it was overbought in a downtrend. “In a downtrend” can be run a few different ways. One example would be to say it is under its 200-day MA. Another would be to say it recently made a 100-day low. If you run most “overbought” tests you’ll find that results are typically negative (and good for shorting) under the first definition. The 2nd definition frequently gives more positive (bad for shorting) results. Many times the downside edge is eliminated completely. This is what occurred for me tonight when I looked at a few things. While I might be leaning slightly short-term bearish, I’m not prepared to back it up with real money just yet.

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:

<i>NYSE (New lows - new highs) / Totals Issues > 33% two days ago. SP-500 jumps over 5% from low of 2 days ago.</i>										
<i>Buy on close. Sell X Days later. \$100,000 per trade. 1970 - present</i>										
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%	Low undercut by about 5% 2-3 weeks
3/10/1975	Sell	\$84.95		later before rally took off.
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%	Low was undercut by 4% a couple of times
2/15/1991	Sell	\$369.06		over the next 2 months before rally stuck.

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

none

Open Big 50 Trades

None

Catapult for ETF's Trades

none

Broad Market Large Cap CBI - 0

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

In my scans tonight, the stocks and ETF's that were coming up as short possibilities were mostly banks and financials. BAC for instance has become extremely extended short-term. There is resistance looming overhead around \$35 as well. I almost put this one out there as a trade idea before realizing there was no way most subscribers would be able to short it. ETF's like XLF and RKH also appear ready to retrace some of their recent run-up. The problem with looking to play these is that shorting financial stocks has suddenly become difficult. You could just buy some SKF, but my concern is that without the normal inflow of short-sellers that might look to sell into this bounce, prices may not fall so easy. We should still see a retracement, but it may not be as deep or as long. It's difficult to say. The one thing that seems certain is that the dynamics of this trade are different than in the past. Therefore caution would be warranted for anyone looking to take it. So nothing official tonight.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
CBS	7/8/2008	\$17.59	\$18.06	2.67%		sell on open
CBS	7/15/2008	\$16.71	\$18.06	8.08%		sell on open
DBA	7/21/2008	\$36.76	\$35.50	-3.43%		sell on close > 10ma
UNG	7/22/2008	\$47.57	\$45.60	-4.14%		sell on close > 10ma

As noted in the intraday update, CBS hit its target and will be closed tomorrow at the open.

Stocks and ETF's on my Radar

GOOG put in a nice day today. Unfortunately many traders may have missed out due to the gap up.

A possibility for a short would be ICF – the Realty ETF. It has closed higher 6 days in a row, has a 3-period RSI over 90, and was turned back at it declining 200-day moving average today. Could offer decent risk/reward as a short with an intraday trigger and a stop above today's high.

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

None

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