

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 28, 2008

Issue 134

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	Avg Max Move	Avg MM + 1 Std Dev
August 27, 2008	Weak Bounce	1-17 days	Bearish	-5.30%	-8.90%
August 27, 2008	SOX drop SPX up	1-3 days	Bearish	-2.30%	-4.51%
August 26, 2008	Bad Breadth & Volume	1-15 days	Bullish	3.54%	6.37%
August 25, 2008	3 Up While Volume Declines	1-13 days	Bearish	-2.76%	-5.24%
August 20, 2008	2 Bad Breadth Days No Low	1-8 days	Bullish	3.45%	6.53%
August 19, 2008	1% Drop Extreme Low Vol	1-10 days	Bearish	-4.04%	-7.14%
August 15, 2008	SPX up 0.5 Vol Lowest in 20	1-20 days	Bearish		
August 8, 2008	Nasdaq Dn Sox Up	1-30 Days	Bullish		
July 7, 2008	5 Weeks Lower	1-10 weeks	Bearish		
March 17, 2008	Consumer Sentiment Stretch	1-12 months	Bullish		

If the avg max move is achieved it will appear in **bold and green**. If the avg + 1 std deviation is achieved, the study will be removed from active status.

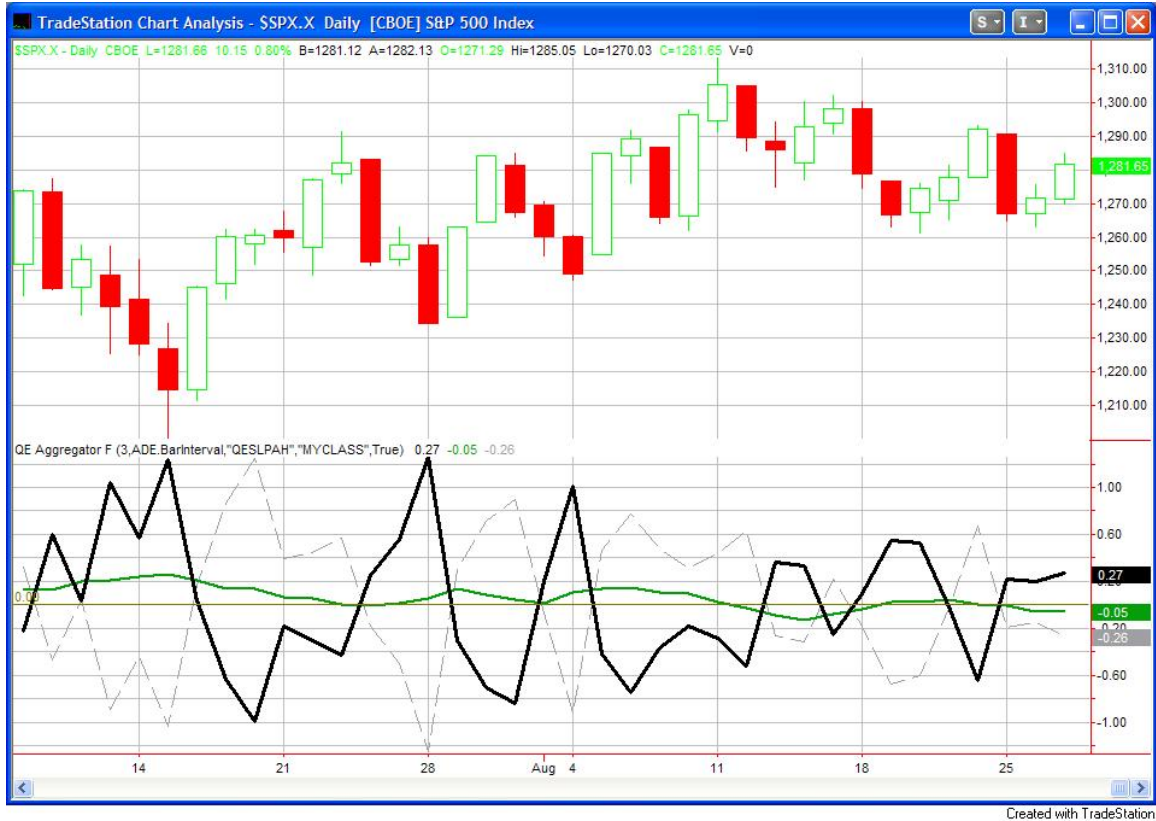
Short-term Outlook (1-5 days) –slightly bearish – updated 8/28

The market rallied a bit today. All of the major indices closed up near 1%. Breadth was strong with up volume trouncing down volume by over 3 to 1. Total volume was weak, though and came in extremely light once again.

There are a few notable negatives tonight. The VIX:VXV Ratio slipped back below 0.90 this afternoon. This indicator is discussed in detail in the intermediate-term outlook below. Generally, moves this low appear to have a bearish intermediate-term influence on the market. There was some reason to discount the low reading earlier in the week, since the slow end-of-August expected environment artificially lowered the VIX. We're nearing the end of the week, now and the ratios is back in oversold territory. At this point it is becoming less about Summer doldrums and more about volatility expectations that could be a bit out of whack. I'll be keeping an eye on this ratio over the next few days.

Second, the market has closed higher two days in a row. [In tonight's blog](#) I show how this condition has acted as a reliable short trigger over the last 15 months.

Below is tonight's Aggregator:



Very little change from yesterday. With Monday's action falling out of the calculation, we should see a sharp drop in the differential line tomorrow. With the Aggregator below "0", the black Differential likely to get there tomorrow, and the negative points I discussed above, I'm looking to start scaling into a short Index trade tomorrow.

Intermediate-term Outlook (1 week – 2 months)–neutral – updated 8/25

It's been over 5 weeks since the July bottom. The oversold bounce has played out and if the rally is going to continue it is going to take more than short-covering at this point. Over the last few weeks volume patterns have been quite negative. While breadth hasn't been bad, there still hasn't been the kind of thrust that often marks heavy buying interest near the beginning of a new bull move. Breadth and volume will be key to watch and right now neither one seems to be suggesting a significant upside edge for the market.

The positive action in the Semiconductor Index (SOX) was providing hope in the form of leadership. I showed in a few studies recently that a leading SOX has typically been a good thing for the overall market. The MarketSci blog did a follow up on my studies recently that looked at SOX leadership from a different perspective. The results there were quite interesting and also suggested that positive action in the SOX was a good thing. The SOX did lag during the bounce the last three days. It should be monitored closely. If it rolls over the rest of the market would have a difficult time continuing its rally off the July lows.

An indicator I've discussed here a bit before is the VIX:VXV ratio. The VIX measures option volatility out 30 days. The VXV uses the same calculation but measures out 90 days. Their values and movement are frequently quite close. When the VIX moves significantly above or below the VXV then that can provide us clues about volatility expectations for the short and intermediate-term. It can also serve as a directional indicator.

On Friday the VIX closed at 18.81 while the VXV closed at 21.48. The VIX:VXV ratio therefore came in at $18.81 / 21.48 = 0.88$. This is an unusually low reading. Adam Warner of the [Daily Options Report](#) believes part of the reason for the current low VIX reading is that the end of August is traditionally a quiet market period and option traders are factoring this in to their volatility models. I'm inclined to agree. Based on this line of thinking, if the market did nothing this week (unlikely) the VIX:VXV ratio should move closer to 1 since the slow August period will come off the books.

Below is a study which shows how the market has performed in the past when the ratio has moved below 0.90. While the current ratio may be slightly understated, the test indicates why it is important to monitor the ratio. The VXV has only been around since December of 2006. The CBOE did calculate it back several more years though. I have been able to acquire their data back to 2002. Therefore, rather than using less than 1 year of actual data, I'm using an additional 5+ years of generated data to get a decent sample size.

<i>VIX:VXV Ratio closes below 0.90. Buy SPX on close. Sell X days later. \$100k/trade. 2002-present.</i>										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
20	(\$20,549.59)	34	16	18	47.06	\$1,656.46	(\$2,614.05)	0.63	0.56	(\$604.40)
19	(\$17,111.82)	34	16	18	47.06	\$1,683.52	(\$2,447.12)	0.69	0.61	(\$503.29)
18	(\$12,526.33)	35	17	18	48.57	\$1,622.39	(\$2,228.17)	0.73	0.69	(\$357.90)
17	(\$21,022.65)	38	17	21	44.74	\$1,575.27	(\$2,276.30)	0.69	0.56	(\$553.23)
16	(\$14,647.43)	39	19	20	48.72	\$1,627.50	(\$2,278.49)	0.71	0.68	(\$375.58)
15	(\$29,253.84)	41	16	25	39.02	\$1,488.57	(\$2,122.84)	0.70	0.45	(\$713.51)
14	(\$15,621.57)	42	23	19	54.76	\$1,079.20	(\$2,128.58)	0.51	0.61	(\$371.94)
13	(\$15,931.25)	43	22	21	51.16	\$1,050.21	(\$1,858.85)	0.56	0.59	(\$370.49)
12	(\$15,746.97)	48	24	24	50.00	\$1,229.83	(\$1,885.95)	0.65	0.65	(\$328.06)
11	(\$24,134.60)	52	23	29	44.23	\$1,058.96	(\$1,672.09)	0.63	0.50	(\$464.13)
10	(\$17,144.36)	53	25	28	47.17	\$1,158.05	(\$1,646.27)	0.70	0.63	(\$323.48)
9	(\$17,028.91)	56	26	30	46.43	\$1,045.20	(\$1,473.47)	0.71	0.61	(\$304.09)
8	(\$13,911.60)	64	32	32	50.00	\$1,050.76	(\$1,485.50)	0.71	0.71	(\$217.37)
7	(\$9,075.56)	70	34	36	48.57	\$1,117.33	(\$1,307.35)	0.85	0.81	(\$129.65)
6	(\$5,293.58)	78	44	34	56.41	\$946.98	(\$1,381.19)	0.69	0.89	(\$67.87)
5	(\$11,855.80)	91	47	44	51.65	\$868.44	(\$1,197.10)	0.73	0.77	(\$130.28)
4	(\$16,025.48)	109	52	57	47.71	\$841.79	(\$1,049.10)	0.80	0.73	(\$147.02)
3	(\$9,510.66)	135	68	67	50.37	\$764.78	(\$918.15)	0.83	0.85	(\$70.45)
2	(\$973.64)	184	94	90	51.09	\$621.27	(\$659.70)	0.94	0.98	(\$5.29)
1	(\$2,206.77)	337	184	153	54.60	\$404.66	(\$501.07)	0.81	0.97	(\$6.55)

A modest bearish bias is certainly evident when considering the above numbers.

Rather than simply looking at a study based on time, I also looked to see how the market performed using this simple strategy: **Short** the S&P 500 any time the VIX:VXV ratio drops below 0.9. Cover when the ratio again moves above 1. Below are some performance statistics based on the above strategy:

TradeStation Performance Summary

Collapse ^

All Trades

Total Net Profit	\$21,171.12	Profit Factor	2.15
Gross Profit	\$39,637.71	Gross Loss	(\$18,466.59)
Roll Over Credit	\$0.00		
Open Position Profit/Loss	(\$1,128.66)		
Select Total Net Profit	\$21,171.12	Select Profit Factor	2.15
Select Gross Profit	\$39,637.71	Select Gross Loss	(\$18,466.59)
Adjusted Total Net Profit	(\$596.72)	Adjusted Profit Factor	0.98
Adjusted Gross Profit	\$27,103.17	Adjusted Gross Loss	(\$27,699.89)
Total Number of Trades	14	Percent Profitable	71.43%
Winning Trades	10	Losing Trades	4
Even Trades	0		
Avg. Trade Net Profit	\$1,512.22	Ratio Avg. Win:Avg. Loss	0.86
Avg. Winning Trade	\$3,963.77	Avg. Losing Trade	(\$4,616.65)
Largest Winning Trade	\$8,774.18	Largest Losing Trade	(\$7,985.67)
Largest Winner as % of Gross Profit	22.14%	Largest Loser as % of Gross Loss	43.24%
Net Profit as % of Largest Loss	265.11%		
Sclt. Net Profit as % of Largest Loss	265.11%	Adj. Net Profit as % of Largest Loss	(7.47%)
Max. Consecutive Winning Trades	4	Max. Consecutive Losing Trades	1
Avg. Bars in Winning Trades	41.00	Avg. Bars in Losing Trades	89.00
Avg. Bars in Total Trades	54.71		

Fairly strong performance for a short-sided system during a period where the market has made substantial gains. Especially notable in my eyes are the length of the trades. Note that this is not a short-term trading technique. The average winning trades lasted 2 months and the losers about 4 ½ months. Below is a list of all trades generated by the strategy:

#	Type	Date/Time	Signal	Price	Roll Over Pips	Shares/Ctrts	Gross P/L	% Profit	Run-up DrawDown
1	Sell Short	01/02/03	Short	\$909.03	\$0.00	110	\$5,239.30	5.24%	\$5,425.20
	Buy to Cover	01/24/03	Cover	\$861.40		\$5,239.30	\$5,239.30		(\$2,862.20)
2	Sell Short	08/12/03	Short	\$990.35	\$0.00	100	(\$5,328.00)	(5.38%)	\$999.00
	Buy to Cover	11/17/03	Cover	\$1,043.63		(\$5,328.00)	(\$88.70)		(\$7,330.00)
3	Sell Short	01/16/04	Short	\$1,139.82	\$0.00	87	\$2,873.61	2.90%	\$2,953.65
	Buy to Cover	03/11/04	Cover	\$1,106.79		\$2,873.61	\$2,784.91		(\$2,036.67)
4	Sell Short	03/25/04	Short	\$1,109.28	\$0.00	90	\$4,144.50	4.15%	\$4,234.50
	Buy to Cover	08/12/04	Cover	\$1,063.23		\$4,144.50	\$6,929.41		(\$3,716.10)
5	Sell Short	08/25/04	Short	\$1,104.96	\$0.00	90	(\$2,271.60)	(2.28%)	\$1,329.30
	Buy to Cover	10/29/04	Cover	\$1,130.20		(\$2,271.60)	\$4,657.81		(\$3,338.10)
6	Sell Short	12/09/04	Short	\$1,189.24	\$0.00	84	\$3,848.04	3.85%	\$3,974.88
	Buy to Cover	04/15/05	Cover	\$1,143.43		\$3,848.04	\$8,505.85		(\$3,349.08)
7	Sell Short	06/02/05	Short	\$1,204.29	\$0.00	83	\$2,278.35	2.28%	\$2,995.47
	Buy to Cover	10/13/05	Cover	\$1,176.84		\$2,278.35	\$10,784.20		(\$3,450.31)
8	Sell Short	11/25/05	Short	\$1,268.25	\$0.00	78	(\$2,881.32)	(2.91%)	\$1,755.78
	Buy to Cover	05/01/06	Cover	\$1,305.19		(\$2,881.32)	\$7,902.88		(\$3,892.98)
9	Sell Short	07/03/06	Short	\$1,280.19	\$0.00	78	\$2,956.98	2.96%	\$3,023.28
	Buy to Cover	07/13/06	Cover	\$1,242.28		\$2,956.98	\$10,859.86		\$0.00
10	Sell Short	08/16/06	Short	\$1,295.43	\$0.00	77	(\$7,985.67)	(8.01%)	\$457.38
	Buy to Cover	02/27/07	Cover	\$1,399.14		(\$7,985.67)	\$2,874.19		(\$12,792.78)
11	Sell Short	06/19/07	Short	\$1,533.70	\$0.00	65	\$2,652.65	2.66%	\$2,805.40
	Buy to Cover	06/26/07	Cover	\$1,492.89		\$2,652.65	\$5,526.84		(\$235.30)
12	Sell Short	10/09/07	Short	\$1,565.15	\$0.00	63	\$3,572.10	3.62%	\$4,762.17
	Buy to Cover	11/01/07	Cover	\$1,508.45		\$3,572.10	\$9,098.94		(\$689.22)
13	Sell Short	12/20/07	Short	\$1,460.12	\$0.00	68	\$3,298.00	3.32%	\$3,327.24
	Buy to Cover	01/04/08	Cover	\$1,411.62		\$3,298.00	\$12,396.94		(\$2,633.64)
14	Sell Short	05/12/08	Short	\$1,403.58	\$0.00	71	\$8,774.18	8.80%	\$9,342.18
	Buy to Cover	06/30/08	Cover	\$1,280.00		\$8,774.18	\$21,171.12		(\$2,602.86)
15	Sell Short	08/21/08	Short	\$1,277.71		78	n/a	n/a	\$9.36
	Buy to Cover	open	n/a	\$1,292.18		n/a	n/a		(\$1,199.64)

When looking at “systems” like this it is important to test for its robustness. Exiting at a ratio of 1 seemed like a nice round number to me. Testing other numbers near it can let me know whether my choice was simply lucky or whether it is in a range of possible profitable exits. Below is a robustness test for the exit:

VIX:VXV Ratio closes below 0.90. Short SPX on close. Cover SPX when the ratio closes above X. \$100k/trade. 2002-present.											
X Ratio	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade	
1.05	\$6,281.53	8	5	3	62.50	\$7,476.82	(\$10,367.52)	0.72	1.20	\$785.19	
1.04	\$3,325.80	8	5	3	62.50	\$6,885.67	(\$10,367.52)	0.66	1.11	\$415.73	
1.03	\$4,363.83	9	6	3	66.67	\$5,967.62	(\$10,480.63)	0.57	1.14	\$484.87	
1.02	\$4,858.36	10	6	4	60.00	\$5,028.09	(\$6,327.54)	0.79	1.19	\$485.84	
1.01	\$25,055.46	14	10	4	71.43	\$4,148.60	(\$4,107.62)	1.01	2.52	\$1,789.68	
1	\$21,171.12	14	10	4	71.43	\$3,963.77	(\$4,616.65)	0.86	2.15	\$1,512.22	
0.99	\$20,022.46	16	13	3	81.25	\$2,706.35	(\$5,053.38)	0.54	2.32	\$1,251.40	
0.98	\$21,782.52	17	14	3	82.35	\$2,545.20	(\$4,616.77)	0.55	2.57	\$1,281.32	
0.97	\$23,201.43	19	14	5	73.68	\$2,405.53	(\$2,095.20)	1.15	3.21	\$1,221.13	
0.96	\$16,794.89	21	14	7	66.67	\$2,161.59	(\$1,923.91)	1.12	2.25	\$799.76	
0.95	\$18,716.37	22	16	6	72.73	\$2,116.27	(\$2,523.98)	0.84	2.24	\$850.74	

Between 0.95 and 1.01 seem to work well. The important take away from all this is that a low VIX:VXV ratio can suggest the market is in a topping phase. A pullback would seem likely to occur at some point in the following weeks or months. It is not necessarily a “signal” to go short. It should put you on the alert, though, to watch for short opportunities. I believe the behavior of this ratio will be important to watch over the next week, especially if it doesn’t quickly move back towards higher levels. For those that would like to learn more about the VXV, I have found Bill Luby’s [VIX and More](#) site to be an excellent resource.

In summary, breadth has basically been neutral. Volume and the VIX:VXV ratio are bearish and should be monitored. On the positive side we have the SOX leadership, which the bulls hope will get back in gear after a couple of off days. The S&P did break its pattern of higher lows last week, but quickly rebounded. A move back below last weeks lows would not look good from a technical standpoint and could suggest a retest of the July lows.

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	0.00
DJ US Insurance Index	IAK	0.00	DJ US Financial	IYF	0.00
DJ US Regional Banks	IAT	0.00	DJ US Financial Services	IYG	0.00
DJ US Utilities	IDU	0.00	DJ US Healthcare	IYH	2.11
DJ US Oil&Gas Expl & Prod	IEO	0.00	DJ US Industrial Sector	IYJ	0.38
DJ US Oil Equip & Svcs	IEZ	0.00	DJ US Consumer Goods	IYK	2.04
DJ US Pharmaceuticals	IHE	2.70	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	4.88	DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	0.00	DJ US Technology Sector	IYW	1.01
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	7.89
DJ US Consumer Svcs	IYC	1.75	Nasdaq 100	QQQQ	0.00

Additional New Trade Ideas

SPY – short 1/4 of index position at \$128.63. Based on short-term market outlook section.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
BBH	8/22/2008	\$199.79	\$200.19	0.20%		
EWY	8/26/2008	\$43.99	\$44.50	1.16%	\$43.74	

Stocks and ETF's on my Radar

none

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