

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 2, 2008

Issue 136

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 31, 2008	Gap Dn then Drop No 3day Lo	1-3 days	Bullish	2.50%	4.30%
August 31, 2008	Gap Up Gap Down	1-6 days	Bearish	-2.60%	-4.80%
August 29, 2008	2 Days 75% Brdth-No 10 hi	1-10 days	Bearish	-3.27%	-5.69%
August 27, 2008	Weak Bounce	1-17 days	Bearish	-5.30%	-8.90%
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%
8/19 & 8/31	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) –neutral – updated 9/2

After a couple of solid up days on strong breadth the markets choppy tendencies reasserted themselves on Friday. Bulls who were hoping the strong move the previous few days would lead to a quick breakout were disappointed. Volume came in at the lightest level of the year.

Most technicians consider light volume on pullbacks to be a positive. When the volume is extremely light and the pullback rather steep, this is not necessarily the case. I demonstrated this in the [August 19th study](#) – which has now triggered again. The validity of the study could be questioned since the light volume was at least partially due to the long weekend.

Another potential negative is the fact that strong moves on Friday's do have a bit of a tendency to follow-through the next day. This is especially true when the market is in a long-term downtrend. I looked at this in a bit of detail in the June 23rd Subscriber Letter. The problem with applying that study to this instance is that we are facing a 3-day weekend in the US. Other markets are open on Monday and they will undoubtedly have a large influence on Tuesday's trading. Also, some of the worry on Friday could have been attributed to Hurricane Gustov. By Tuesday the questions about Gustov should be answered. With such unusual circumstances facing the weekend I'm inclined to heavily discount, and perhaps dismiss, any potential Friday-Monday carryover effects.

I also looked at potential end/beginning of month tendencies too see if there was an edge there. Since 1960 there have been 40 times when the S&P 500 has dropped 1% or more on the last day of the month. Twenty-four (60%) of those times it closed higher the next day. This isn't exactly a compelling number. I filtered the data further to look at instances where the S&P 500 was trading below its 200-day moving average. In this case there were 21. Eleven of them finished higher the next day. Looking out a little further didn't help either as days 2-5 the winners fluctuated between 10 and 12 out of the 21 trades. I'd therefore conclude that there appears to be no discernable advantage or disadvantage following a 1% selloff on the last day of the month.

Looking at the price pattern provided some mixed results. The SPY gapped up on Thursday and ran higher without ever filling the gap. On Friday it did the same thing to the downside. Below is a study which represents this kind of action in the SPY.

SPY has an unfilled gap up that closes higher than the open followed by an unfilled gap down that closes lower than the open. Both gaps are at least 0.25%. Buy on day 2 close. Hold X days. \$100k/trade. 1993-present.									
X Days	Net Profit	Trades	Wins	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
10	(\$10,759.82)	27	11	40.74	\$3,208.33	(\$2,878.22)	1.11	0.77	(\$398.51)
9	(\$14,074.74)	27	9	33.33	\$3,618.71	(\$2,591.28)	1.40	0.70	(\$521.29)
8	(\$10,760.00)	28	10	35.71	\$3,137.71	(\$2,340.95)	1.34	0.74	(\$384.29)
7	(\$13,160.17)	28	9	32.14	\$3,052.04	(\$2,138.34)	1.43	0.68	(\$470.01)
6	(\$18,918.31)	28	11	39.29	\$1,700.59	(\$2,213.22)	0.77	0.50	(\$675.65)
5	(\$10,382.44)	28	10	35.71	\$2,415.22	(\$1,918.59)	1.26	0.70	(\$370.80)
4	(\$3,635.81)	29	12	41.38	\$1,916.55	(\$1,566.73)	1.22	0.86	(\$125.37)
3	(\$1,712.67)	30	15	50.00	\$1,452.15	(\$1,566.33)	0.93	0.93	(\$57.09)
2	\$1,769.33	30	15	50.00	\$1,351.97	(\$1,322.16)	1.02	1.10	\$58.98
1	(\$2,944.44)	30	13	43.33	\$808.88	(\$791.76)	1.02	0.78	(\$98.15)

The first three days following such instances have been a crapshoot historically. On days 4-6, though, the suggestion is quite bearish.

Interestingly, I ran another study which looked at the current action a bit differently. This next study suggested a strong edge over the first three days.

SPY gaps down by at least 0.25% and closes over 1% lower on the day. Today's close is higher than the close 2 days ago. Buy on close. Sell X bars later. \$100k/trade. 1993-present.									
X Days	Net Profit	Trades	Wins	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
3	\$15,822.32	16	14	87.50	\$1,856.72	(\$5,085.87)	0.37	2.56	\$988.90
2	\$9,833.35	16	10	62.50	\$2,141.37	(\$1,930.06)	1.11	1.85	\$614.58
1	\$4,245.55	16	8	50.00	\$1,555.01	(\$1,024.32)	1.52	1.52	\$265.35

The winning percentage 3 days out is quite impressive as is the size of the average win. The average loss should also be noted as it is extremely large. The two losses occurred in early July and early October of 2002.

With these new studies above factored in, an updated chart of the Quantifiable Edges [Aggregator](#) is below:



The green Aggregator line is still negative. The combination of active studies is still suggesting more downside is expected over the next few days. The black differential line is also negative, which indicates the S&P has outperformed expectations over the last 3 days. Unless there is a strong rally on Tuesday, this line will move back to positive territory. While the aggregate of the studies is slightly negative, with an 87.5% win rate the gap and drop study above makes a good case for some short-term upside. Tuesday I'm looking to take profits on short positions that were established on Thursday. If Tuesday is down big, I may even consider flipping to the long side for a quick trade based on the study I just mentioned.

Intermediate-term Outlook (1 week – 2 months)–neutral to slightly bearish–updated 9/2

I've been looking for a sign that the market is ready to launch a new bull move higher and I've yet to find it. In fact, over the last couple of weeks I've begun to see some negatives line up.

Last week I showed a detailed study of the VIX:VXV ratio. The bottom line was that a move below 0.90 in the ratio tended to have bearish implications over the intermediate-term timeframe. With the slow end-of-August trading being factored in it was suggested that the VIX may be a bit lower than normal. August is now behind us. Even with the sharp drop on Friday the ratio still lies only at 0.91. A move below 0.9 from here on out would act as confirmation of last week's signal. It would suggest a difficult environment could ensue over the next couple of months.

Another indicator that is continuing to suggest bearish consequences is the Nasdaq to NYSE volume ratio. I discussed this ratio two weeks ago as we saw a bit of a spike up at the time. Historically, when the Nasdaq volume begins to run high as compared to NYSE volume, it suggests excessive speculation. Often this leads to a selloff. On Wednesday we once again saw the ratio spike to a high level. Below is another study with bearish intermediate-term results.

<i>The Nasdaq to NYSE volume ratio spikes to its highest level in 50 days. Buy Nasdaq on close. Sell X days later. \$100k/trade. 1990-present.</i>														
X Days	Net Profit	Gross Profit	Gross Loss	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
100	(\$98,072.66)	\$31,638.53	(\$129,711.19)	9	2	7	22.22	\$28,138.25	(\$33,591.28)	\$15,819.27	(\$18,530.17)	0.85	0.24	(\$10,896.96)
90	(\$73,409.68)	\$28,803.37	(\$102,213.05)	9	2	7	22.22	\$28,253.89	(\$34,478.16)	\$14,401.69	(\$14,601.86)	0.99	0.28	(\$8,156.63)
80	(\$94,741.02)	\$21,928.48	(\$116,669.50)	11	2	9	18.18	\$20,499.64	(\$34,290.24)	\$10,964.24	(\$12,963.28)	0.85	0.19	(\$8,612.82)
70	(\$77,732.46)	\$48,082.63	(\$125,815.09)	12	4	8	33.33	\$19,992.90	(\$35,851.86)	\$12,020.66	(\$15,726.89)	0.76	0.38	(\$6,477.71)
60	(\$60,856.11)	\$62,770.12	(\$123,626.23)	12	3	9	25.00	\$24,212.50	(\$31,756.56)	\$20,923.37	(\$13,736.25)	1.52	0.51	(\$5,071.34)
50	(\$45,819.16)	\$57,358.79	(\$103,177.95)	12	3	9	25.00	\$26,868.75	(\$27,780.84)	\$19,119.60	(\$11,464.22)	1.67	0.56	(\$3,818.26)
40	(\$17,620.68)	\$54,249.53	(\$71,870.21)	12	5	7	41.67	\$19,144.30	(\$19,988.54)	\$10,849.91	(\$10,267.17)	1.06	0.75	(\$1,468.39)
30	(\$64,499.31)	\$31,294.45	(\$95,793.76)	15	4	11	26.67	\$14,911.19	(\$16,804.34)	\$7,823.61	(\$8,708.52)	0.90	0.33	(\$4,299.95)
20	(\$36,431.57)	\$29,892.79	(\$66,324.36)	15	8	7	53.33	\$8,590.80	(\$16,200.36)	\$3,736.60	(\$9,474.91)	0.39	0.45	(\$2,428.77)
10	(\$21,436.04)	\$38,595.57	(\$60,031.61)	20	8	12	40.00	\$19,103.70	(\$17,212.14)	\$4,824.45	(\$5,002.63)	0.96	0.64	(\$1,071.80)
5	(\$47,022.63)	\$19,545.49	(\$66,568.12)	21	7	14	33.33	\$4,835.70	(\$12,889.14)	\$2,792.21	(\$4,754.87)	0.59	0.29	(\$2,239.17)

There is deterioration in the number of trades because of the amount of overlap when looking at longer periods. These results are shockingly bad when you consider the fact that the Nasdaq made strong gains over the test period. Looking out 100 days, 7 of 9 trades were losers. The average loss was 18%. There were two wins, one that gained 28% and the other that only scratched out a 3% rise. A few weeks ago I dismissed the spike in this ratio, because I found the concept of excessive speculation to be questionable due to the high levels of bearishness in both consumer and market sentiment indicators. I no longer feel it should be dismissed, but rather considered carefully.

A few weeks ago the price action in the Nasdaq, and especially in the SOX, had provided some bullish implications going forward. Upside leadership in these areas tends to act as a positive for the entire market. Over the last two weeks this has changed. The Nasdaq and SOX indices have pulled back much sharper than the broader market. In fact, while the S&P 500 is in the middle of its three-week range, the Nasdaq is at the lower end of its range and the SOX rolled over on Friday to post a 3-week low.

I did run some studies to see if there were ominous implications when the Nasdaq was in a position of leadership and then pulled back sharply in comparison to the NYSE. Results weren't terribly compelling but they did have a bullish tilt. They suggested you're normally better off just buying sharp pullbacks and not worrying about deteriorating leadership. With the studies we've seen over the last few weeks suggesting strong SOX leadership is a positive, studies showing bullish implications with regards to failing leadership would have to be much more convincing before I'd believe the SOX breakdown could possibly be a good thing.

In summary, the current studies are mixed with a slightly bearish tilt. Volume patterns remain weak. Breadth has picked up, but not to the levels that would imply a bullish outlook based on Lowry's research of 90% upside days. (These were discussed about a month ago – email me if you need that report.) Rather we've been treated to upside days of between 75% and 80% which haven't provided bullish expectations. The combination of the VIX:VXV ratio and the Nasdaq:NYSE Volume ratio suggests investors may be getting a bit careless. Individually, these kinds of readings carry negative expectations. The volume and volatility based studies may be questioned due to the slow summer trading but that should end this week as traders get back to work. The next week or two could be critical as the market may tip its hand

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	1.41
DJ US Oil&Gas Expl & Prod	IEO	0.00	DJ US Industrial Sector	IYJ	0.00
DJ US Oil Equip & Svcs	IEZ	0.00	DJ US Consumer Goods	IYK	0.68
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	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	5.26
DJ US Consumer Svcs	IYC	0.44	Nasdaq 100	QQQQ	0.00

Additional New Trade Ideas

None official. See radar section for an emerging setup.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
BBH	8/22/2008	\$199.79	\$199.97	0.09%	#####	
EWY	8/26/2008	\$43.99	\$43.46	-1.20%	\$43.74	stopped out at open
SPY(S)	8/28/2008	\$129.28	\$128.79	0.38%		cover @ \$129

SPY missed the posted entry limit by \$0.05 and the cratered for the rest of the day. Good news for the current SPY short, bad news if you waited for the posted entry price to be hit. This is the 4th time in August where I posted an entry limit at the prior days close and the trade gapped in the direction of the trade, never filled and moved strongly in the predicted direction. Incredibly frustrating from a newsletter performance standpoint. Hopefully some of you were able to gain and edge and find an entry in the stated direction anyway.

Based on the short-term market outlook above, I'm going to be looking to take profits on the current SPY trade and wait for the next setup.

Stocks and ETF's on my Radar

GILD – This has triggered a setup first published in the 4/2 Subscriber Letter. It is a setup that I prefer to use for ETF's rather than individual stocks as it tends to perform better with ETF's. Should it continue to stretch or form a doji or narrow range bar I may consider an entry. The setup along with current stats is below:

- 1) Closes under 10-day moving average for at least 10 days.
- 2) Closes above 200-day MA.
- 3) Today is makes its lowest low in 10 days.

Buy on close. Sell on close above the 10-day MA. Over the last 10 years across the current S&P 100 stocks the following stats would apply:

Trades	752
Wins	557
Losses	192
Win %	74.1%
Avg Win	2.6%
Avg Loss	-4.3%
Avg Trade	0.8%
Profit Factor	1.74

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