

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 12, 2008

Issue 144

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 |
|--------------------|-----------------------------|-------------|---------|--------------|--------------------|
| September 12, 2008 | 20-Day Reversal Bar | 1-17 days | Bullish | 4.93% | 9.39% |
| September 11, 2008 | Bad Breadth Rebound | 1-6 Days | Bearish | -4.10% | -5.85% |
| 8/27 & 9/11 | Weak Bounce | 1-17 days | Bearish | -5.30% | -8.90% |
| 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 | | |
| 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 in *bold italic blue*.

Short-term Outlook (1-5 days) – approaching bearish – updated 9/12

Thursday's market action was extremely unusual and a bit confusing. The major indices all gapped lower by over 1% this morning. After some morning selling they began to rebound. The market caught fire near the close and they all finished up over 1% today. Volume was fairly solid and rose slightly over yesterday. Breadth was where the confusion came in. Only about 42% of NYSE issues advanced on Thursday, but up volume accounted for over 60% of total volume.

The discrepancy between issues breadth and volume breadth is extremely unusual. I checked to see if there was any edge when there was a discrepancy of this magnitude. I was unable to find any edge. In fact there have only been 6 other occurrences and they seemed to be random in their performance.

The fact that advancing issues trailed is generally not a good thing. Below is a simple study which demonstrates this:

| <i>Advancing issues make up less than 45% of total issues. SPX closes at least 0.5% higher.</i> | | | | | | | | | | |
|-------------------------------------------------------------------------------------------------|---------------|--------|------|--------|--------|------------|--------------|-----------|---------------|------------|
| <i>Buy on close. Sell X days later. \$100k/trade. 1970 - present.</i> | | | | | | | | | | |
| X Days | Net Profit | Trades | Wins | Losses | % Wins | Avg Win | Avg Loss | W/L Ratio | Profit Factor | Avg Trade |
| 11 | (\$19,068.58) | 37 | 19 | 18 | 51.35 | \$2,588.49 | (\$3,791.67) | 0.68 | 0.72 | (\$515.37) |
| 10 | (\$1,039.73) | 38 | 21 | 17 | 55.26 | \$2,561.29 | (\$3,225.11) | 0.79 | 0.98 | (\$27.36) |
| 9 | (\$5,309.51) | 38 | 21 | 17 | 55.26 | \$2,656.10 | (\$3,593.39) | 0.74 | 0.91 | (\$139.72) |
| 8 | \$6,161.00 | 38 | 23 | 15 | 60.53 | \$2,613.22 | (\$3,596.21) | 0.73 | 1.11 | \$162.13 |
| 7 | \$991.91 | 39 | 20 | 19 | 51.28 | \$2,578.53 | (\$2,662.04) | 0.97 | 1.02 | \$25.43 |
| 6 | (\$14,479.60) | 39 | 18 | 21 | 46.15 | \$2,328.71 | (\$2,685.54) | 0.87 | 0.74 | (\$371.27) |
| 5 | (\$14,509.06) | 40 | 20 | 20 | 50.00 | \$1,849.02 | (\$2,574.48) | 0.72 | 0.72 | (\$362.73) |
| 4 | (\$14,891.00) | 40 | 20 | 20 | 50.00 | \$1,578.22 | (\$2,322.77) | 0.68 | 0.68 | (\$372.28) |
| 3 | (\$13,229.22) | 40 | 20 | 20 | 50.00 | \$1,567.98 | (\$2,229.44) | 0.70 | 0.70 | (\$330.73) |
| 2 | (\$4,231.66) | 40 | 18 | 22 | 45.00 | \$1,808.11 | (\$1,671.71) | 1.08 | 0.88 | (\$105.79) |
| 1 | \$10,011.86 | 41 | 21 | 20 | 51.22 | \$1,579.82 | (\$1,158.22) | 1.36 | 1.43 | \$244.19 |

No huge downside edge here, but certainly results that are worse than random. You'd obviously like to see breadth coming in stronger if you're looking for a continued rise.

The price action today was also intriguing and a bit confusing. As I noted last night, I was looking for a good entry point to begin initiating a short position as the studies were indicating a pullback was likely. The pullback was strong on Thursday but only lasted about ½ hour. I've some question as to whether Thursday's dip below last Friday's low was enough to shake out weak holders and begin to launch the market on a strong leg higher. My inclination is that it is not but I'm less excited about shorting here than I would've been without the morning selloff.

Whether a gap lower and strong reversal is a bullish or bearish indication is unclear. Classic technical analysis would suggest that it is bullish. Testing on the SPY would agree with this:

| <i>SPY gaps lower by 1% and finishes at least 1% above yesterday's close.</i> | | | | | | | | | | |
|-------------------------------------------------------------------------------|--------------|--------|------|--------|--------|------------|--------------|-----------|---------------|------------|
| <i>Buy on close. Sell X days later. \$100k/trade. 1993 - present.</i> | | | | | | | | | | |
| X Days | Net Profit | Trades | Wins | Losses | % Wins | Avg Win | Avg Loss | W/L Ratio | Profit Factor | Avg Trade |
| 10 | \$11,497.52 | 8 | 7 | 1 | 87.50 | \$1,728.94 | (\$605.07) | 2.86 | 20.00 | \$1,437.19 |
| 9 | \$9,208.49 | 8 | 7 | 1 | 87.50 | \$1,368.00 | (\$367.50) | 3.72 | 26.06 | \$1,151.06 |
| 8 | \$10,854.91 | 8 | 6 | 2 | 75.00 | \$2,015.15 | (\$618.00) | 3.26 | 9.78 | \$1,356.86 |
| 7 | \$11,642.82 | 8 | 6 | 2 | 75.00 | \$2,295.26 | (\$1,064.36) | 2.16 | 6.47 | \$1,455.35 |
| 6 | \$5,255.66 | 9 | 5 | 4 | 55.56 | \$2,974.75 | (\$2,404.53) | 1.24 | 1.55 | \$583.96 |
| 5 | \$5,634.26 | 9 | 5 | 4 | 55.56 | \$3,336.98 | (\$2,762.67) | 1.21 | 1.51 | \$626.03 |
| 4 | \$3,010.61 | 9 | 5 | 4 | 55.56 | \$2,996.63 | (\$2,993.13) | 1.00 | 1.25 | \$334.51 |
| 3 | (\$1,725.75) | 9 | 4 | 5 | 44.44 | \$2,192.19 | (\$2,098.90) | 1.04 | 0.84 | (\$191.75) |
| 2 | (\$5,088.48) | 9 | 4 | 5 | 44.44 | \$1,015.68 | (\$1,830.24) | 0.55 | 0.44 | (\$565.39) |
| 1 | \$855.85 | 9 | 3 | 6 | 33.33 | \$1,286.01 | (\$500.37) | 2.57 | 1.29 | \$95.09 |

The number of trades is low but the stats are suggestive of bullish implications after a short pullback. Eight of nine instances closed lower at some point in the next 3 days by an average of ¾%. Looking out 10 days every instance had at least 1 close higher. So pretty good stats, but not entirely convincing. I tested on the NDX as well. Here we see a large discrepancy with the SPY results.

| <i>NDX gaps lower by 1% and finishes at least 1% above yesterday's close.</i> | | | | | | | | | | |
|-------------------------------------------------------------------------------|---------------|--------|------|--------|--------|------------|--------------|-----------|---------------|--------------|
| <i>Buy on close. Sell X days later. \$100k/trade. 1986 - present.</i> | | | | | | | | | | |
| X Days | Net Profit | Trades | Wins | Losses | % Wins | Avg Win | Avg Loss | W/L Ratio | Profit Factor | Avg Trade |
| 10 | (\$37,190.29) | 18 | 7 | 11 | 38.89 | \$4,157.34 | (\$6,026.52) | 0.69 | 0.44 | (\$2,066.13) |
| 9 | (\$20,305.22) | 19 | 7 | 12 | 36.84 | \$5,131.97 | (\$4,685.75) | 1.10 | 0.64 | (\$1,068.70) |
| 8 | (\$20,727.07) | 20 | 7 | 13 | 35.00 | \$4,720.94 | (\$4,136.43) | 1.14 | 0.61 | (\$1,036.35) |
| 7 | (\$19,385.05) | 20 | 7 | 13 | 35.00 | \$4,927.51 | (\$4,144.43) | 1.19 | 0.64 | (\$969.25) |
| 6 | (\$14,457.24) | 21 | 8 | 13 | 38.10 | \$5,321.42 | (\$4,386.82) | 1.21 | 0.75 | (\$688.44) |
| 5 | (\$16,675.70) | 22 | 9 | 13 | 40.91 | \$4,886.55 | (\$4,665.74) | 1.05 | 0.73 | (\$757.99) |
| 4 | (\$14,804.84) | 24 | 10 | 14 | 41.67 | \$4,699.14 | (\$4,414.02) | 1.06 | 0.76 | (\$616.87) |
| 3 | (\$28,553.73) | 24 | 9 | 15 | 37.50 | \$3,554.51 | (\$4,036.29) | 0.88 | 0.53 | (\$1,189.74) |
| 2 | (\$27,083.91) | 25 | 11 | 14 | 44.00 | \$2,746.92 | (\$4,092.86) | 0.67 | 0.53 | (\$1,083.36) |
| 1 | (\$9,311.14) | 27 | 10 | 17 | 37.04 | \$3,146.53 | (\$2,398.61) | 1.31 | 0.77 | (\$344.86) |

Results here suggest quite bearish implications. The basic takeaway is that the gap reversal analysis isn't helping out much here. I'd be hesitant to declare the gap and reverse either bullish or bearish.

One study that does suggest today's bar was bullish is one I posted way back near the beginning of January which looked at strong reversals off of 20-day lows. You can find it below with updated stats:

| SPX makes a 20-day low and then closes at least 1% higher on increased volume. | | | | | | | | | | |
|---------------------------------------------------------------------------------------|-------------|--------|------|--------|--------|------------|--------------|-----------|---------------|------------|
| Buy on close. Sell X days later. \$100k/trade. 1970 - present. | | | | | | | | | | |
| X Days | Net Profit | Trades | Wins | Losses | % Wins | Avg Win | Avg Loss | W/L Ratio | Profit Factor | Avg Trade |
| 20 | \$59,088.79 | 24 | 15 | 9 | 62.50 | \$5,145.25 | (\$2,010.00) | 2.56 | 4.27 | \$2,462.03 |
| 19 | \$60,670.88 | 24 | 15 | 9 | 62.50 | \$5,292.39 | (\$2,079.44) | 2.55 | 4.24 | \$2,527.95 |
| 18 | \$63,738.25 | 24 | 15 | 9 | 62.50 | \$5,562.58 | (\$2,188.93) | 2.54 | 4.24 | \$2,655.76 |
| 17 | \$64,400.11 | 24 | 15 | 9 | 62.50 | \$5,279.99 | (\$1,644.42) | 3.21 | 5.35 | \$2,683.34 |
| 16 | \$45,281.72 | 24 | 15 | 9 | 62.50 | \$4,383.96 | (\$2,275.30) | 1.93 | 3.21 | \$1,886.74 |
| 15 | \$42,853.11 | 24 | 15 | 9 | 62.50 | \$4,382.00 | (\$2,541.88) | 1.72 | 2.87 | \$1,785.55 |
| 14 | \$47,635.85 | 25 | 16 | 9 | 64.00 | \$4,069.38 | (\$1,941.57) | 2.10 | 3.73 | \$1,905.43 |
| 13 | \$43,813.06 | 25 | 14 | 11 | 56.00 | \$4,738.46 | (\$2,047.76) | 2.31 | 2.95 | \$1,752.52 |
| 12 | \$41,337.51 | 25 | 13 | 12 | 52.00 | \$4,752.92 | (\$1,704.20) | 2.79 | 3.02 | \$1,653.50 |
| 11 | \$41,742.29 | 25 | 15 | 10 | 60.00 | \$4,123.36 | (\$2,010.81) | 2.05 | 3.08 | \$1,669.69 |
| 10 | \$40,991.55 | 25 | 16 | 9 | 64.00 | \$3,851.27 | (\$2,292.09) | 1.68 | 2.99 | \$1,639.66 |
| 9 | \$32,229.38 | 25 | 14 | 11 | 56.00 | \$4,277.02 | (\$2,513.54) | 1.70 | 2.17 | \$1,289.18 |
| 8 | \$19,941.95 | 25 | 14 | 11 | 56.00 | \$3,853.79 | (\$3,091.92) | 1.25 | 1.59 | \$797.68 |
| 7 | \$16,624.66 | 25 | 12 | 13 | 48.00 | \$3,935.75 | (\$2,354.18) | 1.67 | 1.54 | \$664.99 |
| 6 | \$9,493.38 | 25 | 14 | 11 | 56.00 | \$3,078.67 | (\$3,055.27) | 1.01 | 1.28 | \$379.74 |
| 5 | \$13,890.00 | 25 | 13 | 12 | 52.00 | \$3,306.68 | (\$2,424.74) | 1.36 | 1.48 | \$555.60 |
| 4 | \$11,701.97 | 25 | 14 | 11 | 56.00 | \$2,580.07 | (\$2,219.90) | 1.16 | 1.48 | \$468.08 |
| 3 | \$14,651.14 | 25 | 13 | 12 | 52.00 | \$2,311.27 | (\$1,282.95) | 1.80 | 1.95 | \$586.05 |
| 2 | \$10,851.43 | 26 | 13 | 12 | 50.00 | \$1,713.47 | (\$951.97) | 1.80 | 1.95 | \$417.36 |
| 1 | \$9,692.29 | 26 | 14 | 12 | 53.85 | \$1,625.86 | (\$1,089.14) | 1.49 | 1.74 | \$372.78 |

Some observations from that blog post: *Fourteen days out 16 of 24 trades were winners. Of those sixteen winners, all of them pulled back at least 0.5% from the reversal day close at some point. The average drawdown among those 16 winners was 2.6%. The largest drawdown among winning trades was 6.6% which occurred after the reversal bar last August 6th (2007). Five of the sixteen winners actually posted a lower low before turning higher again. In other words, it's probably not necessary to chase this trade. There will most likely be some backing and filling which should allow for a better entry point or some scaling in.*

Bottom line is today's reversal give the bulls some short-term hope that wasn't evident yesterday. Still, even this bullish study suggests we may see a short-term pullback. Below is a look at the Aggregator:



Even with tonight's bullish study the green Aggregator line is suggesting a downside edge over the next few days. The black differential line shows that the market has underperformed expectations over the last 3 days. Barring a massive selloff tomorrow this will change as Tuesday's big down day falls out of the calculation. Going into the weekend we could be near or at a nice entry point for a swing short. If the market closes weakly higher tomorrow I'd become interested in selling short some SPY near the close. A strong finish would have me wait and re-evaluate over the weekend. As we've seen before, strong Fridays, especially below the 200-day ma and prior to expiration week, tend to follow through on Monday. Therefore I'd feel more comfortable shorting that additional Monday strength than I would shorting on Friday. A close lower would also have me re-evaluate the situation.

Intermediate-term Outlook (1 week – 2 months)–neutral to slightly bearish-updated 9/8

While the drop last week was sharp there is little sign from an intermediate-term standpoint that it was exhaustive in any way. The recent studies which have shown bullish implications are short-term in nature. Most of them will lose their influence by the end of this week.

The drop this week broke the market out of its 5-6 week consolidation and the July lows are the next level of support. At this point, many of the breadth and other exhaustive measures I look at have yet to reach significant levels. Examples of indicators that are nowhere near their mid-July levels include New 52-week lows, the % of Stocks Closing Below Their 40-day MA, the VIX and VIX:VXV Ratio, the CBI, which currently stands at 4, and sentiment surveys.

It's not surprising that panic has not set in since the move down is fairly new. Should the market reach its July lows, it will then be important to monitor these indicators to see if divergences or panic readings develop.

One notable index that broke down to new 52-week lows this week is the Semiconductors (SOX). I've shown some studies in the past that indicators the SOX can act as a leading indicator for the rest of the market. Those studies may be found [here](#) and [here](#). You may also find an interesting and related study on the MarketSci blog [here](#). So if the SOX does a nice job of leading the market to the upside, does a breakdown to a new low serve as a bad omen?

I looked back to 1995 to find all the times the SOX has broken to a 52-week low ahead of the S&P 500. I wanted to see whether the S&P 500 often followed it and also hit a 52-week low. Of the 10 instances I found of the SOX hitting a 52-week low without the S&P, only 3 of them led to a breakdown in the S&P within the next 20 days. Those three were 11/10/2000, 9/5/02, and 10/26/07. The seven instances that didn't lead to an S&P breakdown occurred on 1/15/96, 7/11/96, 12/12/97, 6/3/98, 8/27/98, 7/15/04, and 7/7/06. So while you would rather see the SOX running up and leading the market higher, it doesn't appear to be any kind of death sentence that it has broken down.

In summary it simply appears too early to tell whether the market is going to crack the July lows or not. I am not seeing strong evidence line up for either the bullish or bearish case for the long-term. It will be important to take things as they come at this point and evaluate the market with fresh eyes on a daily basis.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Trades

DELL –bought 1/3 position at \$20.22

EXC – bought 1/3 position @ \$63.97 limit

DELL – bought 1/3 position \$19.30

Open Big 50 Trades

None

Catapult for ETF's Trades

VWO – bought and listed in trades section

FXE – bought and listed in trades section

Broad Market Large Cap CBI – 3/2 (2 DELL,EXC)

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 | 2.33 |
| 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 | 8.11 | DJ US Healthcare | IYH | 0.70 |
| DJ US Oil&Gas Expl & Prod | IEO | 6.90 | DJ US Industrial Sector | IYJ | 1.92 |
| DJ US Oil Equip & Svcs | IEZ | 5.77 | DJ US Consumer Goods | IYK | 1.36 |
| DJ US Pharmaceuticals | IHE | 0.00 | DJ US Basic Materials | IYM | 2.70 |
| DJ US Healthcare Providers | IHF | 0.00 | DJ US Real Estate | IYR | 0.00 |
| DJ US Medical Devices | IHI | 2.44 | DJ US Transportation | IYT | 0.00 |
| DJ US Aerospace & Defense | ITA | 2.78 | DJ US Technology Sector | IYW | 4.02 |
| DJ US Home Construction | ITB | 0.00 | DJ US Telecommunications | IYZ | 2.63 |
| DJ US Consumer Svcs | IYC | 1.32 | Nasdaq 100 | QQQQ | 4.00 |

Additional New Trade Ideas

SPY – sell short ¼ of Index allocation on close between \$125.75 and \$126.50. Trade idea is based on short-term market outlook above.

Active Trades Table

| Symbol | Entry Date | Entry Price | Current Price | % Gain/Loss | Stop | Notes |
|--------|------------|-------------|---------------|-------------|------|----------|
| DELL | 9/4/2008 | \$20.22 | \$19.18 | -5.14% | | Catapult |
| FXE | 9/5/2008 | \$143.20 | \$139.72 | -2.43% | | Catapult |
| VWO | 9/5/2008 | \$37.50 | \$36.99 | -1.36% | | Catapult |
| EXC | 9/9/2008 | \$64.97 | \$66.78 | 2.79% | | Catapult |
| DELL | 9/4/2008 | \$19.30 | \$19.18 | -0.62% | | Catapult |

EXC is approaching its exit target. I will send out the exit trigger in the morning shortly after the open when I am able to calculate it.

Stocks and ETF's on my Radar

MOT – mentioned last night, is certainly now overdone and could be nearing a bounce.

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