

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 16, 2008

Issue 146

## 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 16, 2008	25% VIX stretch	1-6 Days	Bullish	2.73%	4.74%
<b><i>September 15, 2008</i></b>	<b><i>3 Up Days In Choppy Market</i></b>	<b><i>1-4 Days</i></b>	<b><i>Bearish</i></b>	<b><i>-2.28%</i></b>	<b><i>-3.68%</i></b>
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%	(1191.15)-7.14%
August 15, 2008	SPX up 0.5 Vol Lowest in 20	1-20 days	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) –neutral approaching slightly bullish – updated 9/16***

Monday was one day that will not be soon forgotten by a lot of people. The Lehman bankruptcy led to a gap down of over 3%. As is often the case, the market rallied strongly off the large gap down. The rally lasted until the afternoon when the sellers took over once again. And boy did they take over. When it over the S&P was down 4.7%, the Dow 4.4% and the Nasdaq 3.6%. Volume came in at the highest level since the July 17 rally day. Breadth was about as bad as it gets. Almost nothing went up.

Let's first consider the failure to sustain a rally above the opening price. In the history of the SPY there have only been 4 other gaps lower of 3% or more. They were 1/13/99, 9/17/01, 9/21/01, and 1/22/08. All of them closed above their opening price. The worst open to close performer of the bunch was 1/13/99 which "only" rose 2.5% from the open until the close. Loosening the requirements, there have been 21 gaps lower of 2% or more. Seventeen of them closed above the open. Four didn't. Those 4 were 3/8/96, 9/10/98, 9/17/98, and 5/14/99. All 4 of them closed higher the next day, with the largest intraday drawdown being the 5/14/99 instance which lost 1.4% during the day before closing 0.3% higher. This all would seem to suggest a decent likelihood of a bounce tomorrow. Of course the other way to look at it is that the market has already demonstrated it is not acting as it should.

I mentioned that breadth was horrible today. The percentage of up issues was between 5% and 6% according to my data providers. This means that about 1 in 20 issues traded on the NYSE closed higher on the day. A truly remarkable number. I looked back to

1970 to examine other times the number was so low. I found only 3 other instances: 10/9/79, 10/16/87, and 10/27/97. After the '79 incident the S&P continued to trend lower for about another month before finding a bottom. The 10/16/87 incident was followed by the Crash of '87 the next day (which also registered a sub-6% reading). The 1997 occurrence marked the lowest close of that selloff and the market began a significant rally the next day.

I loosened the up issues criteria a bit and looked at it several different ways this evening. Results were similar to those above – inconsistent. Some tests suggested a bit of an upside edge – others suggested downside. For instance there have been 14 times when the S&P made a 200-day low and the ratio also made a 200-day low. Four days later only 5 of 14 instances showed positive returns.

The breadth takeaway in my eyes is that the selling was extremely broad. This *could* indicate the market is nearing capitulation a-la 1997, but it's just one day. A few days like this would certainly create much more convincing statistics. Without extremes being hit in any other breadth indicators I follow such as the McClellan Oscillator, the CBI, and the % of stocks trading above their 40-day ma, I just not inclined to make much of one really bad day and say it's a buy signal.

One popular sentiment indicator that did hit an extreme was the VIX. It spiked up almost 24% today and closed nearly 30% above its 10-day moving average. Below is a related study:

<b>CBOE VIX Index closes at least 25% above its 10-day moving average. Buy S&amp;P 500 on close. Sell X days later. \$100k/trade. 1990-present.</b>											
X Days	All: Net Prof	Trades	Wins	Win %	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
10	\$32,931.43	26	18	69.23	\$8,335.60	(\$6,179.64)	\$2,464.36	(\$1,428.39)	1.73	3.88	\$1,266.59
9	\$26,269.33	26	18	69.23	\$7,503.60	(\$7,244.08)	\$2,309.03	(\$1,911.64)	1.21	2.72	\$1,010.36
8	\$32,264.33	26	20	76.92	\$6,960.84	(\$6,762.92)	\$2,227.53	(\$2,047.72)	1.09	3.63	\$1,240.94
7	\$27,316.15	26	20	76.92	\$7,500.06	(\$7,574.36)	\$1,981.53	(\$2,052.42)	0.97	3.22	\$1,050.62
6	\$26,296.14	26	21	80.77	\$7,272.06	(\$11,038.16)	\$1,922.10	(\$2,813.57)	0.68	2.87	\$1,011.39
5	\$29,777.34	27	19	70.37	\$7,070.28	(\$9,314.08)	\$2,340.03	(\$1,835.41)	1.27	3.03	\$1,102.86
4	\$26,850.38	29	22	75.86	\$4,690.50	(\$6,410.56)	\$1,752.02	(\$1,670.59)	1.05	3.30	\$925.88
3	\$17,798.28	29	21	72.41	\$4,077.70	(\$6,426.24)	\$1,569.06	(\$1,894.01)	0.83	2.17	\$613.73
2	\$19,966.37	33	21	63.64	\$4,809.66	(\$4,929.40)	\$1,829.81	(\$1,538.31)	1.19	2.08	\$605.04
1	\$24,484.03	41	27	65.85	\$5,117.46	(\$3,092.88)	\$1,442.45	(\$1,033.01)	1.40	2.69	\$597.17

Over the next 5-7 days there's been a pretty good chance of a market rebound as can be seen by the "Win %" column. Unfortunately, the instances that weren't winners were quite bad and the winners didn't win that much. The resulting average trade over the next week was about 1%. A 1% gain is not an enticing reward in a market as volatile as this. The market could easily move more than 1% if you take too long in the bathroom tomorrow. I don't believe anyone buying into the market now is doing so in the hope of making 1% over the next week.

Another way to measure the VIX is by looking at the VIX:VXV ratio. Today it spiked up to 1.135, meaning the VIX, which is an estimate of 30-day volatility is 13.5% higher than the VXV, which estimates 90-day volatility. This ratio tends to spike to high levels above 1.1 or so near market bottoms. While the VXV has only been around since last

November, I have data constructed going back to 2002. Since 2002 there have only been 2-3 other periods of time where the ratio reached as high as 1.135. The first was July of 2002. The spike there was extremely early though as it first spiked on 7/10 – two full weeks before the bottom. It gyrated up and down over the next few weeks while the market carved out a (temporary) bottom. July 27, 2007 was the next time the ratio spiked this high. Again it was followed by 2-3 weeks of gyrations. On 8/15 it again spiked above the current level and finally managed to rally nicely from there. Tough to glean a whole lot from just a few instances, but for those who look at VIX spikes to signal a bottom, we certainly got a VIX spike today.

One statistic that will undoubtedly be noted by many is the fact that new lows aren't nearly as high as the July bottom. While this can be a positive divergence, I have found it to be unreliable as noted in [the blog tonight](#).

Also in the blog I suggest readers review some of my past [Fed Studies](#). They can certainly act as a market mover tomorrow. More often than not, when the market falls leading up to a meeting, the Fed tends to provide it some temporary relief.

No Aggregator chart tonight. As negative as the green Aggregator line was last night, it still is negative tonight. The S&P has now greatly underperformed recent expectations, though. In other words, no great edge is being suggested by the Aggregator.

While several indicators aren't quite there yet, additional selling should lead to a decent risk/reward long setup. Brave, aggressive, nimble traders could try and game the Fed. I would prefer to stand aside until they're done. Should the market close lower tomorrow I anticipate we'll see some more extremes and will start to build a long position. Frankly I don't mind being a little bit early with a small position. I think we're very close to a sharp short-covering rally and would like to try and take advantage of it. Also, I suspect we may get a large gap up that sticks and runs one of these days and I don't want to be left holding the bag if it happens.

***Intermediate-term Outlook (1 week – 2 months)–neutral / slightly bearish-updated 9/15***

The song remains the same this week from an intermediate-term standpoint. I am not seeing any evidence that the market is ready to take off. There has been no strong accumulation evidenced by surges in breadth and volume. At the same time the market has also not reached the kind of selling extremes that it hit at past bottoms.

The low this week was fairly close to the July low, yet many of the indicators that suggest panic or capitulation have not provided any such readings. For example the VIX is far below where it reached when the market bottomed in July, March and January. Another example would be the number of new lows. At the July bottom there were over 1150 new lows. On Thursday this number peaked at 370. You could also look at the % of stocks closing above their 40-day moving average. This indicator reached about 37% this past week. At the July, March, January, and November bottoms it dropped below 20%. The CBI, which I track closely in the blog has yet to move above 3. At the other bottoms over the past year it reached 10 or higher every time.

Some might say there is a positive divergence setting up. For there to be a true divergence, though, you'd need to see price fall below the July levels without the indicators doing so. Perhaps the indicators are showing strength. Perhaps they are signaling we could have a lot further to fall. I don't know the answer to that. What I do know is that they are not suggesting the type of panic readings that provide high risk/reward opportunities to try and buy into.

One reader suggested to me that the relatively high volume this week along with the fact that market stopped falling might have suggested institutional support. I decided to test this theory. Below is what I came up with:

<i>After closing lower 3 weeks in a row the S&amp;P 500 closes higher on its highest weekly volume in 4 weeks.</i>										
<i>Buy S&amp;P on close. Sell X weeks later. \$100k/trade. 1960-present.</i>										
X Weeks	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
6	\$2,067.00	33	16	17	48.48	\$4,943.25	(\$4,530.88)	1.09	1.03	\$62.64
5	(\$7,095.66)	33	17	16	51.52	\$4,384.26	(\$5,101.75)	0.86	0.91	(\$215.02)
4	\$18,156.80	34	19	15	55.88	\$4,339.62	(\$4,286.40)	1.01	1.28	\$534.02
3	\$18,582.61	34	21	13	61.76	\$3,600.14	(\$4,386.17)	0.82	1.33	\$546.55
2	\$16,128.88	34	19	15	55.88	\$3,044.95	(\$2,781.68)	1.09	1.39	\$474.38
1	(\$3,545.72)	34	18	16	52.94	\$1,535.01	(\$1,948.49)	0.79	0.89	(\$104.29)

These numbers would indicate no upside edge. I decided to also look at times the market is trading below its 40-week MA:

<i>After closing lower 3 weeks in a row the S&amp;P 500 closes higher on its highest weekly volume in 4 weeks. It closes below its 40-week MA. Buy S&amp;P on close. Sell X weeks later. \$100k/trade. 1960-present.</i>										
X Weeks	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
6	(\$7,999.57)	20	9	11	45.00	\$5,891.22	(\$5,547.32)	1.06	0.87	(\$399.98)
5	(\$22,319.28)	20	9	11	45.00	\$5,246.65	(\$6,321.74)	0.83	0.68	(\$1,115.96)
4	\$8,169.60	21	10	11	47.62	\$6,132.56	(\$4,832.36)	1.27	1.15	\$389.03
3	\$14,728.84	21	14	7	66.67	\$4,040.96	(\$5,977.81)	0.68	1.35	\$701.37
2	\$18,671.68	21	13	8	61.90	\$3,735.45	(\$3,736.15)	1.00	1.62	\$889.13
1	(\$4,264.58)	21	10	11	47.62	\$2,009.25	(\$2,214.28)	0.91	0.82	(\$203.08)

This is even worse.

At the very least I will remain extremely cautious of the long side until I see either 1) more extreme readings from capitulative indicators, or 2) evidence of strength pushing the market higher. I've yet to see much, if any, of either.

## **Catapult and Capitulative Breadth Statistics**

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

### ***Open Catapult Trades***

DELL –bought 1/3 position at \$20.22

DELL – bought 1/3 position \$19.30

DELL – bought last 1/3 position at \$18.36

### ***Open Big 50 Trades***

None

### ***Catapult for ETF's Trades***

VWO – bought and listed in trades section

### ***Broad Market Large Cap CBI – 3/1 (3 DELL)***

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

<b>Index</b>	<b>ETF</b>	<b>CBI %</b>	<b>Index</b>	<b>ETF</b>	<b>CBI %</b>
DJ US Broker Dealers	IAI	3.45	DJ US Energy	IYE	2.33
DJ US Insurance Index	IAK	2.70	DJ US Financial	IYF	1.71
DJ US Regional Banks	IAT	0.00	DJ US Financial Services	IYG	1.40
DJ US Utilities	IDU	2.70	DJ US Healthcare	IYH	2.11
DJ US Oil&Gas Expl & Prod	IEO	6.90	DJ US Industrial Sector	IYJ	1.92
DJ US Oil Equip & Svcs	IEZ	3.85	DJ US Consumer Goods	IYK	0.00
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	1.35
DJ US Healthcare Providers	IHF	0.00	DJ US Real Estate	IYR	1.22
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	5.03
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	7.89
DJ US Consumer Svcs	IYC	0.88	Nasdaq 100	QQQQ	3.00

Still no groups jumping out with extreme capitulative selling.

### **Additional New Trade Ideas**

*SPY – buy 1/4 of index allocation on close of \$120.09 or lower.* Based on market outlook above. Could be a little early but another lower close would leave me wanting some skin in the game in anticipation of a sharp reversal.

Other than that, I'm not particularly interested in new trades in this market.

### Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
DELL	9/4/2008	\$20.22	\$17.99	-11.03%		Catapult
FXE	9/5/2008	\$143.20	\$142.20	-0.70%		<b>sold on open</b>
VWO	9/5/2008	\$37.50	\$34.77	-7.28%		Catapult
EXC	9/9/2008	\$64.97	\$66.94	3.03%		<b>sold on open</b>
DELL	9/10/2008	\$19.30	\$17.99	-6.79%		Catapult
SPY(S)	9/12/2008	\$126.09	\$121.81	3.39%		<b>covered on open</b>
DELL	9/15/2008	\$18.36	\$17.99	-2.02%		bought on open

### Stocks and ETF's on my Radar

None

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