QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 22, 2008 Issue 150

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 21, 2008	2 up days in choppy market	1-4 days	Bearish	-1.17%	-2.00%
September 21, 2008	1% up op-ex Friday	1-5 days	Bearish	-0.70%	-1.32%
September 19, 2008	Big Reversal Days	1-18 days	Bullish	6.30%	10.00%
September 16, 2008	***25% VIX stretch***	***1-6 Days***	***Bullish***	***2.73%***	***4.74%***
8/27 & 9/11	Weak Bounce	1-17 days	Bearish	**-5.30%**	-8.90%
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*** and will be removed tomorrow.

Short-term Outlook (1-5 days) – slightly bullish – updated 9/22

In response to moves by the government and the Federal Reserve the market gapped up massively on Friday. The SPY opened 5.5% higher than Thursday's close – a record. Although some gains were given back over the course of the day, the S&P 500 still finished about 4% higher. Breadth was very good once again with up volume accounting for about 86% of total volume. Total volume appeared to be the largest since January 23rd.

There are a few setups that are pointing to a pullback in the next few days. The first is that we have now had two days up in a row and the market has been dominated by choppiness for the last 16 months. A few weeks ago I posted a simple short system for the choppy environment. The system basically looks to short any two up days and then cover on the first profitable close within the next 4 days. Three additional signals have been closed out since the original publication for profits of 0.32%, 3.41%, and 4.43%. There has been no apparent move away from the choppy environment just yet.

In the August 10th Subscriber Letter I showed a series of tests that examined results during the days following a Friday that closed 1% higher. When the market was trading under its 200-day moving average this setup saw strong follow-through on Monday. Monday profits were largely given back by the end of the week, though. The results are weaker when Friday happens to be an option expiration day.

S&P 500 rises 1% on option expiration Friday and closes < 200ma. Buy on close. Sell X days later. $100k/trade. 11/87 - present.												
X Days	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	($6,600.05)	11	4	7	36.36	$2,306.67	($2,486.40)	$1,079.90	($1,559.95)	0.69	0.40	($600.00)
4	($5,547.70)	11	3	8	27.27	$1,146.86	($3,532.32)	$1,020.02	($1,075.97)	0.95	0.36	($504.34)
3	($3,872.35)	11	5	6	45.45	$1,604.00	($3,730.32)	$968.30	($1,452.31)	0.67	0.56	($352.03)
2	($463.37)	11	5	6	45.45	$1,760.25	($1,176.91)	$867.76	($800.36)	1.08	0.90	($42.12)
1	$2,505.36	11	6	5	54.55	$1,535.64	($1,824.03)	$821.02	($484.16)	1.70	2.03	$227.76

While Monday still seems to have a slight edge, the rest of the week not only gives back the profits, but also turns decidedly negative. There are only 11 instances since the Crash of 87, but all 11 had a close at some point by Thursday that was lower than Friday's close.

So we're in a choppy environment and we've had some up days, the last of which was option expiration. The problem for those looking to short is that the market is not just floating around somewhere below the 200-ma. It is forcefully moving off a long-term low in an attempt to form a major bottom. Forceful moves off lows can some times carry farther than expected.

To demonstrate this I took the basic 20-day low reversal on increasing volume study and looked to see what happened if there were 3 days up off the bottom and the 3rd up day was shorted in anticipation of a pullback.

Following a 1% reversal day the S&P rises 2 additional days. Short one close. Cover X days later. $100k/trade. 1978-present.												
X Days	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
10	$520.63	7	4	3	57.14	$5,163.93	($5,757.22)	$2,411.81	($3,042.21)	0.79	1.06	$74.38
9	($2,885.58)	7	4	3	57.14	$3,797.66	($6,632.78)	$2,151.22	($3,830.15)	0.56	0.75	($412.23)
8	($260.45)	7	3	4	42.86	$4,808.89	($4,845.08)	$3,098.24	($2,388.80)	1.30	0.97	($37.21)
7	($424.65)	7	4	3	57.14	$6,260.75	($6,454.60)	$2,824.81	($3,907.97)	0.72	0.96	($60.66)
6	($107.08)	7	4	3	57.14	$5,691.18	($5,748.96)	$3,003.96	($4,040.97)	0.74	0.99	($15.30)
5	$469.76	7	4	3	57.14	$5,992.14	($6,877.04)	$3,184.96	($4,090.03)	0.78	1.04	$67.11
4	$65.91	7	4	3	57.14	$4,682.70	($5,068.10)	$2,377.30	($3,147.77)	0.76	1.01	$9.42
3	($213.54)	7	4	3	57.14	$3,701.10	($4,455.68)	$2,092.58	($2,861.29)	0.73	0.98	($30.51)
2	($1,291.81)	7	4	3	57.14	$2,894.10	($2,743.40)	$1,236.07	($2,078.70)	0.59	0.79	($184.54)
1	($1,347.58)	7	4	3	57.14	$2,930.40	($4,699.94)	$1,267.16	($2,138.73)	0.59	0.79	($192.51)

Not overwhelmingly negative, but the fact that the edge isn't strongly negative speaks volumes about the potential power behind strong reversals.

Below are a few recent examples where the stock market made a major bottom and didn't hardly pause while running higher for more than a week or so.

October 1998

Created with TradeStation

In October 1998 the market moved higher for nearly 2 straight weeks after bottoming.

2002

Created with TradeStation

October of 2002 showed similar persistence right off the bat.

2003

Created with TradeStation

March of 2003's bottom kicked off with 8 straight days higher.

A chart of the Quantifiable Edges Aggregator is below:

Created with TradeStation

The overperformance of the S&P lately as indicated by the black differential line, combined with the negative short-term expectations illustrated by the green Aggregator line suggest a pullback in the next few days. Looking at how the studies are lining up over the next few days, the green Aggregator line is currently set to fluctuate above and below the 0 line rather than remain consistently bearish. While the probabilities seem fairly good that we'll see a market pullback, I'm much less enthusiastic about trying to short than I would be if the market hadn't just bounced strongly from a long-term low. With what seems like a possible intermediate-term bottom in place, I'd prefer to wait for a pullback and bullish short-term indications to go long. The other option is some studies with increased bearish implications along with a continued rise could get me interested in a short trade, although that seems less likely at this point.

Intermediate-term Outlook (1 week – 2 months)–somewhat bullish -updated 9/22

The force of the bounce the last few days has been astonishing. From a percentage standpoint, a volume standpoint, and a breadth standpoint there has been exceptional strength. The fact that conditions were so overstretched to the downside makes the intermediate-term potential even better.

From a breadth standpoint, Friday marked the 2nd consecutive day with 80% or better up volume. According to Lowry's research, two consecutive 80% up days can be substituted for a 90% up day when looking for a market bottom. The market had put in a 90% down day just 1 day before and 4 90% down days within the last month. For those who have not read the Lowry's paper on market bottoms, it can be found here. It is an excellent read.

The number of new lows had also hit an extreme last week. The net number of new lows minus new highs divided by the total number of issues traded on the NYSE was in excess of 30%. Amazingly, with the sharp 2-day reversal, new highs outnumbered new lows on Friday. This is the 1st time going back to 1970 (as far as I have the data) that new lows have been that negative and then been outnumbered by new highs just 2 days later. It's another sign of the amazing strength of the move.

On a percentage basis, the S&P 500 rallied over 11.5% from its low on Thursday to its high on Friday. I was only able to find two other instances of a 11.5% rally in such a short period of time – 10/10/74 and 10/21/87. In both cases a low was in place but it took some backing and filling before the market was actually able to launch its rally in earnest. Loosening the requirement a little bit there have been 6 times when the S&P has managed to rally over 8% from low to high in 2 days. Three months later the market has always been higher. Five of those times by greater than 5%.

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 50% 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. A few of the more interesting facts to keep in mind include:

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 50% 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.

Another positive sign for the market is the fact that although we've had a huge rally the last two days, there still seems to be a good amount of fear out there. The VIX remains stretched far above its 10-day moving average and the VIX:VXV ratio still sits at a whopping 1.15. There is a large amount of doubt out there with regards to the rally. If the rally can continue those doubters can help provide fuel as they throw in the towel and either start to chase or provide support on pullbacks.

One rationalization I've heard for doubting this rally attempt is that it has basically been constructed by government intervention. While this might seem logical on the surface, it should bee kept in mind that nearly every bottom in the last 21 years was aided by government intervention.

Over the next few days and weeks, it will be important to watch and see whether the market can follow through in a meaningful way and how it acts on pullbacks.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Trades

AAPL – 1/3 @ 127.83

Catapult for ETF's Trades

None

Broad Market Large Cap CBI –1 (AAPL)

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	4.05		DJ US Healthcare	IYH	0.70
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	0.68
DJ US Pharmaceuticals	IHE	0.00		DJ US Basic Materials	IYM	1.35
DJ US Healthcare Providers	IHF	2.04		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	2.51
DJ US Home Construction	ITB	0.00		DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	1.32		Nasdaq 100	QQQQ	3.00

Additional New Trade Ideas

None tonight. Would prefer a pullback to buy into as discussed in the short-term outlook section.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
DELL	9/4/2008	$20.22	$18.44	-8.83%		closed
VWO	9/5/2008	$37.50	$37.00	-1.33%		closed
DELL	9/10/2008	$19.30	$18.44	-4.48%		closed
DELL	9/15/2008	$18.36	$18.44	0.41%		closed
AAPL	9/18/2008	$127.83	$142.50	11.48%		closed
SPY	9/18/2008	$116.61	$126.91	8.83%		closed

While the AAPL trade idea was closed in Friday, it actually fell below its end-of-day target and never hit the intraday. Therefore it is still listed in the Catapult section. I may consider repurchasing it should it pull back a bit.

Stocks and ETF's on my Radar

None