

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 23, 2008

Issue 151

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 23, 2008	Pullback from strong bounce	1-3 days	Bullish	2.58%	5.15%
<i>September 21, 2008</i>	<i>2 up days in choppy market</i>	<i>1-4 days</i>	<i>Bearish</i>	<i>-1.17%</i>	<i>-2.00%</i>
<i>September 21, 2008</i>	<i>1% up op-ex Friday</i>	<i>1-5 days</i>	<i>Bearish</i>	<i>-0.70%</i>	<i>-1.32%</i>
September 19, 2008	Big Reversal Days	1-18 days	Bullish	6.30%	10.00%
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 9/23

The wild ride continued today as the major indices gave back all or most of their gains from Friday. The losses were basically in the 3% - 4.5% range. Breadth was strongly negative as declining issues and declining volume both led advancing issues and advancing volume by about 4 to 1. Volume was curiously light. In fact, it was the lightest volume day in over tow weeks.

Let's first dispel the light volume is a good thing myth. At the beginning of a pullback, light volume does not mean much. Frequently the selling will increase and volume will come in later. I've discussed this previously in the blog, but I ran a new study looking at it tonight:

<i>After closing above its 10-day moving average yesterday, the S&P 500 pulls back today. NYSE volume is the lightest in 10 days. Buy on close. Sell X bars later. \$100k/trade. 1960-present.</i>												
X Days	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	\$2,126.38	59	34	25	57.63	\$4,614.96	(\$6,806.10)	\$1,740.72	(\$2,282.32)	0.76	1.04	\$36.04
4	(\$9,492.87)	61	32	29	52.46	\$4,630.50	(\$6,585.60)	\$1,429.89	(\$1,905.15)	0.75	0.83	(\$155.62)
3	(\$8,636.78)	61	30	31	49.18	\$2,817.50	(\$4,527.60)	\$1,310.15	(\$1,546.49)	0.85	0.82	(\$141.59)
2	(\$13,520.20)	62	28	34	45.16	\$5,018.23	(\$5,656.78)	\$1,131.32	(\$1,329.33)	0.85	0.70	(\$218.07)
1	(\$14,628.21)	63	29	34	46.03	\$2,971.43	(\$3,408.60)	\$806.53	(\$1,118.17)	0.72	0.62	(\$232.19)

No great downside edge demonstrated here, but it does debunk the idea that the low volume today is a positive.

Much of the pullback buying I do is short-term in nature. There are two kinds of pullbacks I especially like to trade and will hold on to for longer periods because they can

lead to real home runs. They are both what I refer to as “1st pullbacks”. The most obvious is a 1st pullback after a base formation breakout. The other kind of 1st pullback is when the stock or index is showing signs of a potential bottom. In either case the risk is defined and the potential reward is many times greater since the hope is to catch a trend early on. One example of an attempt at this was when I (unsuccessfully) bought the 1st pullback in the semiconductors coming off the July bottom.

So if the massive upside reversal on Thursday and Friday could be viewed as a potential bottom, then the 1st pullback began today. Tonight I looked at buying the 1st down close following other strong reversals off of intermediate-term lows in the S&P 500:

<i>S&P moves strongly from 30-day low by rising 1.5% or more on increased volume on the day of the low or the next day. Wait for the market to close down 1 day and then buy on close. Sell X days later. \$100k/trade. 11/87 - present.</i>												
X Days	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	\$19,072.21	25	11	14	44.00	\$10,657.28	(\$3,534.21)	\$3,438.41	(\$1,339.31)	2.57	2.02	\$762.89
4	\$32,557.54	25	14	11	56.00	\$13,377.28	(\$3,154.52)	\$3,209.96	(\$1,125.63)	2.85	3.63	\$1,302.30
3	\$44,242.62	26	22	4	84.62	\$8,279.04	(\$1,805.40)	\$2,194.86	(\$1,011.07)	2.17	11.94	\$1,701.64
2	\$33,017.82	26	16	10	61.54	\$8,484.76	(\$1,660.00)	\$2,433.78	(\$592.27)	4.11	6.57	\$1,269.92
1	\$15,256.06	26	17	9	65.38	\$4,307.74	(\$1,675.86)	\$1,285.76	(\$733.55)	1.75	3.31	\$586.77

In under such circumstances there is a decided edge to the upside over the next three days. While the oversized max win skews the results a little bit, 85% wins over the 1st 3 days is quite impressive. This study certainly suggests a short-term upside edge.

Unfortunately, the selloff on Monday was much more severe than normal. Coming off such a strong upmove this is basically unheard of. I’d suggest subscribers [check out my blog entry tonight](#) for a more detailed discussion, but my basic take away is that the market behaved on Monday in a way that it shouldn’t. I would consider Monday a warning shot. It suggests the intermediate-term thesis that last week’s strong reversal could mark a significant bottom is now substantially in doubt. For the short-term “chop” is still the name of the game and I’ll continue to try and anticipate the reversals based on what the studies are suggesting.

The actual number of active studies has been quite low the last several days. This is largely due to the fact that the “max move + 1 standard deviation” has been getting hit consistently for both bullish and bearish studies. This happened again today as the objectives for both of last night’s bearish studies have already been reached.

An updated Aggregator chart is below:



While the green Aggregator line has turned sharply higher, the market is still overbought based on the outperformance over the last 3 days. Any close lower tomorrow will quickly flip the black differential line back above 0. I will be looking to enter the SPY on a close lower. Details are in the trade ideas section. Intraday traders may consider taking a position if it moves down and looks to be reversing during the day.

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 be 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	2.70	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	1.01
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

SPY – buy ¼ of index allocation on close of \$121 or lower.

It's too choppy and volatile for me to be comfortable trading individual stocks. The prime focus for now will be indices.

Active Trades Table

none

Stocks and ETF's on my Radar

While the Catapult remains open on AAPL, profits were taken on Friday. I may look to re-enter this one yet.

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