

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 24, 2008

Issue 152

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% |
| 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 9/24

More interesting action again today as the market continues to trade in a very wide range. After posting gains over 1% this morning the S&P 500 closed down 1% in the afternoon. Breadth was once again negative. Up volume exceeded down volume by over 3:1. Oddly, total volume contracted once again.

One of the most unusual aspects of the recent volatility is the fact that most of it is occurring overnight. The average true gap over the last two weeks have been the largest in the history of the SPY. A very close second was the period immediately following 9/11/2001. I'll be discussing my thoughts on this a bit more in the blog tomorrow morning.

Another notable is the fact that the VIX has closed more than 10% above its 10-day moving average for 7 days in a row. While rare, most often when this has happened the market has been near a low.

| VIX closes > 10% above its 10-day ma for 7 days in a row. Buy on close. Sell X days later. \$100k/reade. 1990-present | | | | | | | | | | | | |
|---|-------------|--------|------|--------|--------|-------------|--------------|------------|--------------|-----------|---------------|------------|
| X Days | Net Profit | Trades | Wins | Losses | % Wins | Max Win | Max Loss | Avg Win | Avg Loss | W/L Ratio | Profit Factor | Avg Trade |
| 20 | \$40,121.61 | 8 | 6 | 2 | 75.00 | \$16,466.04 | (\$3,609.76) | \$7,311.80 | (\$1,874.58) | 3.90 | 11.70 | \$5,015.20 |
| 19 | \$35,548.77 | 8 | 6 | 2 | 75.00 | \$17,445.48 | (\$2,845.92) | \$6,778.22 | (\$2,560.26) | 2.65 | 7.94 | \$4,443.60 |
| 18 | \$31,211.52 | 8 | 7 | 1 | 87.50 | \$14,510.34 | (\$3,261.28) | \$4,924.69 | (\$3,261.28) | 1.51 | 10.57 | \$3,901.44 |
| 17 | \$30,866.60 | 8 | 7 | 1 | 87.50 | \$13,610.40 | (\$3,873.76) | \$4,962.91 | (\$3,873.76) | 1.28 | 8.97 | \$3,858.33 |
| 16 | \$29,831.45 | 8 | 6 | 2 | 75.00 | \$14,103.30 | (\$2,956.80) | \$5,502.22 | (\$1,590.94) | 3.46 | 10.38 | \$3,728.93 |
| 15 | \$26,579.46 | 8 | 6 | 2 | 75.00 | \$11,937.72 | (\$2,388.32) | \$4,847.68 | (\$1,253.32) | 3.87 | 11.60 | \$3,322.43 |
| 14 | \$25,438.39 | 8 | 6 | 2 | 75.00 | \$11,009.16 | (\$2,112.00) | \$4,803.55 | (\$1,691.46) | 2.84 | 8.52 | \$3,179.80 |
| 13 | \$20,205.67 | 8 | 6 | 2 | 75.00 | \$9,326.94 | (\$3,655.52) | \$4,206.48 | (\$2,516.60) | 1.67 | 5.01 | \$2,525.71 |
| 12 | \$18,794.88 | 9 | 7 | 2 | 77.78 | \$9,603.60 | (\$5,496.48) | \$3,663.22 | (\$3,423.82) | 1.07 | 3.74 | \$2,088.32 |
| 11 | \$17,029.08 | 9 | 7 | 2 | 77.78 | \$8,643.24 | (\$4,426.40) | \$3,594.98 | (\$4,067.90) | 0.88 | 3.09 | \$1,892.12 |
| 10 | \$8,315.20 | 9 | 7 | 2 | 77.78 | \$7,034.16 | (\$4,019.48) | \$2,277.27 | (\$3,812.86) | 0.60 | 2.09 | \$923.91 |
| 9 | \$6,097.63 | 9 | 7 | 2 | 77.78 | \$7,094.58 | (\$4,947.36) | \$1,959.34 | (\$3,808.86) | 0.51 | 1.80 | \$677.51 |
| 8 | \$9,480.51 | 9 | 6 | 3 | 66.67 | \$7,107.30 | (\$3,701.28) | \$2,500.92 | (\$1,841.67) | 1.36 | 2.72 | \$1,053.39 |
| 7 | \$7,046.44 | 9 | 5 | 4 | 55.56 | \$6,697.08 | (\$3,146.88) | \$2,662.88 | (\$1,566.99) | 1.70 | 2.12 | \$782.94 |
| 6 | \$5,470.22 | 9 | 6 | 3 | 66.67 | \$5,240.64 | (\$3,131.04) | \$1,988.90 | (\$2,154.40) | 0.92 | 1.85 | \$607.80 |
| 5 | \$8,510.04 | 9 | 7 | 2 | 77.78 | \$4,639.62 | (\$3,852.64) | \$2,046.83 | (\$2,908.88) | 0.70 | 2.46 | \$945.56 |
| 4 | \$7,391.43 | 9 | 7 | 2 | 77.78 | \$5,514.12 | (\$4,671.04) | \$2,124.90 | (\$3,741.44) | 0.57 | 1.99 | \$821.27 |
| 3 | \$4,519.77 | 9 | 6 | 3 | 66.67 | \$5,883.00 | (\$4,426.24) | \$2,017.25 | (\$2,527.90) | 0.80 | 1.60 | \$502.20 |
| 2 | \$3,290.86 | 9 | 6 | 3 | 66.67 | \$4,528.32 | (\$4,627.20) | \$1,757.32 | (\$2,417.68) | 0.73 | 1.45 | \$365.65 |
| 1 | \$6,492.68 | 9 | 7 | 2 | 77.78 | \$2,656.33 | (\$1,597.44) | \$1,159.58 | (\$812.18) | 1.43 | 5.00 | \$721.41 |

A few things to note. While the action did have a bullish tilt, it was a bit choppy over the 1st two weeks. The average gain of 5% four weeks out looks fairly impressive. If you take out the max win of 16% that number then drops to 3.5% - not bad, but the market is moving that much every day recently. Not shown is the fact that 8 of the 9 instances closed above the trigger price within two days. The lone holdout posted a positive return on day 8.

The S&P has closed lower two days in a row. In the incredibly choppy environment the market has experienced over the last 15 months, [it has paid to buy consecutive down days](#). It has now retraced a little more than 50% of the move from the low last Thursday to the high on Friday. I prefer scaling into positions when the market is in the lower half of its recent range. That helps to place the risk/reward ratio in your favor. We began to scale in at Tuesday's close and I will look to add to it tomorrow.

With the low number of instances and choppy results I elected not to include the VIX study above in the "Active Studies" list. The list therefore remains quite small. The Aggregator chart is below:



As anticipated last night the green Aggregator line and the black differential line are both now above 0. In other words the market has underperformed as of late and is expected to rise in the next few days. Without a strong move higher or a strongly bearish study both lines should continue to rise tomorrow. We began to scale in at Tuesday's close and I will look to add to it tomorrow.

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 \$120 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

| Symbol | Entry Date | Entry Price | Current Price | % Gain/Loss | Stop | Notes |
|---------------|-------------------|--------------------|----------------------|--------------------|-------------|-----------------|
| SPY | 9/18/2008 | \$118.55 | \$118.55 | 0.00% | | bought at close |

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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