

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

November 3, 2008

Issue 180

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
November 3, 2008	SP 500 Up 2 Days Since 6/1/07	1-3 days	Bearish	-1.38%	-2.79%
November 3, 2008	Nas 3-day RSI > 75, Spyx < 30	1-5 days	Bearish	-3.20%	-6.55%
October 31, 2008	2 Strong Breadth Days Under 200	1-5 days	Bearish	-3.20%	-5.90%
October 31, 2008	3 Up Days & Low Spyx Reading	1-10 days	Bearish	-4.60%	-7.58%
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) –somewhat bearish – updated 11/3

After gapping down a bit Friday morning, the market fought back and trended higher for much of the day. It closed the opening gap and all the major indices managed to close up well over 1%. Breadth was again quite strong on both the NYSE and the Nasdaq. The percentage of issues closing up on the day exceeded 60% on both exchanges for the 4th day in a row. My data goes back to 1970 for the NYSE and over that time period this is the 1st time there has been 4 days in a row with an up-issues % greater than 60% while the S&P 500 is under its 200-day moving average. NYSE volume on Friday was the lightest of the week.

The most obvious characteristic of the current charts is the strong rise in price this week. The Nasdaq Composite has now closed higher 4 days in a row and the S&P 500 2 days in a row. I've discussed several times over the last few months that the market has become more choppy since June of 2007, and looking to short any time the S&P 500 has risen two days in a row has been a solid entry technique. Below are updated statistics of a simple system based off this entry technique.

Sell short if the S&P 500 closes higher 2 days in a row. Cover on close below entry price – up to 4 days later. If still not profitable on day 4, close anyway. \$100k/trade. June 1, 2007 – present.

TradeStation Performance Summary

Expand ▾

All Trades

Total Net Profit	\$48,062.56	Profit Factor	12.86
Gross Profit	\$52,114.55	Gross Loss	(\$4,051.99)
Total Number of Trades	48	Percent Profitable	95.83%
Winning Trades	46	Losing Trades	2
Even Trades	0		
Avg. Trade Net Profit	\$1,001.30	Ratio Avg. Win:Avg. Loss	0.56
Avg. Winning Trade	\$1,132.92	Avg. Losing Trade	(\$2,026.00)
Largest Winning Trade	\$7,845.76	Largest Losing Trade	(\$3,230.74)
Max. Consecutive Winning Trades	18	Max. Consecutive Losing Trades	1
Avg. Bars in Winning Trades	2.74	Avg. Bars in Losing Trades	5.00
Avg. Bars in Total Trades	2.83		

Amazingly, the system has not triggered since 9/26/08. Therefore, the 48% profits generated were all achieved prior to the big October selloff. The system is also in an 18-trade winning streak, dating back to April.

The consistently strong breadth this week has not been limited to the NYSE. The Nasdaq has also closed with up issues comprising 60% of all issues for the last four days. The only other time this has happened since 1999 (as far as my Nasdaq data goes back) is 5/2/01.

By lowering the requirement to 55% Nasdaq Up Issues, I was able to find a few instances. They were 5/2/01, 5/21/01, 10/1/04, and 8/17/06. Below is a summary results of those instances:

Nasdaq Up Issues Are 55% of Total Issues for 4 Days in a Row.										
Buy on close. Sell X days later. \$100k/trade. 1999 - present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
6	(\$15,108.20)	4	0	4	0.00	\$0.00	(\$3,777.05)	0.00	0.00	(\$3,777.05)
5	(\$10,578.21)	4	0	4	0.00	\$0.00	(\$2,644.55)	0.00	0.00	(\$2,644.55)
4	(\$4,543.39)	4	1	3	25.00	\$322.32	(\$1,621.90)	0.20	0.07	(\$1,135.85)
3	(\$2,042.75)	4	1	3	25.00	\$1,470.33	(\$1,171.03)	1.26	0.42	(\$510.69)
2	(\$3,635.61)	4	1	3	25.00	\$678.30	(\$1,437.97)	0.47	0.16	(\$908.90)
1	(\$4,933.41)	6	4	2	66.67	\$329.13	(\$3,124.97)	0.11	0.21	(\$822.24)

Instances are much too small to draw any solid conclusions, but the consistently negative returns is interesting.

In Thursday night's Subscriber Letter I showed the following 2 studies related to this same breadth measure:

Nasdaq Advancers Outnumber Decliners By At Least 3 to 2 for 3 Days In A Row										
Buy on close. Sell X days later. \$100k/trade. 1999 - present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
5	(\$3,789.60)	15	7	8	46.67	\$916.32	(\$1,275.48)	0.72	0.63	(\$252.64)
4	(\$4,997.74)	15	5	10	33.33	\$858.55	(\$929.05)	0.92	0.46	(\$333.18)
3	(\$3,556.59)	15	6	9	40.00	\$989.16	(\$1,054.61)	0.94	0.63	(\$237.11)
2	(\$9,845.33)	15	4	11	26.67	\$585.77	(\$1,108.04)	0.53	0.19	(\$656.36)
1	(\$3,798.95)	16	5	11	31.25	\$830.72	(\$722.96)	1.15	0.52	(\$237.43)

Nasdaq Advancers Outnumber Decliners By At Least 3 to 2 the Last 2 Days & Closes Under 200ma										
Buy on close. Sell X days later. \$100k/trade. 1999 - present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
5	(\$25,491.14)	22	7	15	31.82	\$3,124.28	(\$3,157.41)	0.99	0.46	(\$1,158.69)
4	(\$17,520.57)	22	12	10	54.55	\$2,010.98	(\$4,165.23)	0.48	0.58	(\$796.39)
3	(\$21,675.47)	24	11	13	45.83	\$1,315.37	(\$2,780.35)	0.47	0.40	(\$903.14)
2	(\$4,326.86)	25	11	14	44.00	\$2,138.10	(\$1,989.00)	1.07	0.84	(\$173.07)
1	(\$2,521.76)	30	17	13	56.67	\$856.67	(\$1,314.24)	0.65	0.85	(\$84.06)

Both suggested that multiple days of strong breadth often lead to a reversion and a market pullback. Now that we're at 4 days in a row, the rubber band is stretched about as tight as it has ever been with regards to this indicator. This appears to imply breadth is extremely overdone and likely to reverse in the short-term.

I also noted in Thursday's Subscriber Letter that the [Nasdaq Volume Spyx](#) had posted an exceptionally low reading. On Friday it dove even lower, coming in at nearly -9. (Detailed information on S&P 500 Volume Spyx, which is similar, may be found [here](#).)

On its own, a Nasdaq Spyx reading below 0 has provided a short-term bearish edge over the last 9 years:

Nasdaq Spyx Closes Below 0 While the Nasdaq Closes Higher. Buy Nasdaq on close.										
Sell X Days later. \$100k/trade. 2000-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
2	(\$25,846.68)	26	8	18	30.77	\$1,484.63	(\$2,095.76)	0.71	0.31	(\$994.10)
1	(\$6,581.87)	26	11	14	42.31	\$1,020.97	(\$1,272.32)	0.80	0.63	(\$253.15)

When volume Spyx are combined with overbought readings the edge is often quite pronounced. For the test below I loosened the required Spyx reading to anything below 30, but required the Nasdaq to be quite overbought on a short-term basis and trading under the 200ma:

Nasdaq Spyx Closes Below 30 While the Nasdaq's 3-day RSI closes Over 75 and the Nasdaq closes under the 200ma.										
Buy Nasdaq on close. Sell X Days later. \$100k/trade. 2000-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
5	(\$28,835.24)	27	12	15	44.44	\$1,949.60	(\$3,482.03)	0.56	0.45	(\$1,067.97)
4	(\$17,249.67)	28	15	13	53.57	\$1,745.52	(\$3,340.96)	0.52	0.60	(\$616.06)
3	(\$21,997.41)	29	14	15	48.28	\$1,540.84	(\$2,904.62)	0.53	0.50	(\$758.53)
2	(\$5,507.31)	30	13	17	43.33	\$1,838.82	(\$1,730.12)	1.06	0.81	(\$183.58)
1	(\$991.23)	30	14	16	46.67	\$1,547.72	(\$1,416.21)	1.09	0.96	(\$33.04)

Again we are seeing results that favor a bearish bias for the short-term.

To measure the affect of the Nasdaq Volume Spyx, I also ran the study with the Spyx level *above 30*:

Nasdaq Spyx Closes Above 30 While the Nasdaq's 3-day RSI closes Over 75 and the Nasdaq closes under the 200ma.										
Buy Nasdaq on close. Sell X Days later. \$100k/trade. 2000-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
5	\$38,535.56	45	27	18	60.00	\$3,113.48	(\$2,529.35)	1.23	1.85	\$856.35
4	\$24,110.62	47	27	20	57.45	\$2,582.72	(\$2,281.14)	1.13	1.53	\$512.99
3	\$9,850.00	51	28	23	54.90	\$1,891.07	(\$1,873.92)	1.01	1.23	\$193.14
2	\$16,914.55	55	31	24	56.36	\$1,887.31	(\$1,733.01)	1.09	1.41	\$307.54
1	\$7,532.48	55	27	28	49.09	\$1,396.68	(\$1,077.78)	1.30	1.25	\$136.95

As you can see, without the low Volume Spyx reading, the setup changes from solidly bearish to solidly bullish.

I did mention earlier that volume was quite low on Friday. For the Nasdaq it was the lowest volume in 4 days. If we substitute a simple measure of relatively low volume for the Nasdaq Volume Spyx indicator the following results are achieved:

Nasdaq Posts Lowest Volume In 4 Days While the Nasdaq's 3-day RSI closes Over 75 and the Nasdaq closes under the 200ma.										
Buy Nasdaq on close. Sell X Days later. \$100k/trade. 2000-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	(\$2,270.15)	25	15	10	60.00	\$2,313.56	(\$3,697.36)	0.63	0.94	(\$90.81)
4	(\$1,873.30)	25	13	12	52.00	\$2,397.06	(\$2,752.92)	0.87	0.94	(\$74.93)
3	(\$9,410.46)	25	10	15	40.00	\$2,547.07	(\$2,325.41)	1.10	0.73	(\$376.42)
2	(\$2,842.76)	25	9	16	36.00	\$1,686.64	(\$1,126.41)	1.50	0.84	(\$113.71)
1	\$4,771.57	29	15	14	51.72	\$1,319.37	(\$1,072.79)	1.23	1.32	\$164.54

As you can see, the low volume is certainly not a positive, but it also fails to provide an edge anywhere near approaching one that a low Nasdaq Volume Spyx would provide.

The S&P 500 and Nasdaq Volume Spyx indicators are fast becoming some of my favorites to use as filters when they reach extreme levels. I will be providing much more research associated with them over the next few months.

Tonight's [Aggregator](#) chart is below:



Both the green Aggregator line and the black differential line remain solidly below 0. This is the formation I typically look for when considering short trades – bearish expectations combined with recent outperformance. There are two things keeping me from being *aggressively* bearish here. The first is the fact that the market is coming off a potential bottom. As I’ve discussed in the past, the market is more capable of getting overbought and remaining that way after making an intermediate-term bottom than at any other time. Therefore I’m always a bit more cautious when the market is rebounding from significant lows. Secondly, my intermediate-term outlook is bullish. I tend to trade less aggressively when my short-term outlook is in opposition to my intermediate-term outlook.

Intermediate-term Outlook (1 week – 2 months)– bullish -updated 11/3

Last week I highlighted several extremes that the market had reached. They included extremes of breadth, price, and volatility. Several of them with shorter histories only going back 22 years or so were hitting all-time extremes. Others were matched only in the 1930’s. These extremes suggested that the market was more overdue for a bounce than it had ever been by several measures. Almost right on cue, the market put in a huge rally on Tuesday and was able to extend it through the end of the week.

This is the 2nd time this has happened this month – 10/13 being the first time. In that instance the market failed to hold its gains and the next leg down soon began. In most cases large numbers of breadth, price, and volatility extremes have instead led to

significant rallies over a period of several weeks to months. This appears to be the 2nd attempt to generate a decent rally following extreme readings.

One concern several traders have expressed is that so far this rally appears to be a short covering rally. It is a topic that I actually received a few emails about this week. The reason it appears to be driven by short-covering is that the areas that were beaten down the most actually bounced the best. Studies I've conducted in the past have indicated when the market becomes extremely oversold, it is typical that the most oversold areas bounce the best. [One such study I posted to the blog in January](#). The follow-up to that post [can be found here \(2nd paragraph\)](#). Studies like these suggest that a rally that begins with short-covering is typical and not doomed to fail as some would believe.

But do short covering rallies actually stand a BETTER chance of success? There is some evidence they do.

One tool I like to use to measure how leading stocks are doing versus the overall market is the IBD 100. The IBD 100 is an index published by Investors Business Daily. A description from their website states *"The IBD 100 Index tracks the performance of stocks listed in the IBD 100, a proprietary list of the 100 top-ranked companies published every Monday* in Investor's Business Daily. Companies are ranked based on superior earnings, strong price performance, and leadership within their respective industries."*

Last week the IBD 100's return trailed that of the S&P 500. This would suggest that the strongest stocks entering the week were not the ones that performed the best during the week.

I decided to look at how the market performed after bouncing off a low when the S&P led the IBD 100 versus when the IBD 100 led the S&P. My data for the IBD 100 only goes back to April of 2004, but the results are quite interesting nonetheless. With a relatively short history, rather than use tables, I'll show some charts below.

The top pane is the S&P 500 and the bottom is the IBD 100. The chart is weekly going back to 2004. A buy signal is triggered any time the market closes higher after making a 10-week closing low and the *IBD 100 outperforms the S&P 500* on the week of the rebound (leaders outperform laggards):



Here we see there have been 8 instances. Three times the S&P 500 went on to make further gains over the next 6 weeks and 5 times it fell over the next 6 weeks.

Below we see times the market closed higher after making a 10-week closing low and the S&P 500 led the IBD 100 on the week of the rebound (laggards outperform leaders). This is the situation we are in now.



In this case there have also been 8 instances since 2004. But here we see that all eight went on to post successful rallies over the following 6 weeks. The size of the gains on winning trades is also a bit larger. These results would suggest that not only is it *normal* for the laggards to outperform the leaders when the market is attempting to rally from a low, but it is *desirable*.

The incredibly negative and volatile action the market has experienced the last 2 months should be sufficient to have washed out enough sellers that the market could put in a bit of a rally at this stage. Whether the lows are able to hold on a longer-term basis is beyond my vision at this point. I do believe the market is more likely to rally than to collapse over the next several weeks and possibly longer. I expect to trade more aggressively from the long side than the short side in the immediate future.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Trades

none

Catapult for ETF's Trades

None

Broad Market Large Cap CBI - 0

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	0.68
DJ US Regional Banks	IAT	0.00	DJ US Financial Services	IYG	0.00
DJ US Utilities	IDU	0.00	DJ US Healthcare	IYH	4.93
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	2.04
DJ US Pharmaceuticals	IHE	2.70	DJ US Basic Materials	IYM	0.00
DJ US Healthcare Providers	IHF	6.12	DJ US Real Estate	IYR	2.44
DJ US Medical Devices	IHI	7.32	DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	0.00	DJ US Technology Sector	IYW	0.00
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	2.63
DJ US Consumer Svcs	IYC	1.75	Nasdaq 100	QQQQ	0.00

Excessive oversold readings have been pretty much relieved across the board.

Additional New Trade Ideas

None – The QQQQ is very close to the short entry from Friday. Since I feel caution is appropriate on the short-side I will wait another day before looking to take on additional exposure.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
QQQQ (S)	10/31/2008	\$32.84	\$32.89	-0.15%		

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