QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

November 6, 2008 Issue 183

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 6, 2008	S&P 500 Drops 5% today	1-4 days	Bullish	5.28%	8.43%
November 5, 2008	**VXO closes 20% under 10ma**	**1-5 days**	**Bearish**	**-3.58%**	**-7.03%**
November 5, 2008	**SP Rises 3%, Vol under 10ma**	**1-3 days**	**Bearish**	**-3.74%**	**-7.16%**
November 4, 2008	SP 10-day %R>80 Spyx < 0	1-5 days	Bearish	-1.90%	-3.10%
November 4, 2008	SP 10day %R>80 Inside Day<200	1-3 days	Bearish	-2.10%	-3.69%
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 brown**. 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 11/6

The market got hit hard today as the major indices all lost around 5%. Breadth was lopsided to the downside, with both the Nasdaq and the NYSE posting 90% downside volume days. Volume in general was quite light, coming in both nelow yesterday's level and below its 10-day moving average.

I looked back at all prior 5% drops in the S&P 500 since 1960. From 1960 until 1987 there weren't any. Since 1987 there have now been 14 of them. Since early September this was the 6th. Generally these large drops have been followed by a bounce at some point over the next few days. Of the 13 instances, 10 closed higher the following day. If you give the trade 4 days to work then 12 of 13 closed higher than the entry at some point. The lone loser was October 16, 1987. That date is notable because it was the Friday prior to Black Monday. All instances are found in the table below (also on the blog):

Hanna Capital Management, LLC 16 Hillcrest Rd., Medfield, Massachusetts 02052 781-956-6952

S&P 500 Drops 5% Today		
Instance	Date	Closed > Close of -5% Day
1	October 16, 1987	NO
2	October 19, 1987	Next day
3	October 26, 1987	Next day
4	January 8, 1988	Next day
5	October 13, 1989	Next day
6	October 27, 1997	Next day
7	August 31, 1998	Next day
8	April 14, 2000	Next day
9	September 29, 2008	Next day
10	October 7, 2008	4 days later
11	October 9, 2008	2 Days Later
12	October 15, 2008	Next day
13	October 22, 2008	Next day

Below are the 1-week stats following all the S&P 5%+ drops:

S&P 500 drops > 5%. Buy on close. Sell X days later. $100k/trade. 1960-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	$24,304.91	11	8	3	72.73	$12,331.51	($12,167.91)	$5,389.36	($6,269.98)	0.86	2.29	$2,209.54
4	$24,309.19	11	9	2	81.82	$10,588.68	($12,157.32)	$4,235.97	($6,907.25)	0.61	2.76	$2,209.93
3	$6,373.45	11	7	4	63.64	$8,531.60	($9,701.00)	$4,327.09	($5,979.04)	0.72	1.27	$579.40
2	$10,605.06	12	9	3	75.00	$10,183.87	($16,188.58)	$4,182.86	($9,013.56)	0.46	1.39	$883.76
1	$11,546.99	13	10	3	76.92	$5,328.00	($20,424.58)	$3,426.69	($7,573.29)	0.45	1.51	$888.23

The fact that volume came in lighter today will be viewed by many as a positive. I ran some tests on relatively low volume occurring on large selloff days (2.5%+) and found the results to be inconclusive. Some suggested the low volume may have slight bullish implications. Others suggested the low volume could have slightly bearish implications.

Tonight's Aggregator chart is below:

Even with tonight's bullish 5% drop study the Aggregator remains quite negative. The black differential line, which measures how the market has done versus expectations over the last 3 days, flipped to positive with today's selloff. In other words, the last 3 days as a whole has been worse than expected. The differential value closed at 0.30, meaning on average over the last 3 days the market has underperformed expectations by 0.30% per day. If we use QQQQ in the upper panel instead of the S&P 500 you can see the differential is even larger.

Here you can see the underperformance jumps from 0.30% to 0.68% per day. So while the green Aggregator line is still suggesting there may be more downside to come based on the studies over *the next few days*, the black differential line is saying that over *the last few days* it has already overshot to the downside. I typically begin to take profits when this happens. Having already outperformed expectations, I'd rather book profits than push my luck. This is especially true when my intermediate-term outlook conflicts with the short-term Aggregator as it does now.

Many of the bearish studies in the Summary List are short-term in nature. They will be coming off in the next day or two regardless of whether they meet their objectives or not. A further pullback could eliminate them faster and perhaps lead to some additional bullish studies. If the market continues down the next day or so, I will likely begin looking to buy.

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	0.00
DJ US Regional Banks	IAT	0.00		DJ US Financial Services	IYG	0.00
DJ US Utilities	IDU	0.00		DJ US Healthcare	IYH	0.00
DJ US Oil&Gas Expl & Prod	IEO	0.00		DJ US Industrial Sector	IYJ	0.00
DJ US Oil Equip & Svcs	IEZ	0.00		DJ US Consumer Goods	IYK	0.00
DJ US Pharmaceuticals	IHE	0.00		DJ US Basic Materials	IYM	0.00
DJ US Healthcare Providers	IHF	2.04		DJ US Real Estate	IYR	1.22
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	0.00
DJ US Home Construction	ITB	0.00		DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	0.00		Nasdaq 100	QQQQ	0.00

Nothing even remotely high anymore.

Additional New Trade Ideas

None – Another quiet day for the systems as well. Now it just a matter of waiting for the next edge to reveal itself.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
QQQQ (S)	10/31/2008	$32.84	$32.295	1.66%		covered

The short trade idea in QQQQ was closed out today via an intraday update. The first half was covered at $32.60 and the 2nd half at the close. It wasn't the best-timed trade idea in terms of entry or exit. Still we were able to pull out a decent profit from it.

October Final Trade Idea Results

I posted the Summary stats to the blog, but did not have a chance to post the details here yet. In the October 20th Letter I posted all the October trades up until that point. Rather than re-posting all of them, below are the trade ideas since that Subscriber Letter, along with summary results for the complete month. If you would like another copy of the October 20 Subscriber Letter just shoot me a note. First, the caveats that I discussed a couple of weeks ago with these results:

I don't suggest position sizes. The primary reason for this is I'm not acting as a financial advisor. I don't feel it is appropriate to suggest allocation sizes without understanding someone's financial situation and risk tolerance. Even for my own trading I run different portfolios with different levels of aggressiveness. For instance, my most aggressive portfolio is my IRA. Here I may use options to sometimes get 400-500% leveraged. The partnership I manage on the other hand takes much more conservative stances and rarely reaches or exceeds 100% exposure.

Since I don't suggest position sizes this is not truly a performance report, but rather a trade idea scorecard. Therefore, no matter how objective I try to be the reporting of the results is always going to be skewed depending on how you approach the trades. For *instance, I always recommend scaling into the Catapult positions in 3 parts, whereas the "System" trades (whatever system I unveil other than Catapult) are normally one entry. The "QE Index" trades I normally recommend scaling into as well. For my own trading I trade much much larger size with the index trades than any of the individuals. I also control my exposure by limiting the total amount invested per day. As I mentioned, this will very depending on the account I'm trading. My most aggressive account I may put in up to 100%/day and get heavily leveraged using options. A conservative account may max out at 15%-20% per day.*

I've also mentioned in the past that days with large numbers of triggers tend to produce better results than those with less triggers. Also, the later trades in a cluster tend to provide profits to overshadow the early trades in a cluster. Therefore, one way to play the Catapult trades is to only begin taking them once there are several active. However they are taken, they typically provide 1-2 excellent opportunities to profit greatly each year. Early October was one of those times. Last January and March also provided nice opportunity. June/July was a difficult group of trades, although utilizing intraday exits when they were sent out would have alleviated much of that pain.

It's unlikely anyone would have taken all of the trades with equal amounts, so results could vary greatly depending on your approach.

Trades Since 10/17:

MA	Stock	Catapult	Long	10/24/2008	$121.01	10/24/2008	$131.00	8.3%
SPY	Index	QE Index	Long	10/27/2008	$83.95	10/28/2008	$90.55	7.9%
MA	Stock	Catapult	Long	10/27/2008	$127.63	10/29/2008	$140.80	10.3%
MA	Stock	Catapult	Long	10/28/2008	$126.35	10/29/2008	$140.80	11.4%
HPQ	Stock	Catapult	Long	10/28/2008	$31.18	10/29/2008	$35.50	13.9%

Summary Results for October:

October									
	Trades	Wins	Losses	Win %	Avg Win	Avg Loss	Avg Trade	Profit Factor	Total Gains
Total	42	35	7	83.33%	16.72%	-5.22%	12.57%	13.73	516.9%
Index	5	2	3	40.00%	6.27%	-5.89%	-1.03%	-0.46	-5.1%
Catapult	37	33	4	89.19%	16.39%	-4.72%	14.11%	28.67	522.0%
System	0	0	0	0.00%	0.00%	0.00%	0.00%	0.00	0.0%

Obviously October blew away all other months this year. I expect it will be a very long time before we see results anywhere near this strong again.