QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

November 7, 2008 Issue 184

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 7, 2008	2 Lower Closes On High Volume	1-3 days	Bearish		
November 7, 2008	Dow Double 4% Drop	1-2 days	Bullish		
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 3, 2008	***Nas 3-day RSI > 75, Spyx <30***	***1-5 days***	***Bearish***	***-3.20%***	***-6.55%***
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 bullish – updated 11/7

Thursday was the 2nd big drop in a row. The S&P 500 has closed over 5% lower on both Wednesday and Thursday. Basically everything else dropped hard as well. Breadth was extremely negative with close to 95% down volume on the NYSE for the 2nd day in a row. Volume rose to its highest level in over a week.

Oh how the list of active studies that make up the Aggregator has changed. In the last two days all the bearish studies have hit their Average Max Move. Many have gone 1 standard deviation beyond that. This has eliminated them from remaining "active".

A few notables about today's action. First, I mentioned breadth was very weak for the 2nd day on a row. Looking back to 1970 I was able to find 7 other times where the NYSE posted a 90% down day for 2 days in a row. Instances are low but in 6 of those cases the market managed to close above the trigger day's close within the next 2 days. The average gain of those 6 instances was over 1%.

Further suggesting a bounce in the next 2 days is the fact that the market lost SO much the last 2. The only other time I was able to find that the S&P has closed lower by 5% or more 2 days in a row since 1960 was during the Crash of '87. Since my Dow data goes back to 1920 I decided to use that. I was able to find 4 instances where the Dow dropped 5% or more 2 days in a row. They are listed below using a holding length of 2-days.:

#	Type	Date/Time	Signal	Price	Roll Over Pips	Shares/Ctrts Profit/Loss	Gross P/L Cum Net Profit	% Profit	Run-up DrawDown
1	Buy	10/29/29	Sharp Drop	$230.10	$0.00	434	$18,835.60	18.86%	$22,307.60
	Sell	10/31/29	Sell	$273.50		$18,835.60	$18,835.60		$0.00
2	Buy	11/06/29	Sharp Drop	$232.10	$0.00	430	$1,892.00	1.90%	$5,676.00
	Sell	11/08/29	Sell	$236.50		$1,892.00	$20,727.60		($6,149.00)
3	Buy	10/10/32	Sharp Drop	$58.50	$0.00	1709	$2,221.70	2.22%	$6,836.00
	Sell	10/13/32	Sell	$59.80		$2,221.70	$22,949.30		$0.00
4	Buy	07/21/33	Sharp Drop	$88.70	$0.00	1127	$4,620.70	4.62%	$8,565.20
	Sell	07/25/33	Sell	$92.80		$4,620.70	$27,570.00		$0.00

Of course the Dow didn't drop 5% today. It did drop over 4%. Relaxing the requirements to 4% instead of 5% would have yielded the following results:

Dow closes down by 4% or more 2 days in a row.										
Buy on close. Sell X days later. $100k/trade. 1920 - present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
5	$31,559.43	10	7	3	70.00	$6,204.80	($3,958.07)	1.57	3.66	$3,155.94
4	$24,412.14	11	7	4	63.64	$7,601.78	($7,200.08)	1.06	1.85	$2,219.29
3	$43,714.53	11	6	5	54.55	$9,785.22	($2,999.36)	3.26	3.91	$3,974.05
2	$50,559.67	11	9	2	81.82	$6,304.87	($3,092.10)	2.04	9.18	$4,596.33
1	$29,957.29	13	10	3	76.92	$4,628.85	($5,443.73)	0.85	2.83	$2,304.41

There appears to be a bullish edge over the 1st two days. After that it dissipates. One of the instances included above was the Crash of 1987. The rest of them all took place between 1929 and 1940. I'm continuing to see evidence that the only market era even resembling the current one is the Great Depression. But even then this setup was good for a quick bounce.

I've discussed a number of times that the market environment since June of 2007 has been extremely choppy. Follow through in either direction has been scarce on a daily basis. Because of this, it has generally paid off to buy the market any time it closes lower multiple days in a row in anticipation of a short-term gain.

S&P 500 closes lower 2 days in a row.										
Buy on close. Sell X days later. $100k/trade. May 31, 2007 - present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
3	$21,741.60	44	26	18	59.09	$2,421.49	($2,289.84)	1.06	1.53	$494.13
2	$17,684.53	44	28	16	63.64	$1,678.84	($1,832.70)	0.92	1.60	$401.92
1	$17,193.74	44	26	18	59.09	$1,355.42	($1,002.63)	1.35	1.95	$390.77

As you can see, there is a bit of an edge to the upside over the next 1-3 days. In fact 86% of the instances posted a close higher than the instance-day close within the next 3 days. One issue with today's selloff was that it came on relatively high volume compared to the recent past. Below are two tables. The first shows what happened when the volume did NOT come in at a 5-day high. The 2nd one shows when volume was at a 5-day high.

S&P 500 closes lower 2 days in row and does NOT post the higest volume in 5 days.										
Buy on close. Sell X days later. $100k/trade. May 31, 2007 - present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
3	$30,728.85	32	21	11	65.63	$2,722.56	($2,404.08)	1.13	2.16	$960.28
2	$22,219.67	32	22	10	68.75	$1,762.49	($1,655.51)	1.06	2.34	$694.36
1	$18,146.17	32	19	13	59.38	$1,655.83	($1,024.21)	1.62	2.36	$567.07

Eliminating those instances where the market volume closed at a 5-day increased profits by a good amount. Now the 2nd table:

S&P 500 closes lower 2 days in row and posts the higest volume in 5 days.									
Buy on close. Sell X days later. $100k/trade. May 31, 2007 - present.									
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade
3	($8,987.25)	12	5	7	41.67	$1,156.99	($2,110.32)	0.55	0.39	($748.94)
2	($4,535.14)	12	6	6	50.00	$1,372.14	($2,128.00)	0.64	0.64	($377.93)
1	($952.43)	12	7	5	58.33	$540.02	($946.52)	0.57	0.80	($79.37)

Here we see the average trade is quite negative – especially when compared to the previous test. This could suggest the bounce is not as assured as it might appear on the surface.

Tonight's Aggregator chart is below:

Both the green Aggregator and black differential lines have quickly flipped to positive, suggesting a bounce appears likely to soon occur. I don't plan on getting too aggressive right here but will look to scale in. Only 50 points now until we're around new lows. A break through there could lead to more panic selling. Employment comes out at 8:30 tomorrow and it should be interesting.

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

Additional New Trade Ideas

SPY (1/4 position) – buy at $90.86 on open. If not filled at open, then wait until the close and buy at $90.86 limit. With recent volatility and the employment number coming out Friday it appears unlikely we'll get a flat open. I'm interested in buying the gap down since we're already oversold. I do not want to chase the gap up. Small position size to begin will allow for further allocations if deemed advantageous. If it doesn't bounce here the selloff could get scary. Therefore small position size may be appropriate. Potential reward is sizable for an index trade, but so are current risks.

Active Trades Table

none

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