QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 9, 2008 Issue 205

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
December 9, 2008	SOX lags SPX 10-high < 200ma	1-2 days	Bearish	-2.70%	-5.00%
December 9, 2008	2 Up Closes in Chop	1-4 days	Bearish	1.50%	2.90%
December 8, 2008	Gap Down & Reverse	1-2 days	Bearish	-2.60%	-5.20%
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 12/9

The market gapped up to a new rally high. After pulling back a bit in the morning it managed to add to its gains by the end of the day. A selloff in the last 15-20 minutes still left the S&P up over 3.5% on the day. Breadth was strong and volume came in higher.

On the positive side we now have a higher low and a higher high in place on the chart. This is the first time this has been seen since August. It's another positive sign suggesting the current move may turn into a tradeable rally lasting more than just a few days or weeks.

I looked at gaps up to new 10-day highs that go on to close higher in the SPY. It's happened 23 times since 1995. Results were just slightly bearish as losers edged out winners over the next 1-10 days. Interestingly it has only happened 3 times while the market was trading below its 200-day moving average: 9/16/98, 10/15/02, and 11/4/08. All 3 times it closed lower 1,2, and 3 days later.

I did not like the fact that the SOX lagged the rally. A leading SOX has typically been good for the market. When the SPX has made new 10-day highs under the 200ma while leading the SOX by a significant amount:

SPX closes higher and outperforms SOX by at least 1.5%. SPX closes at a 10-day high and under the 200ma.										
Buy on close. Sell X days later. $100k/trade. 1995-present.										
X days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factd	Avg Trade
5	($19,756.42)	13	4	9	30.77	$1,444.33	($2,837.08)	0.51	0.23	($1,519.72)
4	($25,566.92)	13	5	8	38.46	$1,219.84	($3,958.27)	0.31	0.19	($1,966.69)
3	($19,346.67)	13	3	10	23.08	$2,136.39	($2,575.58)	0.83	0.25	($1,488.21)
2	($17,703.49)	13	3	10	23.08	$2,350.27	($2,475.43)	0.95	0.28	($1,361.81)
1	($11,040.59)	13	6	7	46.15	$1,520.94	($2,880.89)	0.53	0.45	($849.28)

Decreasing the outperformance requirement to 1% led to 18 instances with similar results.

This was the 2nd close higher in a row. In the choppy downward environment since 5/31/07 this has consistently led to a pullback sometime in the next few days. Below is an updated performance report using the "simple short chop system" since 5/31/07. (Short any 2 higher closes. Cover at 1st profitable close. Allow 4 days for a profitable close. Exit if not profitable after 4 days.)

All Trades			
Total Net Profit	$56,326.65	Profit Factor	14.90
Gross Profit	$60,378.64	Gross Loss	($4,051.99)
Total Number of Trades	51	Percent Profitable	96.08%
Winning Trades	49	Losing Trades	2
Even Trades	0		
Avg. Trade Net Profit	$1,104.44	Ratio Avg. Win:Avg. Loss	0.61
Avg. Winning Trade	$1,232.22	Avg. Losing Trade	($2,026.00)
Largest Winning Trade	$8,783.02	Largest Losing Trade	($3,230.74)
Max. Consecutive Winning Trades	21	Max. Consecutive Losing Trades	1

There have been 21 winners in a row going back to April. Tough to ignore such a win streak.

The Aggregator chart is updated below:

The black differential line shows the market has outperformed expectations over the last few days. The green Aggregator line is suggesting a pullback seems likely. Coming off a bottom shorting can sometimes be a bit more dangerous. Also the market has now put in its first higher high to go with a higher low. The trend could be changing here for a while. Still there are some fairly strong signs that the market is likely to pull back short-term.

I mentioned two possible resistance levels for SPY last night. The first was around 90, which was gapped right through. The 2nd was the 50-day moving average which today closed at $93.11. As quickly as the 50-day is declining it will be well under $93 tomorrow and approaching Monday's high in the next few days. Now that we ar in between the 2 levels I will look to put on a short position. As I usually prefer to do for index positions, I will scale into it. Details in trade idea section below.

Intermediate-term Outlook (2 weeks – 2 months)–slightly bullish -updated 12/8

Last week I remarked that *"the market has managed to bounce strongly from levels that were extremely oversold based on historical measures. Most of the time in the past this has led to continued follow through over the next few weeks or months. This is the third try for such a rally since early October. The first two attempts quickly died out."*

When looking for clues that a bounce such as the current one could be successful there are a few different indications that many market technicians may look for. Strong bounces off the bottom frequently will move many indicators from oversold to overbought. If they get either more overbought than is traditionally seen or remain overbought for a longer time period than is typical, then that is commonly viewed as a positive. Other indications that are frequently considered a good sign are momentum divergences. It could be argued we are seeing both right now, so I thought I'd break these down a little bit.

At first the fact that the market rallied 5 days in a row off the bottom and the S&P rose nearly 20% over those 5 days suggested unusual strength and persistence. The table below is from the November 28th Subscriber Letter which looked at instances of 5 higher closes following long-term lows:

SPX makes 5 higher closes after closing at a 50-day low 6 days ago. Remains under 200ma.										
Buy on close. Sell X days later. $100k/trade. 1960-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
25	$35,968.38	14	12	2	85.71	$3,092.14	($568.65)	5.44	32.63	$2,569.17
23	$36,761.80	14	13	1	92.86	$2,921.50	($1,217.70)	2.40	31.19	$2,625.84
20	$28,284.79	14	11	3	78.57	$2,838.72	($980.37)	2.90	10.62	$2,020.34
15	$14,110.81	14	9	5	64.29	$1,861.74	($528.97)	3.52	6.34	$1,007.92
10	($6,382.02)	15	8	7	53.33	$1,586.21	($2,724.53)	0.58	0.67	($425.47)
9	($10,256.82)	15	8	7	53.33	$1,419.53	($3,087.58)	0.46	0.53	($683.79)
8	($10,271.99)	15	7	8	46.67	$1,657.37	($2,734.19)	0.61	0.53	($684.80)
7	($9,209.11)	15	8	7	53.33	$1,544.51	($3,080.74)	0.50	0.57	($613.94)
6	($6,535.05)	15	9	6	60.00	$1,348.09	($3,111.31)	0.43	0.65	($435.67)
5	($3,265.23)	15	9	6	60.00	$1,407.27	($2,655.10)	0.53	0.80	($217.68)
4	$2,179.77	15	9	6	60.00	$1,381.05	($1,708.28)	0.81	1.21	$145.32
3	$5,373.79	15	12	3	80.00	$1,024.13	($2,305.25)	0.44	1.78	$358.25
2	($10.85)	15	9	6	60.00	$967.67	($1,453.31)	0.67	1.00	($0.72)
1	$3,279.16	15	11	4	73.33	$573.68	($757.84)	0.76	2.08	$218.61

Choppy results over the 1st two weeks give way to consistent strength over the next 4-5 weeks.

The problem is that day 6 the S&P sold off about 9% for the 2nd worst day of this bear market. Hardly the kind of buying fortitude you'd expect. Still, it recovered quite a bit over the last 4 days of this week. So perhaps hope is not lost. It has now been 10 trading days since the bottom and we've yet to see 2 down days in a row. (Of course the 2 days that were down were quite brutal.)

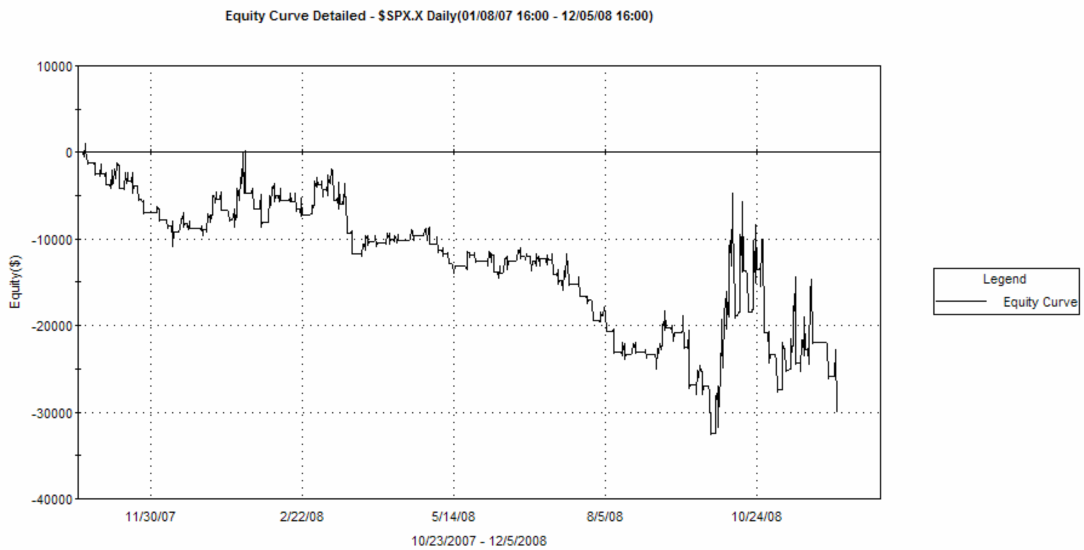
I decided to look at other times the market came off a long-term low and over the next 10 days went without posting 2 down days in a row:

S&P makes 100 day low and then over the next 10 day it does NOT have an instance of 2 down days in a row.										
Buy on close of 10th day. Sell X days later. $100k/trade. 1960-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
50	$7,388.51	27	14	13	51.85	$7,212.89	($7,199.38)	1.00	1.08	$273.65
40	$17,732.78	29	16	13	55.17	$4,903.27	($4,670.73)	1.05	1.29	$611.48
30	$26,555.88	29	18	11	62.07	$3,991.09	($4,116.70)	0.97	1.59	$915.72
20	$16,944.16	29	21	8	72.41	$2,229.89	($3,735.44)	0.60	1.57	$584.28
15	$13,889.19	29	21	8	72.41	$2,022.33	($3,572.48)	0.57	1.49	$478.94
10	$19,028.29	29	19	10	65.52	$1,809.67	($1,535.54)	1.18	2.24	$656.15
9	$19,869.96	29	20	9	68.97	$1,623.99	($1,401.10)	1.16	2.58	$685.17
8	$10,954.67	29	17	12	58.62	$1,592.87	($1,343.68)	1.19	1.68	$377.75
7	$6,890.46	29	18	11	62.07	$1,286.72	($1,479.14)	0.87	1.42	$237.60
6	$4,898.50	29	18	11	62.07	$1,442.64	($1,915.36)	0.75	1.23	$168.91
5	($2,520.48)	29	16	13	55.17	$1,460.05	($1,990.86)	0.73	0.90	($86.91)
4	($6,641.99)	30	15	15	50.00	$1,285.39	($1,728.19)	0.74	0.74	($221.40)
3	($6,136.83)	31	16	15	51.61	$870.25	($1,337.39)	0.65	0.69	($197.96)
2	($9,538.98)	32	12	20	37.50	$690.34	($891.15)	0.77	0.46	($298.09)
1	($8,832.91)	32	11	21	34.38	$508.64	($687.05)	0.74	0.39	($276.03)

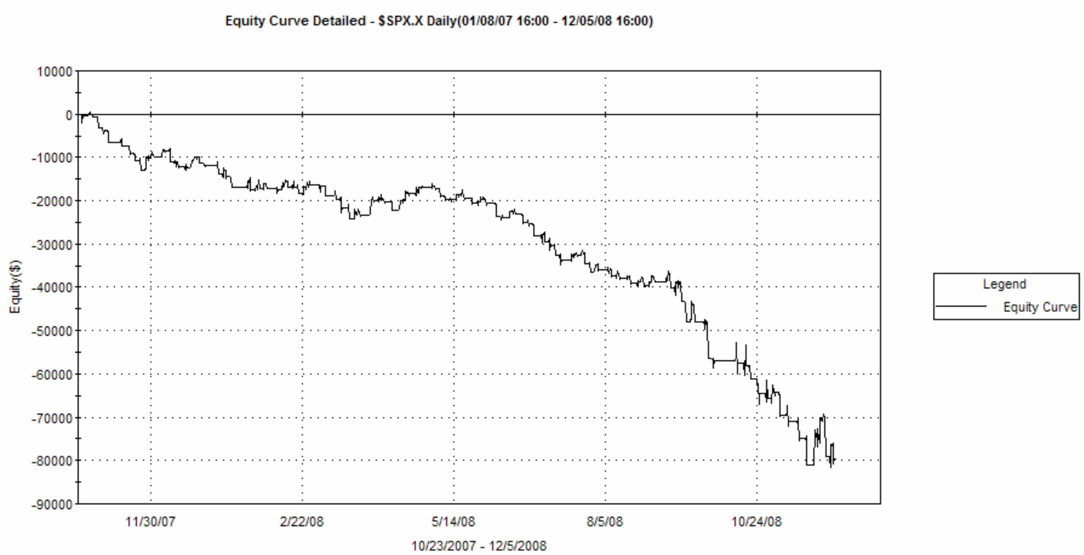
I don't find the results here too encouraging. Over the next 50 days the positive performance wreaks of underperformance when compared to long-term norms.

I also thought it might be helpful to break down the Trend vs. Chop chart that I show each week on the charts page of the website. The basic chart looks at both upside and downside follow-through from day to day. Below I broke it down to downside follow-through and upside follow-through.

The first chart looks at results of shorting any down day and then covering the short whenever the market closes higher. If the chart is trending down that means chop is prevailing and the market is reversing with more force than it is following through. In an up market it's not a bad thing to see downside follow-through fail. During the early October selloff you see the chart saw a quick rise, but since that time it has chopped lower.



Not only would we like to see a lack of downside follow-through, but upside follow-though should strengthen if the market is strengthening. Below is the upside Trend vs. Chop chart. (In this chart you buy after and up day and sell and go flat on any down day.)



What we see here is that although the market has moved higher the last couple of weeks, upside follow through on a day to day basis has not been strong. The downside reversals have done a nice job of wiping out any follow-through gains. This should change if the market is truly strengthening.

I've seen it pointed out by several people that we are now seeing several divergences on the charts and that this should be considered a positive sign. In general this line of thinking is correct. Below is a table of results going back to 1960 that looked to purchase possible RSI divergences following 100-day lows:

14-Day RSI Divergence appears as S&P 500 attempts to rally from a 100-day low.										
Buy on close. Sell X days later. $100k/trade. 1960-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
150	$270,114.18	29	20	9	68.97	$18,060.87	($10,122.58)	1.78	3.96	$9,314.28
140	$188,583.90	30	20	10	66.67	$15,256.04	($11,653.69)	1.31	2.62	$6,286.13
130	$216,013.32	31	22	9	70.97	$13,488.47	($8,970.33)	1.50	3.68	$6,968.17
120	$194,687.72	31	20	11	64.52	$13,782.75	($7,360.67)	1.87	3.40	$6,280.25
110	$193,738.18	32	20	12	62.50	$14,068.76	($7,303.08)	1.93	3.21	$6,054.32
100	$177,498.12	34	21	13	61.76	$12,666.72	($6,807.93)	1.86	3.01	$5,220.53
90	$176,109.62	35	22	13	62.86	$11,637.43	($6,147.22)	1.89	3.20	$5,031.70
80	$164,443.02	36	25	11	69.44	$9,767.36	($7,249.19)	1.35	3.06	$4,567.86
70	$141,507.62	37	24	13	64.86	$8,879.14	($5,507.05)	1.61	2.98	$3,824.53
60	$129,886.45	39	25	14	64.10	$7,816.17	($4,679.85)	1.67	2.98	$3,330.42
50	$108,260.68	40	25	14	62.50	$7,617.90	($5,870.49)	1.30	2.32	$2,706.52
40	$84,700.81	45	29	16	64.44	$6,883.29	($7,182.16)	0.96	1.74	$1,882.24
30	$87,006.24	48	32	16	66.67	$6,029.06	($6,620.23)	0.91	1.82	$1,812.63
20	$62,952.67	52	30	22	57.69	$5,799.11	($5,046.39)	1.15	1.57	$1,210.63
10	$61,158.44	62	38	24	61.29	$3,795.91	($3,461.93)	1.10	1.74	$986.43

Pretty good results when looking at winning %, profit factor, and average trade. The problem is we've already seen many of these divergences this year and they've all failed in a meaningful way. Below is a chart from April-present. The purple trendlines drawn on the bottom identify RSI divergences that were present at the time of a rally attempt.

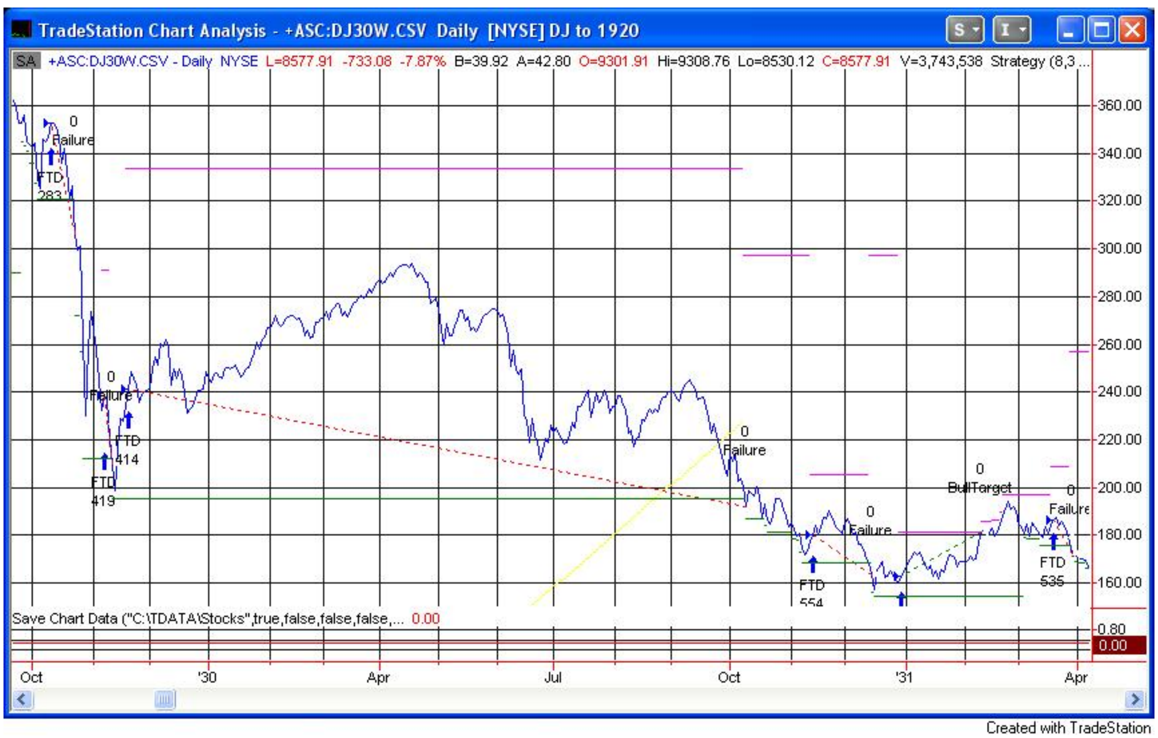
Using a 20-day holding period, results below are listed from 1998 –present. What strikes me here is that RSI divergences such as we're seeing now worked quite well after "normal" corrections in otherwise healthy markets. The failures occurred during the 2000-2002 bear and the current bear.

Buy	10/09/98	Buy	$970.10	$0.00	103	$17,602.70	17.62%
Sell	11/06/98	Sell	$1,141.00		$17,602.70	$76,791.10	
Buy	09/27/99	Buy	$1,281.21	$0.00	78	$968.76	0.97%
Sell	10/25/99	Sell	$1,293.63		$968.76	$77,759.86	
Buy	12/01/00	Buy	$1,334.55	$0.00	74	($3,794.72)	(3.84%)
Sell	01/02/01	Sell	$1,283.27		($3,794.72)	$73,965.14	
Buy	02/26/01	Buy	$1,250.06	$0.00	79	($7,689.86)	(7.79%)
Sell	03/26/01	Sell	$1,152.72		($7,689.86)	$66,275.28	
Buy	06/05/02	Buy	$1,046.06	$0.00	95	($8,746.65)	(8.80%)
Sell	07/03/02	Sell	$953.99		($8,746.65)	$57,528.63	
Buy	10/11/02	Buy	$806.48	$0.00	123	$10,855.98	10.94%
Sell	11/08/02	Sell	$894.74		$10,855.98	$68,384.61	
Buy	03/13/03	Buy	$804.19	$0.00	124	$8,356.36	8.38%
Sell	04/10/03	Sell	$871.58		$8,356.36	$76,740.97	
Buy	05/13/04	Buy	$1,097.55	$0.00	91	$2,521.61	2.52%
Sell	06/14/04	Sell	$1,125.26		$2,521.61	$79,262.58	
Buy	06/09/06	Buy	$1,259.85	$0.00	79	$591.71	0.59%
Sell	07/10/06	Sell	$1,267.34		$591.71	$79,854.29	
Buy	08/17/07	Buy	$1,415.97	$0.00	70	$4,247.60	4.29%
Sell	09/17/07	Sell	$1,476.65		$4,247.60	$84,101.89	
Buy	01/10/08	Buy	$1,409.19	$0.00	70	($5,453.00)	(5.53%)
Sell	02/08/08	Sell	$1,331.29		($5,453.00)	$78,648.89	
Buy	03/18/08	Buy	$1,287.50	$0.00	77	$5,944.40	6.00%
Sell	04/16/08	Sell	$1,364.70		$5,944.40	$84,593.29	
Buy	09/18/08	Buy	$1,210.34	$0.00	82	($21,640.62)	(21.80%)
Sell	10/16/08	Sell	$946.43		($21,640.62)	$62,952.67	
Buy	11/14/08	Buy	$913.01		109	n/a	n/a
Sell	open	n/a	$876.07		n/a	n/a	

The 70's bear market was filled with failed divergences as well. There were 6 of them between February and September of 1974 as the market continued to sink to new depths. This seems to suggest that while momentum divergences may prove useful in secular bull markets, they simple aren't reliable in strong bear markets.

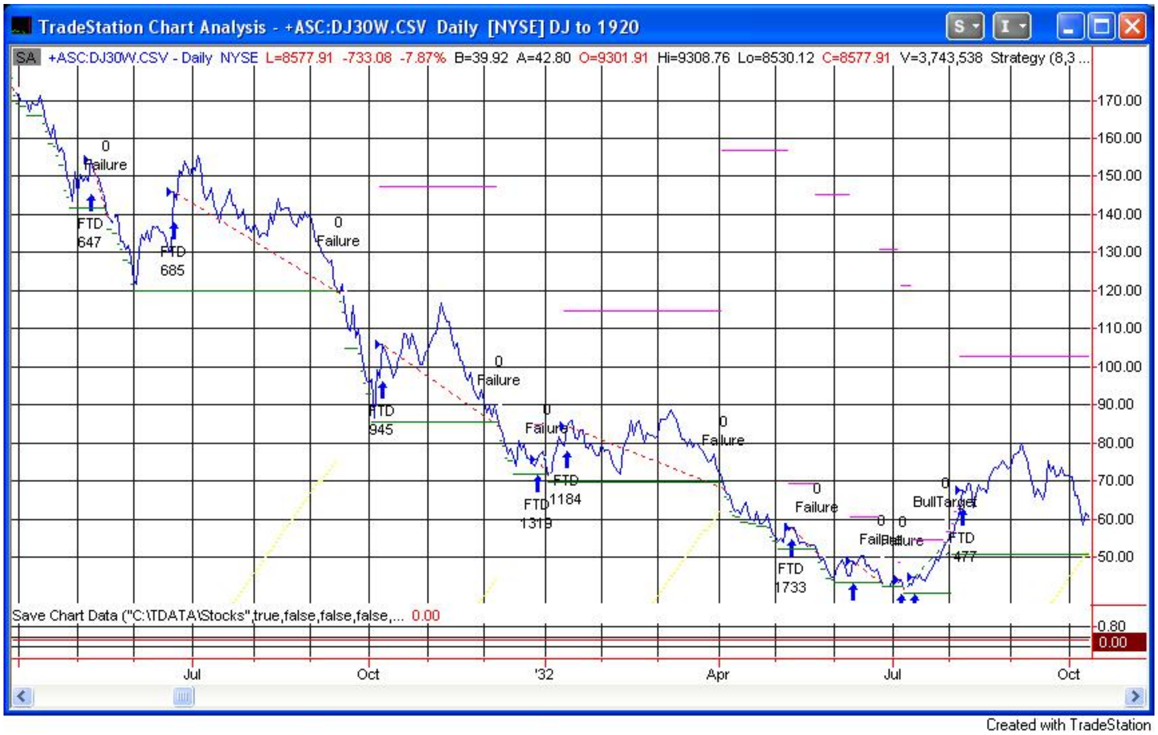
This isn't terrible surprising. Most traditional tools have failed to work well in the current environment. Consider IBD Follow-Through-Days for instance. There have been no less than six failed follow-through days since the beginning of the year. In the October 20th Subscriber Letter I looked at how follow-through days would have faired following the Crash of 1929. Below is an excerpt from that Letter:

I thought it would be interesting to see how FTD's performed following the 1929 crash. As a brief reminder, "success" for a FTD would entail either 1) The market making a new high or 2) a rally from the close of the FTD that equals at least twice the distance from the low to the FTD. Below are charts spanning the period from 1929 to in 1932.



In this chart we see several failures and one FTD that led to a rally meeting its target. While it didn't meet the definition of success, the rally in the early part of 1930 was actually the best over the time period.

Next is '31 – '32:



Plenty more failures are seen here before the market finally bottoms in mid-1932. All told there were 13 failed FTD's and one successful one before the 1932 bottom arrived.

In summary, we are seeing evidence that in a secular bull market would strongly suggest a sizeable rally of some length is due (overdue). It is important to be cognizant of the fact that such traditional tools simply cannot be relied upon in the current environment. The market has gone down further and longer than it almost always has without a strong rally of intermediate-term duration. We've had a nice rally off the lows and there's a decent possibility that the market could already have begun a multi-month move higher. Trading with a somewhat bullish bias, especially if we take out and hold above the 11/28 highs and the 50-day moving average would seem a better bet than trading with a bearish bias. Flexibility will be important, though. That bullish bias will need to be constantly rethought. We're not experiencing a "typical" market selloff and the first intermediate-term rally may well not be typical either.

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

Additional New Trade Ideas

SPY – short ¼ index position at $92.00 limit. If not filled during day, short @ $91.00 LIMIT ON CLOSE. The last few trades we have missed the fills. Let's see if this one takes. Reason based on short-term market outlook.

I won't be available to send out intraday updates tomorrow. With the current short-term outlook in conflict with the possible bullish intermediate-term prospects, I'd likely look to take half profits at the close if there was a fill that went strongly in my favor.

Active Trades Table

None.

GSG from last night gapped through the limit price. All of the other commodity ETF's mentioned did as well.