

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 12, 2008

Issue 208

## 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 11, 2008	Inside Day < 200ma	1-3 days	Bearish	-2.20%	-4.65%
December 10, 2008	SOX Up SPX Down	1-8 days	Bullish	5.70%	9.10%
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) – neutral – updated 12/11*

The market sold off hard in the afternoon on Thursday, leaving the major indices down about 3% on average. Breadth was negative on the NYSE by about 4 to 1 and volume came in a little higher than yesterday.

I spent most of the day traveling and returned home near 1am. Unfortunately this means a very brief report tonight.

The futures are down over 4% from the close in large part due to the failure of the auto bailout bill. I've often discussed in the past how extra large reactions are frequently overreactions. Should the market open anywhere near this level tomorrow we may see a reflex rally in the next few days.

In [the blog on October 23<sup>rd</sup>](#) I showed a table that looked at 2% gaps lower and how the market tended to close above that kind of severe open most of the time. Tonight I ran some additional stats on extremely large gaps lower:

SPY gaps down 2% or more and at least twice the 100-day average absolute gap.										
Buy on OPEN. Sell X days later. \$100k/trade. 1994-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	\$74,999.83	24	16	8	66.67	\$5,846.63	(\$2,318.28)	2.52	5.04	\$3,124.99
4	\$49,730.23	24	15	9	62.50	\$5,092.67	(\$2,962.21)	1.72	2.87	\$2,072.09
3	\$43,324.79	25	18	7	72.00	\$4,181.55	(\$4,563.31)	0.92	2.36	\$1,732.99
2	\$49,094.98	26	16	10	61.54	\$4,827.93	(\$2,815.18)	1.71	2.74	\$1,888.27
1	\$56,024.00	30	21	9	70.00	\$3,696.92	(\$2,401.27)	1.54	3.59	\$1,867.47
0	\$33,458.92	32	20	11	62.50	\$2,933.83	(\$2,292.51)	1.28	2.33	\$1,045.59

The only instance that didn't see a reversal in the next few days was the October 6, 2008 occurrence. An average gain of over 3% in a week is very strong.

If the market opens down big tomorrow intraday traders may have a long-side advantage. A gap that large normally comes with a healthy dose of panic selling. Those that panic and sell are normally the ones that get fleeced.

***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 28<sup>th</sup> Subscriber Letter which looked at instances of 5 higher closes following long-term lows:

<b>SPX makes 5 higher closes after closing at a 50-day low 6 days ago. Remains under 200ma.</b>										
<b>Buy on close. Sell X days later. \$100k/trade. 1960-present.</b>										
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 1<sup>st</sup> 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 2<sup>nd</sup> 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:

<b>S&amp;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.</b>												
<b>Buy on close of 10th day. Sell X days later. \$100k/trade. 1960-present.</b>												
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)		

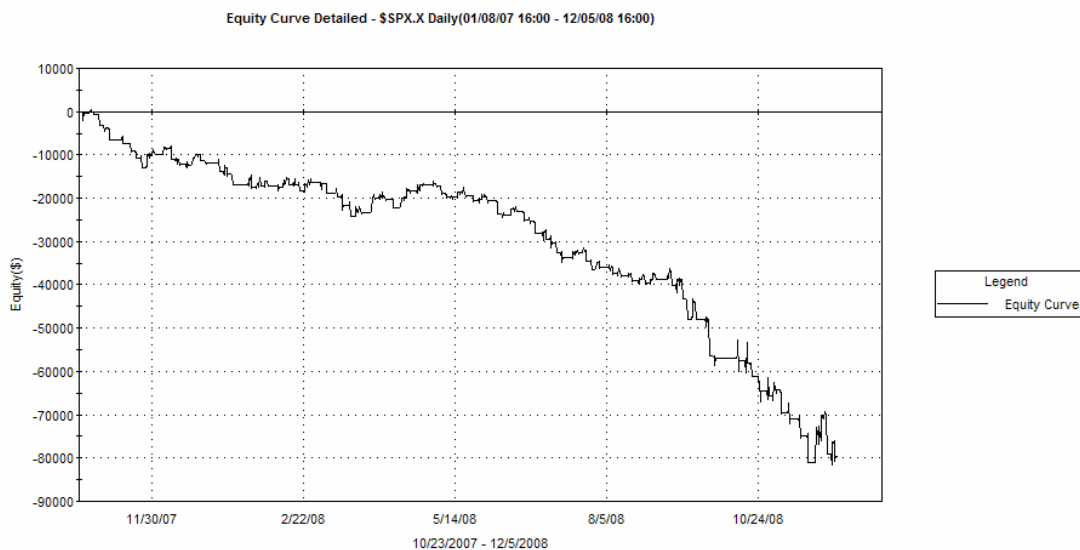
I don't find the results here too encouraging. Over the next 50 days the positive performance wrecks of underperformance when compared to long-term norms.

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-through 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

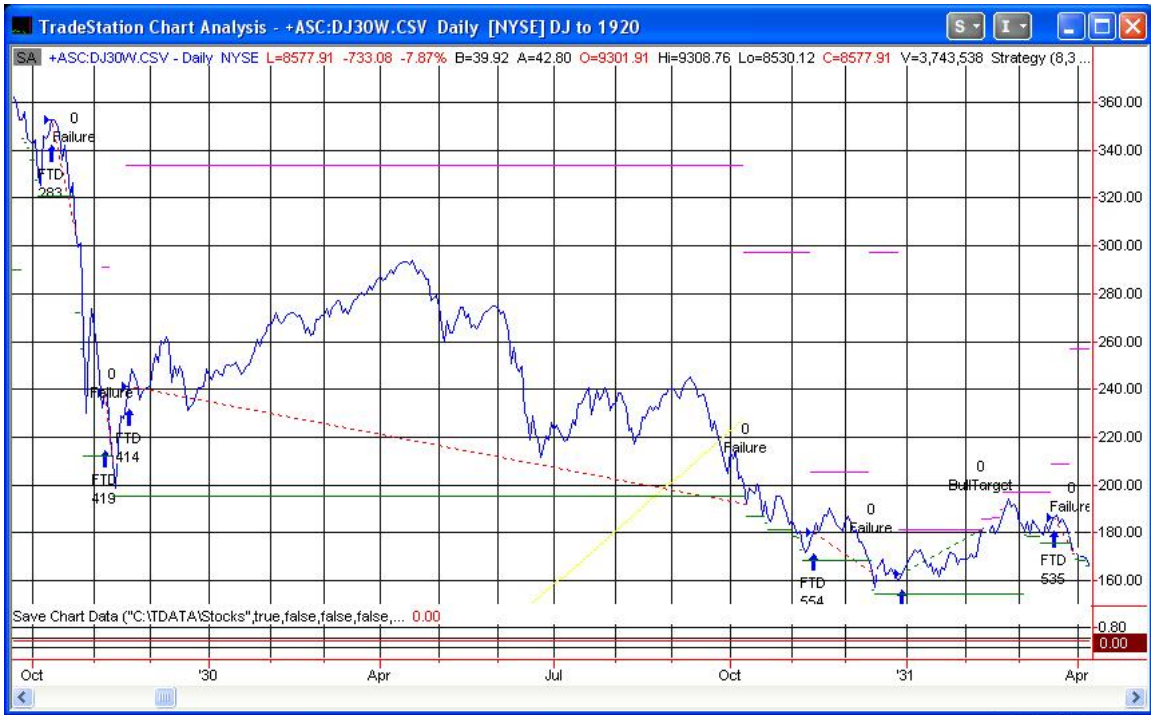
“normal” corrections in otherwise healthy markets. The failures occurred during the 2000-2002 bear and the current bear.

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	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 20<sup>th</sup> Subscriber Letter I looked at how follow-through days would have faired following the Crash of 1929. Below is an excerpt from that Letter:

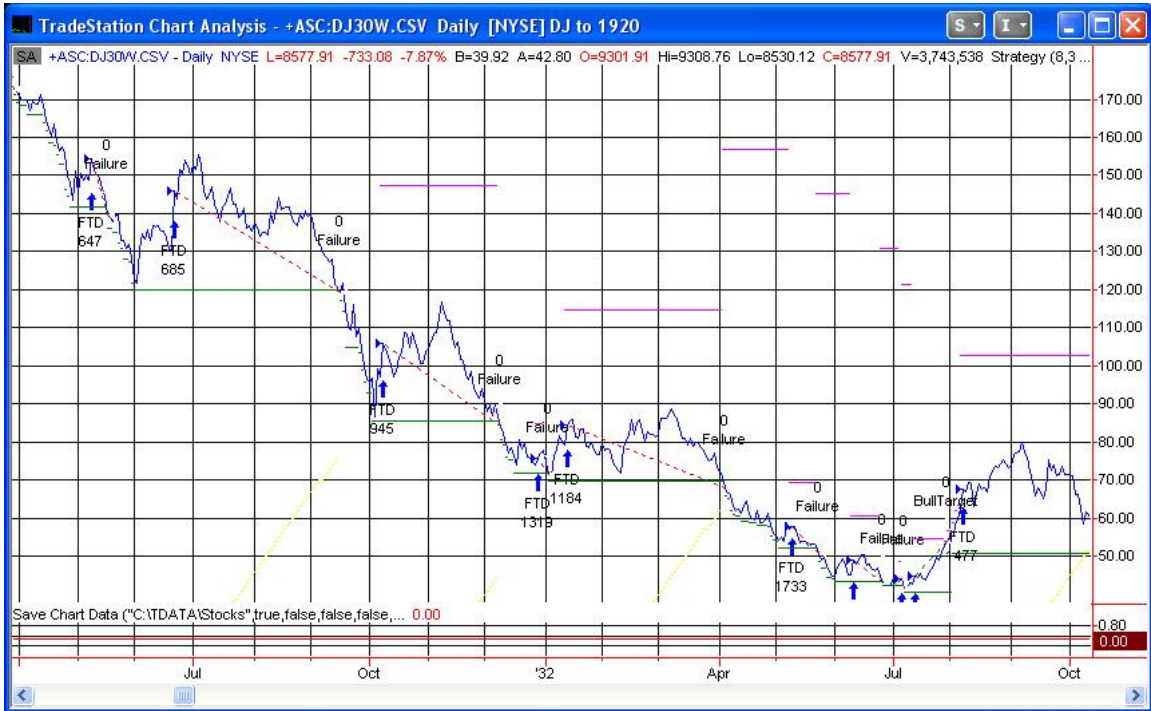
*I thought it would be interesting to see how FTD’s performed following the 1929 crash. As a brief reminder, “success” for a FTD would entail either 1) The market making a new high or 2) a rally from the close of the FTD that equals at least twice the distance from the low to the FTD. Below are charts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



Created with TradeStation

*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:*



Created with TradeStation

*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**

*Nothing official tonight. Those inclined to play intraday may want to consider a long-side bias if this gap remains this large.*

### **Active Trades Table**

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