QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 15, 2008 Issue 209

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 15, 2008	Gap Down & reverse	1-2 days	Bearish	-2.30%	-4.60%
December 15, 2008	December Op-Ex Week	1-5 days	Bullish	1.90%	3.10%
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 12/15

After gapping down very large in the morning on Friday the market fought its way back to close positive. The Nasdaq, smallcaps, and semiconductors performed especially well. NYSE breadth was solidly positive as the up issues % finished around 60% and the up volume % finished at 71%. Volume overall rose slightly but remained below average.

I've shown a few studies recently that have suggested when the market gaps down big and then reverses strongly, it often becomes short-term exhausted. I looked at 2% gaps on Thursday night and although there was a strong inclination for them to close above their opening price within the next few days, instances that actually fought back to close in positive territory on the day of the gap are fairly rare. Below are results following such instances:

SPY gaps down 2% and closes postive.										
Buy on close. Sell X days later. $100k/trade. 1994-present.										
X Days	Net Profit	Trades	Wins	Losss	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	$8,435.10	6	4	2	66.67	$3,403.06	($2,588.56)	1.31	2.63	$1,405.85
4	$10,276.97	6	4	2	66.67	$3,437.06	($1,735.63)	1.98	3.96	$1,712.83
3	$12,000.38	6	4	2	66.67	$3,220.77	($441.36)	7.30	14.59	$2,000.06
2	($1,741.02)	6	3	3	50.00	$1,004.91	($1,585.25)	0.63	0.63	($290.17)
1	($5,334.13)	6	2	4	33.33	$1,300.14	($1,983.60)	0.66	0.33	($889.02)

Not obvious in the above table, and perhaps most important is the fact that ALL 6 closed lower than the trigger price at some point within the next 3 days. I decided to examine the short-term pullback further and tested different gap %'s:

SPY gaps down X% and closes postive.										
Short on close. Cover at first profitable close up to 3 days later. Exit 3 days later regardless. $100k/trade. 1994-present.										
X%	Net Profit	Trades	Wins	Losss	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
2	$9,255.58	6	6	0	100.00	$1,542.60	$0.00	100.00	100.00	$1,542.60
1.75	$6,776.92	7	6	1	85.71	$1,542.60	($2,478.66)	0.62	3.73	$968.13
1.5	$22,936.20	10	9	1	90.00	$2,823.87	($2,478.66)	1.14	10.25	$2,293.62
1.25	$34,741.19	18	16	2	88.89	$2,382.26	($1,687.47)	1.41	11.29	$1,930.07
1	$38,148.68	31	26	5	83.87	$1,864.64	($2,066.38)	0.90	4.69	$1,230.60

Even as small as a 1% gap down that reversed and closed higher showed a fairly strong tendency to pull back at some point in the next 3 days. Measures above 1% have been extremely reliable.

Since 1% gave a good amount of occurrences, I used that to test again with a 1-5 day exit strategy.

SPY gaps down 1% and closes postive.										
Buy on close. Sell X days later. $100k/trade. 1994-present.										
X Days	Net Profit	Trades	Wins	Losss	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	($10,682.36)	29	15	14	51.72	$2,237.53	($3,160.38)	0.71	0.76	($368.36)
4	($15,087.39)	29	13	16	44.83	$2,231.47	($2,756.03)	0.81	0.66	($520.25)
3	($8,432.18)	30	14	16	46.67	$1,819.53	($2,119.10)	0.86	0.75	($281.07)
2	($19,767.73)	31	14	17	45.16	$1,306.31	($2,238.59)	0.58	0.48	($637.67)
1	($11,182.12)	31	13	18	41.94	$1,450.49	($1,668.81)	0.87	0.63	($360.71)

The bearish suggestion is the strongest over the next 2 days. As we know from above, about 84% close lower than the trigger within the next 3 days.

Not all short-term signs are bearish, though. I noted the other night the positive action in the SOX and the bullish influence that has had on the market in the past. The SOX action continues to suggest a bullish bias. On Friday as the S&P rose 0.7% the SOX rose over 4.5%. Below is another SOX strength test which confirms the bullish tendency suggested by the other SOX test of a few days ago:

SOX outperforms SPX by 3% or more today.										
Buy on close. Sell X days later. $100k/trade. 1994-present.										
X Days	Net Profit	Trades	Wins	Losss	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	$105,212.93	177	108	69	61.02	$2,088.28	($1,743.79)	1.20	1.87	$594.42
4	$92,686.13	197	115	82	58.38	$1,828.75	($1,434.39)	1.27	1.79	$470.49
3	$110,005.87	216	133	82	61.57	$1,700.53	($1,416.64)	1.20	1.95	$509.29
2	$78,572.44	242	136	106	56.20	$1,521.81	($1,211.27)	1.26	1.61	$324.68
1	$63,635.38	274	151	123	55.11	$1,076.74	($804.50)	1.34	1.64	$232.25

Rarely do I make much of seasonality, but we are entering a period where it gets a lot of publicity. No doubt traders will hear about a possible "Santa Claus Rally" many times in the next few weeks. When looking at the S&P 500, though, I found the best week in December to be option expirations week. The edge has been especially pronounced over the last 24 years. During that period the market has closed the week higher about 81% of the time.:

Buy December Friday prior to op-ex. Sell X days later. $100k/trade. 1984-present.										
X Days	Net Profit	Trades	Wins	Losss	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	$20,413.93	21	17	4	80.95	$1,513.39	($1,328.43)	1.14	4.84	$972.09
4	$12,234.85	21	14	7	66.67	$1,225.06	($702.28)	1.74	3.49	$582.61
3	$13,078.61	21	13	8	61.90	$1,328.08	($523.30)	2.54	4.12	$622.79
2	$9,331.23	21	13	8	61.90	$1,000.67	($459.69)	2.18	3.54	$444.34
1	$4,496.96	21	11	10	52.38	$959.31	($605.55)	1.58	1.74	$214.14

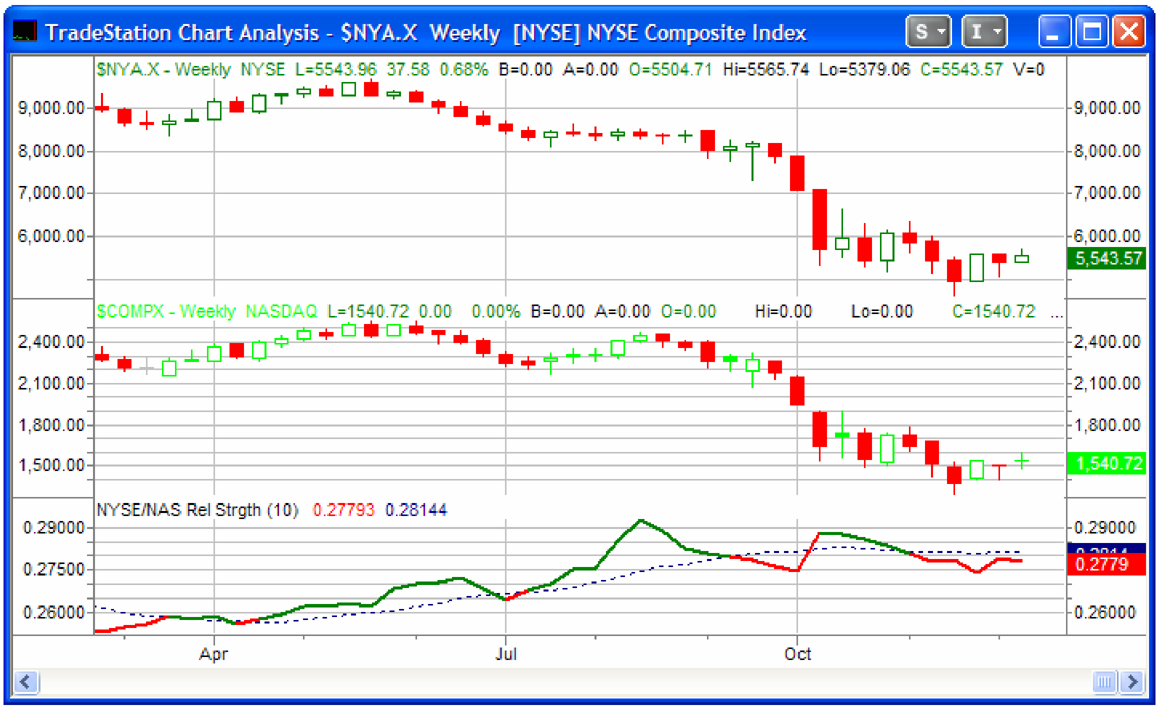
With the above studies now included the Aggregator chart is updated below:

A choppy market last few days along with mixed results from the studies leaves both the black differential and green Aggregator lines fairly close to zero. If you squint a little you can see they are both above zero. Still, the apparent upside edge isn't terribly strong. The Aggregator is set to strengthen in the next few days as the lone active bearish study is the first scheduled to drop off. Should the market pull back in the next day or so the play would seem to be to the upside. At this point that is what I'm watching for.

Intermediate-term Outlook (2 weeks – 2 months)–slightly bullish -updated 12/15

Little has changed this week with regards to the intermediate-term. The market is still attempting to put together a rally off of extremely oversold conditions. Last week I looked at such ideas as divergences and the ability of the market to rally during overbought conditions. Much of what I looked at is still intact. Results suggested a couple of things. First, that the current rally attempt was showing several indicators that would suggest a rally is likely if the market was in a secular bull market mode. Second, since we aren't in secular bull market mode at the time being, those indicators are simply not reliable.

One indicator that is yet to fire a bullish signal is the Nasdaq/NYSE Relative Strength indicator I use. Below is a weekly chart with a 10-week ema of the Nasdaq/NYSE ratio shown in the bottom pane. When the solid thick line is above the dotted line it turns green and signals the Nasdaq has been outperforming the NYSE. When it is red, the NYSE has been leading. Historically, a leading Nasdaq has been a positive sign for the stock market.



Going back to January 1972 the NYSE composite has gained 5792 points when the Nasdaq has been leading. Over the same time period the NYSE Composite has lost 855 points when it has led the Nasdaq. While a leading Nasdaq is no layup to further gains, it's something I'd prefer to see, especially considering how the market has struggled over the last 36 years when it hasn't led.

I remain somewhat optimistic that the market will be able to put together some kind of multi-month rally here soon. I also anticipate I will remain wary of getting too aggressive trying to play momentum with any such rally. This is not the typical bear market and the first concerted rally attempt will likely not be typical either.

Seasonal Testing

One seasonal tendency that you may see mentioned in the next few weeks in the January Effect. The January Effect suggests that small caps (especially beaten down ones) tend to outperform large caps in January (and part of December). I decided to run some simple tests based on this hypothesis.

I found that over the last 20 years from December 15th (or the next trading day if that is a weekend) to February 1st the Russell 2000 has outperformed the S&P 500 12 times. While that isn't a sizeable winning percentage the total gains have outsized the total losses by about 5 to 1.

Even more interesting is the action the last few weeks of December. Again buying at the close on the 15th and this time selling at the close of the 1st day of the New Year, the Russell 2000 has outperformed the S&P 500 15 of the last 20 years. Gross gains have been 27.61% or 1.84%/win average. Gross losses have been only -5.15%, or -1.03% per average loss. The net gain was 22.46% or 1.12% per trade. This is a sizable difference when talking about a relatively short-term spread between 2 indices.

There are a number of ways to play this. The simplest of which perhaps would be to wait for a day or two of outperformance by the S&P and then enter a spread transaction in anticipation of both a mean reversion and a seasonal tendency.

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	0.38
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	1.35
DJ US Healthcare Providers	IHF	2.04		DJ US Real Estate	IYR	0.00
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	0.50
DJ US Home Construction	ITB	0.00		DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	0.44		Nasdaq 100	QQQQ	0.00

No capitulative action evident.

Additional New Trade Ideas

The market reversing direction every day last week has not allowed for much to set up. Patience is difficult but normally advisable at times like this.

Active Trades Table