

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 19, 2008

Issue 213

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
Active					
December 19, 2008	2 Down In Chop	1-2 days	Bullish	1.67%	3.50%
December 17, 2008	S&P up 4% on mediocre volume	1-4 days	Bearish	-5.70%	-10.60%
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		
Dropped Tonight					

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) –very slightly bullish – updated 12/19

Over the last two days the market has given back most of its Fed-day rally. The major indices all fell fairly sharply this afternoon and finished the day down near 2%. This is the first time the S&P has fallen on consecutive days since the November 20th bottom. Breadth was weak, but not to a great extreme. Decliners outpaced advancers by about 3 to 2 and down volume led up volume by about 3 to 1. Total volume crept slightly higher than yesterday.

Most unusual about the action the last two days is that the VIX has fallen substantially along with the market. There has never before been back to back days where the S&P lost 0.75% and the VIX lost 4%. In fact, back to back days where they both fell at all are fairly unusual:

VIX and SPX close lower 2 days in a row.														
Buy on close. Sell X days later. \$100k/trade. 1987-present.														
Days In	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Fac	Avg Trade	All: Gross	All: Gross
10	\$24,838.78	40	28	12	70.00	\$5,101.20	(\$6,529.50)	\$1,927.69	(\$2,428.06)	0.79	1.85	\$620.97	53975.44	-29136.66
9	\$30,893.22	41	27	14	65.85	\$6,098.45	(\$5,982.00)	\$2,235.77	(\$2,105.18)	1.06	2.05	\$753.49	60365.77	-29472.55
8	\$23,561.42	42	27	15	64.29	\$5,391.75	(\$5,793.75)	\$2,053.17	(\$2,124.95)	0.97	1.74	\$560.99	55435.66	-31874.24
7	\$19,280.25	42	27	15	64.29	\$4,593.68	(\$5,593.68)	\$1,918.52	(\$2,167.99)	0.88	1.59	\$459.05	51800.03	-32519.78
6	\$19,221.01	43	27	16	62.79	\$4,356.32	(\$4,706.28)	\$1,823.29	(\$1,875.49)	0.97	1.64	\$447.00	49228.81	-30007.8
5	\$22,258.66	43	26	17	60.47	\$4,622.56	(\$3,842.61)	\$1,720.93	(\$1,322.68)	1.30	1.99	\$517.64	44744.23	-22485.57
4	\$21,737.90	43	28	15	65.12	\$4,542.40	(\$3,666.00)	\$1,591.89	(\$1,522.33)	1.05	1.95	\$505.53	44572.85	-22834.95
3	\$10,970.79	43	24	19	55.81	\$5,344.00	(\$4,371.84)	\$1,527.61	(\$1,352.20)	1.13	1.43	\$255.13	36662.56	-25691.77
2	\$1,742.04	44	22	21	50.00	\$4,579.14	(\$3,443.25)	\$1,101.69	(\$1,071.19)	1.03	1.08	\$39.59	24237.11	-22495.07
1	(\$4,148.29)	48	25	23	52.08	\$2,327.98	(\$2,214.00)	\$686.32	(\$926.36)	0.74	0.81	(\$86.42)	17158.01	-21306.3

Prior to testing I'd thought perhaps the results might be a little bearish. If the market was falling without fear, then it might have further to fall. This test showed no evidence of bearishness though. Not particularly bullish either and more in line with random than anything else. I decided to also require the VXO to be stretched at least 5% below its 10-period moving average to see if that made a big difference:

VXO and SPX close lower 2 days in a row. The VXO closes at least 5% below its 10-day moving average.															
Buy on close. Sell X days later. \$100k/trade. 1987-present.															
Days In	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Fact	Avg Trade	All: Gross	All: Gross	
10	\$374.20	17	11	6	64.71	\$4,607.25	(\$3,114.91)	\$1,179.83	(\$2,100.65)	0.56	1.03	\$22.01	12978.09	-12603.89	
9	\$461.51	17	9	8	52.94	\$4,710.00	(\$3,835.42)	\$1,528.25	(\$1,661.59)	0.92	1.03	\$27.15	13754.25	-13292.74	
8	(\$7,100.28)	18	8	10	44.44	\$4,129.50	(\$3,852.21)	\$1,375.22	(\$1,810.21)	0.76	0.61	(\$394.46)	11001.77	-18102.05	
7	(\$5,286.36)	18	8	10	44.44	\$4,362.00	(\$2,661.00)	\$1,806.56	(\$1,973.88)	0.92	0.73	(\$293.69)	14452.46	-19738.82	
6	(\$4,340.48)	18	8	10	44.44	\$4,356.32	(\$4,084.11)	\$1,768.37	(\$1,848.74)	0.96	0.77	(\$241.14)	14146.96	-18487.44	
5	\$1,658.22	18	10	8	55.56	\$4,194.44	(\$3,842.61)	\$1,403.49	(\$1,547.08)	0.91	1.13	\$92.12	14034.89	-12376.67	
4	\$1,709.41	18	12	6	66.67	\$4,111.60	(\$3,666.00)	\$1,261.95	(\$2,239.00)	0.56	1.13	\$94.97	15143.38	-13433.97	
3	(\$4,070.32)	18	8	10	44.44	\$3,977.08	(\$4,371.84)	\$1,504.21	(\$1,610.40)	0.93	0.75	(\$226.13)	12033.68	-16104	
2	(\$6,059.47)	18	8	10	44.44	\$4,175.44	(\$3,443.25)	\$1,185.71	(\$1,554.51)	0.76	0.61	(\$336.64)	9485.66	-15545.13	
1	(\$5,821.21)	20	10	10	50.00	\$1,467.69	(\$2,087.94)	\$606.51	(\$1,188.63)	0.51	0.51	(\$291.06)	6065.13	-11886.34	

Here the suggestion is slightly more bearish. Not nearly enough to base a short trade on though.

The 2nd successive close lower triggered our 2-days lower in chop system. This is the first such trigger since 11/20. Choppy trading has been the dominant market characteristic over the last 18 months – even more so than the downtrend. Below is an updated performance table of the 2 Days Lower In Chop.

All Trades

Total Net Profit	\$39,629.02	Profit Factor	2.69
Gross Profit	\$63,061.76	Gross Loss	(\$23,432.74)
Total Number of Trades	48	Percent Profitable	87.50%
Winning Trades	42	Losing Trades	6
Even Trades	0		
Avg. Trade Net Profit	\$825.60	Ratio Avg. Win:Avg. Loss	0.38
Avg. Winning Trade	\$1,501.47	Avg. Losing Trade	(\$3,905.46)
Largest Winning Trade	\$10,716.03	Largest Losing Trade	(\$10,506.45)
Max. Consecutive Winning Trades	17	Max. Consecutive Losing Trades	2
Avg. Bars in Winning Trades	2.38	Avg. Bars in Losing Trades	4.00
Avg. Bars in Total Trades	2.58		

I'm finding it a bit difficult to get too excited about a long entry just yet though.

I have updated the [Aggregator](#) chart below:

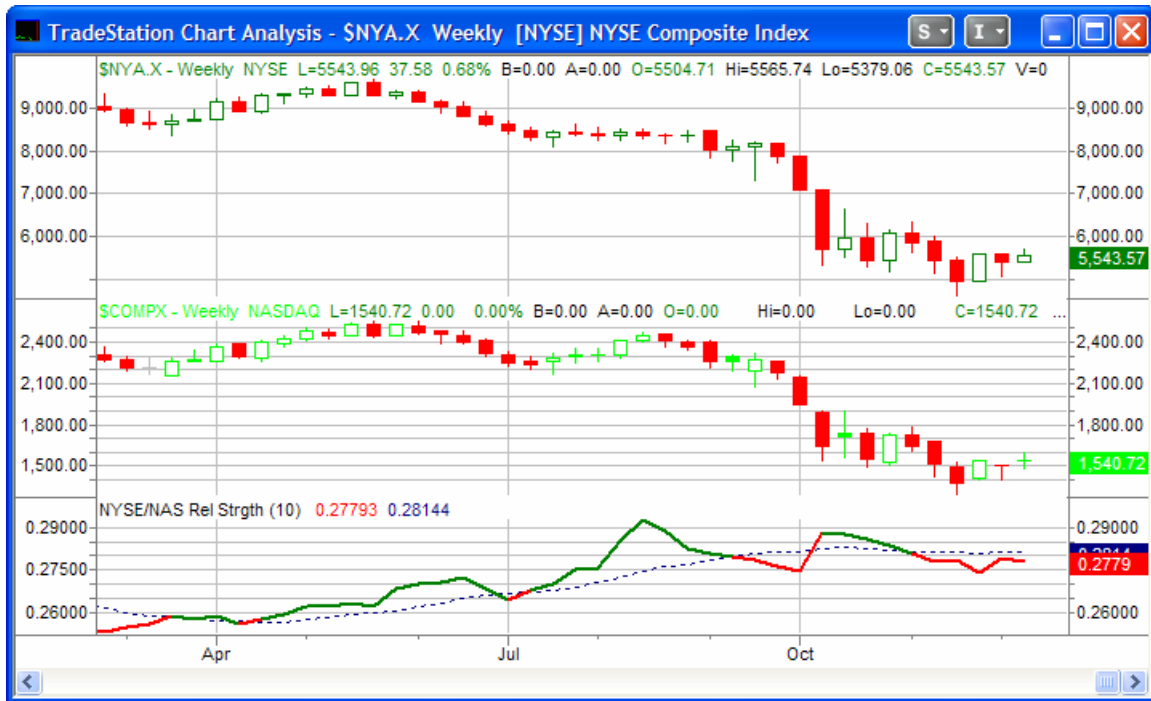


While the black differential line remains below the zero line, the green Aggregator has crept up above zero into neutral ground. With the lines on either side of zero the Aggregator chart is in neutral territory. I'd prefer to have a clearer edge before attempting an index position.

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	0.34
DJ US Regional Banks	IAT	0.00	DJ US Financial Services	IYG	0.70
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	0.00	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	0.00
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

IEF – short @ \$99.85 limit. – IEF triggered system -80514 for the 2nd day in a row. I'll look to short it at or above Thursday's close. Bonds are appearing too overdone at this point. This ETF pays dividends monthly but the Ex-date is typically the 1st of the month and the pay-date a few days later. Since I'm just looking for a short-term reversion trade, having to pay the dividend due to holding a short position shouldn't be a problem as long as the trade idea is exited before the end of the year.

For those who are unable to borrow IEF to short, an alternative would be PST, which is a double – inverse fund.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
FXE(s)	12/18/2008	\$145.27	\$142.64	1.81%		shorted on open

The exit signal for FXE is a close below its 5-day moving average. Friday that would be around \$141.40.

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