# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 29, 2008 Issue 218

## 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 29, 2008 | 10/100 ATR < 0.60 | n/a | Bearish | n/a | n/a |
| December 29, 2008 | 2 Days up in chop | 1-4 days | Bearish | -1.50% | -3.00% |
| December 24, 2008 | NR10 Low Vol 10 under 200ma | 1-4 days | Bearish | -2.60% | -4.90% |
| December 23, 2008 | Santa Rally | 1-5 days | Bullish | 1.90% | 3.60% |
| December 22, 2008 | Nasdaq Volume Spyx < -5 | 1-6 days | Bearish | -4.50% | -9.20% |
| March 17, 2008 | Consumer Sentiment Stretch | 1-12 months | Bullish | | |
| Dropped Tonight - none | | | | | |

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) –slightly bearish – updated 12/29***

Friday was another snoozefest for traders. After a slight gap up the market traded basically sideways for most of the day. Breadth was positive as both the NYSE Up Issues % and Up Volume % came in above 70%. Total volume was again extremely low and not much higher than Wednesday's shortened session.

Notable about the recent action is the sharp drop in volatility over the past couple of weeks. Two ways in which I show volatility on the charts page are using Average True Range % and the Absolute Average Gap %. After hitting extraordinarily high levels in October, both of these measures are now posting extremely low readings.

While I've heard many market analysts suggest that lowered volatility is a positive sign, I've found that sharply lowered volatility is actually quite negative. Below is a study that looks at the 10-day average true range of the SPY in comparison to the 100-day average true range. Historically, lower ratios have been followed by negative returns while higher ratios have produced positive returns.

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| 10-day Avg True Range over the 100-day Average True Range is less than X. | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Buy on close. Sell tomorrow at close. $100k/trade. 1993-present. | | | | | | | | | | |
| X | Net Profit | Trades | Wins | Losses | % Wins | Avg Win | Avg Loss | W/L Ratio | Profit Factor | Avg Trade |
| ALL | $93,331.33 | 3803 | 1991 | 1784 | 52.35 | $826.54 | ($870.13) | 0.95 | 1.06 | $24.54 |
| 1.4 | $86,171.79 | 3447 | 1805 | 1615 | 52.36 | $768.49 | ($805.54) | 0.95 | 1.07 | $25.00 |
| 1.3 | $73,520.96 | 3271 | 1713 | 1531 | 52.37 | $753.67 | ($795.25) | 0.95 | 1.06 | $22.48 |
| 1.2 | $46,717.41 | 2975 | 1542 | 1406 | 51.83 | $732.82 | ($770.47) | 0.95 | 1.04 | $15.70 |
| 1.1 | $34,813.29 | 2542 | 1314 | 1202 | 51.69 | $702.71 | ($739.23) | 0.95 | 1.04 | $13.70 |
| 1 | ($10,944.36) | 1950 | 1006 | 926 | 51.59 | $677.61 | ($747.97) | 0.91 | 0.98 | ($5.61) |
| 0.9 | ($36,217.03) | 1251 | 637 | 603 | 50.92 | $660.23 | ($757.51) | 0.87 | 0.92 | ($28.95) |
| 0.8 | ($10,891.98) | 632 | 327 | 300 | 51.74 | $658.34 | ($753.90) | 0.87 | 0.95 | ($17.23) |
| 0.7 | ($9,538.19) | 217 | 109 | 105 | 50.23 | $682.54 | ($799.38) | 0.85 | 0.89 | ($43.95) |
| 0.6 | ($6,295.27) | 32 | 14 | 18 | 43.75 | $716.30 | ($906.86) | 0.79 | 0.61 | ($196.73) |

As can be seen on the website the current reading 0.58. There have only been 32 prior days with readings below 0.6. The average day following such readings was a loss of about 0.2%.

The drop has been especially sharp over the last week. The 5-day ATR divided by the 50-day ATR is now about 0.4. This is the 1st time since the inception of the SPY that this ratio has dropped below 0.45.

The average absolute gap % has also dropped significantly in the last 2 weeks. The 10-day average absolute gap % is now less than ½ the 100-day average absolute gap %. Since 1993 there have been 221 days where the 10-day reading has been less than half the 100-day reading. The average performance on the day following such low readings has been negative 0.035%.

Taking a broader view of this indicator I broke it down by times the 10-day exceeded the 100-day average absolute gap and times the 100-day exceeded the 10-day. When the 10-day has exceeded the 100-day (signifying the market has been subject to gap more than usual as of late) the average 1-day return for the SPY was 0.027% . When the SPY was gapping less than usual (the 10-day was less than the 100-day) the average 1-day SPY return was 0.018%. In other words the market has performed 50% better following periods when is has been more gappy than average vs. times when it's been less gappy than average.

With only 3 trading days left in 2008 I decided to look at market performance for the last 3-days and last 1-day broken down by how the market has performed up until that point. First the final-day performance:

| 1 day left in year and year-to-date performance is X or less. | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Buy on close. Sell 3 days later. $100k/trade. 1961-present. | | | | | | | | | | |
| X | Net Profit | Trades | Wins | Losses | % Wins | Avg Win | Avg Loss | W/L Ratio | Profit Factor | Avg Trade |
| 50 | $1,117.39 | 46 | 26 | 20 | 56.52 | $404.43 | ($469.89) | 0.86 | 1.12 | $24.29 |
| 40 | $1,117.39 | 46 | 26 | 20 | 56.52 | $404.43 | ($469.89) | 0.86 | 1.12 | $24.29 |
| 30 | $398.94 | 43 | 24 | 19 | 55.81 | $406.44 | ($492.40) | 0.83 | 1.04 | $9.28 |
| 20 | $495.40 | 35 | 19 | 16 | 54.29 | $405.65 | ($450.75) | 0.90 | 1.07 | $14.15 |
| 10 | ($1,241.35) | 23 | 10 | 13 | 43.48 | $442.88 | ($436.16) | 1.02 | 0.78 | ($53.97) |
| 0 | $998.39 | 12 | 8 | 4 | 66.67 | $448.06 | ($646.52) | 0.69 | 1.39 | $83.20 |
| -10 | $1,761.60 | 8 | 6 | 2 | 75.00 | $487.37 | ($581.30) | 0.84 | 2.52 | $220.20 |

Nothing significant in this table. The performance looks pretty good in especially bad years of -10% or less. Unfortunately the number of instances is too low to draw any solid conclusions from.

A peek at the last 3 days shows more of the same.

| *3 days left in year and year-to-date performance is X or less.* | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| *Buy on close. Sell 3 days later. $100k/trade. 1961-present.* | | | | | | | | | | |
| X | Net Profit | Trades | Wins | Losses | % Wins | Avg Win | Avg Loss | W/L Ratio | Profit Factor | Avg Trade |
| 50 | $14,025.78 | 47 | 30 | 17 | 63.83 | $960.48 | ($869.91) | 1.10 | 1.95 | $298.42 |
| 40 | $14,025.78 | 47 | 30 | 17 | 63.83 | $960.48 | ($869.91) | 1.10 | 1.95 | $298.42 |
| 30 | $13,828.20 | 45 | 29 | 16 | 64.44 | $984.49 | ($920.13) | 1.07 | 1.94 | $307.29 |
| 20 | $4,389.79 | 37 | 23 | 14 | 62.16 | $718.30 | ($866.52) | 0.83 | 1.36 | $118.64 |
| 10 | ($2,005.26) | 23 | 11 | 12 | 47.83 | $736.62 | ($842.34) | 0.87 | 0.80 | ($87.19) |
| 0 | $3,117.87 | 13 | 8 | 5 | 61.54 | $755.43 | ($585.11) | 1.29 | 2.07 | $239.84 |
| -10 | $2,610.77 | 9 | 6 | 3 | 66.67 | $775.31 | ($680.36) | 1.14 | 2.28 | $290.09 |

Unfortunately these end of year studies failed to produce a substantial edge.

Certainly notable is the fact that Friday marked the 2nd day in a row where the S&P 500 closed higher. While the move on Wednesday and Friday was muted it does trigger the "2 Days Up In Chop" that I've discussed before. I've updated the summary stats on this system below.

*If SPX closes higher 2 days in a row sell short on close. Cover at first profitable close. If after 4 days the trade is still not profitable, close anyway. $100k/trade. 6/1/2007 – present.*

| All Trades | | | |
|---|---|---|---|
| Total Net Profit | $58,618.92 | Profit Factor | 15.47 |
| Gross Profit | $62,670.91 | Gross Loss | ($4,051.99) |
| Total Number of Trades | 52 | Percent Profitable | 96.15% |
| Winning Trades | 50 | Losing Trades | 2 |
| Even Trades | 0 | | |
| Avg. Trade Net Profit | $1,127.29 | Ratio Avg. Win:Avg. Loss | 0.62 |
| Avg. Winning Trade | $1,253.42 | Avg. Losing Trade | ($2,026.00) |
| Largest Winning Trade | $8,783.02 | Largest Losing Trade | ($3,230.74) |
| Max. Consecutive Winning Trades | 22 | Max. Consecutive Losing Trades | 1 |
| Avg. Bars in Winning Trades | 2.74 | Avg. Bars in Losing Trades | 5.00 |

The last 22 trades dating back to April 24th have all been winners.

I have updated the Aggregator chart below:


Both the green Aggregator line and the black differential line are now a bit below zero. The reading for the Aggregator is -0.11, which is covered by the -0.13 differential on the chart above. Both lines below zero indicate that the expectation over the next few days is negative while the S&P has outperformed expectations over the last few days. This is typically the kind of setup I look for to initiate short positions.

While there has been a slight outperformance over the last few days the market is hardly stretched to the upside. In fact the S&P closed almost right at its 5-day moving average, is trading below it's 10-day moving average, and the 10-day %R is near oversold at 32. While most indicators are suggesting bearish probabilities over the near term, risk/reward isn't great with the market trading in the lower-end of its recent trading range. Rather than aggressively begin to short based on the current studies, I'd prefer to try and get a bit better potential risk/reward. Therefore I'll hope for some further strength in the next day or so to allow myself to scale a short position into.

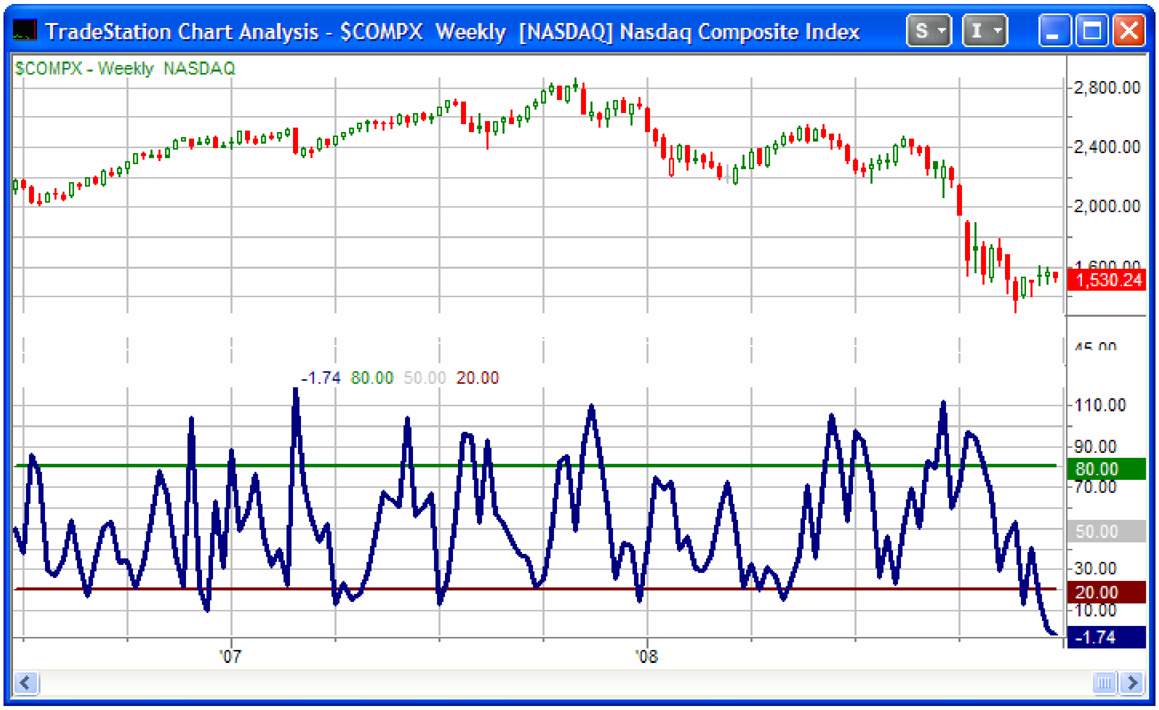
***Intermediate-term Outlook (2 weeks – 2 months)– very slightly bullish -updated 12/29***

It has now been about 5 weeks since the market bottomed in mid-November. After bouncing sharply from severely oversold conditions the 1st week, the market has failed to follow through at all since. As time goes by observations like positive divergences and strong thrusts off bottoms are waning in importance. I'm looking for further evidence that suggests a continued rally may be at hand. So far I'm not seeing much.

Last week I discussed a recent study that suggested a move above the 50-day moving average after spending so much time below it was most likely to lead to a range-bound market.

I also discussed the fact that the Nasdaq failing to take a leadership role was a potential negative. This remains the case.

Lastly, I showed a study which looked at Nasdaq Weekly Volume Spyx readings under 10. It suggested bearish implications for the next 4-5 weeks. This week's Nasdaq Volume Spyx dropped even lower and posted a -1.74 reading.




The negative influence remains in place this week for the Nasdaq Volume Spyx indicator.

Also notable about the Nasdaq is that it has now has two inside weeks in a row. Last February I used two inside weeks as one definition of a triangle formation. Results of that test suggested that breakout of these triangles were more often false moves than not. The Nasdaq composite has had 6 such setups since 1970 with 5 of the breakouts actually working. Still with the majority of securities tested showing failed breakouts are more likely, I'd be wary of the first sharp move out of this consolidation.

2008 has certainly seen some historic action. Choppiness, volatility, and negative performance numbers have been approached only by Great Depression markets. We saw numerous examples of this in October and November. With the Dow down about 35% year-to-date I decided to look at performance following other years where it fell 30% or more. What I found is that there have only been 3 other years where the Dow has closed down over 30%. All 3 of these years came in the 1930's. They were 1930, 1931 and 1937. It's dangerous to infer much from only 3 instances, but there is nothing to suggest that extremely bad years are likely to be followed by extremely good ones. Both 1930 and 1931 were followed by further selling. And while 1937 was followed by a positive performance in 1938, it didn't happen without first dropping over 18% in the 1st quarter.

The more time goes by without a continuation of the rally off the November lows, the more neutral I've become. Even in the worst markets of all time there were substantial intermediate-term moves where the market rallied strongly higher for a few months before rolling over. No matter how dire the long-term outlook for the market may be, there should be some intermediate-term relief at some point. At this point, though, I'm becoming less inclined to try and hang on to positions for intermediate-term gains. The short-term swing trading has been where I've found the best results in the last several months and that's where I'll likely continue to focus until I begin to see more evidence of a strong intermediate-term move.

## 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 | 1.25 | | DJ US Financial Services | IYG | 0.70 |
| DJ US Utilities | IDU | 0.00 | | DJ US Healthcare | IYH | 0.70 |
| DJ US Oil&Gas Expl & Prod | IEO | 5.17 | | 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 | 2.70 | | 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 | 2.44 | | 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 |

*Oil & Gas is starting to see a little capitulative action. Nothing extremely broad yet.*

**Additional New Trade Ideas**

*SPY – short ¼ index position on CLOSE OVER $87.16.* Based on short-term market outlook above. I'd prefer to see the market get a little more stretched to the upside before beginning to allocate capital short. Therefore I'll wait for the close tomorrow rather than attempt a morning or intraday entry.

**Active Trades Table**

| Symbol | Entry Date | Entry Price | Current Pr | % Gain/Lo | Stop | Notes |
|---|---|---|---|---|---|---|
| IEF(s) | 12/19/2008 | $99.85 | $99.64 | 0.21% | $99.75 | cover @ $99.12 limit |
| QQQQ(1/4) | 12/23/2008 | $29.06 | $29.19 | 0.45% | | sold on open |

IEF failed to provide a fill on Friday and instead gapped up. I'll still look to exit at $99.12 but have also place a protective stop on the position.