

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 31, 2008

Issue 220

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 31, 2008	10/200 Put/Call < 0.85	1-9 days	Bearish	-2.70%	-5.00%
December 29, 2008	10/100 ATR < 0.60	n/a	Bearish	n/a	n/a
March 17, 2008	Consumer Sentiment Stretch	1-12 months	Bullish		
Dropped Tonight					
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%

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) – bearish – updated 12/31

The market put in a strong day on Tuesday. After gapping up in the morning it briefly retraced before trending higher for the rest of the day. The major averages were all up in the 2.5% neighborhood. Breadth was very strong as advancers outnumbered decliners on the NYSE by about 4 to 1 while up volume led down volume by nearly 9 to 1. Total volume rose over the levels seen the last few days but was still well below average.

I noticed some interesting readings in volatility and sentiment indicators tonight. First of all the VIX closed at a 20-day low. This has traditionally led to underperformance over the next few days and weeks. Below is a study which illustrates this:

<i>VIX closes at its lowest level in 20 days while the S&P 500 fails to close at a 10-day high.</i>												
<i>Buy S&P 500 on close. Sell X days later. \$100k/trade. 1990-present.</i>												
X Days	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
20	\$12,261.47	89	45	44	50.56	\$10,497.52	(\$11,406.75)	\$2,952.32	(\$2,740.75)	1.08	1.10	\$137.77
19	\$24,234.18	91	46	44	50.55	\$10,548.86	(\$9,084.00)	\$2,865.86	(\$2,445.35)	1.17	1.23	\$266.31
18	\$25,460.79	92	51	41	55.43	\$11,832.36	(\$7,037.80)	\$2,635.61	(\$2,657.45)	0.99	1.23	\$276.75
17	\$23,404.75	93	51	42	54.84	\$11,735.72	(\$5,904.00)	\$2,357.96	(\$2,305.98)	1.02	1.24	\$251.66
16	\$32,221.62	94	57	37	60.64	\$10,498.32	(\$6,835.50)	\$2,255.79	(\$2,604.29)	0.87	1.33	\$342.78
15	\$5,925.95	97	52	44	53.61	\$11,723.64	(\$18,406.92)	\$2,368.18	(\$2,664.08)	0.89	1.05	\$61.09
14	\$25,861.42	99	53	46	53.54	\$10,660.60	(\$16,832.76)	\$2,560.16	(\$2,387.55)	1.07	1.24	\$261.23
13	\$20,869.27	102	58	44	56.86	\$11,590.76	(\$14,181.72)	\$2,344.31	(\$2,615.93)	0.90	1.18	\$204.60
12	\$35,524.95	105	62	43	59.05	\$9,071.40	(\$12,783.96)	\$2,206.35	(\$2,355.08)	0.94	1.35	\$338.33
11	\$28,231.65	109	63	46	57.80	\$8,530.60	(\$12,277.44)	\$2,232.82	(\$2,444.27)	0.91	1.25	\$259.01
10	\$34,738.53	112	59	53	52.68	\$8,486.40	(\$7,760.76)	\$2,303.14	(\$1,908.43)	1.21	1.34	\$310.17
9	\$15,024.22	115	63	52	54.78	\$7,976.80	(\$8,328.60)	\$1,782.77	(\$1,870.97)	0.95	1.15	\$130.65
8	(\$3,450.88)	117	59	58	50.43	\$5,720.00	(\$7,650.40)	\$1,606.30	(\$1,693.50)	0.95	0.96	(\$29.49)
7	(\$34,111.02)	125	63	62	50.40	\$5,301.40	(\$6,996.18)	\$1,421.04	(\$1,994.14)	0.71	0.72	(\$272.89)
6	(\$26,582.83)	130	64	66	49.23	\$4,143.44	(\$8,324.55)	\$1,355.92	(\$1,717.61)	0.79	0.77	(\$204.48)
5	(\$23,565.87)	144	76	68	52.78	\$3,704.00	(\$6,085.50)	\$1,292.18	(\$1,790.75)	0.72	0.81	(\$163.65)
4	(\$46,046.10)	156	78	77	50.00	\$4,419.43	(\$9,721.62)	\$1,070.27	(\$1,682.17)	0.64	0.64	(\$295.17)
3	(\$21,492.67)	172	86	86	50.00	\$4,039.00	(\$5,537.61)	\$1,025.51	(\$1,275.42)	0.80	0.80	(\$124.96)
2	(\$11,332.95)	194	102	92	52.58	\$3,779.85	(\$4,209.66)	\$835.79	(\$1,049.82)	0.80	0.88	(\$58.42)
1	\$7,544.74	246	134	109	54.47	\$2,346.51	(\$2,470.65)	\$688.79	(\$777.55)	0.89	1.09	\$30.67

Not terribly bearish, but still it underperforms the long-term upward drift of the market.

Some other indicators that have provided extreme readings in the last couple of days are the Put/Call ratios. I'm not a huge fan of put/call ratios but I have found some value in them when they reach extremes. Since the CBOE has tracked them over the last 13 years the total put/call levels have drifted higher. To account for this drift I typically normalize a short-term moving average by dividing it by a longer one. The one I look at the most is the 10-day put/call divided by the 200-day put/call. This ratio hit its lowest level since November of 2007 today. Below are other times the ratio hit long-term lows:

<i>10-day average CBOE put/call ratio divided by the 200-day average CBOE put/call ratio hits a 200-day low.</i>												
<i>Buy S&P 500 on close. Sell X days later. \$100k/trade. 1996-present.</i>												
X Days	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
10	\$5,789.29	20	11	9	55.00	\$5,263.83	(\$7,372.05)	\$2,296.31	(\$2,163.35)	1.06	1.30	\$289.46
9	\$2,506.77	21	10	11	47.62	\$5,196.49	(\$5,875.80)	\$2,343.91	(\$1,902.94)	1.23	1.12	\$119.37
8	(\$4,875.07)	21	9	12	42.86	\$4,770.49	(\$7,490.70)	\$1,971.84	(\$1,885.13)	1.05	0.78	(\$232.15)
7	(\$409.61)	22	11	11	50.00	\$4,286.97	(\$3,495.45)	\$1,169.64	(\$1,206.88)	0.97	0.97	(\$18.62)
6	(\$2,012.56)	22	11	11	50.00	\$3,194.79	(\$3,313.80)	\$1,076.42	(\$1,259.38)	0.85	0.85	(\$91.48)
5	(\$2,451.83)	24	11	13	45.83	\$2,898.18	(\$3,306.45)	\$1,256.26	(\$1,251.59)	1.00	0.85	(\$102.16)
4	(\$471.45)	27	14	13	51.85	\$3,806.19	(\$4,906.20)	\$1,091.63	(\$1,211.87)	0.90	0.97	(\$17.46)
3	\$5,334.18	30	16	14	53.33	\$3,372.03	(\$2,357.16)	\$864.34	(\$606.81)	1.42	1.63	\$177.81
2	(\$4,059.07)	41	20	21	48.78	\$3,583.44	(\$2,328.92)	\$629.63	(\$792.93)	0.79	0.76	(\$99.00)
1	(\$9,474.31)	62	30	31	48.39	\$2,786.04	(\$2,531.86)	\$485.63	(\$775.59)	0.63	0.61	(\$152.81)

Similar to the VIX study above suggests underperformance to perhaps mildly bearish tendencies.

The ratio actually dropped below 0.83 today. Another test I ran was to review other times it dropped to 0.85 or lower:

10-day average CBOE put/call ratio divided by the 200-day average CBOE put/call ratio drops below 0.85.

Buy S&P 500 on close. Sell X days later. \$100k/trade. 1996-present.

X Days	Net Profit	Trades	Wins	Losses	% Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
10	\$2,233.59	25	14	11	56.00	\$4,544.96	(\$4,216.85)	\$1,749.08	(\$2,023.04)	0.86	1.10	\$89.34
9	(\$13,913.69)	25	8	17	32.00	\$3,715.04	(\$4,920.30)	\$2,170.53	(\$1,839.88)	1.18	0.56	(\$556.55)
8	(\$7,599.20)	26	11	15	42.31	\$3,523.52	(\$4,614.72)	\$1,838.19	(\$1,854.62)	0.99	0.73	(\$292.28)
7	(\$7,843.73)	26	13	13	50.00	\$3,976.35	(\$5,081.34)	\$1,580.46	(\$2,183.82)	0.72	0.72	(\$301.68)
6	(\$9,046.38)	26	12	14	46.15	\$3,141.92	(\$4,150.74)	\$1,583.60	(\$2,003.54)	0.79	0.68	(\$347.94)
5	(\$11,339.11)	28	10	18	35.71	\$3,757.60	(\$6,793.38)	\$1,920.83	(\$1,697.08)	1.13	0.63	(\$404.97)
4	(\$8,656.59)	29	13	16	44.83	\$3,024.00	(\$9,797.04)	\$1,261.95	(\$1,566.37)	0.81	0.65	(\$298.50)
3	\$3,371.56	29	16	13	55.17	\$3,552.64	(\$4,220.70)	\$1,272.22	(\$1,306.45)	0.97	1.20	\$116.26
2	\$3,825.77	31	20	11	64.52	\$2,158.56	(\$2,823.40)	\$962.64	(\$1,402.46)	0.69	1.25	\$123.41
1	\$7,345.00	32	19	13	59.38	\$2,440.30	(\$2,093.99)	\$753.16	(\$535.77)	1.41	2.05	\$229.53

Of the 3 tests this one produces the most bearish results.

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



Both the green Aggregator line and the black differential line remain below zero. This indicates the market has recently outperformed expectations and that expectations for the next few days are negative. This is a typical shorting configuration. The first piece of an index position was entered at the close Tuesday. I'll continue to look to cautiously scale in. The facts that the market remains mid-range combined with currently positive seasonality are keeping me from trading more aggressively.

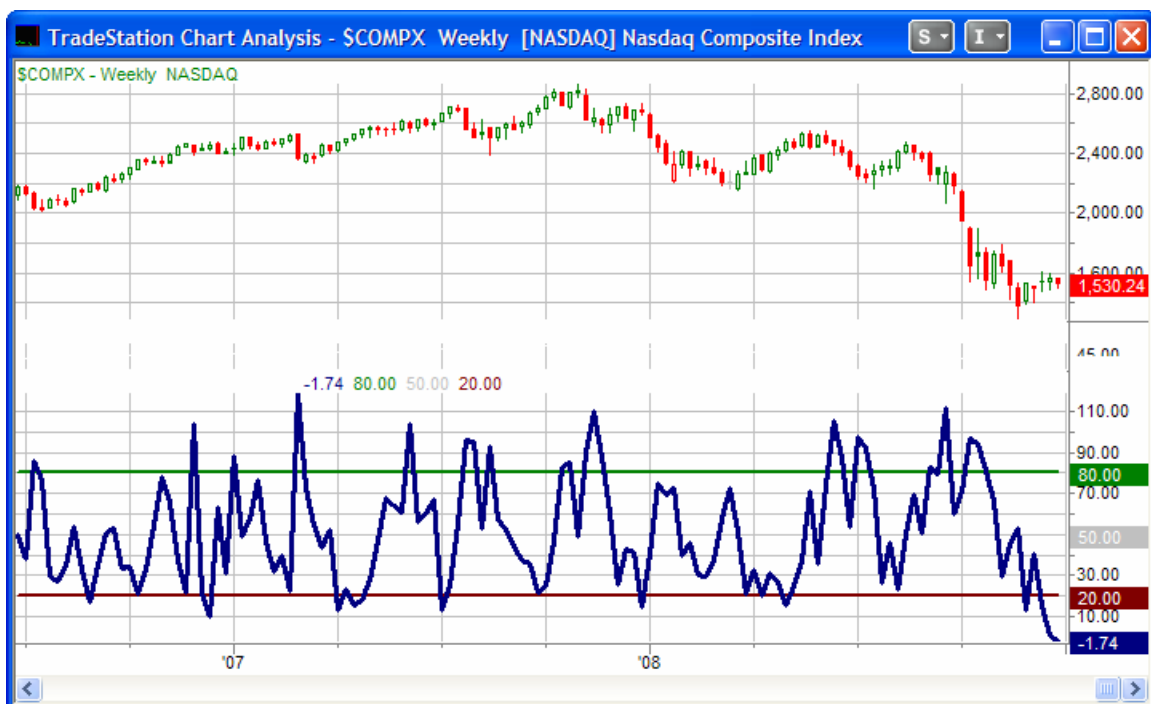
Intermediate-term Outlook (2 weeks – 2 months)– very slightly bullish -updated 12/29

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

Additional New Trade Ideas

SPY – short 1/4 index position on CLOSE OVER \$89.00. Based on short-term market outlook above. It is also notable that a close higher tomorrow would trigger the [2 Days Up In Chop](#) strategy that has performed so well over the last several months.

Also notable is that several stocks and one ETF (MOO) triggered system -81217 tonight. This is one of the more reliable short systems used in the subscriber Letter. I won't track any of these officially, but traders may want to check out the [triggers page](#) if they are in search of additional trade ideas.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Pr	% Gain/Loss	Stop	Notes
SPY(s) 1/4	12/30/2008	\$88.97	\$88.97	0.00%		shorted on close

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