

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 29, 2009

Volume 2 Issue 19

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					
January 29, 2009	VXO 15% Below 10ma	1-5 days	Bearish	-2.50%	-5.20%
January 29, 2009	Gap Up N Go	1-4 days	Bearish	-3.70%	-7.70%
January 28, 2009	3 Up Days < 200 Declining Vol	1-10 days	Bearish	-3.15%	-5.70%
January 27, 2009	2 Days Up In Chop	1-4 days	Bearish		
January 27, 2009	SPX Rally On Lightest Vol in 10	1-5 days	Bearish	-2.15%	-4.20%
Jan 22 and Jan 28	Tight range Inside Days	1-6 days	Bearish	-2.60%	-4.90%
January 5, 2009	Appel Breadth Thrust	1-20 days	Bullish	3.70%	5.70%
Active - Long Term					
December 18, 2008	Break above 50-day		Neutral - Trading Range		
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*.

Short-term Outlook (1-5 days) – updated 1/29 - bearish

The market viewed the government efforts (“bad bank”, Fed statement, stimulus package) in a positive light today. The S&P gapped up over 2% this morning. It managed to stay strong throughout the day as well. At the close the S&P 500, Russell 2000, Nasdaq Composite and S&P 400 were all up over 3%. Breadth was strongly positive with NYSE Up Issues coming in at 85% and Up Volume at 89%. Total volume rose to its highest levels in a week.

Days that gap higher, don’t fill their gap and close above their open (Gap & Go’s) have a tendency to pull back over the next several days. Generally the larger the gap the stronger this tendency is. Below is a study that breaks down 1-week performance by gap size:

<i>SPY gaps at least X% above yesterday's close. It never trades <= yesterday's close and closes > the open. Close < 200ma. Buy on close. Sell 5 days later. \$100k/trade. 1994-present.</i>										
X%	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
2	(\$25,698.62)	13	7	6	53.85	\$2,424.73	(\$7,111.96)	0.34	0.40	(\$1,976.82)
1.5	(\$33,744.51)	21	10	11	47.62	\$2,680.23	(\$5,504.26)	0.49	0.44	(\$1,606.88)
1	(\$37,764.10)	34	16	17	47.06	\$2,337.01	(\$4,420.96)	0.53	0.50	(\$1,110.71)
0.5	(\$48,817.79)	57	30	26	52.63	\$1,867.86	(\$4,032.83)	0.46	0.53	(\$856.45)
0	(\$69,335.71)	92	48	43	52.17	\$1,604.92	(\$3,403.99)	0.47	0.53	(\$753.65)

With the “% Wins” column is basically a coin toss risks have outweighed rewards on average by 2:1 or more. The poor risk/reward is what creates the negative expectancy.

With only 13 instances of 2% or higher gaps I decided to use the 1% gap level as my criteria for the next test in order to get a decent sample size. Below I look at the daily performance numbers over the following week:

SPY gaps at least 1% above yesterday's close. It never trades <= yesterday's close and closes > the open. Close < 200ma.										
Buy on close. 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	(\$37,764.10)	34	16	17	47.06	\$2,337.01	(\$4,420.96)	0.53	0.50	(\$1,110.71)
4	(\$47,839.54)	37	17	20	45.95	\$1,811.28	(\$3,931.56)	0.46	0.39	(\$1,292.96)
3	(\$26,244.80)	37	15	22	40.54	\$2,023.10	(\$2,572.33)	0.79	0.54	(\$709.32)
2	(\$22,387.38)	38	19	19	50.00	\$1,882.88	(\$3,061.17)	0.62	0.62	(\$589.14)
1	(\$11,011.50)	39	21	18	53.85	\$735.79	(\$1,470.17)	0.50	0.58	(\$282.35)

The bearish expectancy peaks at 4 days across the sample. About 70% of all instances closed below their trigger price at some point in the following 3 days. This number increases to 89% when looking out 6 days.

I also filtered to see only those times when the SPY made a 10-day high on the day of its Gap & Go. Instances were low but results were interesting nonetheless.

SPY gaps at least 1% above yesterday's close. It never trades down to yesterday's close, makes a 10-day high, and closes above the open. Close < 200maBuy on close. 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
10	(\$25,291.36)	9	2	7	22.22	\$2,109.28	(\$4,215.70)	0.50	0.14	(\$2,810.15)
9	(\$21,159.33)	9	4	5	44.44	\$1,262.33	(\$5,241.73)	0.24	0.19	(\$2,351.04)
8	(\$19,711.46)	9	4	5	44.44	\$1,137.77	(\$4,852.51)	0.23	0.19	(\$2,190.16)
7	(\$6,656.58)	9	3	6	33.33	\$1,960.06	(\$2,089.46)	0.94	0.47	(\$739.62)
6	(\$15,968.96)	9	2	7	22.22	\$1,331.37	(\$2,661.67)	0.50	0.14	(\$1,774.33)
5	(\$16,051.58)	9	4	5	44.44	\$381.32	(\$3,515.37)	0.11	0.09	(\$1,783.51)
4	(\$15,576.52)	10	4	6	40.00	\$910.14	(\$3,202.85)	0.28	0.19	(\$1,557.65)
3	(\$17,876.44)	10	2	8	20.00	\$411.88	(\$2,337.53)	0.18	0.04	(\$1,787.64)
2	(\$13,085.56)	10	5	5	50.00	\$527.87	(\$3,144.98)	0.17	0.17	(\$1,308.56)
1	(\$8,612.63)	10	4	6	40.00	\$524.18	(\$1,784.89)	0.29	0.20	(\$861.26)

Among this sample 9 of 10 instances closed lower at some point in the following three days. If you instead look out six days then all ten suffered at least one close lower than the close of the entry day.

Also notable today is the fact that the VXO closed more than 15% below its 10-day moving average. This can be viewed as a sign of complacency by traders as they become overconfident in a rally and begin to underprice the options. Historically a VXO this undersold had suggested bearish implications:

VXO crosses under 15% below 10-day MA on a closing basis.										
Buy SPX on close. Sell X days later. \$100k/trade. 1987-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	(\$46,666.18)	49	18	31	36.73	\$1,632.60	(\$2,453.32)	0.67	0.39	(\$952.37)
4	(\$34,574.50)	50	19	31	38.00	\$1,267.18	(\$1,891.97)	0.67	0.41	(\$691.49)
3	(\$28,912.02)	51	25	26	49.02	\$992.94	(\$2,066.75)	0.48	0.46	(\$566.90)
2	(\$19,134.02)	53	24	29	45.28	\$1,202.05	(\$1,654.59)	0.73	0.60	(\$361.02)
1	(\$858.45)	53	22	31	41.51	\$916.40	(\$678.04)	1.35	0.96	(\$16.20)

Not shown above is that 83% of all instances closed below their trigger price at some point in the next few days.

Tonight's [Aggregator](#) chart is below:



No real surprise with the Aggregator chart. Our studies are dominated by bearish implications placing the green Aggregator line in negative territory. The strong move in the SPX over the last few days has seen it greatly outperform expectations. This is illustrated by the strongly negative black Differential line. This is a configuration that remains ripe for shorting. I will look to scale in to the 3rd of 4 possible legs on Thursday as described in the trade ideas section below.

Intermediate-term Outlook (2 weeks – 2 months)–neutral -updated 1/26

Tonight I'm going to look out a bit further than I usually do. Not for purposes of trying to predict the next several years, but to help traders set some expectations.

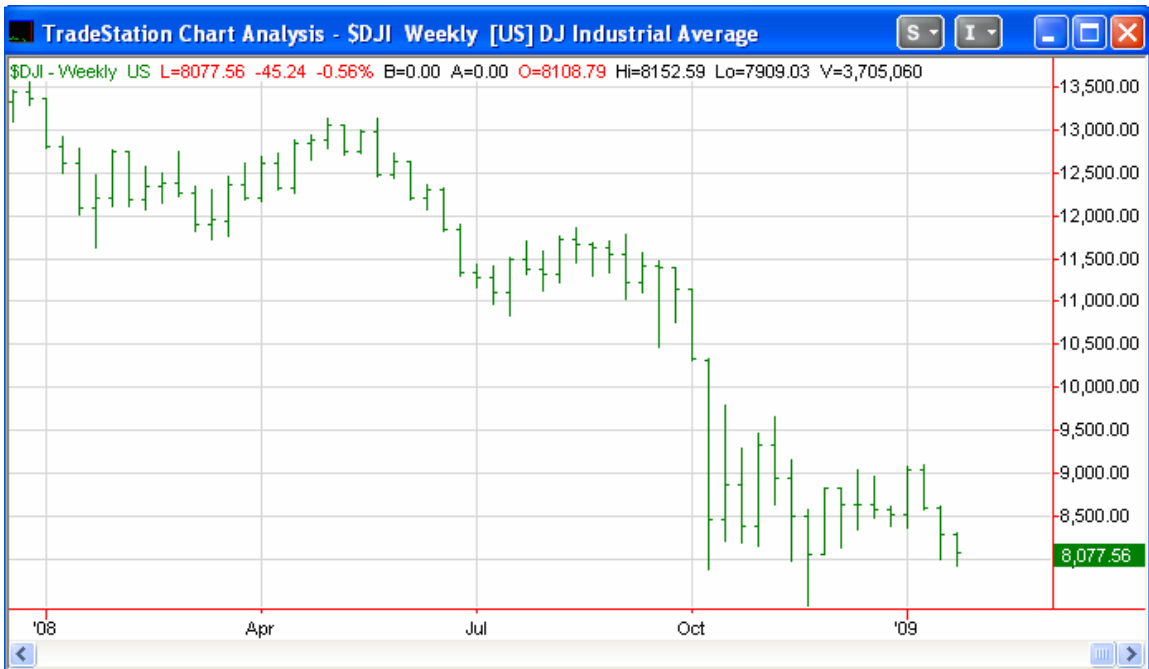
Back in October/November I ran several studies which showed the action at that time was unlike anything seen since the 1930's. [Volatility, for instance went beyond anything even seen in 1987](#). I also posted several studies in the newsletter and the blog which illustrated just how extreme conditions had become. Examples [here](#) and [here](#).

So if we are to liken the Crash of '29 to the 43% S&P selloff from September to November of 2008, then it may be worth it to take a look at action following the 1929 crash.

This first chart is a weekly view of the Dow in '29 and '30. After the October crash there was a bounce and then a pullback that ended around the end of December '29. From there the market rallied over 30% before topping out in early April. By any standards this bear-market rally was quite strong. I think most people would be thrilled with a 30% rally over the next 3 ½ months.



So let's now look at the current chart:



While the bounce has been a bit more drawn out here, a case could be made that the current situation resembles the beginning of 1930 which marked the start of that 30%+ rally.

Lest anyone get too excited by a 30%+ rally in the market over the next few months, let's take a very long-term look at how the Dow performed after that 1930 rally topped out:



I put a blue horizontal line near the top of the 1930 rally looked at in the earlier chart. As you can see, that 1930 top took about 24 years before it was surpassed again. This is not to suggest that the market will be near the same level in 2030 as it is today. There is a lesson here, though. I don't think there is hardly any chance that the market is about to put in a move so strong that will take it to new highs in the next year or so. If the economy isn't able to recover quickly then we may be in for a protracted difficult time. There were numerous bear market rallies over the timeline shown above. When the music stopped on those upmoves it was vital to show agility and step aside. As traders look to capture rallies over the next several months and years, I believe it will be important to make sure they remain cognizant of the possibility that the rally is just a rally and not the next great secular bull market.

As far as studies go, the negative influence of the Nasdaq Weekly Volume Spyx study from the end of December has fallen off the board. Still I'm not seeing much that's terribly convincing from either the bullish or bearish case when looking out over the next several weeks. I intend to remain open to both possibilities and to focus on the short-term.

Catapult and Capitulative Breadth Statistics

(Catapult Presentation Part 1) (Catapult Presentation Part 2)

Open Catapult Triggers

USB (1/21)

The big move in the banks today left us with just one active Catapult.

Catapult for ETF's Trades

Broad Market Large Cap CBI – 1 (USB)

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	0.68
DJ US Regional Banks	IAT	1.25	DJ US Financial Services	IYG	1.40
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	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	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	0.88	Nasdaq 100	QQQQ	0.00

Additional New Trade Ideas

SPY – short ¼ index position @ \$87.39 limit. Based on short-term market outlook above.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)s	1/27/2009	\$84.53	\$87.39	-3.38%		
SPY(1/4)s	1/28/2009	\$86.40	\$87.39	-1.15%		shorted at open

A bit early on the timing but still expecting a turn down. Looking for 3rd quarter on Thursday.

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