

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

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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					
February 18, 2009	2 Down In chop	1-3 days	Bullish	1.60%	3.40%
February 18, 2009	2.5% drop after 5-day low	1-5 days	Bullish	4.20%	7.90%
February 12, 2009	Weak Bounce	1-10 days	Bearish	-4.50%	-7.80%
Active - Long Term					
February 9, 2009	Nasdaq Breadth Thrust	1-20 days	Bullish	5.90%	9.60%
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 2/19 – slightly bullish

After Tuesday's big move down the market spent most of Wednesday in a relatively tight range. It was touch and go up until the closing bell where the Nasdaq and S&P closed slightly lower. Breadth was unusually negative for such a mild drop. The NYSE Up Issue % came in at 28% and the Up Volume % was 35% today. Total volume declined a bit from Tuesday's levels.

I sent out an intraday update this afternoon suggesting a close in the SPY between \$79.25 and \$80 was potentially bearish. The reason was that weak bounces following strong selloffs are prone to near immediate failure. The SPY failed to reach this target area and closed slightly lower on the day. The line can sometimes be fine between a weak bounce and a mild selloff, but let's look at the implications of each to better understand why a close below that target area was not a bearish event.

First let's look again at the "weak bounce" price study. (There were also some based on breadth – one of which I linked to today.) The table below is updated through January 14th:

SPX drops 1.75% or more yesterday. Today it closes higher but recovers less than 1/4 of yesterday's drop.										
Buy on close. Sell X days later. \$100k/trade. Last 20 years.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
10	(\$47,182.29)	40	12	28	30.00	\$2,570.33	(\$2,786.65)	0.92	0.40	(\$1,179.56)
9	(\$44,659.82)	41	15	26	36.59	\$2,149.67	(\$2,957.88)	0.73	0.42	(\$1,089.26)
8	(\$37,642.83)	43	15	28	34.88	\$2,519.91	(\$2,694.34)	0.94	0.50	(\$875.41)
7	(\$39,016.23)	45	16	29	35.56	\$2,588.13	(\$2,773.32)	0.93	0.51	(\$867.03)
6	(\$36,530.37)	45	15	30	33.33	\$2,299.72	(\$2,367.54)	0.97	0.49	(\$811.79)
5	(\$32,646.73)	48	20	28	41.67	\$1,651.43	(\$2,345.55)	0.70	0.50	(\$680.14)
4	(\$30,136.20)	48	19	29	39.58	\$1,520.78	(\$2,035.55)	0.75	0.49	(\$627.84)
3	(\$31,784.77)	50	17	33	34.00	\$1,763.11	(\$1,871.44)	0.94	0.49	(\$635.70)
2	(\$21,661.55)	51	24	27	47.06	\$1,167.61	(\$1,840.16)	0.63	0.56	(\$424.74)
1	(\$21,286.71)	51	20	31	39.22	\$743.77	(\$1,166.52)	0.64	0.41	(\$417.39)

What I saw here was an immediate and consistent downside edge – both with regards to % Wins as well as Avg. Trade. But what if instead of the weak bounce we examine a mild selloff? Below are results that look at this:

After dropping over 1.75% yesterday the S&P 500 falls less than 0.5% today.										
Buy on close. Sell X days later. \$100k/trade. 1988-present										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
10	\$43,484.65	32	22	10	68.75	\$3,132.99	(\$2,544.11)	1.23	2.71	\$1,358.90
9	\$51,688.97	33	24	9	72.73	\$2,940.02	(\$2,096.83)	1.40	3.74	\$1,566.33
8	\$56,550.70	33	23	10	69.70	\$3,125.03	(\$1,532.49)	2.04	4.69	\$1,713.66
7	\$46,578.79	33	25	8	75.76	\$2,540.72	(\$2,117.42)	1.20	3.75	\$1,411.48
6	\$41,041.18	33	22	11	66.67	\$2,495.38	(\$1,259.73)	1.98	3.96	\$1,243.67
5	\$26,962.97	33	21	12	63.64	\$2,170.26	(\$1,551.05)	1.40	2.45	\$817.06
4	\$22,265.55	34	21	13	61.76	\$2,345.70	(\$2,076.47)	1.13	1.82	\$654.87
3	\$16,305.69	34	22	12	64.71	\$1,842.00	(\$2,018.18)	0.91	1.67	\$479.58
2	\$8,890.54	34	21	13	61.76	\$1,405.85	(\$1,587.10)	0.89	1.43	\$261.49
1	\$7,185.04	34	22	12	64.71	\$1,039.10	(\$1,306.27)	0.80	1.46	\$211.32

Here we see that over the last 21 years there has been an immediate and consistent upside edge. Both % wins and Avg. Trade are nearly inverted from the 1st study. Let's take this one a step further, though. To help ensure the 0% to -0.5% isn't over optimized I ran a test showing % drop ranges:

First let's look at this in the context of "next day" performance:

After dropping over 1.75% yesterday the S&P 500 falls less than X% today.										
Buy on close. Sell at tomorrow's close. \$100k/trade. 1988-present										
X%	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
-0.1	\$1,578.45	6	4	2	66.67	\$794.25	(\$799.27)	0.99	1.99	\$263.08
-0.2	\$723.02	16	10	6	62.50	\$660.36	(\$980.10)	0.67	1.12	\$45.19
-0.3	\$7,837.36	21	15	6	71.43	\$914.53	(\$980.10)	0.93	2.33	\$373.21
-0.4	\$12,540.72	27	20	7	74.07	\$988.41	(\$1,032.51)	0.96	2.74	\$464.47
-0.5	\$7,185.04	34	22	12	64.71	\$1,039.10	(\$1,306.27)	0.80	1.46	\$211.32
-0.6	\$8,483.42	39	25	14	64.10	\$1,145.18	(\$1,439.01)	0.80	1.42	\$217.52
-0.7	\$6,746.09	41	25	16	60.98	\$1,145.18	(\$1,367.72)	0.84	1.31	\$164.54
-0.8	\$6,035.19	47	30	17	63.83	\$1,050.24	(\$1,498.35)	0.70	1.24	\$128.41
-0.9	\$9,748.19	53	34	19	64.15	\$1,141.70	(\$1,529.97)	0.75	1.34	\$183.93
-1	\$4,658.76	58	37	21	63.79	\$1,097.43	(\$1,711.72)	0.64	1.13	\$80.32

Here we see the bullish edge, while not huge, is evident across the spectrum. Now let's look at the 5-day returns:

After dropping over 1.75% yesterday the S&P 500 falls less than X% today.										
Buy on close. Sell 5 days later. \$100k/trade. 1988-present										
X%	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
-0.1	\$7,158.41	6	3	3	50.00	\$3,959.16	(\$1,573.02)	2.52	2.52	\$1,193.07
-0.2	\$11,748.32	16	9	7	56.25	\$2,509.77	(\$1,548.51)	1.62	2.08	\$734.27
-0.3	\$22,812.76	21	13	8	61.90	\$2,607.11	(\$1,384.96)	1.88	3.06	\$1,086.32
-0.4	\$31,975.18	27	17	10	62.96	\$2,659.69	(\$1,323.95)	2.01	3.42	\$1,184.27
-0.5	\$26,962.97	33	21	12	63.64	\$2,170.26	(\$1,551.05)	1.40	2.45	\$817.06
-0.6	\$27,832.23	38	23	15	60.53	\$2,179.11	(\$1,485.81)	1.47	2.25	\$732.43
-0.7	\$29,512.26	39	24	15	61.54	\$2,158.31	(\$1,485.81)	1.45	2.32	\$756.72
-0.8	\$29,569.55	45	27	18	60.00	\$2,173.47	(\$1,617.45)	1.34	2.02	\$657.10
-0.9	\$48,497.38	51	31	20	60.78	\$2,579.87	(\$1,573.93)	1.64	2.54	\$950.93
-1	\$52,928.22	56	34	22	60.71	\$2,628.66	(\$1,656.65)	1.59	2.45	\$945.15

More of the same here as the bullish edge is again apparent across the spectrum. The average trade numbers of around 1% are fairly sizable for a 5-day holding period.

In addition to the price action, breadth readings are also becoming notable. The 10-day EMA of the NYSE Up Issues % closed at 0.3764. In the past I've shown how moves below 0.375 have resulted in bullish short-term expectations. See more on this indicator here:

<http://www.quantifiableedges.com/members/nyseadvdeclarge.php>

The McClellan Oscillator is also reaching extreme territory. Worden Bros. measure of the indicator hit -192 today. Their readings are typically slightly less extreme for whatever reason. [In the past I've shown how](#) moves below -200 have often led to sharp bounces. There have been failures since that study, but I believe it still contains a bit of an upside edge nonetheless.

I did not include tonight's mild selloff study in the aggregator simply because we already have two price-based studies that looked at the recent sharp drop. I thought a third within one day would be overkill.

With that in mind, tonight's [Aggregator](#) chart is below:



Not much change from last night. The green Aggregator line has pulled back some but still remains squarely above 0. The black differential line is more stretched than it has been in a long time, indicating strong underperformance versus expectations over the last 3 days.

As I mentioned last night I'd be more enthusiastic about this setup if the market wasn't just breaking down from a base around the 800 level. There's still a good amount of room to go until we reach the November lows and I don't want to get overcommitted too soon. I want to have reserves to put to work should there be action near or below that level.

Still, a further decline tomorrow should push some of the breadth indicators over the brink and activate even more bullish studies. Therefore I'll be looking to add to the current SPY long trade idea position on weakness tomorrow as laid out in the trade idea section below.

Intermediate-term Outlook (2 weeks – 2 months)–neutral -updated 2/17

While the selling was fairly strong this past week, no major support levels were broken for the S&P 500 or Nasdaq Composite. The S&P is now trading near the lower end of its recent range while the Nasdaq is in the middle of its range. The Dow on the other hand did drop to its lowest levels since November. While it could be considered a warning sign, the Dow's broken support is not terribly alarming just yet. The index is only comprised of 30 stocks and it wasn't confirmed by any of the other major indices – including the Smallcaps and Midcaps.

I've included a chart of the S&P 500 below for reference:



The dark red line is the 800 level. Thursday's low was at 808 and the January low was 804. The spike down in November saw the S&P dip below 750, but there was only one day where it closed below 800. A move down through the 800 level could lead to a sharp selloff that might test or break through the November lows.

Last week I noted the Nasdaq had undergone a breadth thrust that was strong enough that it had often led to intermediate-term rallies in the past. The measure we used to conduct the tests was the 10-day EMA of the Nasdaq Up Volume %. It had spiked above 64% as of Friday the 6th. In testing some systems related to this indicator we found that a reasonable exit signal would come when the indicator dropped back down into the mid-40's. As of Friday it was already down to between 50% and 51%. A breadth failure in the Nasdaq could also confirm price failures if the market is unable to rally from these nearby support levels.

The Nasdaq does continue to outperform the NYSE. Even this week where the markets fell, the Nasdaq held up better than the NYSE Composite Index, falling 3.6% vs. the NYSE's 4.9% decline. The Nasdaq's relative strength line has now broken to new highs. The Nasdaq:NYSE ratio is now at its highest level since 2005. If nothing else, this would seem to indicate that should the market manage to muster a multi-month rally here soon then the best opportunities for profit may lie in Nasdaq stocks. This is especially true of trend-following methods as I expect the Nasdaq stocks are better positioned to emerge into leadership positions.

As I've been saying, I expect we're likely to see a decent rally of 30% or more lasting at least 2-3 months emerge here at some point. I have serious doubts that next rally will lead to a multi-year bull market run, though. Until I see signs otherwise, I'm treating this market as one that is more similar to the 1930's than any other period in time. Past evidence of this includes volatility studies, Dow Trend vs. Chop studies, and studies of

severe selloffs such as we saw in the fall. I'll be sure to revisit these studies when appropriate. For now my focus remains short-term.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Triggers

DOW (Dow Chemical) –@ \$9.29 (1/3)

DOW (Dow Chemical) –@ \$8.62 (1/3)

New

DOW (Dow Chemical) – buy last 1/3 position @ \$8.60 limit

CAT – buy 1/3 position @ \$28.44 limit

Catapult for ETF's Trades

none

Broad Market Large Cap CBI – 4/2 (DOW-3, CAT)

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	1.16
DJ US Insurance Index	IAK	5.41	DJ US Financial	IYF	3.42
DJ US Regional Banks	IAT	5.00	DJ US Financial Services	IYG	3.50
DJ US Utilities	IDU	0.00	DJ US Healthcare	IYH	0.00
DJ US Oil&Gas Expl & Prod	IEO	1.72	DJ US Industrial Sector	IYJ	1.15
DJ US Oil Equip & Svcs	IEZ	3.85	DJ US Consumer Goods	IYK	2.72
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	2.70
DJ US Healthcare Providers	IHF	2.04	DJ US Real Estate	IYR	2.44
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

.Insurers and banks starting to see an uptick in capitulative action.

Additional New Trade Ideas

SPY – buy ¼ index position at \$77.00 limit. If not filled, buy @ \$78.50 limit ON CLOSE.
Based on short-term market outlook from above. I'm looking to add to the current ¼ index position on weakness during the day. If not filled, I'll loosen the limit price for an end-of-day fill.

DOW & CAT from the Catapult section above.

From the triggers list, USO has made a few appearances lately. It is at a point where I would normally look to take a stab at it. With 3 trades already listed for this evening, I'll take a pass again here. Should we get no Catapults triggering tomorrow and USO suffers another down day, then I'll most likely look to enter at that time.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
DOW	2/17/2009	\$9.29	\$8.60	-7.43%		Catapult
DOW	2/18/2009	\$8.62	\$8.60	-0.23%		Catapult
SPY	2/18/2009	\$79.22	\$79.03	-0.24%		

The average price on the DOW position is now \$8.955. For those who may have missed my recent discussion of Catapult trades, you may find it in Tuesday's Subscriber Letter:

[2009-02-17 QE Subscriber Letter.pdf](#)

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