

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 22, 2009

Volume 2 Issue 98

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 + 1/2 Std Dev
Active					
May 22, 2009	1% Drop on Bad Breadth	1-9 days	Bullish	2.90%	3.90%
May 21, 2009	Failed Gap Up Closes Near Low	1-3 days	Bullish	2.80%	4.30%
May 21, 2009	2 Down In Chop	1-3 days	Bullish		
May 20, 2009	NR10 Low Volume 10	1-4 days	Bearish	-3.00%	-5.20%
May 19, 2009	2.5% rise low volume	1-5 days	Bearish	-5.30%	-7.70%
May 18, 2009	5 Lower lows from 50-day high	1-10 days	Bearish	-2.40%	-3.30%
May 14, 2009	3 Dn & 2 Drop 1.75%	1-10 days	Bullish	5.70%	7.60%
Active - Long Term					
April 20, 2009	Low Nasdaq Weekly Vol Spyx	1-10 weeks	Bearish		
Dropped Tonight					

If the avg max move is achieved it will appear in **bold and brown**. If the avg + 1/2 std deviation is achieved, the study will in **bold italic blue**.

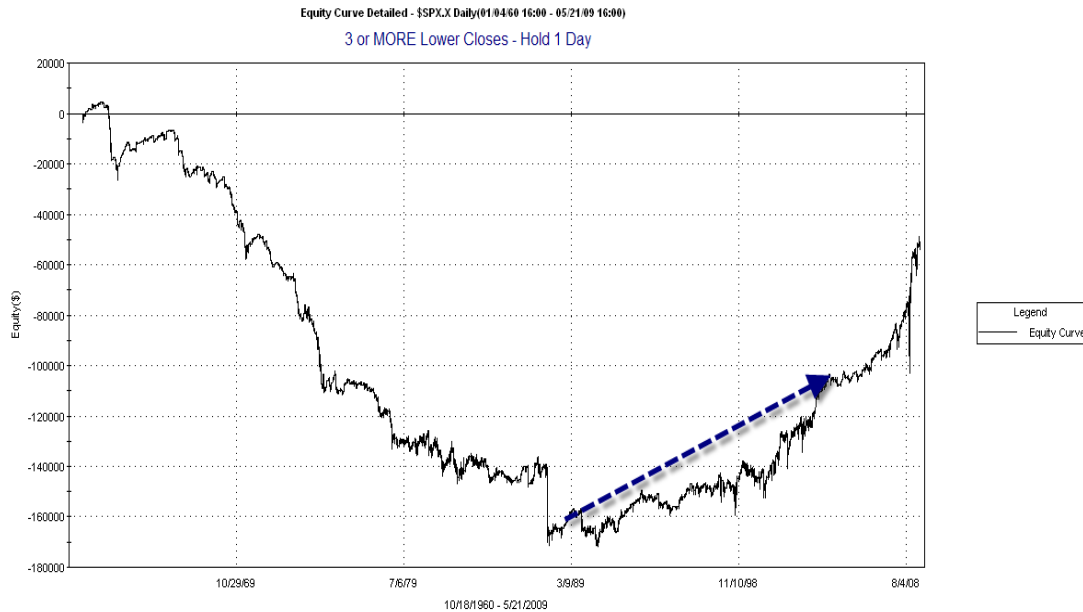
Short-term Outlook (1-5 days) – updated 5/22 – neutral

The market suffered a bit of a drop on Thursday. After gapping lower by over 1%, it only briefly traded above its opening price early in the morning. After that it sold off until near the end of the day. A rally in the last half hour brought it back near the opening price. The S&P 500 finished down 1.7% and the Nasdaq down 1.9%. Breadth was skewed to the downside as would be expected. The NYSE Up Issues % came in at 27% and the Up Volume % at 23%. Total volume shrunk from yesterday's levels.

Three lower closes is often cited as having an upside edge. And it does – kind of. That edge is often misunderstood, though. The first place I saw 3 lower closes quantified was in Larry Connors book "How Markets Really Work". One of the chapters in the book looked at consecutive days higher and lower. It basically found that after the market has moved in 1 direction for several days, there is a tendency for it to revert.

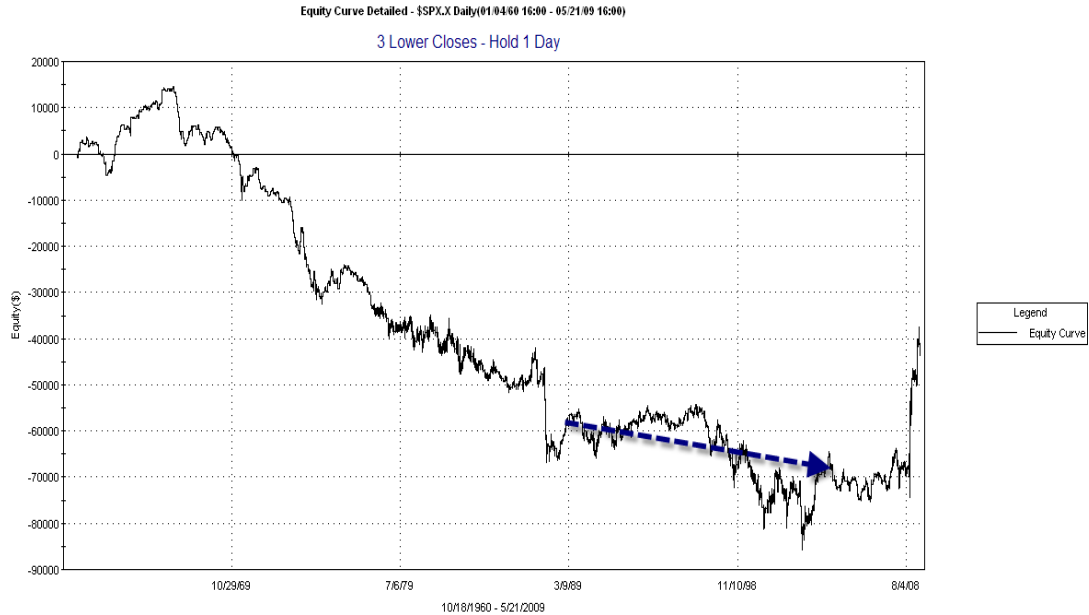
He measured 3 lower closes in that book from 1989 – 2003. As Larry measured 3 lower closes he looked at any time the market had pulled back for *at least* 3 days in a row and then showed performance statistics for the following days. What many traders fail to realize when they review his research is that there is a large historical difference between "at least" 3 days in a row and "exactly 3" days in a row. I decided to examine this in some detail tonight.

First let's look at a chart of buying the S&P 500 any time it has closed lower for at LEAST 3 days in a row and then selling the next day. Keep in mind, if it is down again day 4 it will be bought again. Same with day 5, 6, 7 etc. until there is finally an up day.



There are a few things to note here. First, trying to buy all 3+ day pullbacks prior to 1987 was a losing strategy. After that it the market showed less tendency to trend and more tendency to chop and buying 3+ day drops became profitable. The period covered by the blue arrow shows the period covered in “How Markets Really Work”.

Now let's look at what happened if you bought the market after 3 and only 3 lower closes. In other words, the third day lower was bought. The position was exited the next day. If the market continued to head south it was ignored. There was no further buying on day 4, 5, or 6.



There is a striking difference between the two graphs. There does appear to be a recent upside edge, but most of it is concentrated on some outlier trades that occurred in the last year. Until very recently there was no advantage to buying the third close lower in a row.

Why the stark differences? I believe much of the reason is due to the strength of the eventual snapback. The more stretched the market gets to the downside, the greater the snapback typically is. The “3 or more” study guarantees a winning trade in every sequence. In other words, it will continue to buy each day until it has a winning day. Only after that will the count reset. The further the market drops, the more vicious the snapback is likely to be.

Below is a table that illustrates this concept covering the time period of 1989 – present. The left hand column is the number of days the market moved lower. The right hand column is the average up day the following day. (Down/losing days are not looked at here.)

QE Chop Lower Closes: wsneede	All: Avg Winning Trade
5	1,298.99
4	994.21
3	842.90
2	864.49
1	756.80

As I stated above, the longer the pullback, the stronger the snapback.

Also consider when is snapback most vicious...during bear markets. Note the two time periods on the 2nd equity chart where buying three lower closes has actually provided an edge on the 4th day. Those 2 time periods were during the current and prior bear markets.

So is there really an edge to buying three lower closes? Recently during bear market periods – yes. Historically, no. Of course if you understand the mean reversion will likely eventually take place, you can still take advantage of the pullback. You will need some patience, though. Below is a chart of buying day 3 and holding for 3 days.



This chart looks more like the 3 OR MORE chart shown above. In this case it is due to the longer holding period. The longer you hold the more likely you are to participate in the eventual snapback.

Anyway, with “2 Days Down In Chop” already active, I’m not about to add a “3 days down” study to the Aggregator as well.

Below is a study taken from the 5/12 Subscriber Letter that does suggest some bullish implications over the next few days. (Table not updated.)

SPX drops 1% and decliners more than double advancers. Buy SPX on close. Sell X days later. \$100k/trade. From 10/20/87 – present.

QE bad breadth pullb: daysin	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	209,160.38	232	156	76	67.24	2,691.47	-2,772.49	0.97	1.99	901.55
9	234,845.87	237	164	73	69.20	2,605.31	-2,635.96	0.99	2.22	990.91
8	201,802.01	251	164	86	65.34	2,582.42	-2,578.08	1.00	1.91	803.99
7	215,319.51	270	168	102	62.22	2,616.16	-2,197.99	1.19	1.96	797.48
6	198,530.12	286	177	109	61.89	2,479.01	-2,204.18	1.12	1.83	694.16
5	179,244.85	312	186	126	59.62	2,298.01	-1,969.72	1.17	1.72	574.50
4	119,886.30	333	191	142	57.36	2,027.72	-1,883.16	1.08	1.45	360.02
3	145,611.16	364	224	140	61.54	1,749.82	-1,759.64	0.99	1.59	400.03
2	142,575.80	414	231	183	55.80	1,709.30	-1,378.54	1.24	1.57	344.39
1	106,678.01	464	279	185	60.13	1,132.22	-1,130.88	1.00	1.51	229.91

There seems to be a decent upside edge provided here and I'll include it among the active studies.

The [Aggregator](#) chart has been updated below.



The green Aggregator has climbed up to barely breach the 0 line into what I normally refer to as “neutral” territory. In other words the studies are predicting short-term returns

about equal to the long-term drift of the market. If the studies stayed the same tomorrow, then the Aggregator line would actually fall to very slightly negative. So even with with recent pullback, I'm not seeing compelling buying evidence.

The black differential line is showing the market is now a little short-term oversold as it flipped squarely above the 0 line tonight.

I also marked on the chart the area of the recent swing low. The S&P approached that level on Thursday before bouncing. Not seen on the chart but also notable is that support level also acted as resistance in January, February, and April. It appears to be an important level and a break down through it could lead to a sharp selloff.

With little compelling evidence I am going to stand aside tonight. Aggressive traders could look to play a short-term bounce and use the potential support level as a possible stop area on the trade.

My intermediate-term outlook remains bearish. Therefore I'd rather short into that bounce should it arrive here – assuming some bearish studies also emerge while the bounce takes place.

Intermediate-term Outlook (2 weeks – 2 months)– bearish -updated 5/18

Over the last few weeks we've seen some intermediate-term bearish evidence building up. The [Nasdaq Weekly Volume Spyx readings were the 1st sign of impending weakness](#). While the market seemingly ignored those readings to begin with, they do remain in effect for the next several weeks. Next, in the May 4th subscriber Letter I showed two studies that questioned the leadership at that point.

The strong outperformance by transports and telecom suggested a bearish edge for at least 4 weeks from that point. There's still two weeks to go for those studies.

Worden Bros. T2112 indicator, which measures the number of stocks trading at least 2 standard deviations above their 40-day moving average, hit a historical peak on May 8th at 55.93%. ([I looked at this indicator in the May 5th blog.](#)) The reaction this past week was strongly negative. So much so that the 10-day ema of the Up Issues % is now registering multiple sub-50 readings for the 1st time since the March bottom. Continued weakness would be worrisome.

Lastly, we saw in tonight's short-term outlook the implications of 5 lower lows coming off of a 50-day high. While the downside edge was most prevalent over the 1st two weeks, even as far out as 4 weeks there were negative expectations. What's quite unusual about the current setup is that it is occurring under the 200-day moving average. To have a 50-day high occur under a 200-day moving average it needs to first be preceded by a strong downtrend. Below are charts of the last 4 times the S&P has posted 5 lower lows following a 50-day high while under the 200ma. The blue arrow indicates where the setup took place.

May 2008



December 2002



May 2001



April/May 1982



Interesting that 3 of the 4 were “sell in May and go away” setups. Only one occurred that wasn’t in May.

From an intermediate-term perspective I am now seeing indications of volume, leadership, breadth, and price that suggest we should see some additional downside in the next few weeks. I am therefore changing the bias to bearish. For my trading this means that I will be more demanding of long entries and quicker to take profits on the long side. On the short side I will be more aggressive with my setups and perhaps hope to catch longer moves.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Triggers

RTN – bought 1/3 position @ \$44.87

RTN @ \$44.44 limit (hold off for now)

Catapult for ETF’s Trades

none

Broad Market Large Cap CBI – 2/1(RTN-2)

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	0.00
DJ US Regional Banks	IAT	0.00	DJ US Financial Services	IYG	0.00
DJ US Utilities	IDU	1.35	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	2.84
DJ US Pharmaceuticals	IHE	2.86	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	2.94	DJ US Technology Sector	IYW	1.62
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	0.48	Nasdaq 100	QQQQ	2.00

Additional New Trade Ideas

RTN – buy 1/3 Catapult position ON CLOSE @ \$43.50 limit. – I didn't take the 2nd entry today but will tomorrow should RTN close a bit lower. It appears highly unlikely that there will be a 3rd and final entry. This one will likely max out at a 2/3 position.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
RTN(1/3)	5/19/2009	\$44.87	\$43.68	-2.65%		Catapult
SPY(s)(1/4)	5/20/2009	\$91.95	\$89.99	2.14%		avg exit price shown

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