

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 26, 2009

Volume 2 Issue 99

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 26, 2009	Friday VIX spike without S&P selloff	1 day	Bearish		
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					
May 8, 2009	Nasdaq Relative Strength Lagging		Bearish		
April 20, 2009	Low Nasdaq Weekly Vol Spyx	1-10 weeks	Bearish		

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 5/26 – neutral approaching bullish

Friday's pre-holiday action was light and slow. It seems little was accomplished by the market. The Dow, Nasdaq, and S&P 500 all closed down less than 0.25%. Mid and small caps struggled a little more but still were even down 1%. Breadth was mixed. The NYSE Up Issues % came in at 51.5% and the Up Volume % was only 40%. Total volume was very low as often happens going in to a holiday.

Friday's action provided very little in the way of unusual or extreme activity that could help to provide an edge over the next few days. One oddity I did note was the action in the VIX. While the S&P traded higher for most of the day and only closed lower by 0.15% at the end of the day, the VIX also traded higher and actually rose over 4%. Seeing the VIX rise by that much when the S&P is basically neutral is fairly unusual. It is even more unexpected due to the fact that it happened on a Friday. The natural movement of the VIX is to drift lower on Fridays and pop higher on Monday mornings. This is basically just an adjustment in volatility due to the fact that options won't be trading over the weekend. It's not a tradable phenomenon since the cash VIX is not a tradable index, and it's basically already factored in to the VIX futures prices. Therefore, with the S&P flat on a typical Friday, you would normally expect the VIX to close slightly lower. Ahead of a long weekend you would expect a slightly bigger than usual drop in the VIX. Friday the opposite occurred. The VIX spiked while the market did little.

I decided to look at other instances where similar action has occurred on a Friday to see whether it might provide an edge. This 1st table shows all instances where the VIX rose at least 4% while the S&P did no worse than a 0.2% drop.

<i>Today is Friday. The S&P rises or does no worse than a 0.2% drop. The VIX rises 4% or more.</i>										
<i>Buy on close. Sell X days later. \$100k/trade. 1991-present.</i>										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
3	(\$10,889.41)	32	18	14	56.25	\$829.16	(\$1,843.88)	0.45	0.58	(\$340.29)
2	(\$11,464.76)	32	16	16	50.00	\$676.29	(\$1,392.84)	0.49	0.49	(\$358.27)
1	(\$16,274.90)	32	11	21	34.38	\$445.68	(\$1,008.45)	0.44	0.23	(\$508.59)

There seemed to be a decent downside edge, although it really only lasted 1 day. To try and allow for a few more instances I also checked to see the results on 3%+ VIX rises.

<i>Today is Friday. The S&P rises or does no worse than a 0.2% drop. The VIX rises 3% or more.</i>										
<i>Buy on close. Sell X days later. \$100k/trade. 1991-present.</i>										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
3	(\$12,895.86)	40	21	19	52.50	\$889.62	(\$1,661.99)	0.54	0.59	(\$322.40)
2	(\$12,985.33)	40	18	22	45.00	\$707.34	(\$1,168.97)	0.61	0.50	(\$324.63)
1	(\$19,756.41)	40	14	26	35.00	\$489.42	(\$1,023.40)	0.48	0.26	(\$493.91)

We got 25% more instances and the end results remained essentially the same. Rather than using 0.2% as the S&P requirement, I also looked at it in terms of average true range (ATR). The 20-day average true range of the S&P currently stands at about 20 points. The 1.33 drop on Friday is much less than 1/10th of an ATR. I used 1/10th as the required number in this next test.

<i>Today is Friday. The S&P rises or does no worse than drop of 1/10th of the 20-day ATR. The VIX rises 4% or more.</i>										
<i>Buy on close. Sell X days later. \$100k/trade. 1991-present.</i>										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
3	(\$15,056.71)	26	13	13	50.00	\$960.41	(\$2,118.62)	0.45	0.45	(\$579.10)
2	(\$9,857.99)	26	13	13	50.00	\$699.70	(\$1,458.01)	0.48	0.48	(\$379.15)
1	(\$12,233.91)	26	9	17	34.62	\$833.72	(\$1,161.02)	0.72	0.38	(\$470.54)

More of the same here. Generally you are looking at about 65% losers with an average day posting a drop of about 0.5%.

Another oddity from this week was that although the S&P has now closed lower for 4 days in a row, it has still failed to erase the 1-day gains from Monday. I looked at other similar instances below:

S&P posts 4 lower closes in a row but fails to erase the 1-day gains just prior to the selloff. Buy on close. Sell X days later. \$100k/trade. 1960-present.

X Days	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	-9,230.50	9	3	6	33.33	2,691.33	-2,884.08	0.93	0.47	-1,025.61
9	-5,598.91	9	5	4	55.56	1,655.20	-3,468.73	0.48	0.60	-622.10
8	-618.48	9	4	5	44.44	2,263.05	-1,934.14	1.17	0.94	-68.72
7	-2,084.20	9	4	5	44.44	2,335.64	-2,285.35	1.02	0.82	-231.58
6	-8,342.99	9	4	5	44.44	1,464.35	-2,840.08	0.52	0.41	-927.00
5	-4,457.04	9	3	6	33.33	2,239.83	-1,862.75	1.20	0.60	-495.23
4	-6,516.83	9	4	5	44.44	1,178.69	-2,246.32	0.52	0.42	-724.09
3	-10,777.38	9	3	6	33.33	789.62	-2,191.04	0.36	0.18	-1,197.49
2	-5,928.39	9	3	6	33.33	706.96	-1,341.54	0.53	0.26	-658.71
1	-4,794.64	9	2	7	22.22	676.13	-878.13	0.77	0.22	-532.74

Too few instances to read much into but it appears there's a possible downside influence over the next 1-3 days. Not discernable from the above table is that 8 of 9 instances saw the market close low on at least 1 of the next 2 days. I haven't included this particular study in the Aggregator due to the low number of instances, but it still may be worth keeping in mind.

We are entering the end-of-month seasonally positive time period. My Stock Traders Almanac notes that during Memorial Day week "Dow down 7 of last 12, up 12 straight from 1984-1995." Using the S&P as my proxy I decided to run some tests looking at Memorial Day week returns.

First let's look at a table that shows the average returns for each day of the week from 1961-2008. It is important to note that the returns are for each individual day and not cumulative throughout the week.

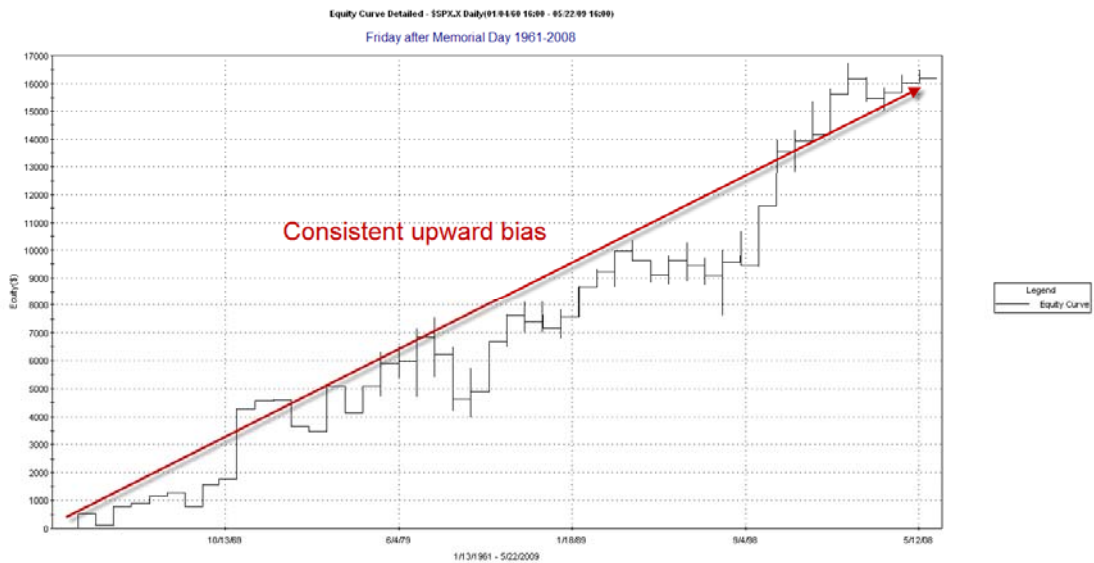
S&P Performance on X day after Memorial Day. 1961-present.												
X Day	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	Max Win	Max Loss	W/L Ratio	Profit Factor	Avg Trade
Friday	\$16,176.10	48	33	15	68.75	\$731.86	(\$531.69)	\$2,528.16	(\$1,589.54)	1.38	3.03	\$337.00
Thursday	\$14,798.99	48	29	18	60.42	\$739.39	(\$369.07)	\$5,021.64	(\$1,587.76)	2.00	3.23	\$308.31
Wednesday	(\$319.93)	48	29	19	60.42	\$485.86	(\$758.41)	\$1,867.70	(\$1,673.88)	0.64	0.98	(\$6.67)
Tuesday	(\$696.60)	48	17	31	35.42	\$1,177.24	(\$668.05)	\$3,443.56	(\$2,768.00)	1.76	0.97	(\$14.51)

Tuesday was the worst day (again 35% winners!) and Friday was the strongest day. To try and determine whether there might actually be an edge here I created some charts. The most notable ones are below. First I look at Tuesday's return over the years.



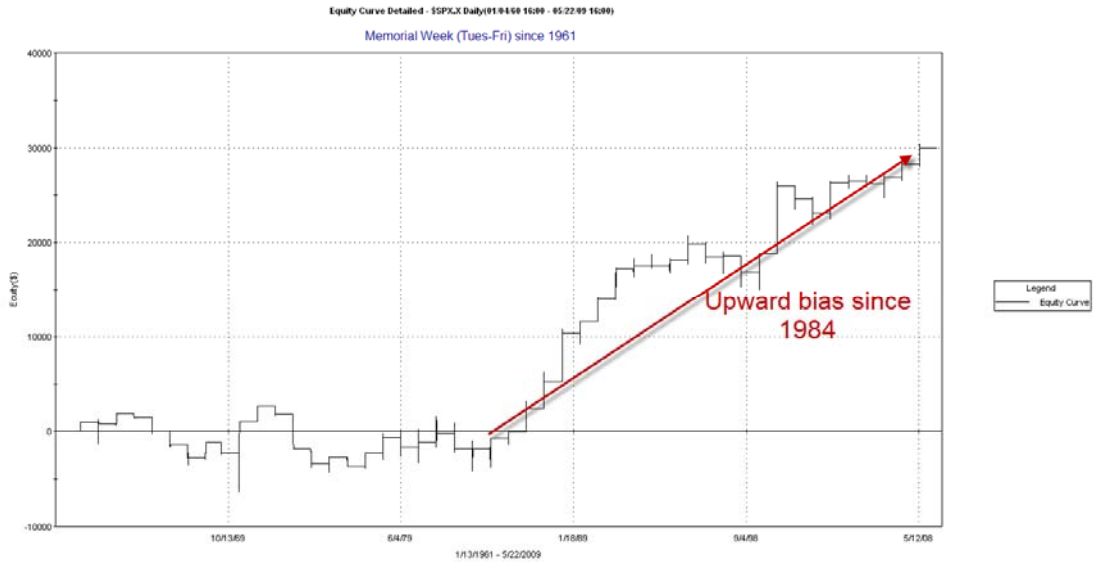
I see nothing here that would make me want to bet either direction.

How about Friday after Memorial Day, which appeared strong in the table?



Friday's chart is much more consistent and would seem to indicate Friday should have some positive seasonality associated with it.

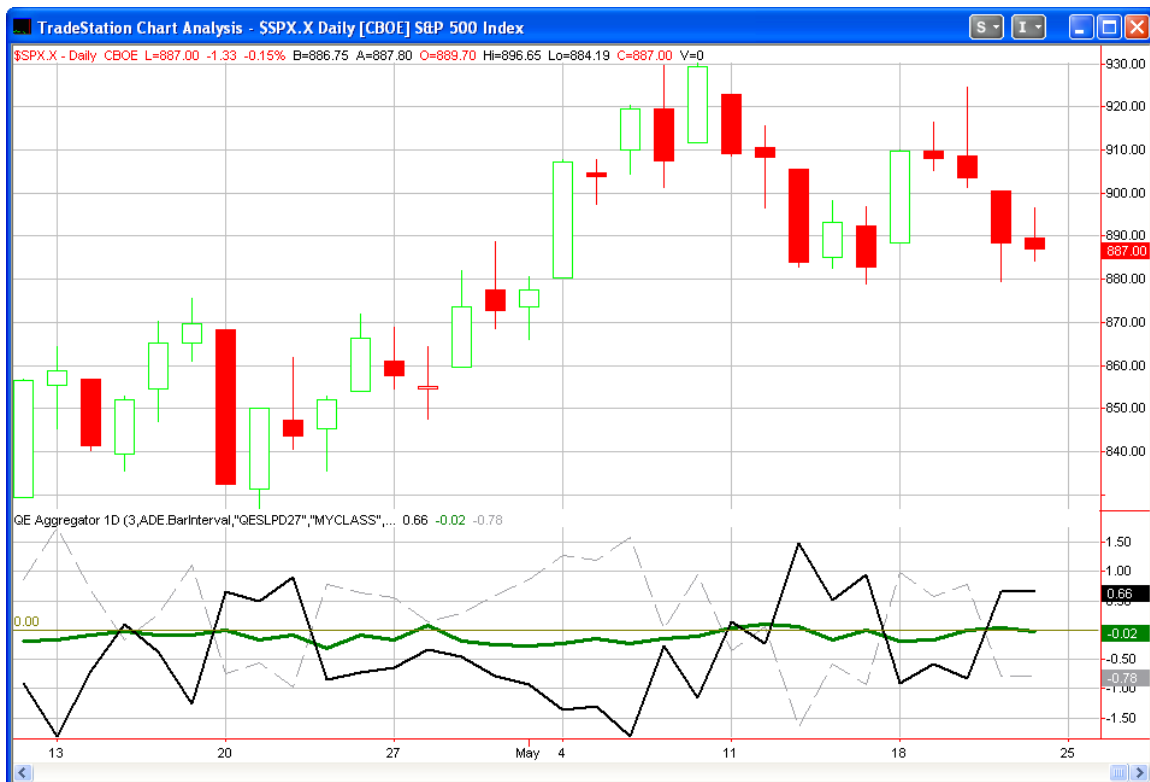
Now let's look at the week as a whole:



While there was no edge evident until the early 80's, there does appear to be an upward bias since then.

Combined with our current active studies this would all suggest that while Tuesday is iffy and the market may struggle, we're likely to see some positive action by the end of the week.

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



The green Aggregator line continues to wiggle around 0 with a -0.02 reading at present. Without accounting for Tuesday's upcoming action, the Aggregator is currently poised to flip back positive tomorrow and for the rest of the week. Meanwhile the black differential line is showing that over the last few days the S&P has underperformed expectations and is short-term oversold.

As I noted in Thursday's Letter, around 880 appears to be an important level as it represents not only short-term support where the market has bounced a few times in the past 6 days, but also marks the same area that acted as market resistance in January, February, and April.

A move short-term move higher from this area is appearing more likely. A break and close below 875-880 could trigger a quick, sharp, selloff.

With this in mind, I'm looking to take advantage of any weakness on Tuesday so that I may benefit from the potential bounce later in the week.

Intermediate-term Outlook (2 weeks – 2 months)– updated 5/26 - bearish

Last week I noted indications of volume, leadership, breadth and price that were suggesting downside in the coming weeks. After a huge day on Monday, the market pulled back the rest of the week. It still managed a small gain on the week, though. All of the intermediate-term indications discussed last week are still active.

Today I am going to show a slight twist on an intermediate-term indicator that I've discussed before. The idea comes from Gerald Appel's book "[Technical Analysis – Power Tools For Active Investors](#)". In it he discusses a relative strength measure of the NYSE vs. the Nasdaq looked at on a weekly chart. The premise behind the indicator is that the market tends to perform better when the appetite for Nasdaq stocks is greater than the appetite for NYSE stocks.

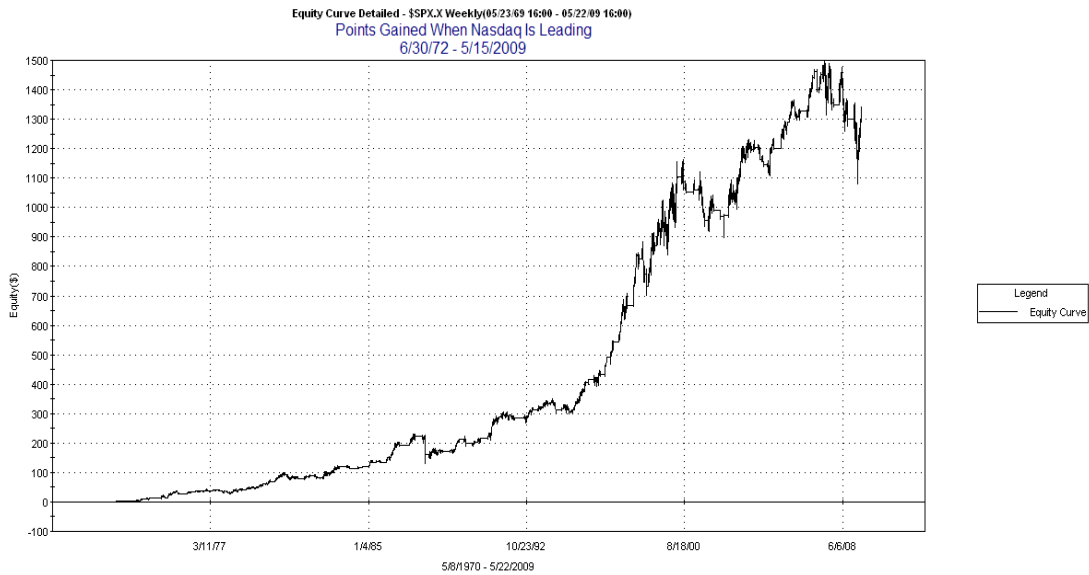
Part of this is due to the higher volatility of the Nasdaq, and part of it is due to investors willingness to speculate more aggressively when their outlook is positive. Critics of the indicator suggest the reason it works is largely due to the higher beta of the Nasdaq. That may be part of it, but it doesn't mean the indicator is without value. In fact, whatever the reasons behind it, the indicator has been an excellent barometer over the years. In the book, Mr. Appel suggests using a 10-week relative strength indicator to measure this phenomenon.

Since I normally trade the S&P 500 and not the NYSE Composite, I applied the indicator to the S&P 500. Doing so, I found the results to be even better. The indicator is shown in the chart below.



The two lines on the bottom panel are the relative strength indicator. When the solid line closes above the dotted line that means the Nasdaq is leading the S&P. When it closes below the dotted line, that means it is lagging the S&P. To make it even easier to view I've made the line green when the Nasdaq is leading and red when the Nasdaq is lagging.

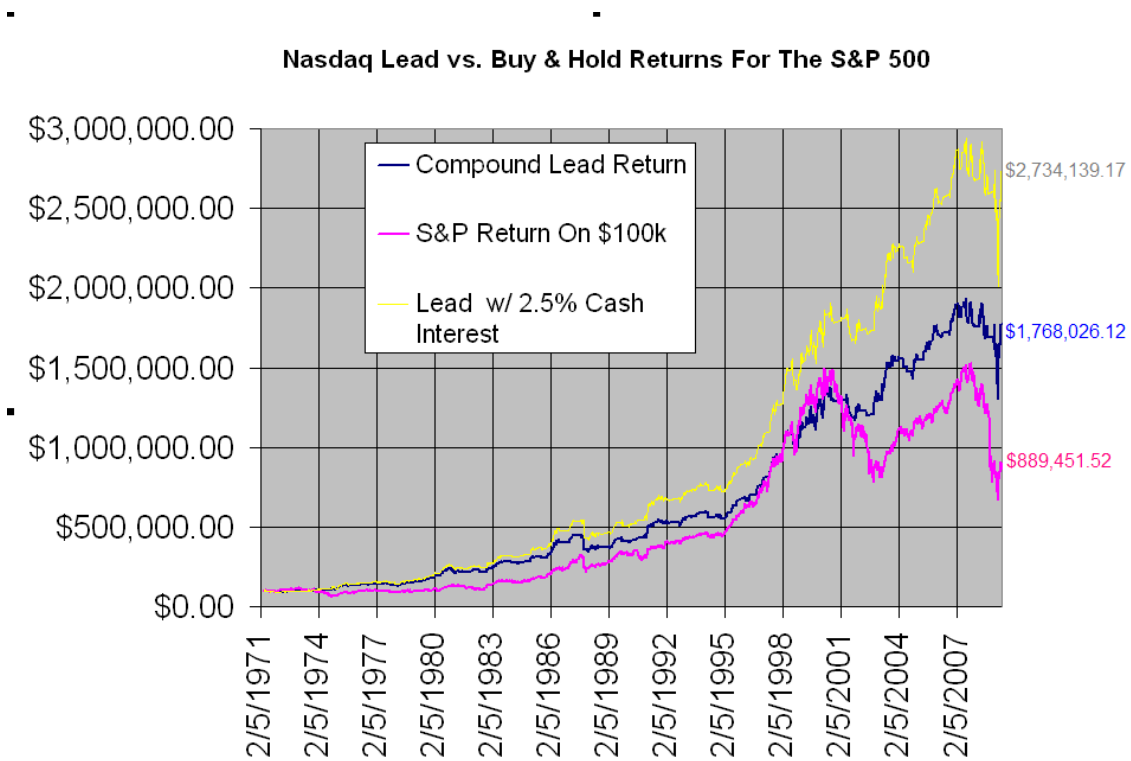
The performance can be evaluated a number of ways. This first equity graph (courtesy of Tradestation) shows the points gained in the S&P 500 since June 30, 1972 – May 15, 2009.



As you can see, over the time period measured the S&P gained 1,341.27 points when the Nasdaq was leading. Meanwhile, the total points gained by the S&P over the period was 775.74. The Nasdaq held a leadership position just slightly more than ½ the time during the period. So almost twice the gains (points-wise) were achieved in nearly half the time. Not bad.

What if you started with a \$100,000 portfolio and compared buy and hold to only holding when the Nasdaq led?

I decided to show these results in Excel.



These results represent returns from 4/19/1971 – 5/22/2009. They do not include dividends. The pink line is the growth of \$100k in the S&P 500. The blue line shows the results of investing in the S&P only when the Nasdaq is in a leadership position and earning 0% interest otherwise. The yellow line shows results if instead of earning 0% interest, you managed to earn a steady 2.5% interest on your cash balance while not in the market. While 2.5% isn't easily doable today, over most of the time period it was extremely low.

It appears the only period where the Nasdaq/S&P Relative Strength Indicator didn't provide an edge was during the 1995-2000 boom market when you would have wanted to be invested basically the whole time.

The ending value differences are striking. By sitting out of the market when the Nasdaq is lagging and earning a minimal interest rate on your cash, returns more than tripled. Nearly \$2,000,000 more would have been earned on an investment of \$100,000.

The Nasdaq/S&P relative strength indicator is well worth keeping an eye on and is a useful tool for measuring the health of the market. I've recently added it as one of the weekly charts I track on the [Quantifiable Edges members charts page](#).

I've also posted a few files on the [free downloads section of the website](#) that may be downloaded.

- 1) The 1st file is the Excel worksheet that shows exactly how the model was built and the returns calculated. It also includes the chart shown above. Anyone interested in using Excel for historical backtesting or modeling, or who would like to see exactly how the relative strength indicator was calculated, may find it useful.
- 2) The 2nd file is a zip file for Tradestation users. In the zip file is an .eld with the indicator that you may apply to your charts and a strategy that will allow you to run your own tests. Also included in the zip file is a worksheet that has everything all set up. It was created in Tradestation 8.5 (build 2289). My understanding is that if you are using an older version of Tradestation the .eld should import fine, but the worksheet may not open properly. Therefore, after importing the .eld file you'll need to set up your own chart to apply the indicator and strategy.

I will be posting my discussion of this indicator to the blog as well this evening.

Currently the Nasdaq is lagging according to this indicator, which simply serves as further confirmation of the bearish outlook.

I noted the 880 support level in the short-term outlook today. The recent highs were around 930 on May 8th. I'm currently expecting 880 to fall before 930 is broken. A weekly close below 880 could usher in a multi-week pullback, which we haven't seen since the March bottom.

As a reminder, a bearish bias for my trading typically means that I will play the short side more aggressively and perhaps look for longer-term holdings. I will also play the long-side more conservatively. That means looking for favorable entries and taking fairly quick profits when they make themselves available.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Triggers

RTN – bought 1/3 position @ \$44.87

RTN - bought 1/3 position @ \$43.47

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	0.00	DJ US Healthcare	IYH	0.74
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	0.71
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	2.56	DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	2.94	DJ US Technology Sector	IYW	0.00
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	0.48	Nasdaq 100	QQQQ	0.00

Even 4 days of selling hasn't done anything to move the CBI sector percentages higher.

Additional New Trade Ideas

SPY – buy 1/4 index position @ \$88.75 limit. If not filled during day, buy @ \$89.02 limit on *CLOSE*. I'm anticipating a little bit with this one. I'd like to enter on a pullback to near Friday's lows. I expect if the market closes lower tomorrow, some bullish studies will emerge. Therefore I'll basically be looking for any lower close at the end of the day if I'm not filled at that point.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
RTN(1/3)	5/19/2009	\$44.87	\$43.47	-3.12%		Catapult
RTN(1/3)	5/22/2009	\$43.47	\$43.47	0.00%		bought on close

The 2nd lot of RTN was purchased at the close on Friday based on our entry criteria from Thursday night.

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