

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 28, 2009

Volume 2 Issue 101

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 28, 2009	1% Drop on Bad Breadth	1-9 days	Bullish	2.90%	3.90%
May 27, 2009	5 day low to 10-day high	1-5 days	Bearish	-1.90%	-2.90%
May 27, 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 28, 2009	SOX up 1% while SPX down 1%	1-20 days	Bullish	13.10%	16.10%
May 8, 2009	Nasdaq Relative Strength Lagging		Bearish		
April 20, 2009	Low Nasdaq Weekly Vol Spyx	1-10 weeks	Bearish		
Dropped Tonight					
May 27, 2009	Gap dn 0.5% close up in top 10% range	1-2 days	Bearish	-1.90%	-2.70%

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 5/28 –slightly bearish

The market dropped sharply Wednesday, thanks in large part to the bond market. The S&P and Dow were down about 2% while the Nasdaq dropped about 1%. Breadth was weak as the NYSE Up Issues % came in at 30% and the Up Volume % at 20%. Total volume looked to be slightly lower than yesterday.

There were a few bullish studies that popped up tonight. I've discussed several time in the past that when the SOX rises in the face of a selloff it is often a good thing. Below I've updated a study from the 2/26/09 letter that looks at returns following an SPX drop and SOX rise of 1%.

SPX declines at least 1% while the SOX rises at least 1%.										
Buy SPX on close. Sell X days later. \$100k/trade. 1995-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
20	\$81,506.10	20	18	2	90.00	\$4,859.21	(\$2,979.88)	1.63	14.68	\$4,075.31
19	\$74,915.13	20	18	2	90.00	\$4,568.82	(\$3,661.78)	1.25	11.23	\$3,745.76
18	\$71,117.08	20	18	2	90.00	\$4,441.53	(\$4,415.25)	1.01	9.05	\$3,555.85
17	\$62,598.05	21	19	2	90.48	\$3,728.01	(\$4,117.07)	0.91	8.60	\$2,980.86
16	\$63,966.93	21	19	2	90.48	\$3,738.19	(\$3,529.30)	1.06	10.06	\$3,046.04
15	\$63,565.61	21	19	2	90.48	\$3,813.80	(\$4,448.28)	0.86	8.14	\$3,026.93
14	\$52,258.20	21	19	2	90.48	\$3,219.00	(\$4,451.37)	0.72	6.87	\$2,488.49
13	\$42,307.57	21	17	4	80.95	\$3,234.85	(\$3,171.23)	1.02	4.34	\$2,014.65
12	\$31,088.54	21	16	5	76.19	\$2,807.87	(\$2,767.48)	1.01	3.25	\$1,480.41
11	\$28,982.46	21	14	7	66.67	\$3,324.36	(\$2,508.36)	1.33	2.65	\$1,380.12
10	\$10,433.93	21	14	7	66.67	\$2,331.71	(\$3,172.86)	0.73	1.47	\$496.85
9	\$7,309.58	22	14	8	63.64	\$1,950.56	(\$2,499.77)	0.78	1.37	\$332.25
8	\$11,576.38	22	14	8	63.64	\$2,227.95	(\$2,451.87)	0.91	1.59	\$526.20
7	\$12,795.30	22	14	8	63.64	\$2,119.23	(\$2,109.25)	1.00	1.76	\$581.60
6	\$18,514.58	22	17	5	77.27	\$2,147.59	(\$3,598.89)	0.60	2.03	\$841.57
5	\$23,771.44	22	14	8	63.64	\$2,553.36	(\$1,496.96)	1.71	2.98	\$1,080.52
4	\$8,195.36	22	12	10	54.55	\$2,198.46	(\$1,818.62)	1.21	1.45	\$372.52
3	\$1,599.28	22	12	10	54.55	\$1,749.29	(\$1,939.22)	0.90	1.08	\$72.69
2	\$5,031.20	23	11	12	47.83	\$2,110.25	(\$1,515.13)	1.39	1.28	\$218.75
1	\$8,667.17	24	12	12	50.00	\$1,590.20	(\$867.93)	1.83	1.83	\$361.13

Three to four weeks out you're looking at 90% winners. The average S&P gain over the next 4 weeks was over 4%. Meanwhile, if you bought the leading SOX instead of the SPX, then your average trade more than doubled for a gain of 8.2%.

Just when all the intermediate-term studies were beginning to point bearish, we get a bullish one.

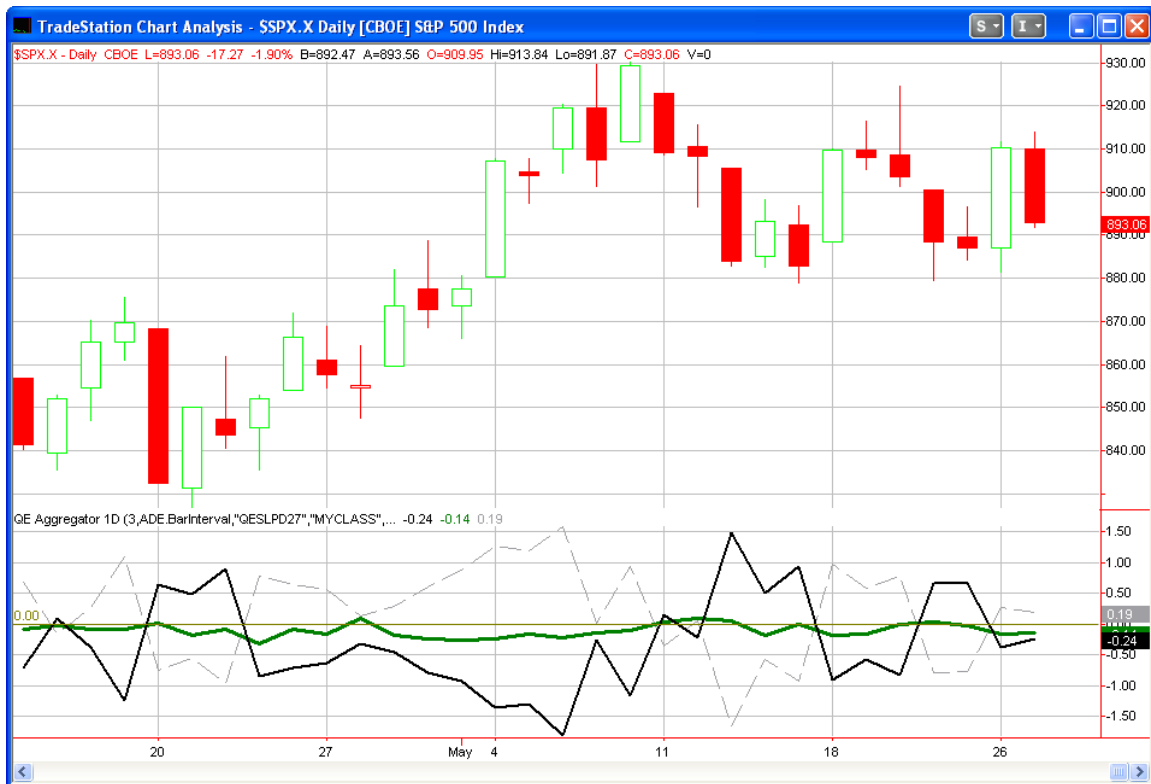
Also potentially short-term bullish is the strength and breadth of Wednesday's move lower. Below is a study from the 5/12 Letter. (Table not updated)

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: days in	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

Here we see a bullish edge over the next 2 weeks.

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



Even with Wednesday's sizable selloff and bullish studies the Aggregator chart is largely unchanged. The green Aggregator line remains squarely below 0, suggesting net bearish expectations from the active studies list. Also the black differential line is still below zero, illustrating the SPX has outperformed expectations over the last few days.

Obviously I was kicking myself this afternoon for not suggesting a more aggressive short entry in last night's Letter. More downside may be in store over the next few days, but to try an entry here would be chasing the market a bit. I'll wait for a more favorable entry point.

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

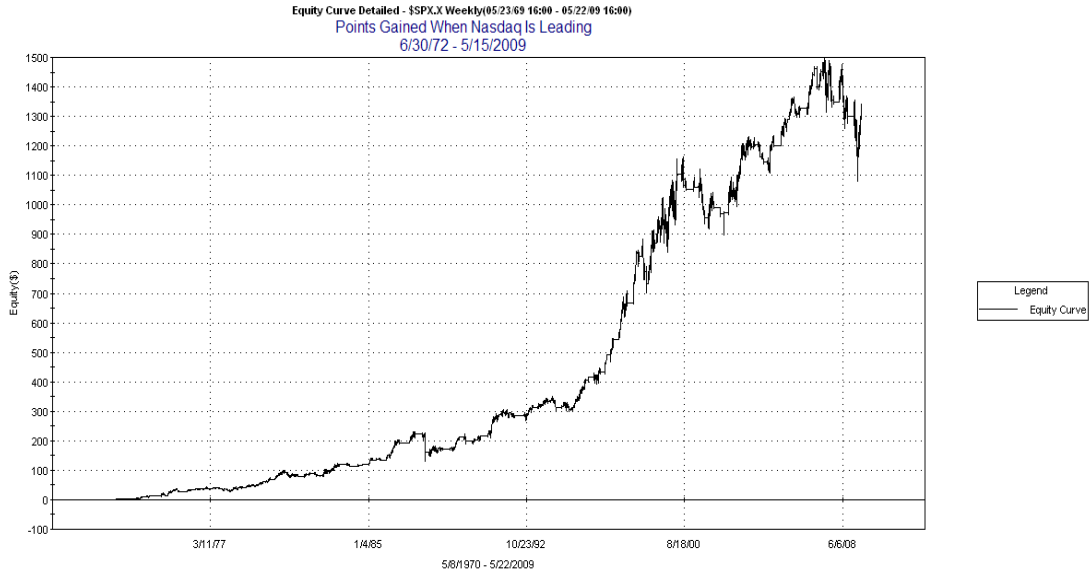
indicator suggest the reason it works is largely due to the higher beta of the Nasdaq. That may be part of it, but it doesn't mean the indicator is without value. In fact, whatever the reasons behind it, the indicator has been an excellent barometer over the years. In the book, Mr. Appel suggests using 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.

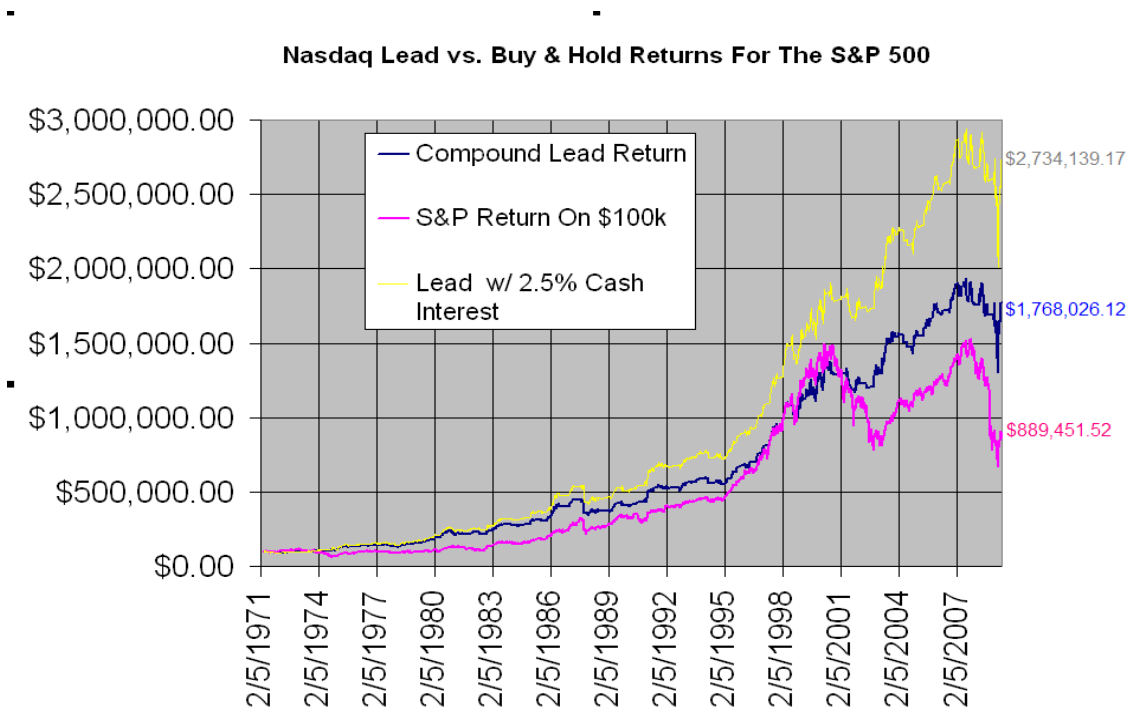
The performance can be evaluated a number of ways. This first equity graph (courtesy of Tradestation) shows the points gained in the S&P 500 since June 30, 1972 – May 15, 2009.



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 @ \$44.87

RTN @ \$43.47 (I have exited both though they remain open as per the official system)

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	0.00	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	0.00	Nasdaq 100	QQQQ	0.00

Very little is oversold at this point.

Additional New Trade Ideas

None tonight.

From the systems triggers page GILD, SLE, and PM all look like compelling setups. If my outlook for tomorrow were bullish I might take a stab at all three. Instead I'll wait one more day to see how things play out.

IEF also showed up on the ETF list. Commodity and bond ETFs have a propensity to stretch further before reversing than broad market equity ETF's. Therefore I normally prefer to either see them show up on the list for a few nights in a row, or to see some plurality among the group with several bond ETF's triggering at the same time. With this in mind I'm going to hold off on IEF as well.

Aggressive traders could consider playing any of the above trade ideas. In my eyes the most compelling looks like Sara Lee (SLE) for the simple fact that there is potential support nearby that could be used to set a stop and contain some risk.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
RTN(1/3)	5/19/2009	\$44.87	\$44.25	-1.38%		stopped out
RTN(1/3)	5/22/2009	\$43.47	\$44.25	1.79%		stopped out

RTN was stopped out with just a few minutes to go in the day. This one just couldn't manage to bounce with the strength that is typical of a Catapult, and I thought it best to protect against the possibility of another leg down.

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