

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 29, 2009

Volume 2 Issue 102

## 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
<b>Active</b>					
May 29, 2009	Memorial Day Friday	1 day	Bullish		
May 28, 2009	1% Drop on Bad Breadth	1-9 days	Bullish	2.90%	3.90%
<b>May 27, 2009</b>	<b>5 day low to 10-day high</b>	<b>1-5 days</b>	<b>Bearish</b>	<b>-1.90%</b>	<b>-2.90%</b>
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%
<b>Active - Long Term</b>					
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		
<b>Dropped Tonight</b>					
May 14, 2009	3 Dn & 2 Drop 1.75%	1-10 days	Bullish	5.70%	7.60%

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 5/29 –slightly bearish**

The market is having a very hard time picking a direction these days. Since the beginning of May we've been oscillating in tighter and tighter ranges. Thursday it gapped up, sold off and then reversed back up and finished strongly. The S&P 500 closed up 1.5% and the Nasdaq up 1.2%. Breadth was solid as the NYSE Up Issues % was 65% and the Up Volume % was 73%. Total volume was up a little from Wednesday's levels.

It seemed there was little of consequence to speak of today.

The gap up, reverse below yesterday's low, and the strong finish may appear to be a bullish pattern with follow through potential over the next few days. Testing on the SPY would seem to support this idea.

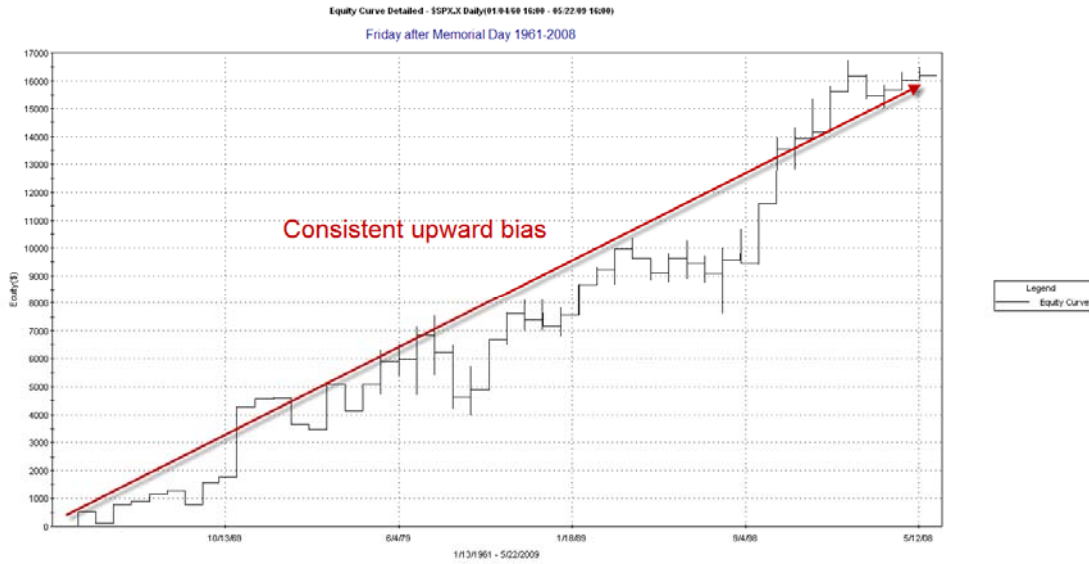
<b>SPY gaps up at least 0.5%, reverses and makes a lower low than yesterday (potential shakeout), then reverses again and closes above the open and in the top 25% of its daily range. Buy on close. Sell X days later. \$100k/trade. 1994 - present.</b>										
X days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	\$1,959.68	19	12	7	63.16	\$1,884.15	(\$2,950.02)	0.64	1.09	\$103.14
4	\$16,195.72	19	11	8	57.89	\$2,954.55	(\$2,038.05)	1.45	1.99	\$852.41
3	\$19,385.40	20	13	7	65.00	\$2,701.93	(\$2,248.53)	1.20	2.23	\$969.27
<b>2</b>	<b>\$23,351.66</b>	<b>20</b>	<b>15</b>	<b>5</b>	<b>75.00</b>	<b>\$2,331.61</b>	<b>(\$2,324.50)</b>	<b>1.00</b>	<b>3.01</b>	<b>\$1,167.58</b>
1	\$13,481.31	20	13	7	65.00	\$1,618.85	(\$1,080.53)	1.50	2.78	\$674.07

Not only did the SPY exhibit this pattern, but the QQQQ did as well. I ran the same test on QQQQ to confirm the SPY results. (I will often do this when there are a low number of instances.) Those results are below.

<b>QQQQ gaps up at least 0.5%, reverses and makes a lower low than yesterday (potential shakeout), then reverses again and closes above the open and in the top 25% of its daily range. Buy on close. Sell X days later. \$100k/trade. 1994 - present.</b>										
X days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	(\$10,829.92)	19	8	11	42.11	\$5,172.33	(\$4,746.23)	1.09	0.79	(\$570.00)
4	(\$3,486.19)	20	10	10	50.00	\$4,365.08	(\$4,713.70)	0.93	0.93	(\$174.31)
3	(\$1,958.24)	20	11	9	55.00	\$3,210.46	(\$4,141.48)	0.78	0.95	(\$97.91)
2	(\$20,024.28)	20	7	13	35.00	\$2,311.23	(\$2,784.84)	0.83	0.45	(\$1,001.21)
1	(\$130.54)	20	9	10	45.00	\$2,563.18	(\$2,319.91)	1.10	0.99	(\$6.53)

It appears over the 1<sup>st</sup> 2 days we have nearly mirror opposite results. This suggests the positive SPY results (and the negative QQQQ results) are more likely due to chance than to any true edge.

If you recall, over the weekend I posted results for Memorial Day weeks. Friday was the strongest and most consistently bullish day of the week. Below is the chart from the weekend letter showing returns on the Friday after Memorial Day since 1961:



Of course the upward bias for this week may have already been spent.

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



The green Aggregator line remains below 0 tonight, largely due to the strongly negative influence of the “2.5% rise on low volume” and “5 lower lows from a 50-day high” studies. The black differential line is also far below 0, though this could change tomorrow as the strong move on Tuesday falls out of the equation.

Bottom line is the market is rangebound and very choppy at the moment. Mid-range is my least favorite place to trade and that’s where we are. Friday and Monday are both seasonally strong. If we get a strong move higher on Friday then that may very well carry in to Monday (at which point I’d likely be looking to short it.) That may be a tall order though since the market hasn’t closed up even 2 days in a row since May 1<sup>st</sup> and 4<sup>th</sup>.

At any rate, edges right now seem marginal and I’d rather sit out a day and see what tomorrow brings.

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

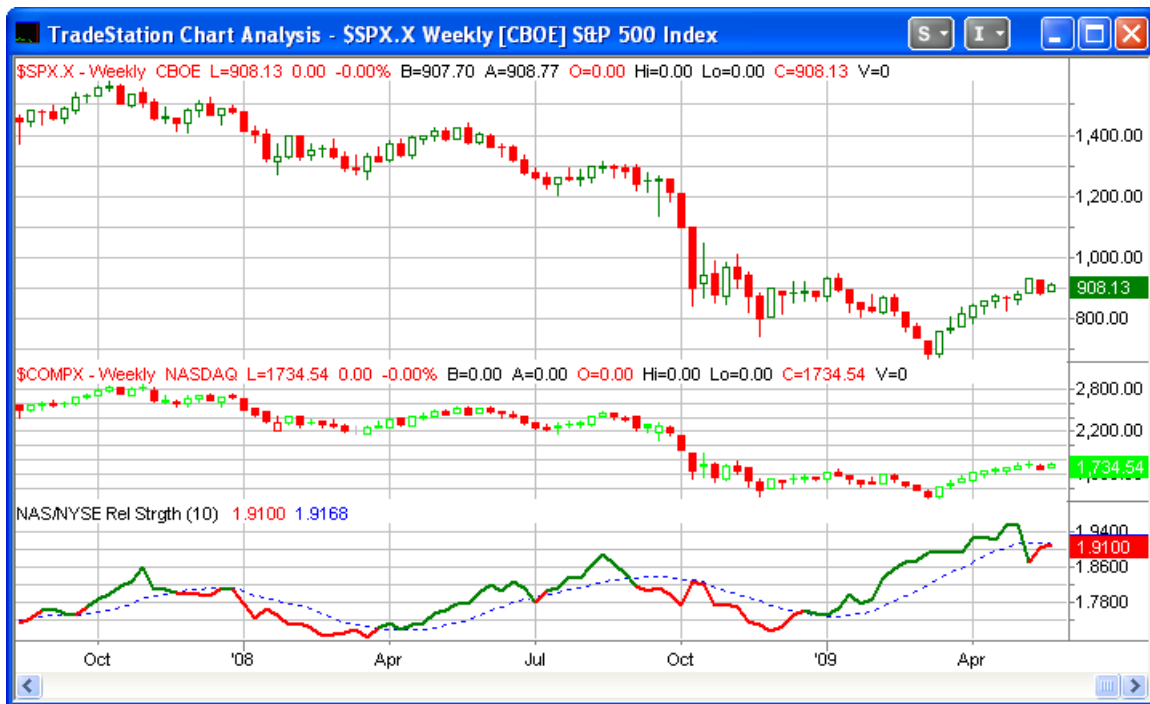
Last week I noted indications of volume, leadership, breadth and price that were suggesting downside in the coming weeks. After a huge day on Monday, the market pulled back the rest of the week. It still managed a small gain on the week, though. All of the intermediate-term indications discussed last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

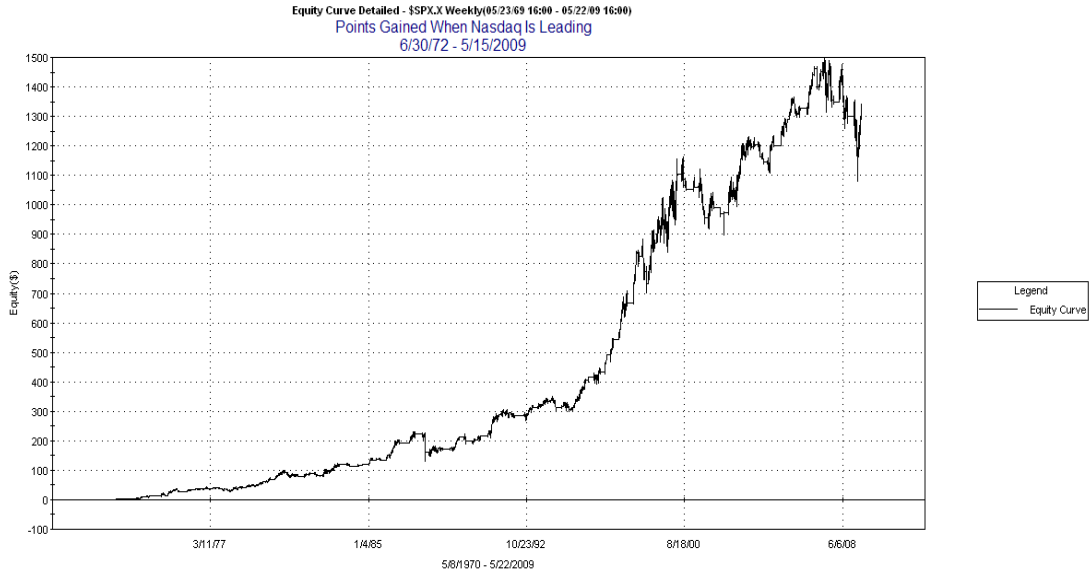
Part of this is due to the higher volatility of the Nasdaq, and part of it is due to investors willingness to speculate more aggressively when their outlook is positive. Critics of the indicator suggest the reason it works is largely due to the higher beta of the Nasdaq. That may be part of it, but it 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.

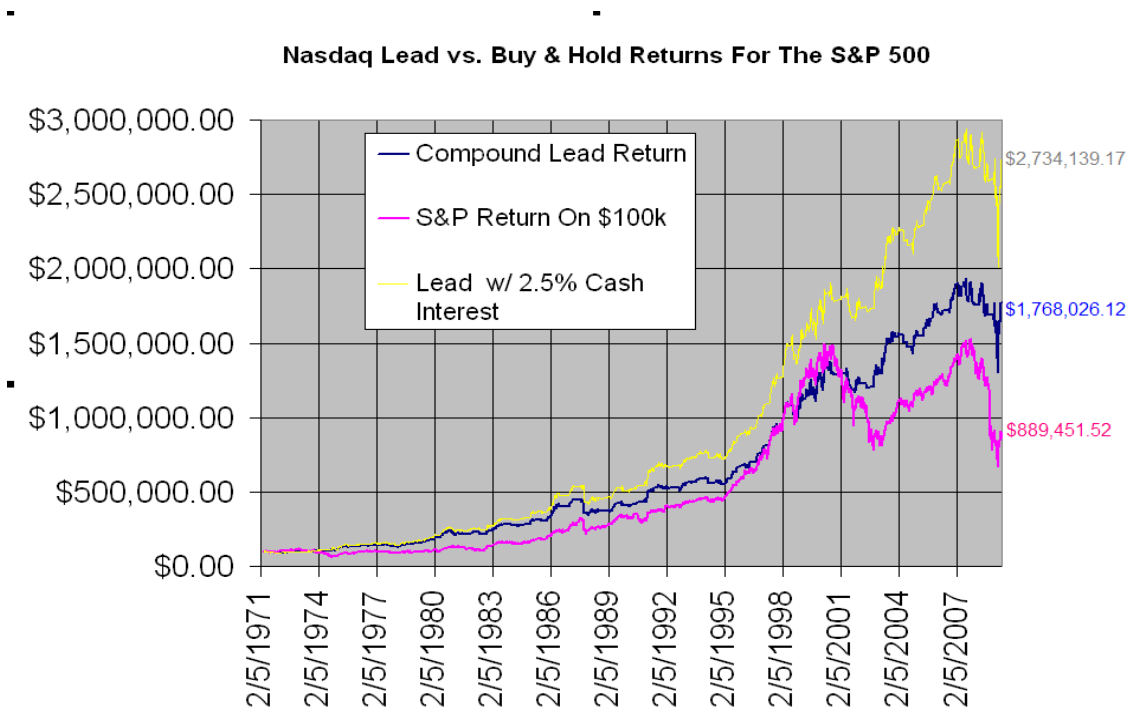
The performance can be evaluated a number of ways. This first equity graph (courtesy of Tradestation) shows the points gained in the S&P 500 since June 30, 1972 – May 15, 2009.



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 1/2 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 1<sup>st</sup> 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 2<sup>nd</sup> 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 8<sup>th</sup>. 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.)***

<b>Index</b>	<b>ETF</b>	<b>CBI %</b>	<b>Index</b>	<b>ETF</b>	<b>CBI %</b>
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.*

**Active Trades Table**

*None*

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