

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

June 9, 2009

Volume 2 Issue 109

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					
June 9, 2009	Low volume near high	1-5 days	Bearish	-2.10%	-3.30%
June 9, 2009	2 days down in chop	1-3 days	Bullish		
June 8, 2009	NDX components overbought	1-3 days	Bearish	-2.30%	-3.10%
June 8, 2009	Gap up & reverse from 20-day high	1-6 days	Bullish	2.60%	3.70%
June 5, 2009	Strong Breadth Low Vol	1-3 days	Bearish		
June 4, 2009	Low vol selloff cluster	1-5 days	Bullish	4.10%	6.00%
June 3, 2009	3up, 2 lower vol, today weakest	1-5 days	Bearish	-1.70%	-2.30%
June 2, 2009	2 strong breadth days & 10-day high	1-10 days	Bullish	2.10%	3.00%
May 28, 2009	1% Drop on Bad Breadth	1-9 days	Bullish	2.90%	3.90%
Active - Long Term					
June 8, 2009	Treasury Spread Rapidly Accelerating		Bullish		
May 28, 2009	SOX up 1% while SPX down 1%	1-20 days	Bullish	13.10%	16.10%
June 1, 2009	Nasdaq Relative Strength Leading		Bullish		
April 20, 2009	Low Nasdaq Weekly Vol Spyx	1-10 weeks	Bearish		
Dropped Tonight					
June 4, 2009	Gap unfilled from high w/ partial rvs	1-3 days	Bearish	-1.20%	-1.80%
June 5, 2009	Nasdaq Spyx < 0 QQQQ 10-high	1-2 days	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 6/9 neutral

Monday was an odd market day. A large gap down led to more selling on very low volume. For a while it looked to be the lowest volume day in over a month. Then in the afternoon a furious rally took the indices positive. That died out in the last 20 minutes and the S&P and Nasdaq both finished the day slightly lower. Breadth was squarely negative on the day. The NYSE Up Issues % was 36% and the Up Volume % came in at 42%. Volume declined for the 6th day in a row.

Checking my database I was only able to find 7 other instances going back to 1960 where volume declined for 6 straight days. Performance following these instances was mixed and suggested no edge.

Low volume while the market is trading near the upper end of its range may suggest buying interest is waning. I did a brief study based on this concept.

NYSE Volume declines for the 4th day in a row. The 10-day %R > 75. 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
5	-22,896.03	38	17	21	44.74	1,366.65	-2,196.63	0.62	0.50	-602.53
4	-16,198.67	38	17	21	44.74	1,440.27	-1,937.30	0.74	0.60	-426.28
3	-5,946.33	38	18	20	47.37	1,204.67	-1,381.52	0.87	0.78	-156.48
2	-3,738.12	39	20	19	51.28	893.89	-1,137.68	0.79	0.83	-95.85
1	-7,127.51	39	19	20	48.72	514.97	-845.59	0.61	0.58	-182.76

These results seem to suggest a mild downside edge over the next week.

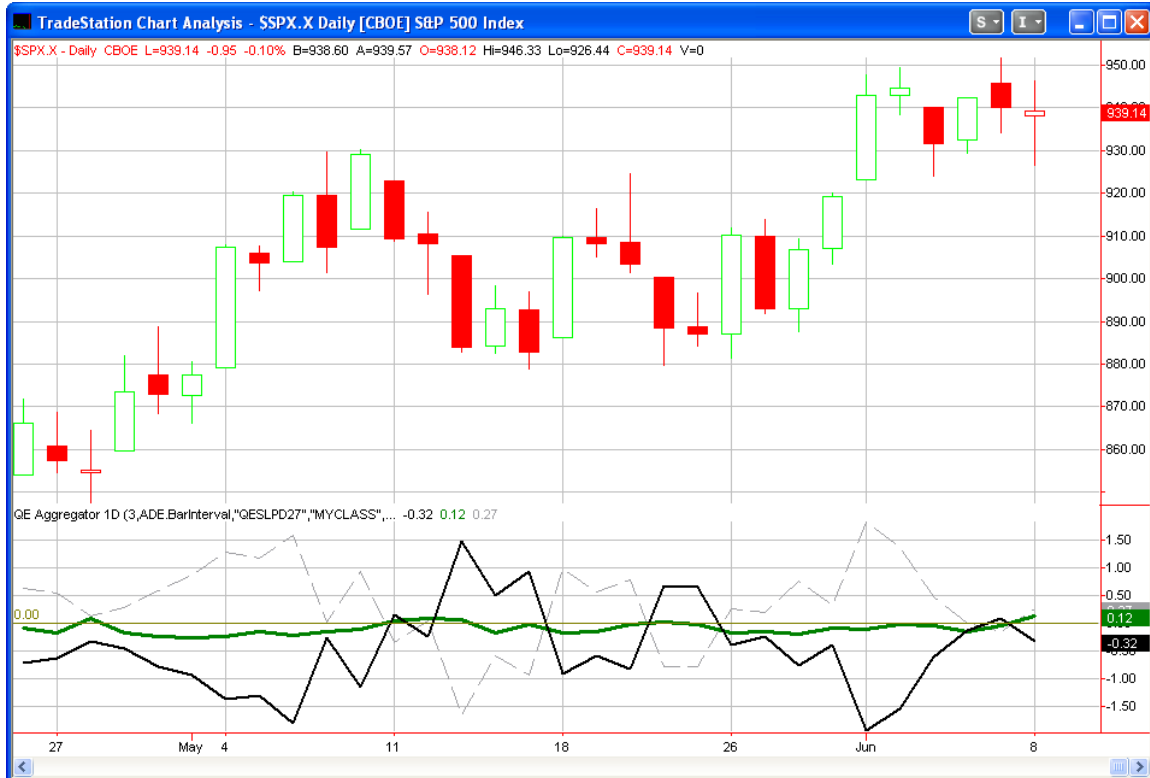
Today was also the 2nd lower close in a row. This triggers our “2 Days Down In Chop” system. The system simply goes long any time the SPX closes lower for two days in a row. It sell at the 1st profitable close up to 3 days later. If after 3 days the position is still not profitable, the position is exited anyway. It has been effective since June of 2007 when the market began to take on an increased tendency to chop. Results from 6/2007 – now are below:

TradeStation Performance Summary				Collapse ^
All Trades				
Total Net Profit	\$44,052.59	Profit Factor	2.21	
Gross Profit	\$80,425.20	Gross Loss	(\$36,372.61)	
Roll Over Credit	\$0.00			
Open Position Profit/Loss	\$0.00			
Select Total Net Profit	\$33,336.56	Select Profit Factor	1.92	
Select Gross Profit	\$69,709.17	Select Gross Loss	(\$36,372.61)	
Adjusted Total Net Profit	\$21,706.03	Adjusted Profit Factor	1.45	
Adjusted Gross Profit	\$69,580.67	Adjusted Gross Loss	(\$47,874.64)	
Total Number of Trades	65	Percent Profitable	84.62%	
Winning Trades	55	Losing Trades	10	
Even Trades	0			
Avg. Trade Net Profit	\$677.73	Ratio Avg. Win:Avg. Loss	0.40	
Avg. Winning Trade	\$1,462.28	Avg. Losing Trade	(\$3,637.26)	
Largest Winning Trade	\$10,716.03	Largest Losing Trade	(\$10,506.45)	

These results are quite good, especially considering this is a “long only” system and the test period contains one of the worst bear markets in history.

Also notable is that tomorrow is Tuesday, which increases the chances of a turnaround. Still, when looking at the general market, the pullback of the last two days has been incredibly mild. It'd be difficult to make a case that the market is now oversold on the daily charts because of it.

Tonight's [Aggregator](#) chart is below:



The green Aggregator line is now a little above 0, suggesting slightly positive expectations over the next few days. The overbought conditions of a few days ago that suggested a downside edge have dissipated. As this has occurred the bearish studies we had lost much of their influence. The black Differential line flipped below 0 today, though just barely. This illustrates that the market has underperformed expectations by a small amount over the last 3 days.

So at this point in time my work is not uncovering a substantial edge. The outlook is neutral and I see no point in attempting an index trade based on a whim.

I did include an ETF setup and discuss a new system in the trade ideas section below.

Intermediate-term Outlook (2 weeks – 2 months)– updated 6/8 – very slightly bullish

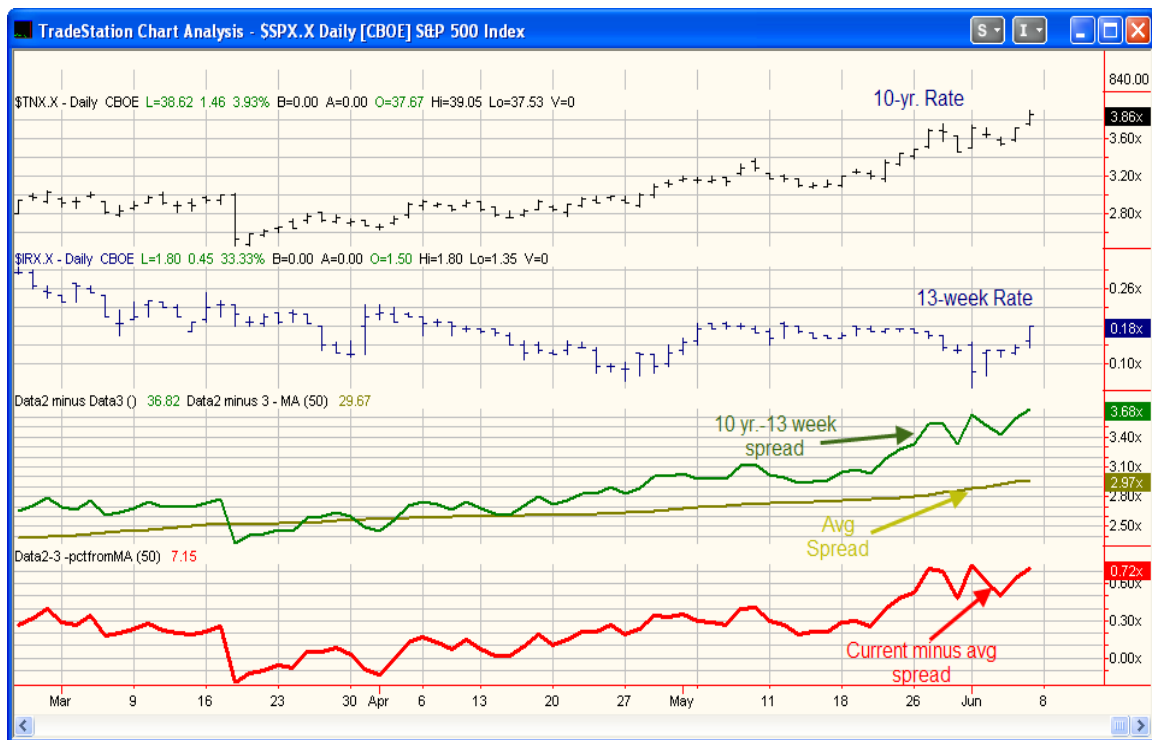
Some of the most interesting action lately has not been in the stock market, but rather in the bond market. Long-term rates have begun to soar while short-term rates have remained stagnant. This has led to a rapid steepening of the yield curve. There's been a fair amount of debate about the effect this may have on the stock market. Bulls say a steep yield curve helps banks make money. It will help the banks balance sheets and will therefore help the economic recovery. Bears say high long-term rates will hurt an already bad housing market, driving prices lower, prompting more "walk away" foreclosures and hurting both the banks and the economy. As subscribers know, I rarely take it upon myself to ponder the fundamentals. So I ran some studies to help get a better feel for how the stock market has reacted in the past to sharp drops in bond prices.

Both the S&P and the 10-year treasury rate (TNX) closed at new 50-day highs on Monday. It nearly happened again on Friday before the S&P slipped to slightly negative on the day. Below are the results following other times the S&P and TNX both closed at 50-day highs.

SPX and TNX (10-yr bond rates) both close at 50-day highs.										
Buy SPX on close. Sell X days later. \$100k/trade. 1963-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
50	(\$41,925.73)	32	13	19	40.63	\$3,506.76	(\$4,605.98)	0.76	0.52	(\$1,310.18)
45	(\$31,255.44)	33	14	19	42.42	\$3,872.64	(\$4,498.55)	0.86	0.63	(\$947.13)
40	(\$20,592.19)	34	16	18	47.06	\$3,650.93	(\$4,389.28)	0.83	0.74	(\$605.65)
35	(\$22,158.93)	36	16	20	44.44	\$3,206.75	(\$3,673.35)	0.87	0.70	(\$615.53)
30	(\$19,453.78)	37	15	22	40.54	\$3,221.40	(\$3,080.67)	1.05	0.71	(\$525.78)
25	(\$1,396.59)	39	18	21	46.15	\$2,884.59	(\$2,539.01)	1.14	0.97	(\$35.81)
20	(\$28,125.61)	40	21	19	52.50	\$1,716.55	(\$3,377.54)	0.51	0.56	(\$703.14)
15	(\$26,996.27)	40	20	20	50.00	\$1,596.33	(\$2,946.14)	0.54	0.54	(\$674.91)
10	(\$11,218.76)	45	26	19	57.78	\$1,227.63	(\$2,270.38)	0.54	0.74	(\$249.31)
5	(\$6,866.07)	61	32	29	52.46	\$1,060.31	(\$1,406.76)	0.75	0.83	(\$112.56)

Note the number of days I'm looking at is 5-50 rather than short-term. As you can see, the market has more often struggled than prospered under such circumstances.

But what's most intriguing about the current bond picture is not the fact that 10-year rates are hitting new intermediate-term highs, but rather the rapid ascension in the spread between 10yr and short-rates. Below is a chart to help illustrate what I'm looking at.



Please review the labels on the chart to understand what I'm looking at. The red line at the bottom is the one I am going to focus on. It is what I'll refer to as the Spread Ascension Value (SAV). Basically what it is looking at is how much higher or lower the current spread is vs. the 50-day average spread. (I also looked at the 100-day average with success.) This way we are not measuring the absolute spread, but rather how stretched the current spread is versus typical recent spreads. A rapid widening would cause this number to spike and that is just what we're currently seeing.

On the above chart you can see that the Spread Ascension Value moved back over 0.7 on Friday. The Spread Ascension Value (SAV) using a 100-day moving average spiked over 0.9 on Friday. I looked back at other times the SAV had reached these kinds of extremes to see how the S&P had performed during such periods. The first test used a 100-day Spread Ascension Value of 0.9. Going back to 1960 I looked see how the S&P performed on those days where the SAV was above this number. What I found is that 0.9 was exceeded about 5% of the time. This amounts to a total of about 2 years and 5 months over the last almost 49 years.

During this 2year and 5 month period of time the S&P gained 94.8%.

One issue I noted when looking through the results is that there was a decent amount of time where the SAV was high because the market was in the process of unwinding an inverted yield curve. In other words, the 10 yr. – 13 week spread was either below 0 today or the average was below 0. I decided to eliminate those instances since we're far from an inverted yield curve.

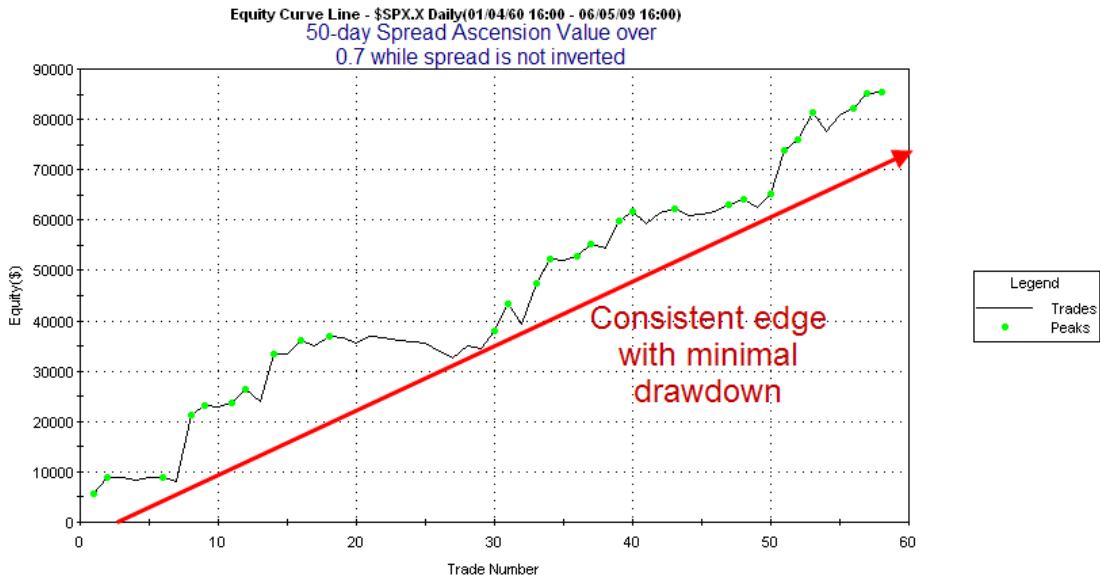
I was surprised to see the results here were even better. In this case the market spent between 3.5% and 4.0% of its time with a 100-day SAV above 9 without a current or 100-day average inversion. That equates to about 20 months. Over the course of those 20 months the S&P gained an outstanding 85.7%. (These gains are additive and not compounded.)

As noted above and shown in the chart I also looked at a 50-day SAV. Like the 100-day test, here I looked at any time the 50-day SAV was 0.7 or above. The basic test without the inversion check showed the bond spread to be in this state a little over 3.5% of the time or just a few days beyond 19 months. Over this time the S&P gained a non-compounded 101.2%. If I perform the inversion exclusion as in the 100-day test then you're looking at a little less than 14 months, or a bit under 2.5% of the time. During these 14 months the market gained a non-compounded 85.2%.

A check of more recent performance shows that in 2008 the S&P gained 19.2% while the 50-day SAV was above 0.7. So far in 2009 the previous day's SAV has been above 0.7 only 3 days – 5/28, 5/29, and 6/2. Over those 3 days the S&P has gained over 3%.

Just as impressive is that the gains have been consistent over time and have not been subject to large whipsaws. Below are the equity graphs from the last test (though they all look basically the same).

This first graph is trade-based.



Next is a time-based look.



No matter how I break it down, it appears a rapidly growing spread suggests a strong edge for the stock market for as long as the SAV stays elevated.

These models seem to be in a bit of conflict with the first bond/stock test I ran above. My interpretation is the following. When stocks and bond rates hit new intermediate-term highs at the same time it often means that stocks may be extended upwards while bonds are extended downwards. This often leads to a reversion. The combination of the stock market being overbought and the bond market being oversold suggests the stock market is likely to struggle over the next several weeks. The 2nd set of studies essentially shows

what happens when the oversold bond market remains oversold and the spread between long and short rates continues to widen. Recall the exit parameter in the 2nd set of studies was a reversion of the rapid widening of the long-short spread. With so much money rapidly leaving bonds, stocks often get a nice boost. (The money has to go somewhere.) It's when the bond market begins to stabilize and the flow into stocks slows that the stock market then begins to struggle.

I will look at this concept in a bit more detail this week. In all likelihood I'll add an SAV chart to the charts pages. I'll also include the model in the Quantifinder so that subscribers are alerted to high SAV's.

In addition to monitoring the bond action this week I'll also be carefully watching the VIX:VXV ratio. It is currently down near 0.94 and dropping. A close below 0.9 would suggest a short bias.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Triggers

none

Catapult for ETF's Trades

none

Broad Market Large Cap CBI – 0

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	0.00
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	0.00
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	0.00	DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	0.00	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

Additional New Trade Ideas

On my radar – There are several securities putting in some swift pullback from highs. Commodity plays are especially interesting here. GLD and SLV have both pulled back after nice rallies and could be ready for a bounce. Two others I'm still keeping an eye on are AAPL and GOOG who both closed down today for the 1st time in 2 weeks. Also, for those who like contracting volatility setups, DBC just posted 2 inside days after closing at a 50-day high.

Fledgling new system and trade idea

GDX – buy @ \$41.30 limit. –GDX has pulled back over the last few days and looks to be attempting a bounce back up based on today's reversal bar. Below is a system that describes the setup:

Setup criteria:

- 1) MA's aligned in uptrending fashion (10 > 20 > 50 > 200).
- 2) Today the price dips below the 20ma but closes above it.
- 3) Today's close is in the top 90% of the days range.
- 4) The close is further below the 10ma than it is above the 20ma.

Basically you're looking for a bounce off the 20-day ma in a nicely uptrending market. The last criteria is one way to see if there is a decent amount of space between the entry and the upside target to make the trade worthwhile.

Buying at the close under the above conditions and selling when the ETF closed above its 10ma would have produced the following results over the last 10 years among my list of 100+ ETF's:

Trades	263
Wins	212
Losses	51
Win %	80.60%
Avg Win	1.17%
Avg Loss	-2.46%
Profit Factor	2.0
Avg Trade	0.47%

Results are pretty good for such a rudimentary entry and exit. The size of the average loss compared to the average gain is a bit concerning. There's a few ways to potentially improve this and I'll look into them over the next few days. The first would be to institute a stop. Monday's low could make a reasonable one. The second improvement might be to let at least part of the trade run longer. The fact that the market is in an uptrend has been established with the 1st criteria. Rather than taking a quick exit, it could pay off to look for larger gains. This might be accomplished by setting a price target at say a 10-day high rather than at the 10ma. Also, a simple trailing stop could be very effective as well.

I'll look into some possible improvements over the next few days and then I'll likely create a new system page for the setup. It's been a while since I've added a new system and this could turn out to be a pretty good one. For now I'm confident enough to track the GDX trade idea.

Active Trades Table

None.

This report has been prepared by Hanna Capital Management, LLC and is provided for information purposes only. Under no circumstances is it to be used or considered as an offer to sell, or a solicitation of any offer to buy securities. While information contained herein is believed to be accurate at the time of publication, we make no representation as to the accuracy or completeness of any data, studies, or opinions expressed and it should not be relied upon as such. Robert Hanna, Hanna Capital Management, LLC or clients of Hanna Capital Management, LLC may have positions or other interests in securities (including derivatives) directly or indirectly which are the subject of this report. This report is provided solely for the information of Hanna Capital Management, LLC clients and prospects who are expected to make their own investment decisions without reliance upon this report. Neither Hanna Capital Management, LLC nor any officer or employee of Hanna Capital Management, LLC accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents. This report may not be reproduced, distributed or published by any recipient for any purpose without the prior express consent of Hanna Capital Management, LLC.

Copyright © 2009 Hanna Capital Management, LLC