

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 18, 2009

Volume 2 Issue 157

## 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
<b>Active</b>				
August 18, 2009	2 Days Down In Chop	1-3 days	Bullish	
August 18, 2009	Up Issues % Under 33% 2 days in row	1-2 days	Bullish	2.40%
August 18, 2009	Range < gap down and close < open	1 day	Bearish	
August 12, 2009	1% Drop & Advances/Decline > 2	1-9 days	Bullish	2.40%
<b>Active - Long Term</b>				
August 4, 2009	75% Up Issues 2 of 3 Days	1-20 days	Bullish	4.80%
July 14, 2009	VIX:VXV drops below 0.9	2-5 months	Bearish	
<b>Dropped Tonight</b>				
August 10, 2009	NDX up 1% Sox Down	1-6 days	Bearish	
August 10, 2009	S&P Up 1% and UUP up 0.5%	1-6 days	Bearish	-5.30%
<b>August 11, 2009</b>	<b>SPY low vol 20 while &gt; 10ma</b>	<b>1-5 days</b>	<b>Bearish</b>	<b>-2.10%</b>
<b>August 14, 2009</b>	<b>SPX hig close 20. NYSE low vol 20.</b>	<b>1-5 days</b>	<b>Bearish</b>	<b>-1.90%</b>

If the avg max move is achieved the study will appear in **bold italic blue** and no longer be active. With the reduced market volatility I am no longer requiring a move of Avg max + ½ Std Dev. to reach the target.

### **Short-term Outlook (1-5 days) – updated 8/18 – bullish**

The market underwent some strong selling on Monday, though most of the damage was done pre-market. After gapping down nearly 2% in the SPY the market failed to put in any rally attempt. It traded in a tight range for most of the day and closed near its lows. Breadth was extremely negative. The NYSE Up Issues % was 10% and the Up Volume % a tiny 6%. Total volume rose a little from Friday's level but was still fairly low.

Looking at the active studies list above tonight it's significant to note that all 4 short-term bearish studies from last night have either expired, met their downside targets, or both. Therefore they have all been dropped from the list. The dropping of bearish studies in itself will have a net positive effect on the Aggregator. Tonight's new studies also net out to a bullish inclination for the next few days.

I have chosen 3 of the most compelling studies from the Quantifnder tonight to include in the Aggregator. First let's look at the lone bearish study among the large bunch tonight. This was first shown in the 4/8/09 Subscriber Letter.

SPY gaps down and closes below the open. The intraday range is less than the size of the overnight gap.

Buy on close. Sell X days later. \$100k/trade. 1993 - present.

QE Finder Tester: 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	-13,206.34	13	7	6	53.85	1,708.10	-4,193.84	0.41	0.48	-1,015.87
9	-13,624.51	13	5	8	38.46	2,285.14	-3,131.28	0.73	0.46	-1,048.04
8	-8,052.53	13	6	7	46.15	2,163.01	-3,004.37	0.72	0.62	-619.43
7	-1,068.63	13	6	7	46.15	2,895.57	-2,634.58	1.10	0.94	-82.20
6	-227.44	13	7	6	53.85	1,826.13	-2,168.39	0.84	0.98	-17.50
5	1,651.96	13	7	6	53.85	1,549.11	-1,531.97	1.01	1.18	127.07
4	-5,931.88	13	6	7	46.15	2,184.43	-2,719.78	0.80	0.69	-456.30
3	-2,637.50	13	5	8	38.46	1,675.08	-1,376.62	1.22	0.76	-202.88
2	-3,084.70	13	4	7	30.77	1,721.92	-1,424.62	1.21	0.69	-237.28
1	-5,502.58	13	3	10	23.08	396.81	-669.30	0.59	0.18	-423.28

Interesting to note about the 3 instances that did not immediately drop further the next day is that NONE of them closed below the trigger day close at any time in the next 8 days. Not that you'd want to read much into 3 instances, but it further confirms that the downside value of this study is really only for 1 day.

It was the 2<sup>nd</sup> day in a row of very weak breadth which is something I looked at on June 17th. Below I have updated the study:

NYSE Up Issues % < 33% for the 2nd day in a row.  
Buy SPX on close. Sell X days later. \$100k/trade. 1/1/99 - present

QE Finder Tester: 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	22,626.99	54	29	25	53.70	3,445.61	-3,091.83	1.11	1.29	419.02
9	53,181.61	57	36	21	63.16	3,414.10	-3,320.29	1.03	1.76	933.01
8	69,621.45	57	37	20	64.91	3,475.21	-2,948.07	1.18	2.18	1,221.43
7	59,211.24	58	39	19	67.24	2,866.35	-2,767.17	1.04	2.13	1,020.88
6	63,947.25	60	39	21	65.00	2,969.23	-2,469.19	1.20	2.23	1,065.79
5	57,428.79	60	39	21	65.00	2,543.64	-1,989.20	1.28	2.37	957.15
4	56,594.08	62	37	25	59.68	2,889.71	-2,013.01	1.44	2.12	912.81
3	41,756.33	65	41	24	63.08	2,524.39	-2,572.65	0.98	1.68	642.41
2	64,852.39	67	44	23	65.67	2,418.00	-1,806.07	1.34	2.56	967.95
1	55,516.55	86	54	32	62.79	1,829.75	-1,352.81	1.35	2.28	645.54

91% of instances closed above the trigger day close at some point in the next week.

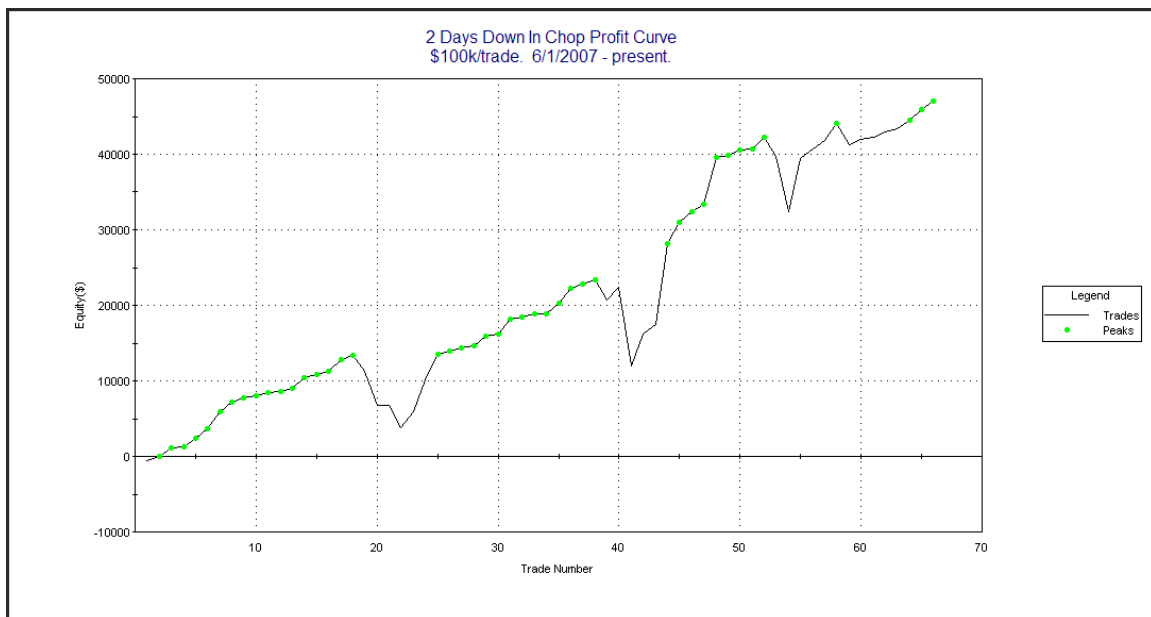
There is a pretty strong inclination for a bounce at some point in the short term. Also notable is that much of the early positive influence only lasts 2 days.

As most subscribers would have already recognized, today marked the 2<sup>nd</sup> down day in a row, triggering the “2 Days Down In Chop” system. I have updated the results for that system below.

SPX closes lower 2 days in a row. Buy on close. Sell next profitable close up to 3 days later. Sell the 3rd days close regardless of profitability. \$100k/trade. 6/1/2007 - present

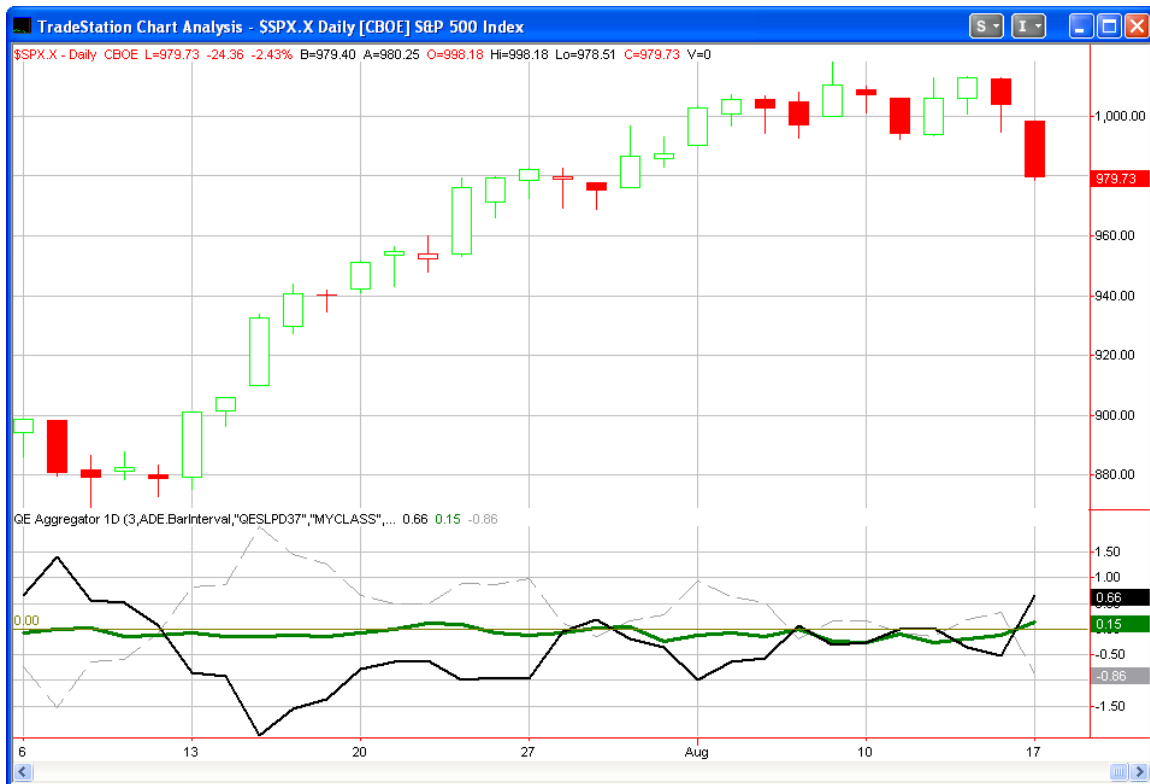
TradeStation Performance Summary			
All Trades			
Total Net Profit	\$47,038.94	Profit Factor	2.30
Gross Profit	\$83,140.50	Gross Loss	(\$36,101.56)
Total Number of Trades	66	Percent Profitable	86.36%
Winning Trades	57	Losing Trades	9
Even Trades	0		
Avg. Trade Net Profit	\$712.71	Ratio Avg. Win:Avg. Loss	0.36
Avg. Winning Trade	\$1,458.61	Avg. Losing Trade	(\$4,011.28)

And here is an updated profit curve which shows the system has been hitting new highs.



Lastly, subscribers may want to note that the S&P Volume SPYX hit 98 today. Moves this high in the past have been followed by better than average returns the next day. Also interesting is that tomorrow is Tuesday – [the most likely day of the week for a rebound from a pullback.](#)

The [Aggregator](#) chart is updated below.



With the bearish studies dropping and mostly bullish studies appearing tonight the green Aggregator line has flipped to positive. This illustrates the net expectation from the active studies is now bullish. The strong selling the last 2 days has also moved the black Differential line above zero. This shows that the market has strongly underperformed expectations over the last few days. Oversold with net positive expectations suggests a bullish edge for tomorrow and perhaps the next few days. This is the configuration I look for when considering long trades.

Based on tonight's studies and the Aggregator chart I'll be looking to begin scaling in to an index position tomorrow. Details are in the trade ideas section below.

Should we get the expected bounce I won't be looking to stay around too long. The sharp runup from the July lows didn't leave much in the way of technical support. Today's move represented a breakdown of the recent range. A sharp decline in the near future is a real possibility.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 8/17 – neutral***

One sign of a potential top that some traders monitor is distribution days. It was popularized by Investors Business Daily. The essential idea is that when the market falls on increasing volume that suggests institutions are selling stock. When clusters of distribution days occur, it is a topping signal. Below are some quotes from [an IBD column published on August 4<sup>th</sup>](#) that discusses distribution.

*“What you're looking for is distribution. If one or more of the major indexes (the NYSE composite, the Nasdaq, the S&P 500 or Dow industrials) falls more than 0.2% in higher volume than in the prior session, that's a distribution day.*

*Distribution means the big money — mutual funds, investment banks and other institutional investors — is dumping shares. That's bad news for the little guy, because institutions make up roughly three-fourths of the market and chart its direction.*

*IBD studies show that when you get a series of three to five distribution days over a few weeks during an uptrend, that's a red flag.”*

*“Identifying distribution days is crucial: If you don't, you might have the wrong take on the market's direction. Then you'll be wrong about every move you make. That's a nice recipe for financial agony... Once distribution days pile up, it's wise to scale back your portfolio. Ease off margin, and get rid of any laggard stocks first. Raise cash and move entirely off stocks if necessary.”*

So the bottom line is that if the market rallying, and you see a cluster of distribution days occur within a fairly short time period, you should begin selling stocks. The market is likely heading for a tumble. Let's take a quantified look at it.

First, before I show test results I will say that clusters of distribution days do often occur near market tops – so they got that part right. But are they predictive of a top and should they be used for purposes of early identification?

I actually devised this test 4 years ago when I wrote an article for TradingMarkets about distribution days. To test the concept I looked for the following criteria:

- 1) The S&P closes above the 200-day moving average (remember – we're looking for a top.)
- 2) Sometime within the last 12 days the S&P closed within 1% of its 200-day high. (Again, confirming we are near a top.)
- 3) Over the last 12 days there have been at least 4 distribution days.

Looking for 4 distribution days within 12 trading days was the criteria I used in the original test based on information at that time. It still seems like a good number according to the above article that suggests *“a series of three to five distribution days over a few weeks during an uptrend, that's a red flag.”*

So if you wanted to use this red flag as a short signal, how would you do looking out over the next 1, 2, and 3 month periods?

Short S&P on close of 4th distribution day within last 12 if it is above its 200ma and has come within 1% of its 200day high in the last 12 days.  
Cover X days later. \$100k/trade. 1980- 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: WinLoss Ratio	All: ProfitFactor	All: Avg Trade
60	-111,222.35	37	10	27	27.03	4,277.81	-5,703.72	0.75	0.28	-3,006.01
40	-89,499.34	42	15	27	35.71	2,944.62	-4,950.69	0.59	0.33	-2,130.94
20	-53,091.36	49	18	31	36.73	2,930.37	-3,414.13	0.86	0.50	-1,083.50

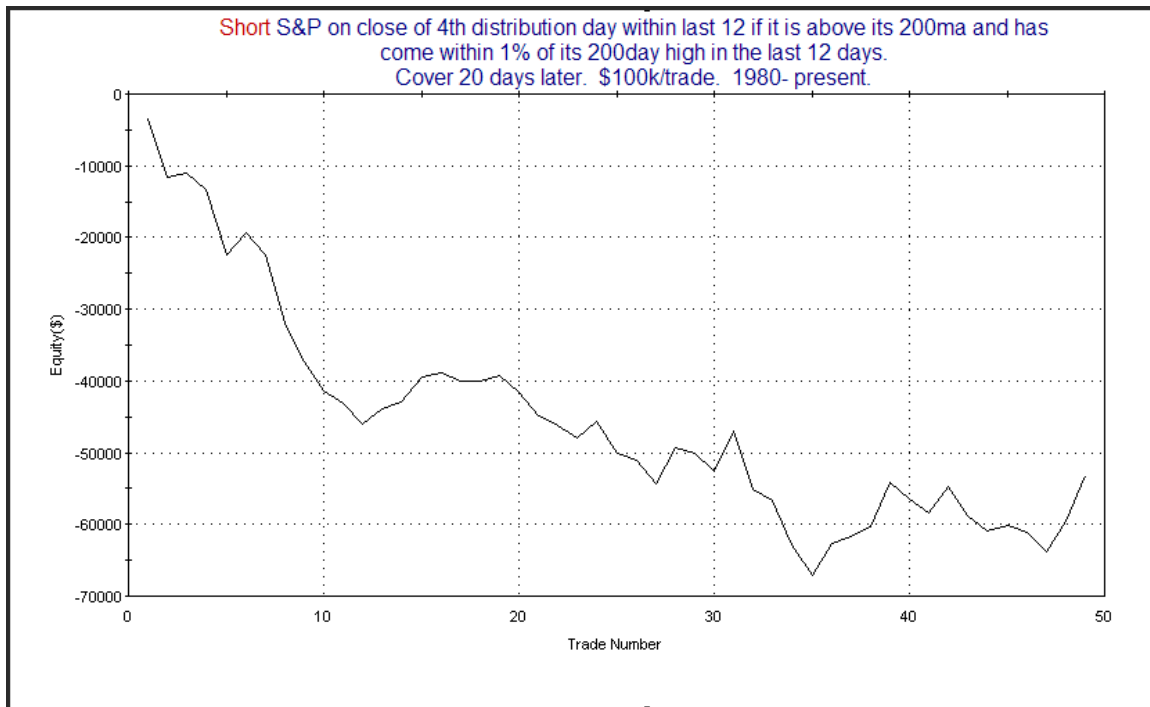
Needless to say these results are horrible. It appears that following a bout of distribution is NOT a good time to be selling. What if we flip the study on its head and instead BUY after such instances when distribution day counters are unloading positions?

Buy S&P on close of 4th distribution day within last 12 if it is above its 200ma and has come within 1% of its 200day high in the last 12 days.  
Sell X days later. \$100k/trade. 1980- 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: WinLoss Ratio	All: ProfitFactor	All: Avg Trade
60	111,222.35	37	27	10	72.97	5,703.72	-4,277.81	1.33	3.60	3,006.01
40	89,499.34	42	27	15	64.29	4,950.69	-2,944.62	1.68	3.03	2,130.94
20	53,091.36	49	31	18	63.27	3,414.13	-2,930.37	1.17	2.01	1,083.50

Not the most explosive results I've ever posted in term of average trade, but a decent edge nonetheless. Wins are bigger than losses and the winning percentage is pretty good. This makes for decent looking profit factors (gross gains / gross losses = profit factor).

Is this a new phenomenon? Did distribution day counting formerly work and in recent years it has failed? That might explain why IBD has discussed it for so long. Sadly, no. Below is the equity curve for the 1<sup>st</sup> test above using a 20-day holding period.



While the results have been helped out by some horrible bear markets in the last decade, it's never been a winning concept.

So why preach it? Well, it's rare that you'll get a top without a bout of distribution days. Therefore, when a top actually does occur, the service or person who talks about their importance can point to the top and say "See, the distribution days signaled it. You would've been fine if you'd just used this tool."

This is somewhat similar to the perception that has been created with regards to follow through days for calling market bottoms. They occur there, but they are not predictive and are pretty much a worthless tool. For detail on follow through days, you may refer to [the series I wrote last year](#). The primary difference here is that while follow through days are generally worthless, counting distribution days to try and identify tops is worse than that – it's hazardous.

The bottom line reality of distribution days is that when the market endures a pullback after an extended uptrend, it's often a buying opportunity and NOT a time to sell.

Of course there are still reasons to be cautious here. The VIX:VXV ratio has slipped back below 0.9. This indicator [which worked so well in the past](#) has been, at best, extremely early this time.

The [Nasdaq continues to lag](#), which has been a condition under which the market has struggled to rally in the past.

On the positive side there is still a breadth thrust signal on the board from the studies list. After such strong breadth moves in July it would be a positive for the market to see the

10-day ema of the advance-decline line remain above 49% or 50% on this pullback. That will be something I'll be keeping an eye on in the days to come.

In general the story remains much the same as last week. Things are a bit overdone after a big run-up. There are some signs that the market could roll over. At this point the pullback has not provided any substantial evidence that a new leg down is beginning. I believe it will at some point though. I still believe *we are in a 30'd style environment* where selloffs and rallies will both be more exaggerated than people are used to.

### **Catapult and Capitulative Breadth Statistics**

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

#### ***Open Catapult Triggers***

*New*

*SLE – 1/3 @ \$9.48 limit (filled @ \$9.45)*

*SLE – 1/3 @ \$9.45 limit (I'll look to enter a bit lower)*

*SLE – 1/3 @ \$9.20 limit*

#### ***Catapult for ETF's Trades***

*None*

#### ***Broad Market Large Cap CBI –3(SLE-3)***

#### ***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	1.00
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	2.70	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	2.13
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	0.00	DJ US Technology Sector	IYW	0.54
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	9.09
DJ US Consumer Svcs	IYC	0.00	Nasdaq 100	QQQQ	2.00

Some telecom stocks have been beaten up lately.

### **Additional New Trade Ideas**

*A full listing of system triggers can be found at the [system triggers page](#) each night. I will cherry pick some of my favorite setups from the S&P 100 and ETF lists along with occasional other trade ideas to track below.*

*SLE – buy 1/3 @ 9.20 limit. Should we get a fill tomorrow the SLE trade idea will be filled up. A reminder that Catapults tend to be the volatile trades we have and this should be taken into account when considering position sizes.*

*SPY buy 1/4 index position @ \$98.31 limit. I'll look to enter the 1<sup>st</sup> lot around Monday's closing price. Based on the short-term market outlook above.*

*SPY buy 1/4 index position @ \$97.60 limit ON CLOSE. Should the market head lower again tomorrow and become more oversold I'll continue to scale in at the close.*

### **Active Trades Table**

<b>Symbol</b>	<b>Entry Date</b>	<b>Entry Price</b>	<b>Current Pr</b>	<b>% Gain/Lo</b>	<b>Stop</b>	<b>Notes</b>
SLE(1/3)	8/14/2009	\$9.45	\$9.20	-2.65%		Catapult
SLE(1/3)	8/14/2009	\$9.35	\$9.20	-1.60%		Catapult

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