

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 19, 2009

Volume 2 Issue 158

## 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 19, 2009	Yest dn 2%. Today strong brdth bad vol	1 day plus	<b>Bearish</b>	
August 18, 2009	Up Issues % Under 33% 2 days in row	1-2 days	Bullish	2.40%
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	<b>Bearish</b>	
<b>Dropped Tonight</b>				
<b>August 18, 2009</b>	<b>2 Days Down In Chop</b>	<b>1-3 days</b>	<b>Bullish</b>	
<b>August 18, 2009</b>	<b>Range &lt; gap down and close &lt; open</b>	<b>1 day</b>	<b>Bearish</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 8/19 – slightly bearish**

As the studies suggested was probable last night the market put in a nice bounce today. The major indices all finished solidly higher. Breadth was strongly higher with the NYSE Up Issues % coming in at 79% and the Up Volume % was 85%. Volume came in quite a bit lower than yesterday, though.

How a market initially bounces after a steep decline often gives some pretty nice clues as to the chances that the bounce will lead to further upside or whether it will shortly roll over. I showed many studies along these lines in the last 12 months or so. The basic story is if you want a bounce to succeed then right from the start you want to see strong breadth and strong volume accompany that bounce. Today the breadth was strong but the volume was sorely lacking. We looked at this combination following a one day drop of 2%+ back in May. I've updated the results table from that Letter below:

SPX drops over 2% yesterday. Today up issues outnumber down issues by at least 3:2 but volume declines. Buy SPX on close. Sell X days later. \$100k/trade. 4/10/2001 - 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
6	-42,628.38	11	0	11	0.00	0.00	-3,875.31	0.00	0.00	-3,875.31
5	-38,320.19	11	3	8	27.27	950.80	-5,146.57	0.18	0.07	-3,483.65
4	-20,015.02	12	5	7	41.67	1,071.96	-3,624.97	0.30	0.21	-1,667.92
3	-24,716.48	12	4	8	33.33	1,664.70	-3,921.91	0.42	0.21	-2,059.71
2	-9,186.82	13	6	7	46.15	1,691.62	-2,762.36	0.61	0.52	-706.68
1	-11,367.05	13	1	12	7.69	1,549.08	-1,076.34	1.44	0.12	-874.39

Day 1 has almost always closed down (12 of 13 times). That was often followed by another weak bounce. Then once you get out 6 days there has been a 100% failure rate and the average decline over 6 days was extremely large. Those results are a little skewed thanks to a 15.6% decline following the 9/30/08 instance and the 8.6% in the six days following the 11/7/08 instance. Therefore rather than try and extrapolate an estimate for the next 6 days, I'll just focus on tomorrow.

Below I have listed all the one-day instances and included some notes and observations at the bottom of the list.

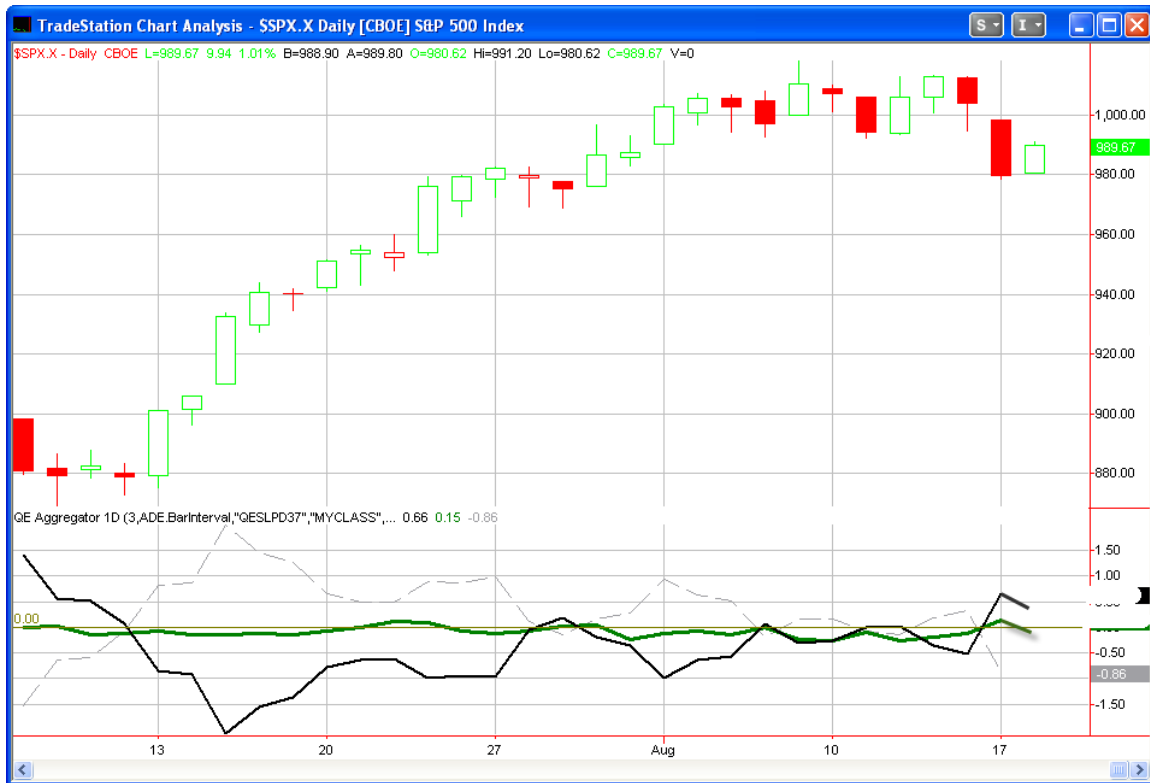
SPX drops over 2% yesterday. Today up issues outnumber down issues by at least 3:2 but volume declines. Buy SPX on close. Sell X days later. \$100k/trade. 4/10/2001 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
04/12/02	Buy	\$1,111.04	(0.76%)	\$343.80
04/15/02	Sell	\$1,102.55		→ (\$1,046.70)
08/26/02	Buy	\$947.95	(1.39%)	\$826.35
08/27/02	Sell	\$934.82		→ (\$1,846.95)
11/27/02	Buy	\$938.87	(0.27%)	\$306.34
11/29/02	Sell	\$936.31		→ (\$336.02)
02/28/07	Buy	\$1,406.82	(0.26%)	\$187.44
03/01/07	Sell	\$1,403.17		→ (\$1,842.45)
08/29/07	Buy	\$1,463.76	(0.42%)	\$317.56
08/30/07	Sell	\$1,457.64		→ (\$850.68)
09/30/08	Buy	\$1,166.36	(0.45%)	\$56.95
10/01/08	Sell	\$1,161.06		→ (\$2,175.15)
11/07/08	Buy	\$930.99	(1.27%)	→ \$2,242.72
11/10/08	Sell	\$919.21		→ (\$2,516.64)
12/10/08	Buy	\$899.24	(2.85%)	\$598.29
12/11/08	Sell	\$873.59		→ (\$3,386.61)
12/12/08	Buy	\$879.73	(1.27%)	\$553.70
12/15/08	Sell	\$868.57		→ (\$2,487.13)
01/08/09	Buy	\$909.73	(2.13%)	\$239.80
01/09/09	Sell	\$890.35		→ (\$2,334.78)
04/15/09	Buy	\$852.06	1.55%	→ \$2,139.93
04/16/09	Sell	\$865.30		→ (\$587.34)
04/21/09	Buy	\$850.08	(0.77%)	→ \$1,368.90
04/22/09	Sell	\$843.55		→ (\$1,112.67)
05/14/09	Buy	\$893.07	(1.14%)	\$432.90
05/15/09	Sell	\$882.88		→ (\$1,568.43)

Observations:

- 1) Even the lone instance that closed higher saw an intraday decline of over 0.5% the next day.
- 2) Only 3 of 13 instances posted an intraday rise of greater than 1% the next day. ←
- 3) 10 of 13 instances saw an intraday DECLINE of greater than 1% the following day. ←

The [Aggregator](#) chart is updated below. (Note charting issues forced me to draw in the values tonight. This has happened on occasion. I expect all will be well tomorrow.)



With bullish studies dropping off and a new bearish study tonight the green Aggregator line has flipped to slightly negative. This means the net expectations for tomorrow based on the active studies are bearish. Meanwhile, the move up today barely made a dent in the strong downmove of the last few days. Therefore the black Differential line has barely begun to work off the underperformance.

So we are expecting downside but the market remains oversold. This means risk/reward is not stellar at this point. If the market can rise or even move sideways for another day or two that could create a nicely favorable shorting opportunity. For now, I'd consider moving off the long side but not yet getting aggressive on the short side if you're involved in index positions.

#### ***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: Win/Loss 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

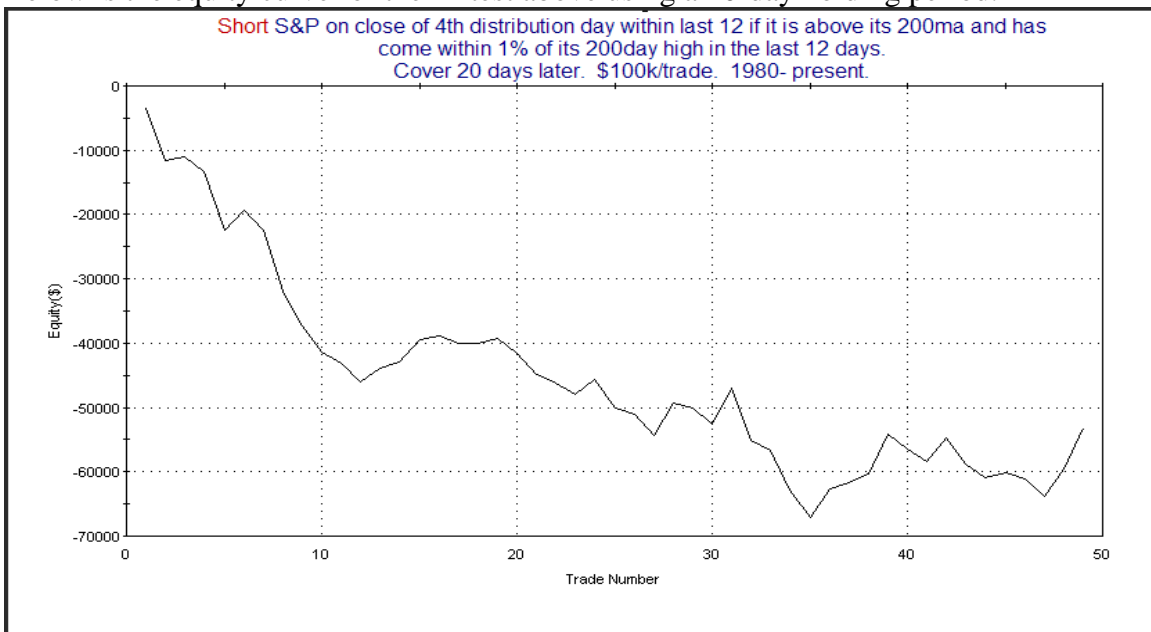
Needless to say these results are horrible. It appears that following a bout of distribution is NOT a good time to be selling. What if we flip the study on its head and instead BUY after such instances when distribution day counters are unloading positions?

**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: Win/Loss 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)***

### **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.*

### **Active Trades Table**

<b>Symbol</b>	<b>Entry Date</b>	<b>Entry Price</b>	<b>Current Pr</b>	<b>% Gain/L</b>	<b>Stop</b>	<b>Notes</b>
SLE(1/3)	8/14/2009	\$9.45	\$9.36	-0.95%		Catapult
SLE(1/3)	8/14/2009	\$9.35	\$9.36	0.11%		Catapult

Tuesday was a bad day for fills based on the limits I set. SLE missed by \$0.01 and SPY missed by \$0.04. Hopefully some of you were more aggressive than the Letter and were able to take advantage of some of the upside.

NOTE: I will be on vacation the next couple of days. I won't be able to send out intraday updates. If the SLE Catapult trade idea triggers an exit I will note it in the nightly Letter and will look to sell on the open. Should it make a strong move tomorrow (say up 2% or so) it will likely trigger an exit.

The charts page may not be updated but the triggers page will.

Also note the intraday Quantifinder will not be active the next 3 days. As always, the nightly Letter will arrive. Hopefully there are no internet issues on this vacation which have me at Starbucks at 5:30am sending it out.

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