

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 21, 2009

Volume 2 Issue 160

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
Active				
August 21, 2009	CBOE Equity Put/Call low	1 day	Bearish	
August 21, 2009	Nasdaq 3:2 breadth for 3 days	1-2 days	Bearish	-1.70%
August 21, 2009	SPX up 3. Vol increases last 2.	1-5 days	Bullish	1.50%
August 20, 2009	2 Days Up In Chop	1-4 days	Bearish	
August 20, 2009	Gap < yest low and close > yest high	1-2 days	Bearish	-1.60%
August 12, 2009	1% Drop & Advances/Decline > 2	1-9 days	Bullish	2.40%
Active - Long Term				
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	
Dropped Tonight				
August 18, 2009	Up Issues % Under 33% 2 days in row	1-2 days	Bullish	2.40%
August 19, 2009	Yest dn 2%. Today strong brdth bad vol	1 day plus	Bearish	

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 8/21 – bearish

A strong 1st half hour led to a slight drift higher the rest of the day on Thursday. The Dow, S&P, and Nasdaq all finished up close to 1%. Breadth was solidly positive. The NYSE Up Issues % was 72% and the Up Volume % was 84%. Total volume closed just slightly higher once again.

A few notables tonight.

First, the last few days have included a sharp drop in volatility. The ratio of the 3 day to the offset 10-day historical volatility has dropped rapidly to 0.16 according to my data. According to [a study I posted to the blog last month](#) a contraction this sharp often leads to a rapid expansion where the next three days are projected to average close to 5 times the volatility of the last 3 days. The S&P is getting close to the top of its recent range. This would suggest we are either in for a breakout or a quick trip down to the lower end of the range (or both).

There were a few interesting studies from the Quantifinder tonight that hadn't popped up in a while. The bullish one came in looking at the increasing volume during rise of the last couple of days.

**SPX rises for the 3rd day in a row. NYSE volume rises the last 2 days.
Buy on close. Sell X days later. \$100k/trade. Last 35 years.**

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	46,734.97	185	110	75	59.46	1,363.45	-1,376.59	0.99	1.45	252.62
4	40,297.10	189	113	76	59.79	1,248.15	-1,325.57	0.94	1.40	213.21
3	39,929.38	189	115	74	60.85	1,078.02	-1,135.72	0.95	1.48	211.27
2	29,312.80	189	107	81	56.61	908.27	-837.92	1.08	1.43	155.09
1	12,142.72	189	95	94	50.26	686.96	-565.09	1.22	1.23	64.25

The edge isn't huge here, but without the rising volume expectations would turn negative, so it is important to distinguish.

One possible negative is that Nasdaq breadth may be getting overdone. The study below addresses this:

**Nasdaq advancers outnumber decliners by 3:2 for 3 days in a row.
Buy Nasdaq on close. Sell X days later. \$100k/trade. 1999 - present.**

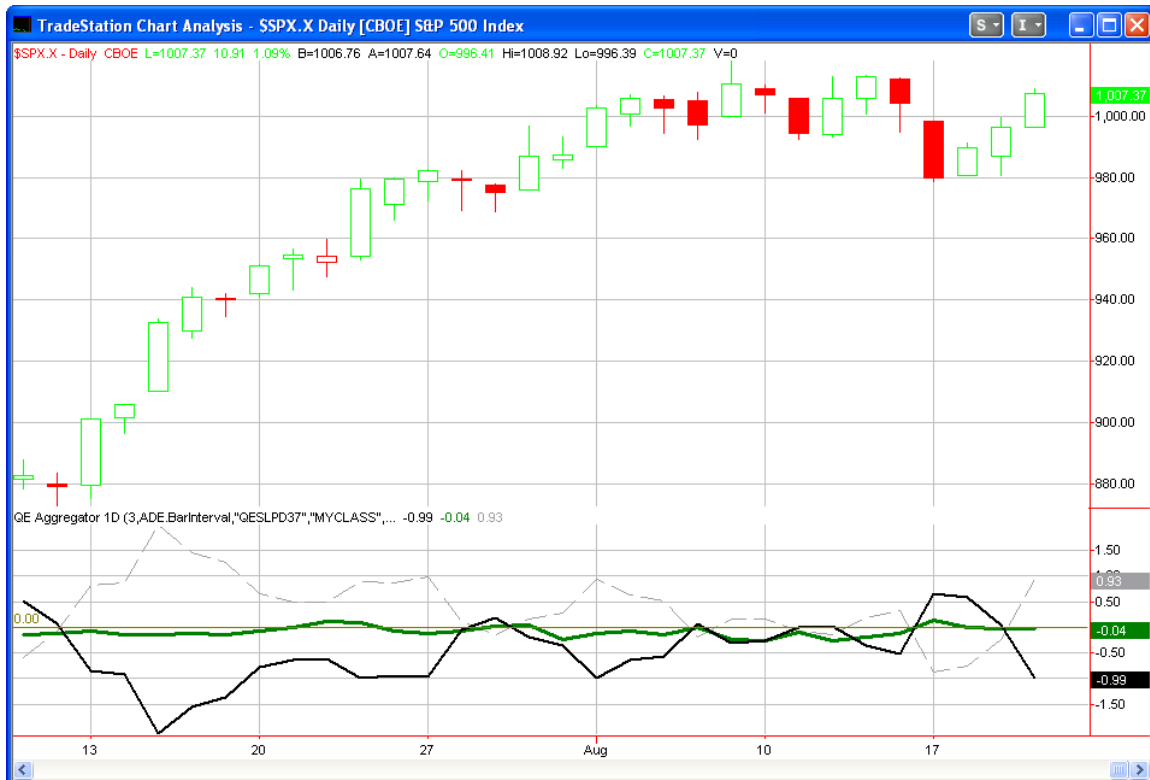
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-6,119.20	21	10	11	47.62	1,576.26	-1,989.25	0.79	0.72	-291.39
4	-6,033.48	21	6	15	28.57	1,637.78	-1,057.34	1.55	0.62	-287.31
3	-3,650.29	21	8	13	38.10	2,010.86	-1,518.25	1.32	0.82	-173.82
2	-11,549.12	21	8	13	38.10	950.77	-1,473.48	0.65	0.40	-549.96
1	-6,140.05	24	9	15	37.50	1,046.58	-1,037.28	1.01	0.61	-255.84

91% of instances closed below the trigger day close at some point in the next 4 days.

While they haven't necessarily pulled back the very next day, they have nearly all pulled back within a few days.

The most compelling short-term indication from today is the fact that the CBOE Equity Put/Call came in at about 72% of its 200ma. Since the March bottom this indicator has performed as well or better than most any at picking short-term pullbacks. You find a recent discussion of it in [the August 14th blog](#) and more details in [the June 12th blog](#).

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



Tonight's studies did little to budge the green Aggregator line, which remains mildly bearish. This means the net expectations of all the active studies is slightly negative. The black Differential line did drop quite a bit though. This illustrates the market has underperformed expectations over the last few days. Overbought with a downside expectation is just the configuration I look for in a short trade.

Bottom Line

The last couple of nights, while expectations have been a bit bearish, I've shied away from trading aggressively because I didn't feel risk/reward was in our favor. For one the market was in the middle of its recent range. Trading consistently from mid-range is a difficult thing to do. Secondly, the market was still short-term oversold by some measures. Over the last 3 days that has changed and it is now overbought. Now there is more room on the downside and less room to the upside which increases risk/reward on a short trade. The short trade idea on a partial index position was hit Thursday morning. If it hadn't been I'd be looking to add exposure here. As it is I'm glad to have a short position. The market is quite close to my entry price so I will not look to add more right away. More aggressive traders certainly could.

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 4th](#) 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?

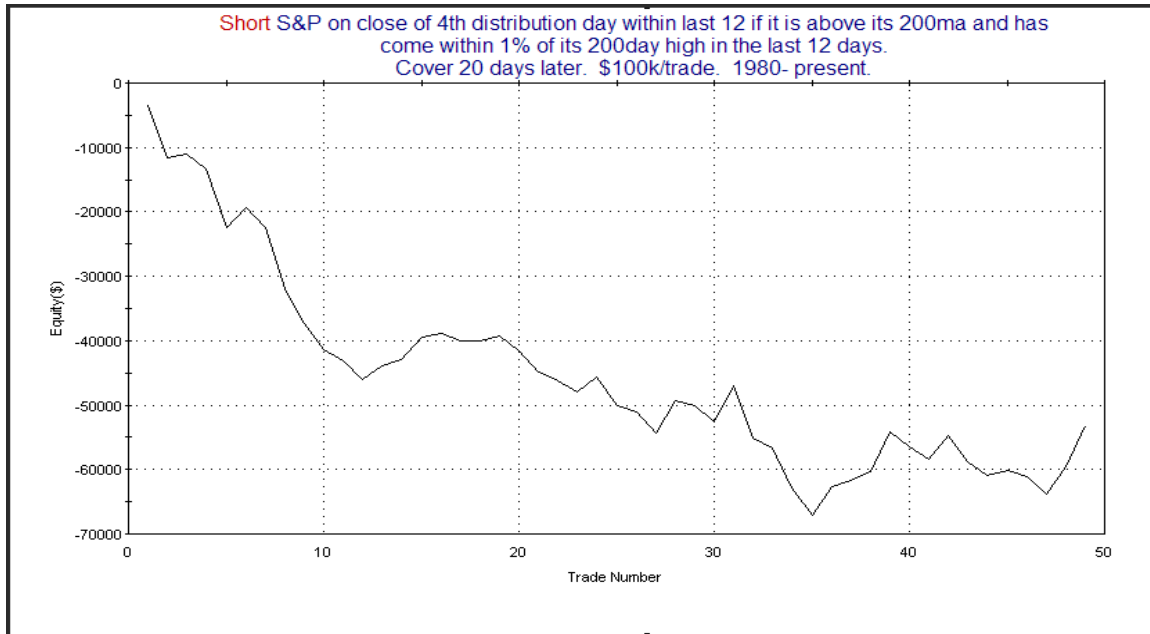
Short S&P on close of 4th distribution day within last 12 if it is above its 200ma and has come within 1% of its 200day high in the last 12 days. Cover X days later. \$100k/trade. 1980- present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	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 1st 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 (filled @ \$9.35)

SLE – 1/3 @ \$9.20 limit(not filled)

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.

None tonight – There could be some more downside index opportunity for aggressive traders. I'm on vacation which makes it a little more difficult to trade. Therefore I'll play it conservative and sit out adding more exposure on Friday.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Pr	% Gain/Lo	Stop	Notes
SLE(1/3)	8/14/2009	\$9.45	\$9.47	0.21%		Catapult
SLE(1/3)	8/15/2009	\$9.35	\$9.47	1.28%		Catapult
SPY(1/4)(s)	8/20/2009	\$100.75	\$100.99	-0.24%		Catapult

SLE has moved up 3 days in a row and still hasn't hit an official exit. It won't take much tomorrow. If it doesn't gap down I'm going to put a stop at \$9.45 in case the market does reverse hard and takes SLE with it. If it gaps below then I'll simply place a limit price at \$9.43. If it opens higher and never stops out, I'll sell all shares at the close tomorrow.

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