

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 27, 2009

Volume 2 Issue 164

## 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 24, 2009	Strong breadth & vol breakout	1-5 days	Bullish	1.50%
August 24, 2009	Op-ex week positive return	1-5 days	Bearish	-0.90%
<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	

If the avg max move is achieved the study will appear in **bold italic blue** and no longer be active.

**Short-term Outlook – updated 8/27**

### The Bottom Line

Another nothing day. The market is wound pretty tight after the last 3 days. Often this can lead to a big move. Unfortunately I'm not seeing a substantial edge to anticipate the direction of the move. In the Proof section below I show one possible way to play such contractions is by using Opening Range Breakouts. Intraday trades require special intraday attention and are therefore not tracked in the Subscriber Letter.

### ***The Proof***

Wednesday wasn't much for action. The market traded in a narrow range for most of the day. When it was over the major indices were basically breakeven, with the Nasdaq and S&P both finishing up 0.1%. Breadth was very slightly negative. The NYSE Up Issues % was 48% and the Up Volume % was 45%. Total volume declined for the 3<sup>rd</sup> day in a row.

Most notable about the last few days is that after Friday's big move the market has essentially gone nowhere. In July I discussed [how sharp 3-day contractions in volatility often led to sizable volatility expansions over the next 3 days](#). The measure I used in that column was the 3-day historical volatility over the 10-day historical volatility (offset 3 days). I showed that drops in the ratio below 0.25 provided a good chance of a quick expansion. Since then we have seen a few examples of this – the most recent being last Thursday, which was followed by Friday's explosive rally. Today the 3/10 offset hv dropped to an incredibly low 0.10.

This brought about a couple of studies from [the 4/7/08 blog](#) that suggested a small upside edge may exist when there is a sharp contraction after a rally. From those studies it appeared risk/reward favored a resumption of the upmove. Tonight I ran a similar study using the 3/10 offset HV and a RSI(2) over 90. In this case the results were somewhat bearish.

SPX 3/10 offset historical volatility closes under 0.25. The 2-day RSI >90. Buy on close. Sell X days later. \$100k/trade. 1989 - 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	-8,204.89	81	47	34	58.02	1,254.95	-1,976.10	0.64	0.88	-101.29
4	-13,011.44	83	40	43	48.19	1,338.28	-1,547.50	0.86	0.80	-156.76
3	-26,020.82	83	41	42	49.40	988.90	-1,584.90	0.62	0.61	-313.50
2	-24,275.19	87	32	55	36.78	972.55	-1,007.22	0.97	0.56	-279.03
1	-20,455.86	107	48	59	44.86	521.44	-770.93	0.68	0.55	-191.18

With conflicting studies based basically on the same premise, I'm inclined to throw all of them out for the time being.

The "2 Days Up In Chop" system also triggered today and was noted in the Quantifinder. I'm not giving this system any weight tonight for 2 reasons. First, as I've shown numerous times lately, 2 Days Up In Chop has struggled to make gains since the March bottom. The uptrend has overpowered it on a few occasions. Second, the last 2 days up were so incredibly weak that they were barely up at all.

The Aggregator, which can be found lower down, is once again suggesting there is no clear directional edge.

So we are faced with a scenario where there stands to be a fairly good chance of a large move, but the direction is unclear. One way to play such a situation would be to consider trading an Opening Range Breakout (ORB). Tony Crabel popularized ORB's years ago. Rather than using historical volatility, he used narrow range bars to identify volatility contractions. The basic concept remains the same, though.

When a volatility expansion is expected traders can try and take advantage of it by waiting for the market to establish a range early in the session and then entering the market upon a breakout of that early range. I played with this concept several different ways tonight and I'll show some of the results below.

This first test looks to enter in the direction of the breakout. It then places a stop on the opposite end of the opening range. The trade is exited at the close if it is not stopped out before the close. Should the breakout prove false and the entire range is reversed in the next 5 minutes, an entry in that direction will be taken. Otherwise, no 2<sup>nd</sup> entry is taken on the day.

Yesterday SPY's 3/10 offset historical volatility is < 0.25. Enter ORB of first X (5 minute) bars. Allow for reversal if range is immediately retraced on next bar. Place stop at opposite end of range. Sell on close if not stopped out. \$100k/trade. 1999 - present.										
X bars	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	15,461.34	192	75	117	39.06	760.51	-355.36	2.14	1.37	80.53
5	14,584.44	194	74	120	38.14	771.25	-354.06	2.18	1.34	75.18
4	13,275.74	193	70	123	36.27	778.23	-334.96	2.32	1.32	68.79
3	9,923.03	203	59	144	29.06	866.24	-286.01	3.03	1.24	48.88
2	12,875.92	226	55	171	24.34	973.57	-237.84	4.09	1.32	56.97
1	5,855.30	284	48	234	16.90	918.79	-163.45	5.62	1.15	20.62

You'll note the longer you wait the higher the winning percentage. While the winning % is relatively low across the board the size of the winners is much larger than the losers and therefore there is a positive expectancy. I also tested this without using a stop and just selling all ORB's at the day's close. That also was profitable although slightly less so than using a stop. The edge here isn't huge, but with some trade management it should be able to be improved. By doing things like trailing stops, taking partial profits, or exiting on a breakdown of a topping (or bottoming) formation traders should be able to improve upon a simple end-of-day exit.

Using the 30-minute ORB (first 6 bars) I broke out the results by longs and shorts to make sure they were both profitable. Below is the longs:

Yesterday SPY's 3/10 offset historical volatility is < 0.25. Enter ORB of first X (5 minute) bars. Allow for reversal if range is immediately retraced on next bar. Place stop at opposite end of range. Sell on close if not stopped out. \$100k/trade. 1999 - present.

#### Long Trades

Total Net Profit	\$3,223.74	Profit Factor	1.16
Gross Profit	\$23,492.13	Gross Loss	(\$20,268.39)
Total Number of Trades	90	Percent Profitable	37.78%
Winning Trades	34	Losing Trades	56
Even Trades	0		
Avg. Trade Net Profit	\$35.82	Ratio Avg. Win:Avg. Loss	1.91
Avg. Winning Trade	\$690.95	Avg. Losing Trade	(\$361.94)
Largest Winning Trade	\$7,337.00	Largest Losing Trade	(\$1,260.00)

Here we see a mild edge. Now the shorts.

Yesterday SPY's 3/10 offset historical volatility is < 0.25. Enter ORB of first X (5 minute) bars. Allow for reversal if range is immediately retraced on next bar. Place stop at opposite end of range. Exit on close if not stopped out. \$100k/trade. 1999 - present.

#### Short Trades

Total Net Profit	\$12,237.60	Profit Factor	1.57
Gross Profit	\$33,546.06	Gross Loss	(\$21,308.46)
Total Number of Trades	102	Percent Profitable	40.20%
Winning Trades	41	Losing Trades	61
Even Trades	0		
Avg. Trade Net Profit	\$119.98	Ratio Avg. Win:Avg. Loss	2.34
Avg. Winning Trade	\$818.20	Avg. Losing Trade	(\$349.32)
Largest Winning Trade	\$3,483.00	Largest Losing Trade	(\$791.91)

Again a fairly mild edge, but a little bit better than the longs.

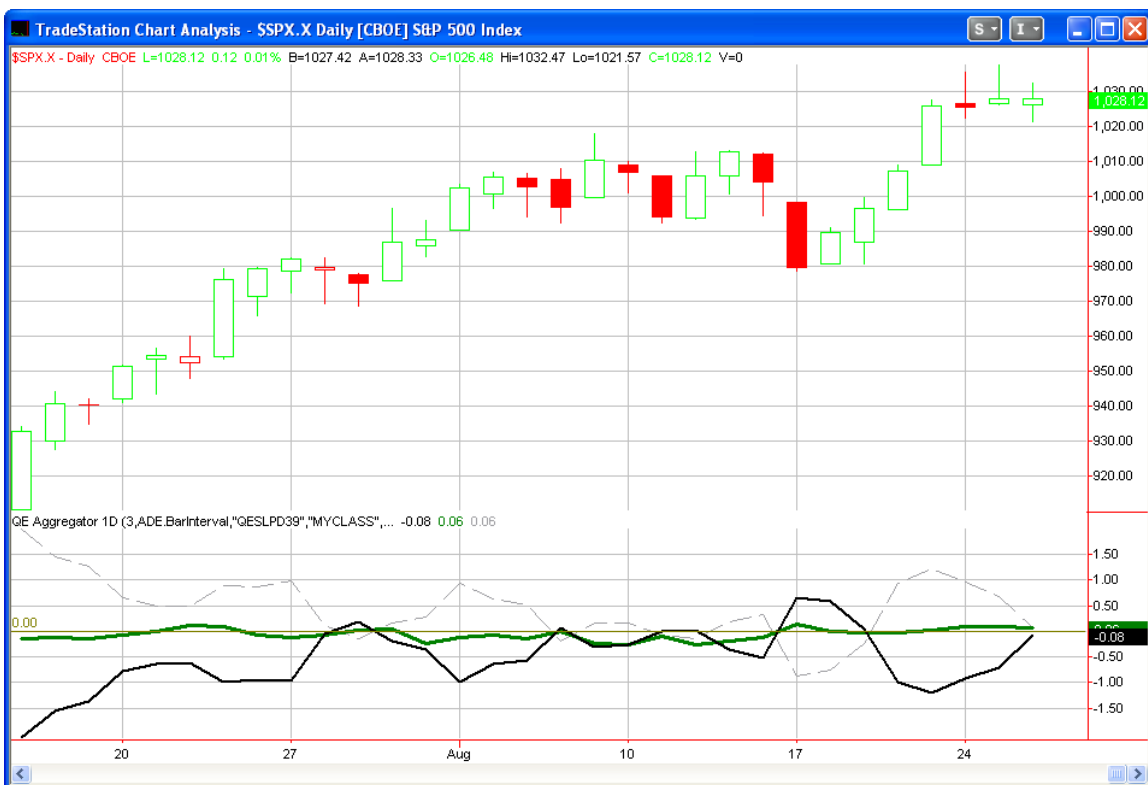
I also checked to see that the low HV actually had a positive influence and it wasn't just the ORB that provided all the edge. To do this I check all instances over the last 10 years that didn't come after a very low 3/10 offset ratio.

Yesterday's 3/10 offset historical volatility is  $> 0.25$ . Enter ORB of first X (5 minute) bars. Allow for reversal if range is immediately retraced on next bar. Place stop at opposite end of range. Sell on close if not stopped out.

QE ORB: minentryba	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	-10,701.46	2,126	760	1,364	35.75	828.69	-469.58	1.76	0.98	-5.03
5	-9,459.45	2,164	720	1,442	33.27	865.25	-438.59	1.97	0.99	-4.37
4	-17,994.62	2,172	658	1,510	30.29	890.85	-400.12	2.23	0.97	-8.28
3	-31,208.67	2,250	598	1,648	26.58	914.33	-350.71	2.61	0.95	-13.87
2	-60,119.30	2,532	522	2,008	20.62	973.31	-282.96	3.44	0.89	-23.74
1	-66,789.96	3,185	467	2,704	14.66	1,027.62	-202.18	5.08	0.88	-20.97

What we see here is a mild negative expectation if the market isn't doesn't have a low 3/10 offset HV ratio. I actually diced it up a little more than this and found generally positive ORB trade results below 0.75 and generally negative results above 0.75..

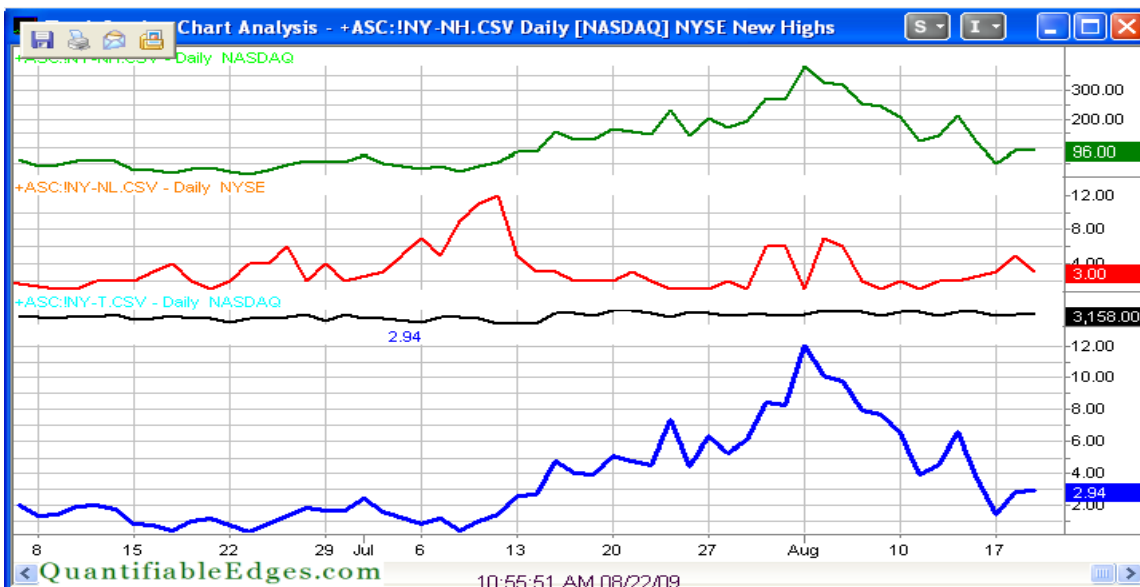
The [Aggregator](#) chart is updated below.



The green Aggregator line is at 0.06 – just 0.01 above neutral drift. The black Differential line shows the market has just barely outperformed expectations over the last few days. With both lines so close to 0, trying to determine a directional edge here is extremely difficult. If you're going to try and partake in a possible big move tomorrow, an ORB type strategy may be one way to play it. At the least it appears there is a decent enough edge that traders could explore ways to enhance it.

**Intermediate-term Outlook (2 weeks – 2 months)– updated 8/24 – very slightly bullish**

Whether this rally can continue or whether it flounders may depend greatly on the breadth of the rally. Breadth is giving somewhat mixed signals lately. One oddity that traders may notice from the charts page is that while the market is now trading at new highs there has been a noticeable dropoff in the number of individual issues hitting new highs. Below is the chart from the website to demonstrate.



The blue line at the bottom is the net % of stocks hitting new 52-week highs. On August 1<sup>st</sup> this number was about 12%. Friday it was only 3% - a 9% dropoff. It's fairly rare to see a dropoff this large, but when I tested it I found that it wasn't necessarily bearish. For purposes of testing I lowered the dropoff required to 5% in order to get enough instances. Regardless of the cutoff I used I found the results to be inconsistent and neither bullish nor bearish. Below is one example of a test I ran.

**SPX makes a 20-day intraday high and close above its 200ma. The net % of stocks hitting new highs on the NYSE is at least 5 points lower than its 20-day high. Buy on close. Sell X days later. 1970 - present**

QE NHs lag on rally: 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
20	16,885.06	26	16	10	61.54	2,088.30	-1,652.78	1.26	2.02	649.43
19	10,845.83	26	14	12	53.85	2,186.88	-1,647.54	1.33	1.55	417.15
18	2,558.27	26	14	12	53.85	1,831.28	-1,923.30	0.95	1.11	98.40
17	-356.37	27	14	13	51.85	1,681.95	-1,838.75	0.91	0.99	-13.20
16	-6,924.34	27	14	13	51.85	1,539.03	-2,190.06	0.70	0.76	-256.46
15	2,688.11	27	15	12	55.56	1,630.76	-1,814.45	0.90	1.12	99.56
14	-2,709.75	27	13	14	48.15	1,733.16	-1,802.92	0.96	0.89	-100.36
13	-1,942.53	29	14	15	48.28	1,922.41	-1,923.75	1.00	0.93	-66.98
12	3,525.81	29	16	13	55.17	1,503.91	-1,579.75	0.95	1.17	121.58
11	2,925.81	29	14	15	48.28	1,467.47	-1,174.59	1.25	1.17	100.89
10	2,778.74	30	15	15	50.00	1,426.81	-1,241.56	1.15	1.15	92.62
9	1,293.47	33	19	14	57.58	951.41	-1,198.80	0.79	1.08	39.20
8	2,294.14	35	20	15	57.14	1,165.27	-1,400.75	0.83	1.11	65.55
7	-2,728.57	38	21	17	55.26	1,212.78	-1,658.64	0.73	0.90	-71.80
6	-627.21	40	24	16	60.00	1,106.06	-1,698.29	0.65	0.98	-15.68
5	-13,004.25	40	17	23	42.50	1,053.26	-1,343.90	0.78	0.58	-325.11
4	-9,092.87	42	17	25	40.48	955.78	-1,013.64	0.94	0.64	-216.50
3	-7,474.66	46	23	23	50.00	664.15	-989.14	0.67	0.67	-162.49
2	-12,506.03	52	22	30	42.31	583.81	-845.00	0.69	0.51	-240.50
1	-8,443.40	67	30	37	44.78	441.60	-586.25	0.75	0.61	-126.02

Is it BETTER to have the number of new highs expanding? Yes. Below I show a similar test where net new highs are also hitting a new high:

**SPX makes a 20-day intraday high and closes above its 200ma. The net % of stocks hitting new highs on the NYSE the highest in 20 days. Buy on close. Sell X days later. 1970 - present**

QE NHs lag on rally: 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
20	59,666.34	87	55	32	63.22	2,926.27	-3,164.95	0.92	1.59	685.82
19	82,536.66	91	59	32	64.84	2,958.05	-2,874.64	1.03	1.90	907.00
18	86,537.02	91	60	31	65.93	2,844.26	-2,713.51	1.05	2.03	950.96
17	65,533.97	93	57	36	61.29	2,718.05	-2,483.18	1.09	1.73	704.67
16	71,709.96	96	61	35	63.54	2,550.55	-2,396.39	1.06	1.85	746.98
15	72,810.49	99	63	36	63.64	2,537.90	-2,418.82	1.05	1.84	735.46
14	58,225.04	102	65	37	63.73	2,360.60	-2,573.34	0.92	1.61	570.83
13	64,551.10	105	72	33	68.57	2,039.31	-2,493.30	0.82	1.78	614.77
12	51,733.67	108	67	41	62.04	2,073.75	-2,127.01	0.97	1.59	479.02
11	51,450.24	112	70	42	62.50	1,997.82	-2,104.69	0.95	1.58	459.38
10	46,021.40	114	66	48	57.89	2,001.49	-1,793.27	1.12	1.53	403.70
9	52,224.07	115	72	43	62.61	1,816.61	-1,827.25	0.99	1.66	454.12
8	46,836.80	123	73	50	59.35	1,736.29	-1,598.25	1.09	1.59	380.79
7	43,034.75	124	73	51	58.87	1,640.14	-1,503.84	1.09	1.56	347.05
6	28,952.82	131	76	55	58.02	1,450.06	-1,477.31	0.98	1.36	221.01
5	19,908.03	138	79	59	57.25	1,285.57	-1,383.93	0.93	1.24	144.26
4	29,381.48	145	76	69	52.41	1,228.56	-927.38	1.32	1.46	202.63
3	23,529.89	153	84	69	54.90	988.79	-862.73	1.15	1.40	153.79
2	22,182.02	167	87	80	52.10	803.28	-596.29	1.35	1.46	132.83
1	17,266.09	217	118	99	54.38	558.37	-491.13	1.14	1.36	79.57

So if we see this number expand then that would help the rally's chances to continue. On the positive side the advance/decline line is hitting new highs. We also had a 90% day on Friday. As we saw in July, if we get a couple of 90% up days within close proximity then that can often be a decent intermediate-term buy signal. Therefore I'll be very interested to see if we get some additional days of extremely strong breadth this week.

Many of the negatives that had been present are still present, such as the low VIX:VXV ratio, the excessive Nasdaq vs. NYSE volume and the generally downsloping total volume over the last few months. Still, the negative effects of these influences has been slow to kick in.

Right now the market is still in rally mode, and betting against it for any extended period of time has not worked. Short trades need to be small and profits taken when available. I expect we're going to see a substantial selloff begin at some point in the next several months. I don't see evidence of it happening just yet.

### **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***

### **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 – Neutral market bias and almost nothing showing up on the triggers page. Wait and see mode.

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