

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 31, 2009

Volume 2 Issue 166

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 28, 2009	False breakdown & close at new high	1-5 days	Bullish	2.00%
August 28, 2009	2 Days Up In Chop	1-3 days	Bearish	
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	

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

Short-term Outlook – updated 8/31

The Bottom Line

The tight range continues. The studies are failing to unearth a substantial edge. Taking a position in anticipation of a move seems a risky endeavor. Looking to range breaks during market coilings like we're currently undergoing could provide traders an edge. I've place some new research on range breakouts in a special section below the intermediate-term outlook.

The Proof

Friday ended the same as every other day this past week – with very little change in the indices. NYSE breadth was mixed. The NYSE Up Issues % came in at 49% while the Up Volume % was 60%. Total volume rose slightly and came in just above average.

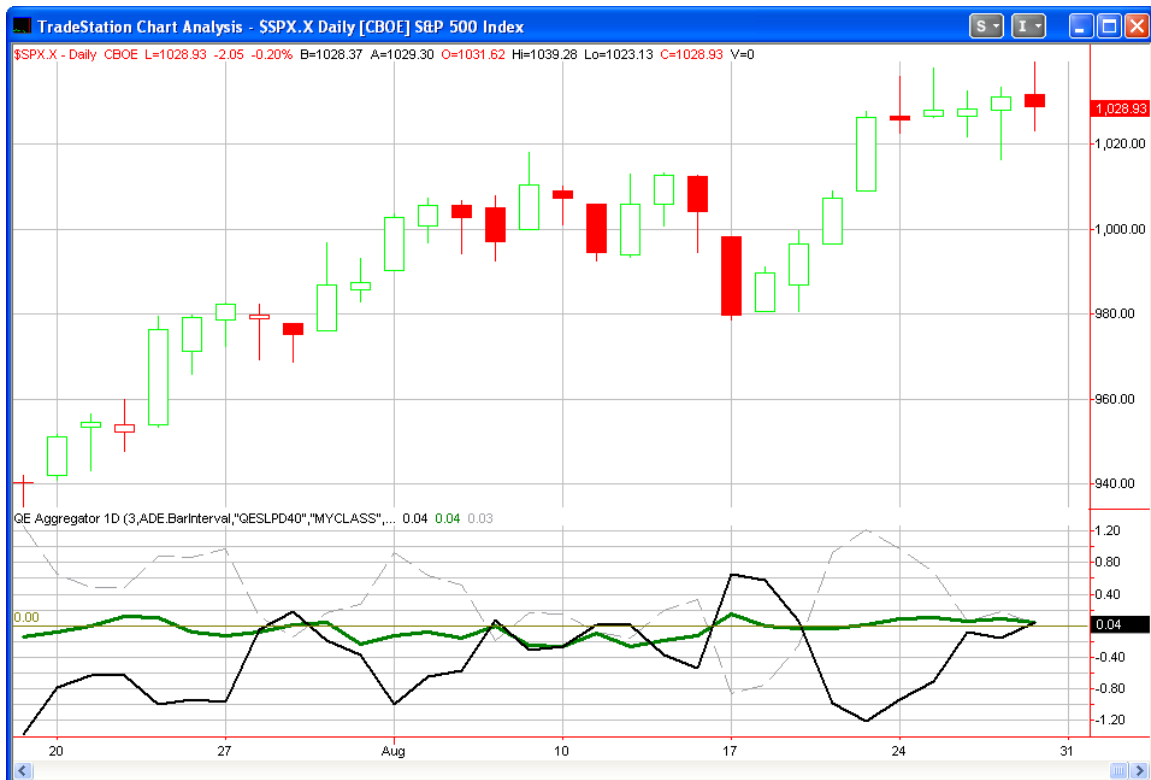
The market has left very few clues this week with any substantial edge. The result of this clueless market has been directionless chop. I've looked at tight range scenarios many many different ways this past week. Being that the market is trading near its highs and above short-term moving averages, most of the tests have suggested a rally continuation

is more likely than a breakdown. It has shown up both ways, though, depending on the construction of the test.

Another study that showed up in the Quantifinder on Friday evening looked at days where the Nasdaq finished up while the Nasdaq Up Issues % closed under 40%. I published this study last in April. From 2001 until that time instances were rare but had led to sharp declines on a fairly consistent basis. Since the March bottom though, we have seen 2 such instances and neither one has even managed to slow the advance. With so few instances to begin with the last two instances have changed the results to look quite a bit more neutral. It'll be interesting to see how this study performs over time but I have elected not to include it in the Aggregator this evening.

The only thing that seems fairly certain is that when the recent range is finally broken in a decisive manner, a sharp move will likely ensue. The last two days we've seen a false breakdown and a false breakout upwards. Eventually we'll get a breakout that sticks for a few days. Based on the extremely tight action this past week I suspect the breakout will arrive shortly.

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



Both the green Aggregator line and the black differential line are extremely close to zero. The studies aren't showing a significant edge over the next few days and the market hasn't done hardly anything over the last few days. This is about as neutral as it gets. It

likely won't change much until the market makes a move. I'd prefer to wait for that move and then evaluate the edges as they unfold. Patience.

Intermediate-term Outlook (2 weeks – 2 months)– updated 8/31 – very slightly bullish

A week of going nowhere has done nothing to clarify the intermediate-term picture. Breadth was the big discussion in last week's outlook nothing was resolved there. The 90% up day on Friday the 21st has not been closely followed by another breadth surge. If it had that would have hinted at real strength.

I also discussed in detail how the number of stocks hitting new 52-week highs had shrunk since late July / early August. While the market was hitting new highs the stocks participating in those highs was declining. As I showed, this is not a death sentence for the rally. Results going forward were mixed. The market outlook does improve substantially, though, when the number of new highs is expanding and confirming the index highs.

The other indicators that have provided some interesting studies over the last several weeks haven't changed at all in the past week, either. Negative indications such as the low VIX:VXV ratio, the excessive Nasdaq vs. NYSE volume and the generally downsloping total volume over the last few months are still in play. Of course the negative effects of these indicators 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 2-3 months. I don't see compelling evidence of it just yet.

Special Discussion on ORB's

In Wednesday night's Letter I posted a study on opening range breakouts. I've added a bit to that study this weekend. First, as review below is my commentary from Wednesday night:

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 2nd 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.

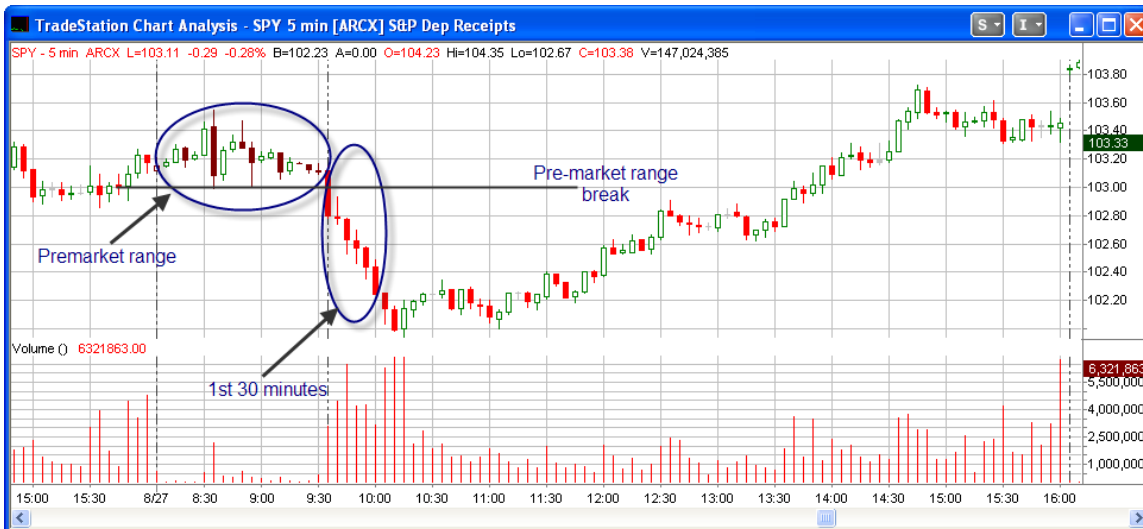
I also checked to see that the low HV actually had a positive influence and it wasn't just the ORB that provided all the edge. To do this I check all instances over the last 10 years that didn't come after a very low 3/10 offset ratio.

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: WinLoss 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

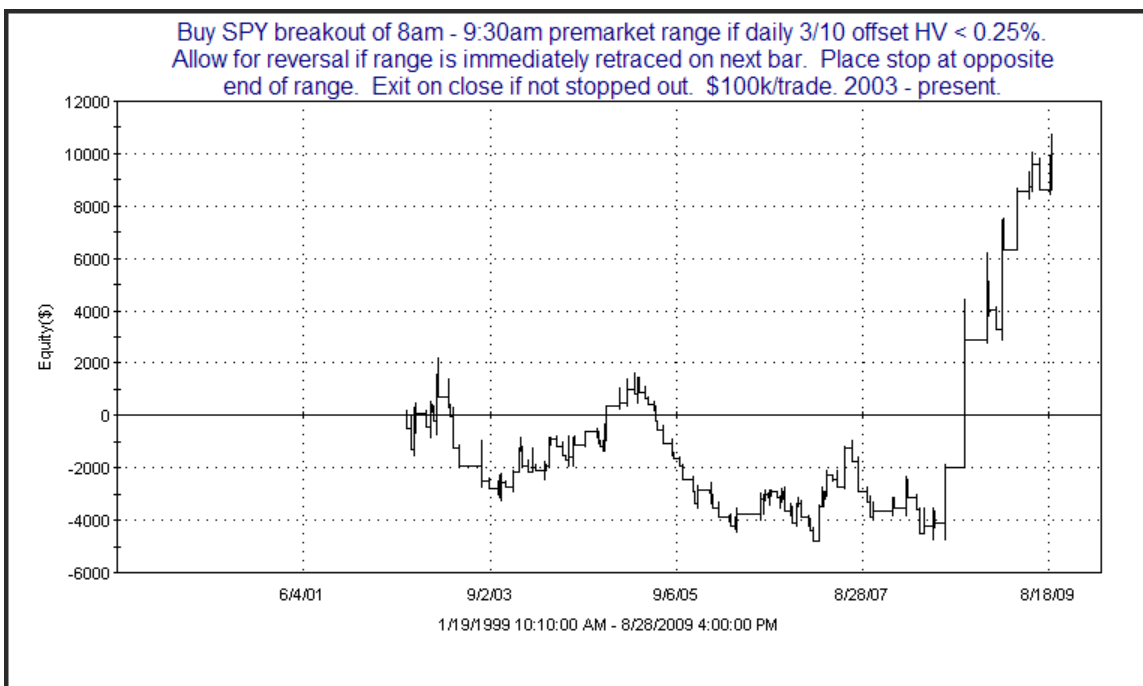
What we see here is a mild negative expectation if the market isn't doesn't have a low 3/10 offset HV ratio. I actually diced it up a little more than this and found generally positive ORB trade results below 0.75 and generally negative results above 0.75.

So all this would suggest that playing a break of the range of the 1st half hour of trading could have provided a decent edge on Thursday. But then the market action was a bit unusual. Below is a 5-minute chart of Thursday's SPY. It includes the pre-market trading from 8am -9:30am eastern.



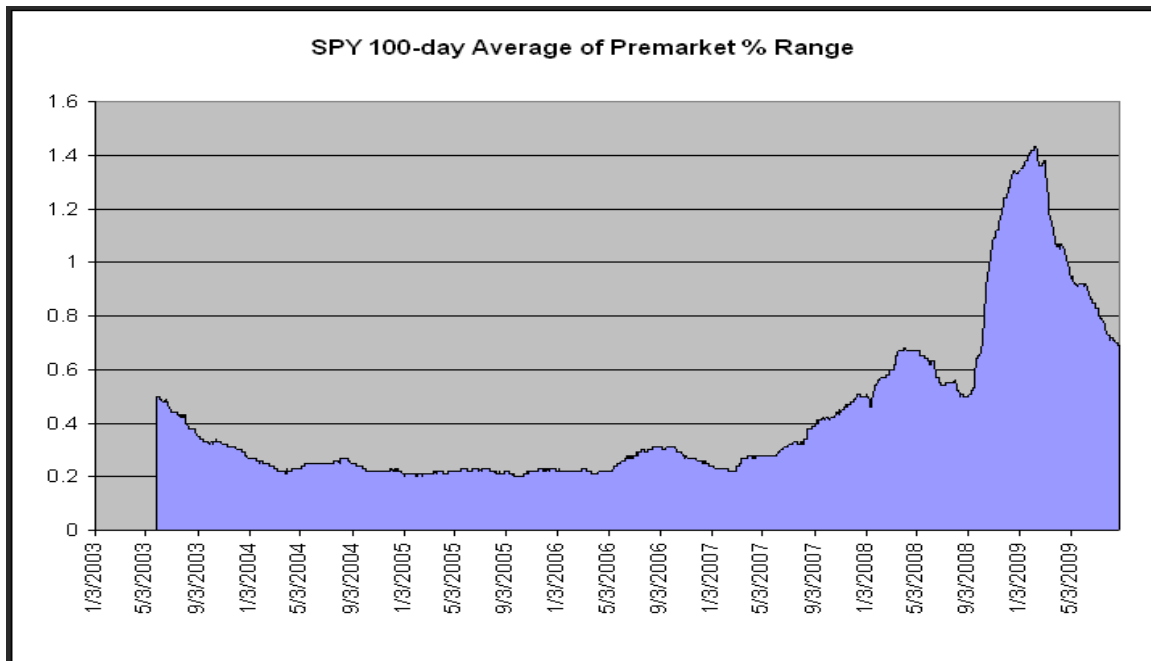
The problem in this scenario of try to play a break of the 1st 30 minutes of trading is that the SPY spent almost the entire 1st 30 minutes selling off. It wasn't a sideways consolidation pattern you'd be looking to take a break of. Instead the market was already very extended. Shorting the 10:05 bar simply isn't a good idea with the market having already free-fallen for the 1st half hour.

An alternate entry here and one that would have done quite well as long as you trailed a stop or took profits at some point would be shorting the breakdown of the premarket trade. But how would using the premarket range as your entry triggers have worked over time?



Here we see that from 2002 – the beginning of my data – through mid-2007, using the pre-market range to play a breakout would have led to small but consistent losses. So what changed in 2007?

I looked at the data a few different ways and devised this chart, which I thought was quite interesting. It measures the size of the range (in percentage terms) of the 8 – 9:30 premarket action in SPY.



What we see here is that in 2007 there was an explosion in volatility in pre-market trading. The explosion peaked in early 2009. And while it has been steeply downtrending lately, it is still about 3 times larger than it was for most of the period prior to 2007. I envision at least 2 implications of the expanded range that may have aided in the success of breakout trading them.

First, with ranges of only 0.25%, pre-2007 trades had stops that were too tight. It was too easy to get stopped out of one of those trades and it happened a lot.

Second, the larger range would also suggest more volume. With more volume and a bigger range, support and resistance levels established pre-market would have more substance. Breaks of these levels would be more impactful since real buying and selling occurred. Low volatility, low volume, premarket drift pre-2007 did not establish meaningful ranges. It appears the more active premarket trading of the last 2 years has helped to establish more meaningful ranges that could be used to a trader's advantage. Traders may want to keep an eye on premarket activity moving forward. Should the above chart continue to quickly erode, then the edge of using premarket levels for support and resistance would also likely erode. If we see a leveling off or move back up in the above chart, then that might suggest using premarket levels for trade triggers could continue to provide an edge.

These tests are in no way meant to represent a complete trading system. The takeaway here is that when the market is trading unusually tight on the daily charts, you will often get a strong move and expansion in volatility. Under these circumstances, if a range is established either pre-market or during early trading with clear levels of support and resistance, traders could look to play a breakout of that range and be confident that risk/reward levels were skewed in their favor.

I also believe some reasonable trade management, stop trailing, and perhaps enhanced entry filters could greatly improve this edge. Traders comfortable trading in an intraday timeframe could look to exploit these edges when they occur.

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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