

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 10, 2009

Volume 2 Issue 173

## 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>				
September 9, 2009	Low range & vol 20 close > 10ma	1-5 days	Bearish	
September 9, 2009	SPY rising on falling volume	1-3 days	Bearish	
September 8, 2009	Strong Breadth No 10-high	1-8 days	Bearish	-4.20%
September 8, 2009	Rise into Labor Day	1-4 days	Bearish	-1.35%
<b>Active - Long Term</b>				
September 10, 2009	Nasdaq Breadth Thrust	1-25 days	Bullish	4.00%
July 14, 2009	VIX:VXV drops below 0.9	2-5 months	Bearish	
<b>Dropped Tonight</b>				
September 2, 2009	1% drop heavy vol no 10-low	1-5 days	Bearish	-2.90%

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

### **Short-term Outlook – updated 9/10**

#### **The Bottom Line**

The outlook really hasn't changed tonight. There was one bullish study added to the active list based on the recent strong Nasdaq breadth. While it was long-term bullish it did little to change the immediate outlook. Intraday traders may also note additional testing in the short-term market outlook section tonight with regards to trading Opening Range Breakouts when the market is already extended upwards.

#### **The Proof**

The market put in some nice gains in the morning and then chopped around most of the afternoon. A late rise saw the SPX closing in the upper end of its intraday range.

Breadth is solidly positive with the NYSE Up Issues % at 71% and the Up Volume % at 66%. Total volume fell off some from Tuesday's level but was still about average.

A lot was picked up by the Quantifinder this evening, with most of the studies leaning bearish. None of the bearish ones provided any additional insights beyond what we've seen in the last few days, though. They primarily suggested that the market was overbought based on both price and breadth. The one bullish study examined the 10-day EMA of the Nasdaq Up Volume %. It's been so strong in the last few days that it has now triggered a breadth thrust buy signal. Below is an excerpt from the 2/9/09 Subscriber Letter that examined this in greater detail. I have not updated the stats this evening, although there have only been a few more instances. The February trigger was a loser, but there were successful breadth thrusts that occurred in both March and July.

*Nasdaq breadth has been especially strong lately. As can be seen on our charts page, [the 10-day ema of the Nasdaq Up Volume %](#) is now close to 64%. This is the highest level it has been at since the bear market began. The chart on that page uses Tradestation's data, which only goes back to 2000. To get a longer term look at the indicator I used Quotes Plus data, which goes back to 1/1/92. There are normally minor discrepancies between data sources when looking at breadth and volume data and Quotes Plus data currently puts the 10-day ema at almost 65%. The test below looks at breadth thrusts that move the ema above 64%:*

<b>Nasdaq Up Volume % 10-day ema crosses over 64%.</b>										
<b>Buy Nasdaq on close. Sell X days later. \$100k/trade. 1992-2/6/2009</b>										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fac	Avg Trade
30	\$75,056.27	19	13	6	68.42	\$7,414.21	(\$3,554.75)	2.09	4.52	\$3,950.33
20	\$65,533.02	20	16	4	80.00	\$5,134.87	(\$4,156.21)	1.24	4.94	\$3,276.65
15	\$51,774.69	23	15	8	65.22	\$4,863.23	(\$2,646.72)	1.84	3.45	\$2,251.07
10	\$18,455.29	23	17	6	73.91	\$1,742.47	(\$1,861.11)	0.94	2.65	\$802.40
9	\$27,723.57	23	16	7	69.57	\$2,339.08	(\$1,385.95)	1.69	3.86	\$1,205.37
8	\$28,370.26	24	18	6	75.00	\$2,136.44	(\$1,680.96)	1.27	3.81	\$1,182.09
7	\$16,080.32	24	15	9	62.50	\$1,827.48	(\$1,259.10)	1.45	2.42	\$670.01
6	\$10,124.79	24	14	10	58.33	\$1,949.10	(\$1,716.26)	1.14	1.59	\$421.87
5	\$4,087.16	24	12	12	50.00	\$1,708.39	(\$1,367.79)	1.25	1.25	\$170.30
4	\$9,701.14	25	15	10	60.00	\$1,637.33	(\$1,485.88)	1.10	1.65	\$388.05
3	(\$1,260.22)	28	16	12	57.14	\$1,643.20	(\$2,295.95)	0.72	0.95	(\$45.01)
2	(\$3,929.78)	29	18	11	62.07	\$955.48	(\$1,920.77)	0.50	0.81	(\$135.51)
1	(\$7,608.66)	29	14	15	48.28	\$731.38	(\$1,189.86)	0.61	0.57	(\$262.37)

*A slight pullback has often been followed by bullish action. Rather than looking at just an exit of X days out, I also decided to use a drop in the 10-day ema as a possible exit as well. Below are the results of buying into an Up Volume % 10-day ema thrust above 64% and then holding until the indicator dips below X%:*

<b>Nasdaq Up Volume % 10-day ema crosses over 64%.</b>										
<b>Buy Nasdaq on close. Sell when Up Vol % ema crosses below X. \$100k/trade. 1992-2/6/2009</b>										
X% ema	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Fac	Avg Trade
0.44	\$112,624.78	17	11	6	64.71	\$11,798.99	(\$2,860.69)	4.12	7.56	\$6,624.99
0.45	\$105,842.15	18	11	7	61.11	\$11,615.21	(\$3,132.17)	3.71	5.83	\$5,880.12
0.46	\$115,435.57	18	12	6	66.67	\$11,197.13	(\$3,155.00)	3.55	7.10	\$6,413.09
0.47	\$118,500.16	18	12	6	66.67	\$11,426.80	(\$3,103.56)	3.68	7.36	\$6,583.34
0.48	\$59,627.05	20	10	10	50.00	\$8,273.10	(\$2,310.40)	3.58	3.58	\$2,981.35
0.49	\$37,459.30	21	10	11	47.62	\$6,542.43	(\$2,542.27)	2.57	2.34	\$1,783.78
0.5	\$42,355.20	21	11	10	52.38	\$6,250.12	(\$2,639.62)	2.37	2.60	\$2,016.91

*Making the exits too tight here reduced profitability greatly. Once the exit trigger dropped to 0.47 or below it appears to be fairly solid. Below is a more detailed performance report which enters on a move above 64% and uses the 47% number as the exit.*

#### All Trades

Total Net Profit	\$126,672.37	Profit Factor	7.80
Gross Profit	\$145,293.75	Gross Loss	(\$18,621.38)
Roll Over Credit	\$0.00		
Open Position Profit/Loss	\$0.00		
Select Total Net Profit	\$126,672.37	Select Profit Factor	7.80
Select Gross Profit	\$145,293.75	Select Gross Loss	(\$18,621.38)
Adjusted Total Net Profit	\$77,127.53	Adjusted Profit Factor	3.94
Adjusted Gross Profit	\$103,351.06	Adjusted Gross Loss	(\$26,223.53)
Total Number of Trades	18	Percent Profitable	66.67%
Winning Trades	12	Losing Trades	6
Even Trades	0		
Avg. Trade Net Profit	\$7,037.35	Ratio Avg. Win:Avg. Loss	3.90
Avg. Winning Trade	\$12,107.81	Avg. Losing Trade	(\$3,103.56)
Largest Winning Trade	\$40,548.60	Largest Losing Trade	(\$4,386.96)
Largest Winner as % of Gross Profit	27.91%	Largest Loser as % of Gross Loss	23.56%

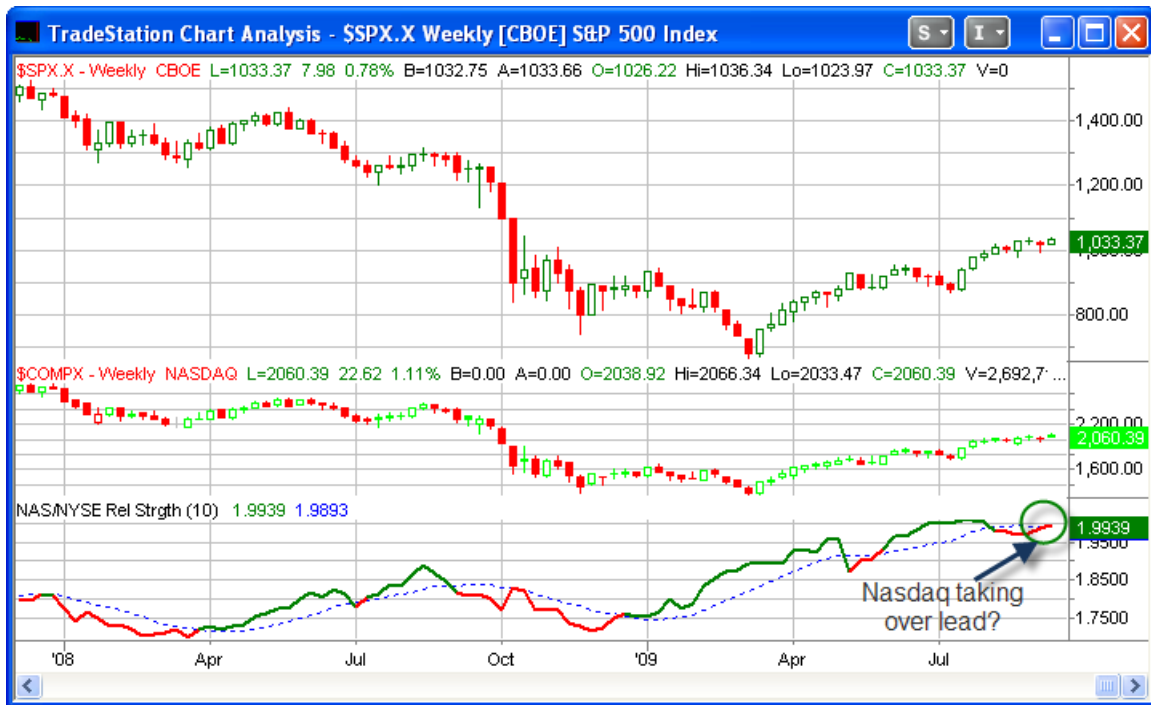
*Most of the numbers here look outstanding. Twice as many winners as losers and the average win is nearly 4 times the average loss. This puts the profit factor at a gaudy 7.8. The one red flag on this report is the "largest winning trade", which I circled above. This trade makes up nearly 28% of all the gross profits. So to more deeply analyze the results I've shown below the listing of all the individual trades.*

#	Type	Date/Time	Signal	Price	Roll Over Pips	Shares/Ctrts Profit/Loss	Gross P/L Cum Net Profit	% Profit
1	Buy	10/16/92	Daily Breadth	\$582.61	\$0.00	171	\$14,155.38	14.21%
	Sell	02/16/93	Sell	\$665.39			\$14,155.38	
2	Buy	06/19/95	Daily Breadth	\$922.09	\$0.00	108	\$12,523.68	12.58%
	Sell	09/26/95	Sell	\$1,038.05			\$26,679.06	
3	Buy	04/25/96	Daily Breadth	\$1,184.17	\$0.00	84	\$2,436.84	2.45%
	Sell	06/14/96	Sell	\$1,213.18			\$29,115.90	
4	Buy	05/05/97	Daily Breadth	\$1,339.24	\$0.00	74	\$24,243.14	24.46%
	Sell	10/17/97	Sell	\$1,666.85			\$53,359.04	
5	Buy	11/02/98	Daily Breadth	\$1,800.91	\$0.00	55	\$28,043.40	28.31%
	Sell	02/09/99	Sell	\$2,310.79			\$81,402.44	
6	Buy	07/02/99	Daily Breadth	\$2,741.02	\$0.00	36	(\$4,386.96)	(4.45%)
	Sell	07/26/99	Sell	\$2,619.16			\$77,015.48	
7	Buy	11/16/99	Daily Breadth	\$3,293.05	\$0.00	30	\$40,548.60	41.04%
	Sell	03/29/00	Sell	\$4,644.67			\$117,564.08	
8	Buy	04/19/01	Daily Breadth	\$2,182.04	\$0.00	45	(\$3,364.20)	(3.43%)
	Sell	05/11/01	Sell	\$2,107.28			\$114,199.88	
9	Buy	11/13/01	Daily Breadth	\$1,892.11	\$0.00	52	\$1,374.36	1.40%
	Sell	12/20/01	Sell	\$1,918.54			\$115,574.24	
10	Buy	11/01/02	Daily Breadth	\$1,360.70	\$0.00	73	(\$3,030.23)	(3.05%)
	Sell	11/11/02	Sell	\$1,319.19			\$112,544.01	
11	Buy	11/21/02	Daily Breadth	\$1,467.55	\$0.00	68	(\$2,529.60)	(2.53%)
	Sell	12/04/02	Sell	\$1,430.35			\$110,014.41	
12	Buy	05/02/03	Daily Breadth	\$1,502.88	\$0.00	66	\$7,119.42	7.18%
	Sell	06/23/03	Sell	\$1,610.75			\$117,133.83	
13	Buy	08/29/03	Daily Breadth	\$1,810.45	\$0.00	55	\$373.45	0.38%
	Sell	09/25/03	Sell	\$1,817.24			\$117,507.28	
14	Buy	01/12/04	Daily Breadth	\$2,111.78	\$0.00	47	(\$1,617.27)	(1.63%)
	Sell	01/28/04	Sell	\$2,077.37			\$115,890.01	
15	Buy	04/05/04	Daily Breadth	\$2,079.11	\$0.00	48	(\$3,693.12)	(3.70%)
	Sell	04/15/04	Sell	\$2,002.17			\$112,196.89	
16	Buy	05/19/05	Daily Breadth	\$2,042.58	\$0.00	48	\$513.12	0.52%
	Sell	06/24/05	Sell	\$2,053.27			\$112,710.01	
17	Buy	08/30/06	Daily Breadth	\$2,185.73	\$0.00	45	\$10,355.40	10.53%
	Sell	12/21/06	Sell	\$2,415.85			\$123,065.41	
18	Buy	09/04/07	Daily Breadth	\$2,630.24	\$0.00	38	\$3,606.96	3.61%
	Sell	10/19/07	Sell	\$2,725.16			\$126,672.37	

While the 41% gain was certainly an outlier, half of the 12 winners achieved gains of greater than 10%, and the largest loser was less than 5%. Even in the low volatility environment of 2006 we see a 10% gain. So while more instances would certainly be preferable, it appears we have a decent amount of evidence here to suggest an upside edge.

A few other things to note here. For one, I checked to see how the S&P had performed rather than the Nasdaq under these circumstances. Results for the S&P were not as encouraging. For instance, after 10 day the Nasdaq averaged a 0.7% gain while the SPX average a -0.1% loss. After 20 days the SPX averaged a 1% gain. The average 20-day return for the Nasdaq was 2.9%. One possible way to play this would be as a pairs trade where you would look for an opportunity to go long the Nasdaq and short the S&P equal amounts.

I also ran a mid-week check on the Nasdaq/S&P 500 Lead/Lag Indicator. If the week ended on Wednesday then the Nasdaq would have taken over the lead. This carries a bullish connotation – especially for the Nasdaq.



So it appears the recent strength in the Nasdaq could be bullish. That doesn't preclude the market from pulling back for a few days as many of the other studies are suggesting is likely. You'll note in the 1<sup>st</sup> table above that these Nasdaq breadth thrusts actually carry a negative expectation over the 1<sup>st</sup> 3 days. So if we get the pullback I'm currently expecting, it may serve as a nice opportunity to either get long the Nasdaq or play a long Nasdaq / short S&P trade.

Also of interest tonight is the fact that the 3/10 offset historical volatility is below 0.25. Readings this low are often followed by a rapid expansion in volatility. This expansion could come in either the form of an upside breakout or a strong selloff. A little over a week ago I did a study on trading Opening Range Breakout's when there was short term contractions in historical volatility as we're seeing now. To download that study you may use the link below:

[ORBs Study.pdf](#)

Tonight I took things a step further. With the SPX at a new closing high and rather extended, I decided to look at other ORB opportunities when the SPY was at a 10-day high. I broke down the results by long trades and short trades. First let's look at the long trades.

Yesterday SPY's 3/10 offset historical volatility is < 0.25. Enter ORB of first 6 (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. 2002 - 9/9/09.

### Long Trades

Total Net Profit	(\$2,561.67)	Profit Factor	0.44
Gross Profit	\$2,033.05	Gross Loss	(\$4,594.72)
Total Number of Trades	25	Percent Profitable	28.00%
Winning Trades	7	Losing Trades	18
Even Trades	0		
Avg. Trade Net Profit	(\$102.47)	Ratio Avg. Win:Avg. Loss	1.14
Avg. Winning Trade	\$290.44	Avg. Losing Trade	(\$255.26)
Largest Winning Trade	\$584.00	Largest Losing Trade	(\$796.50)

A very low win rate and average wins about the same size as average losses leads to bearish results.

Yesterday SPY's 3/10 offset historical volatility is < 0.25 and the SPY closed at a 10-day high. Enter ORB of first 6 (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. 2002 - 9/9/09.

### Short Trades

Total Net Profit	\$4,089.28	Profit Factor	1.95
Gross Profit	\$8,385.50	Gross Loss	(\$4,296.22)
Total Number of Trades	30	Percent Profitable	50.00%
Winning Trades	15	Losing Trades	15
Even Trades	0		
Avg. Trade Net Profit	\$136.31	Ratio Avg. Win:Avg. Loss	1.95
Avg. Winning Trade	\$559.03	Avg. Losing Trade	(\$286.41)
Largest Winning Trade	\$1,777.27	Largest Losing Trade	(\$879.30)

ORB's to the downside seem to clearly favor ORB's to the upside when the market is already extended up. One stat that sticks out to me in these two tests is that the average winner on the short side is nearly the same size as the LARGEST winner on the long side. This would suggest 2 things for tomorrow. 1) A stop placed above the range of the 1<sup>st</sup> half hour is unlikely to increase profitability. 2) Taking some additional short exposure on a downside morning range break could provide an edge.

As a brief aside, I'll look to add the above results to the previous studies and call it a "working paper" that will be updated when I conduct additional ORB studies. I'll put it up on the website for subscribers to access when I'm done.

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



Very little change tonight in the configuration of the Aggregator. The green Aggregator line remains squarely below 0 illustrating the net negative expectations from the studies over the next few days. The black differential line is also well below zero as the market has outperformed expectations by a substantial amount over the last few days and is now overbought. Overbought with negative expectations is what I look for when taking on short exposure.

I may look to take a little more short exposure tomorrow depending on how the market opens. Details in the trade ideas section below.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 9/8 – neutral***

There's little to say from an intermediate-term standpoint that I haven't said in the last couple of weeks. There are a fair amount of indicators suggesting downside but over the last month and a half or so those suggestions haven't been worth anything.

The VIX:VXV ratio again dropped below 0.9 on Friday as noted by the Quantifinder. From 2002 – mid 2009 this was a very reliable precursor to a market selloff. The selloffs didn't always occur immediately. In fact the average amount of time the signal took to completely wear off was close to 4 months. So the fact that it has been nearly 2 months and this indicator hasn't "worked" isn't entirely abnormal.

I believe breadth will be important to monitor as we move forward here. There have been some strong breadth numbers over the last couple of days. In the short-term outlook above I concluded that the combination of market structure and breadth suggested downside rather than upside. This could change should we continue to see strong advance/decline readings. Another breadth measure that may be worth watching is the

NYSE Net New Highs %. I showed a couple of weeks ago that while a lagging number of new 52-week highs is not a death sentence, the market prospects can be substantially improved when new 52-week highs confirm new index price highs. So far we've got a ways to go before either is reached.

I've seen nothing that would cement the idea that the current rally is over. There's a decent amount of evidence that the market has come too far too fast and we'll likely see a pullback at some point here in the not-to-distant future.

The basic premise I'm working under remains that we are in a 1930's – style environment in which both rallies and selloffs will be much more exaggerated than most market participants are used to. Just as the bear market up to March 2009 was incredibly extreme, so has been the rally since then. I believe there is going to be a lot of back and forth over the next few years and the swings will continue to feel extreme. It may be important to keep this in mind when considering market action.

### **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.*

*SPY – Short 1/4 index position @ \$104.25 limit ON OPEN. Based on the short-term market outlook above. Cancel trade if not filled on open. I'll likely look to get shorter if the market moves higher again tomorrow, but will hold off for a day barring a gap up. I'd rather not get run over if the volatility expansion comes in the form of a breakout to the upside. Although the ORB study does suggest upside should be quite limited. Traders could also consider shorting on a possible ORB breakdown tomorrow. I won't attempt this in the newsletter since a letter is a poor medium for intraday trading.*

### **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>
SPY(s)(1/4)	9/9/2009	\$103.12	\$103.73	-0.59%		

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