

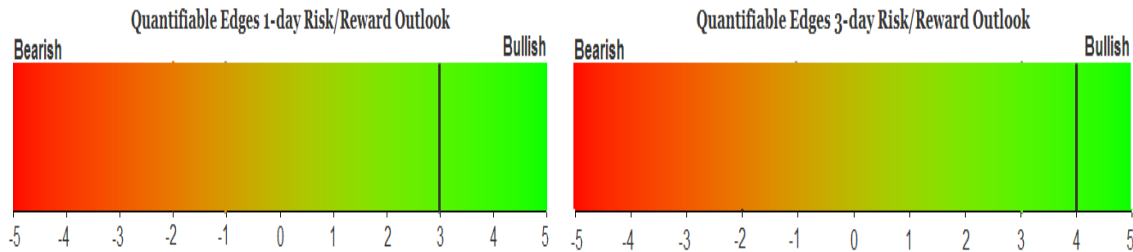
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 5, 2009

Volume 2 Issue 190

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				
October 5, 2009	WR7 Down Followed By NR7	1-5 days	Bullish	1.90%
October 5, 2009	2 Down Totaling -1.5% to start month	1-4 days	Bullish	1.80%
October 2, 2009	2% drop over 200ma to 10-low bot10%	1-5 days	Bullish	2.80%
Active - Long Term				
September 14, 2009	Nasdaq/S&P Lead/Lag Model		Bullish	
July 14, 2009	VIX:VXV drops below 0.9	2-5 months	Bearish	
Dropped Tonight				
October 2, 2009	Less than 5% up volume	1 day	Bullish	
September 28, 2009	Pullback from 20-high drying up	1-5 days	Bullish	2.60%
September 25, 2009	50-high to 8-low in 2 days	1-6 days	Bullish	2.10%
October 1, 2009	2 Down Days End the Quarter	1-2 days	Bullish	

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

Short-term Outlook – updated 10/5

The Bottom Line

The market is oversold and at a point where it has traditionally bounced in the past. Price and seasonality studies are both suggesting short-term upside. While several bullish studies have expired in the last couple of days, they are being replaced with more bullish studies. I expect to see a bounce at some point this week – likely early in the week.

The Evidence

After a disappointing employment report the market opened lower on Friday. The open was about as low as it got, though. It rallied for the 1st hour, briefly going positive before making its high just after 10:30 eastern time. From there it was just a slow drift sideways for the rest of the day. Breadth was negative. The NYSE Up Issues % came in at 33% and the Up Volume % at 32%. Total volume was lower than the last 2 days, but still about average.

There were several edges identified by the Quantifinder on Friday, all suggesting upside. The general themes were early-month weakness and a selloff that was losing steam. Let's first look at the early-month weakness. Below is a study that first appeared in the 6/4/2008 blog. I have updated the stats to present-day.

SPY closes lower 1st 2 days of month and loses at least 1.5%. Buy on close. Sell X days later. \$100k/trade. 1993 - 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
10	53,501.94	17	11	6	64.71	5,610.01	-1,368.02	4.10	7.52	3,147.17
9	46,028.07	17	13	4	76.47	4,068.85	-1,716.76	2.37	7.70	2,707.53
8	40,786.77	17	13	4	76.47	3,558.99	-1,370.02	2.60	8.44	2,399.22
7	32,441.38	17	12	5	70.59	3,356.57	-1,567.50	2.14	5.14	1,908.32
6	26,470.02	17	12	5	70.59	2,848.29	-1,541.90	1.85	4.43	1,557.06
5	24,365.13	17	12	5	70.59	2,689.38	-1,581.47	1.70	4.08	1,433.24
4	23,267.61	17	13	4	76.47	2,235.31	-1,447.85	1.54	5.02	1,368.68
3	18,413.50	17	11	6	64.71	2,173.83	-916.45	2.37	4.35	1,083.15
2	13,905.56	17	8	8	47.06	2,511.87	-773.68	3.25	3.25	817.97
1	3,583.58	17	11	6	64.71	864.42	-987.51	0.88	1.60	210.80

All 17 instances posted a close above the entry price at some point in the next 4 days.

The 1st four days following previous occurrences have consistently provided a bullish edge. Even beyond that as far as 2 weeks out we see risk/reward heavily skewed to the upside.

When there is a rapid deceleration in what was once a sharp selloff that often indicates a bounce is near. I've shown several examples of this concept over time. Two particular studies related to this concept showed up again in the Quantifinder on Friday.

In the 2/19/09 Subscriber Letter I showed several studies related to this. Using a 1.75% drop the 1st day and a drop of less than X% the 2nd day I showed how relatively mild 2nd day drops provided a nice upside edge. Those who wish to review the studies from that letter may use the link below:

[2009-02-19 QE Subscriber Letter.pdf](#)

Friday's drop was just under 0.5%. There I decided to bracket it and examine performance following a drop of between 0.25% and 0.75% immediately after a 1.75% drop. Those results are below.

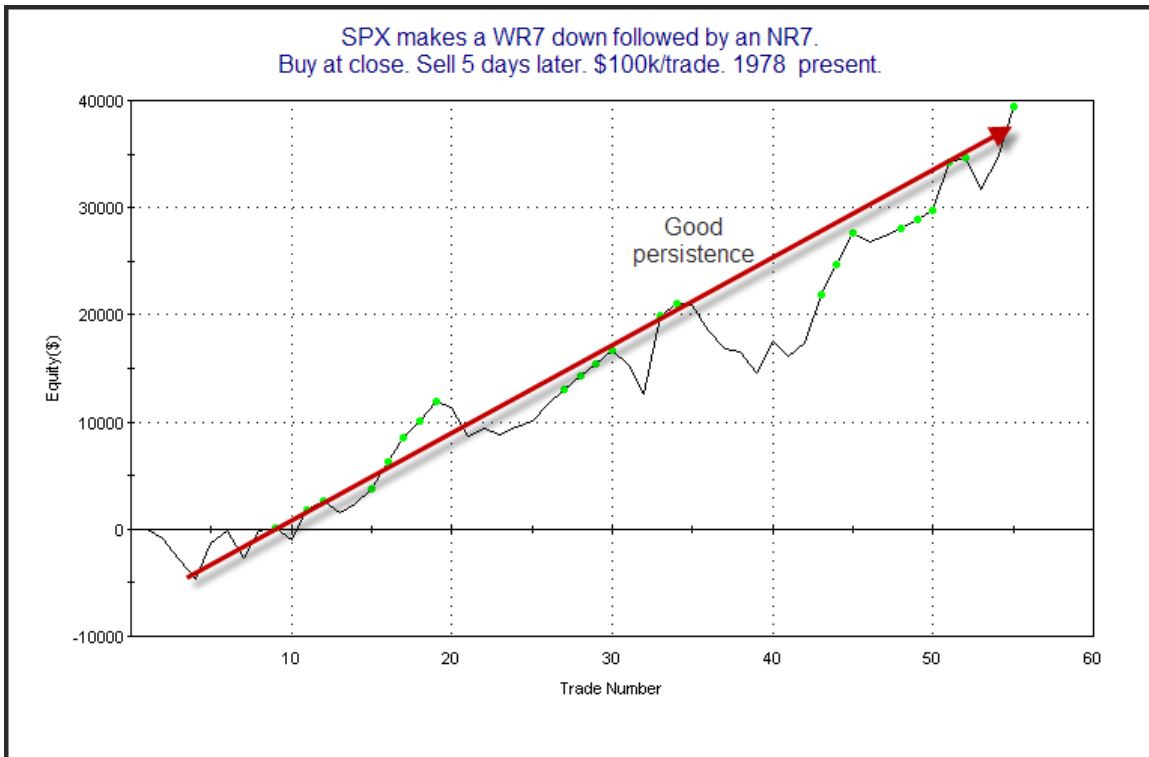
After falling over 1.75% yesterday, SPX falls between 0.25% and 0.75% today. Buy on close. Sell X days later. \$100k/trade. 1988 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	47,404.80	26	19	7	73.08	3,543.83	-2,846.86	1.24	3.38	1,823.26
9	48,261.08	27	17	10	62.96	4,094.94	-2,135.29	1.92	3.26	1,787.45
8	49,454.86	27	18	9	66.67	3,777.89	-2,060.80	1.83	3.67	1,831.66
7	38,433.82	28	18	10	64.29	3,391.60	-2,261.51	1.50	2.70	1,372.64
6	30,380.78	28	18	10	64.29	2,909.01	-2,198.14	1.32	2.38	1,085.03
5	20,344.79	28	18	10	64.29	2,132.18	-1,803.45	1.18	2.13	726.60
4	13,442.25	29	18	11	62.07	2,272.70	-2,496.95	0.91	1.49	463.53
3	-2,370.66	29	15	14	51.72	2,172.92	-2,497.46	0.87	0.93	-81.75
2	4,348.65	30	18	12	60.00	1,525.05	-1,925.19	0.79	1.19	144.96
1	6,383.43	30	19	11	63.33	1,367.10	-1,781.04	0.77	1.33	212.78

Another way to look the deceleration it would be by looking the size of the bars. This was done in a study first published in the 6/24/08 blog. This study uses WR7 and NR7 days. A WR7 is a day whose range is the widest in the last 7 days. An NR7 is a day whose range is the narrowest in the last 7 days.

SPX makes a WR7 down followed by an NR7. Buy at close. Sell X days later. \$100k/trade. 1978 - 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
10	57,486.00	55	40	15	72.73	2,287.17	-2,266.72	1.01	2.69	1,045.20
9	58,057.57	55	38	16	69.09	2,340.11	-1,929.17	1.21	2.88	1,055.59
8	62,682.63	55	35	20	63.64	2,664.11	-1,528.06	1.74	3.05	1,139.68
7	50,068.69	55	34	21	61.82	2,459.88	-1,598.44	1.54	2.49	910.34
6	38,274.66	55	33	22	60.00	2,114.25	-1,431.61	1.48	2.22	695.90
5	39,393.28	55	35	20	63.64	1,955.83	-1,453.04	1.35	2.36	716.24
4	24,818.23	55	33	22	60.00	1,757.85	-1,508.67	1.17	1.75	451.24
3	12,818.90	55	34	21	61.82	1,275.06	-1,453.96	0.88	1.42	233.07
2	14,319.38	55	36	19	65.45	1,097.19	-1,325.24	0.83	1.57	260.35
1	4,811.07	55	31	23	56.36	842.02	-925.72	0.91	1.23	87.47

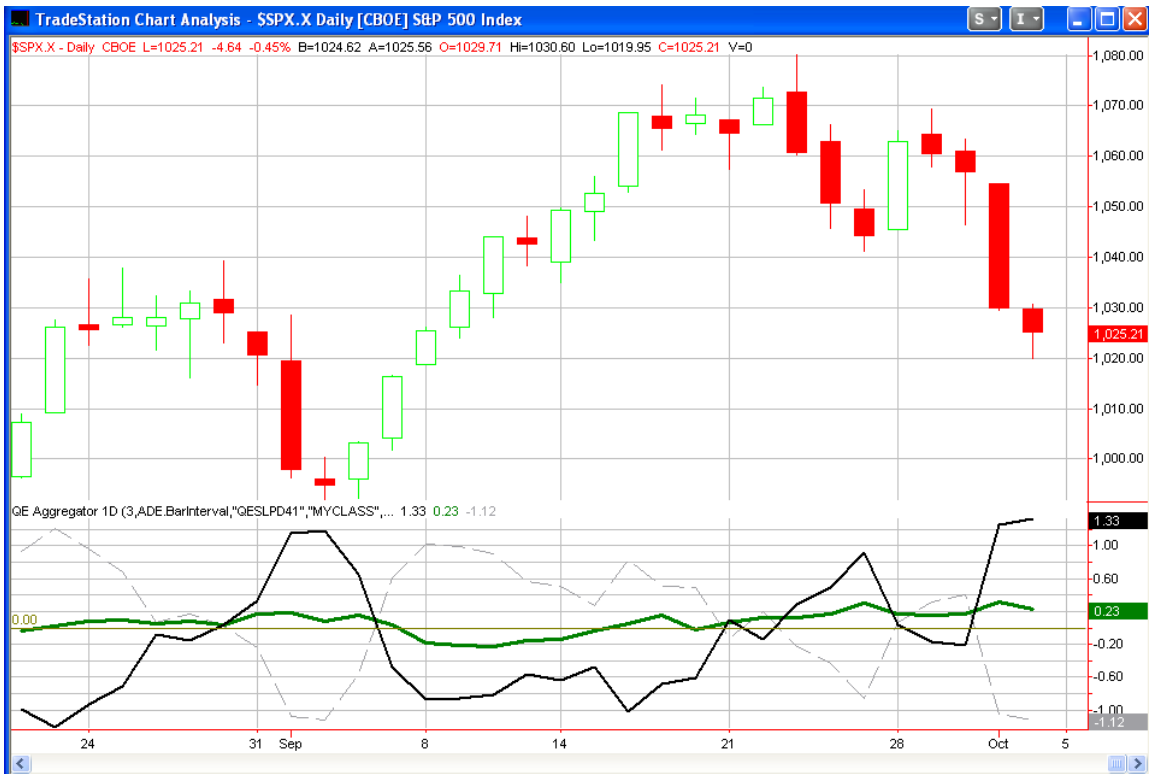
85% of instances posted a close above the entry price at some point in the next 5 days.

This study suggests a decent edge over the next week plus. One aspect of this study that I find particular appealing is that it has been consistent over time. Below is a profit curve using a 5-day exit strategy.



The consistent upward slope shown here is preferable to a jagged equity curve or one where most of the profits were made in a small number of trades.

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



Friday's action did little to change the configuration of the Aggregator chart. The green Aggregator line remains squarely above 0 as the active studies are all suggesting short-term upside. Meanwhile the black Differential line is illustrating the fact that the SPX has strongly underperformed expectations over the last few days. Oversold with positive expectations is short-term bullish configuration. The Aggregator System went long at Thursday's close, which is also when I began taking on exposure.

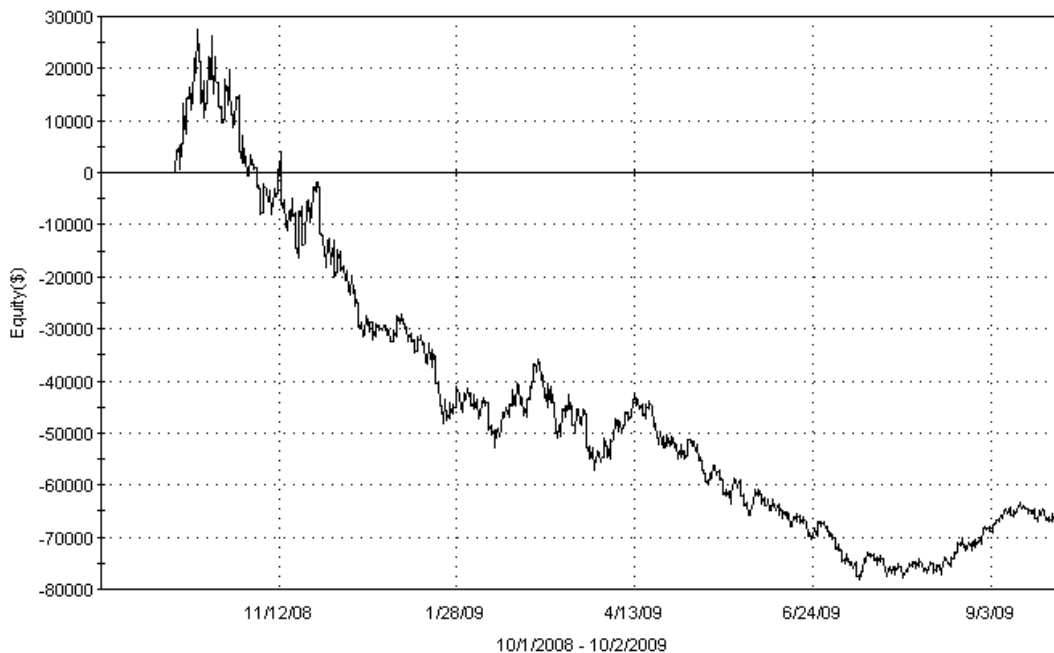
Should we get additional downside on Monday I will be looking to increase my long exposure.

Intermediate-term Outlook (2 weeks – 2 months)– updated 10/5 – slightly bullish

In last week's intermediate-term update I discussed the fact that the Trend vs. Chop chart had turned up over the last 3 months for the 1st time in 3 years. As a quick refresher the Trend vs. Chop chart looks at whether the market is following through on a daily bases or whether it is reversing. The chart is an equity curve of a simple strategy that goes long every up day and short every down day. Therefore a rising line illustrates a market whose moves are persisting from one day to the next. A declining line suggests the market is spending more energy chopping back and forth than following through. The dominant action over the last decade has been chop. Prior to that there was more of a tendency to see trendy behavior. For more detail on the Trend vs. Chart concept you may use this link:

<http://quantifiableedges.blogspot.com/search/label/Trend%20Vs.%20Chop>

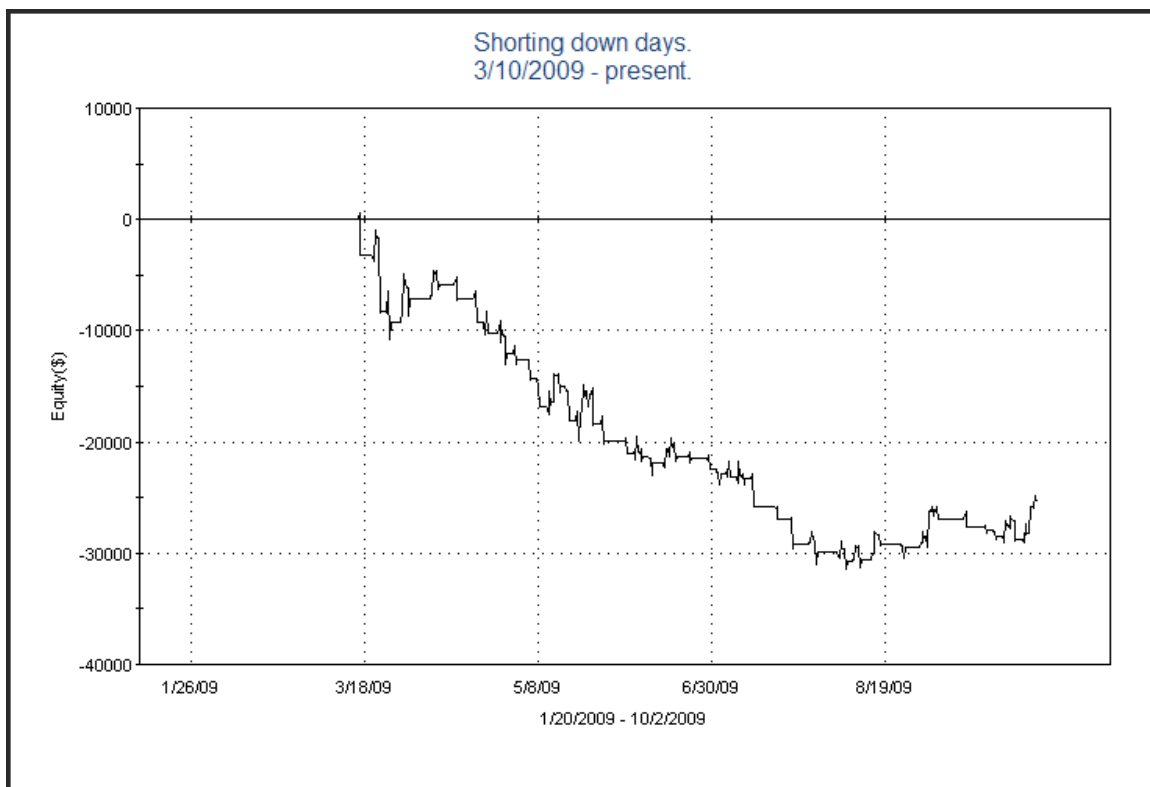
Below is a copy of the Trend vs. Chop chart from the website.



Two comments I had last week were 1) that the recent trendy behavior has made a difficult time for mean-reverting strategies and 2) I wasn't convinced it upturn was going to last. I didn't think it was time to break out strategies that rely on trendy day to day behavior. I received a few questions asking for more detail on my thinking here, so I thought I'd share a few more charts.

I've broken the above Trend vs. Chop chart down into two separate charts below. The first one looks at performance following down days and the second one looks at performance following up days. They both go back only as far as the March bottom. The primary follow through that has been seen in the last few months has been to the upside as the rally has been extremely strong.

First let's look at the market has done the day after a down day:



Until August down days were consistently met by up days. Since then it has been a little bit more of a crapshoot. This past week and a half we saw a little bit of a spike up as the market has had very few up days.

Now let's look at the performance following up days.



There's two periods of extreme follow through noted on this chart. The 1st one I wrote "expected action" next to. Prior to the March bottom I discussed numerous times that bounces from extremely oversold conditions tend to be especially powerful and persistent. You can see in the above chart how right off the bat shorts were punished and the market had a steep rally. I expected this and therefore was very wary of the short side during that time. The move that started in July I did not expect. From late July to mid-September the market rallied about 180 points. Such powerful rallies are extremely unusual when not coming immediately after a deeply oversold bottom. This caused a sharp rise in upside follow through.

Now if you look back to the 1st Trend vs. Chop chart you'll see that this incredibly strong rally, with persistence stronger than anything seen since 2000, has barely been able to make the primary Trend vs. Chop chart curl. We already saw how choppy the decline was over the last few years, so it would seem the biggest threat to the chop is a persistent uptrend. While the rally may or may not be over at this point, the odds of it continuing much longer at a pace that was seen over the July –September period seem remote. Hence the reason for my current expectation that chop will most likely begin to prevail soon enough.

With regards to the intermediate-term, I'll just note a few things here. First, the market is making a lower low after a lower high, which could be the start of downtrend. The S&P 500 is currently sitting right near its 50-day moving average. This could provide short-term support. A sharp move through it would be another sign of a downtrend. The VIX:VXV ratio is almost back to 1 for the 1st time in several months. Moves much above 1 are potentially bullish. Lastly, the Nasdaq continues to outperform the S&P. This is preferred for the bullish scenario. The uptrend may not be dead quite yet, but it remains in a precarious position.

Catapult and Capitulative Breadth Statistics

(Catapult Presentation Part 1) (Catapult Presentation Part 2)

Open Catapult Triggers

XRX 1/3 @ 7.68 – (filled @ \$7.32)

UTX 1/3 @ \$59.99 (filled at \$59.38)

New

UTX buy 1/3 @ \$59.63.

HON buy 1/3 @ \$35.60

Catapult for ETF's Trades

none

Broad Market Large Cap CBI –4(XRX,UTX-2, HON)

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 – buy ¼ index position @ \$101.50 limit ON OPEN. If not filled on open, cancel order and look to buy @ \$101.75 limit ON CLOSE. Based on the short-term market outlook above. I'm looking for a favorable entry to add the 3rd lot.

UTX – buy 1/3 @ \$59.63. New Catapult trigger listed above.

HON – buy 1/3 position @ \$35.60. New Catapult trigger listed above.

Traders should recall that while the Catapults have done very well, they are also very volatile and they are traded without stops. Consider your position sizes carefully if you look to trade a catapult.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Pr	% Gain/Lo	Stop	Notes
IBB	10/1/2009	\$81.21	\$78.64	-3.16%		system 80609
SPY(1/4)	10/1/2009	\$103.00	\$102.49	-0.50%		Aggregator
SPY(1/4)	10/2/2009	\$102.49	\$102.49	0.00%		Aggregator
XRX(1/3)	10/2/2009	\$7.32	\$7.32	0.00%		Catapult
UTX(1/3)	10/2/2009	\$59.38	\$59.63	0.42%		Catapult

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