

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 9, 2009

Volume 2 Issue 194

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 7, 2009 | 2 75% Up Issue Days while SPX>200ma | 1-4 days | Bullish | 2.50% |
| 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 | |

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

Short-term Outlook – updated 10/9

The Bottom Line

Consistent upward strength is failing to create substantial edges the last few days. Expectations are marginally bullish based on Tuesday night's breadth study. With the market now up 4 days in a row and near the top of its recent range, risk/reward isn't terribly favorable. Therefore the outlook remains neutral.

The Evidence

A fairly sizable gap up led to a lot of wiggling and not much else. The SPY opened and closed at nearly the same level, leaving a doji bar. The major indices all closed higher between 0.5% and 1%. Breadth was positive but not extreme. The NYSE Up Issues % came in at 73% and the Up Volume % was 75%. Total volume rose but was still only about average.

It's been an interesting few days. While the market has continued to march higher, it's yet to provide compelling evidence of an immanent reversal. Some traders may view the doji today as bearish, yet I was unable to find strong evidence to back that up. I studied doji's a few weeks ago in the 9/18/09 letter. Below is an excerpt:

For these tests I defined a doji as a bar where the difference between the open and the close was less than 10% of the daily range. So if today's high – low was \$1, then the difference between the open and the close would need to be less than \$0.10 to qualify.

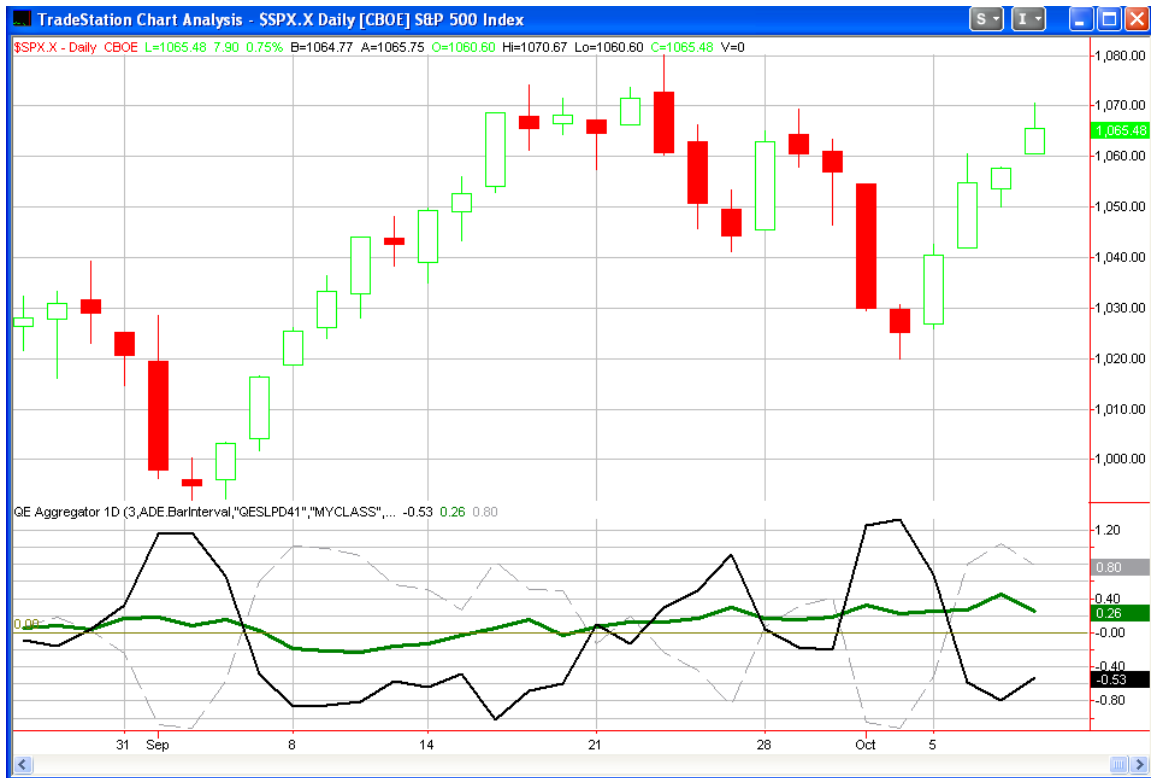
I was unable to find any substantial edges from examining these bars in the SPY. What I did find interesting is that they tended to be more suggestive of a reversal when prices were less extreme. Below is one study that illustrates this.

| Doji occurs in SPY while it makes an X-day intraday high. Buy on close. Sell 2 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 |
| 60 | 2,879.60 | 63 | 34 | 29 | 53.97 | 893.88 | -948.70 | 0.94 | 1.10 | 45.71 |
| 50 | 2,394.64 | 64 | 34 | 30 | 53.13 | 893.88 | -933.24 | 0.96 | 1.09 | 37.42 |
| 40 | 2,325.55 | 71 | 37 | 34 | 52.11 | 886.81 | -896.66 | 0.99 | 1.08 | 32.75 |
| 30 | -750.51 | 74 | 38 | 36 | 51.35 | 889.00 | -959.23 | 0.93 | 0.98 | -10.14 |
| 20 | -5,527.91 | 87 | 42 | 45 | 48.28 | 885.71 | -949.51 | 0.93 | 0.87 | -63.54 |
| 10 | -20,036.39 | 110 | 50 | 60 | 45.45 | 926.30 | -1,105.85 | 0.84 | 0.70 | -182.15 |

Here we see a doji at a 10-day high is more likely to lead to a short-term reversal than a doji at a 50-day high. In fact, as you move from shorter-term highs to longer-term highs the downside edge dissipates and reverses.

Tonight I looked at some additional situations such as doji's occurring when the market has closed higher at least 3 days in a row. Results weren't consistent and they didn't suggest an edge.

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



Little change once again in the Aggregator chart. Expectations remain positive as there has been a dearth of bearish studies despite the run-up. This is illustrated by the green Aggregator line. The black Differential line is showing the SPX remains overbought versus expectations. Overbought with positive expectations is basically a neutral scenario as risk/reward isn't great.

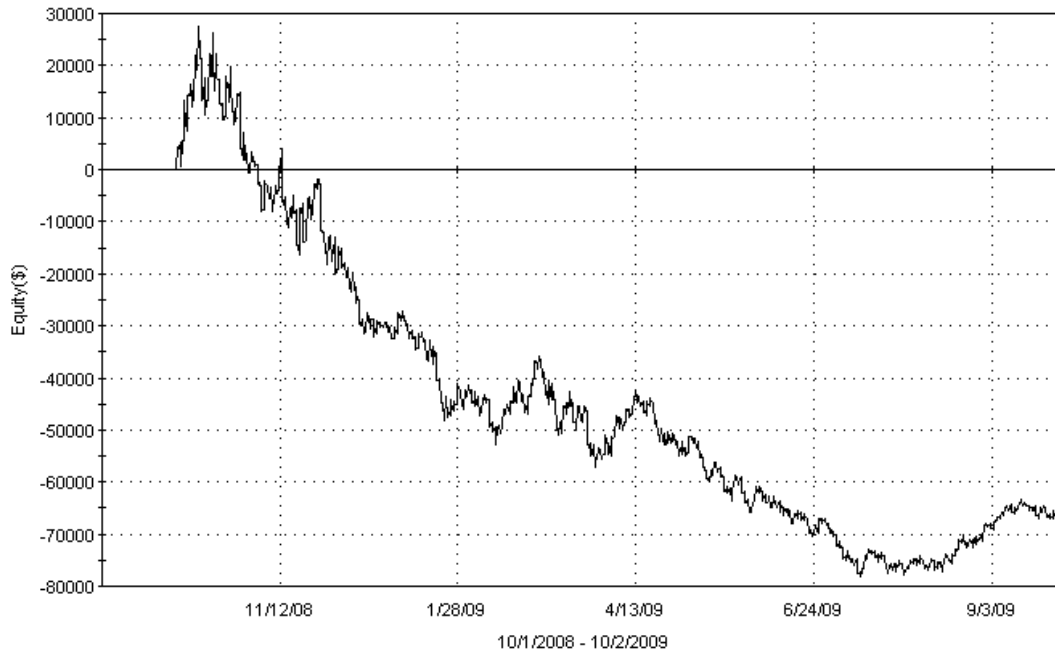
Not only am I seeing a lack of evidence from the extremely small list of studies right now, but the number of triggers on the systems page is also lacking. Situations like this rarely last for long. Edges do emerge. I believe patience is important. I am not looking to add exposure yet.

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>

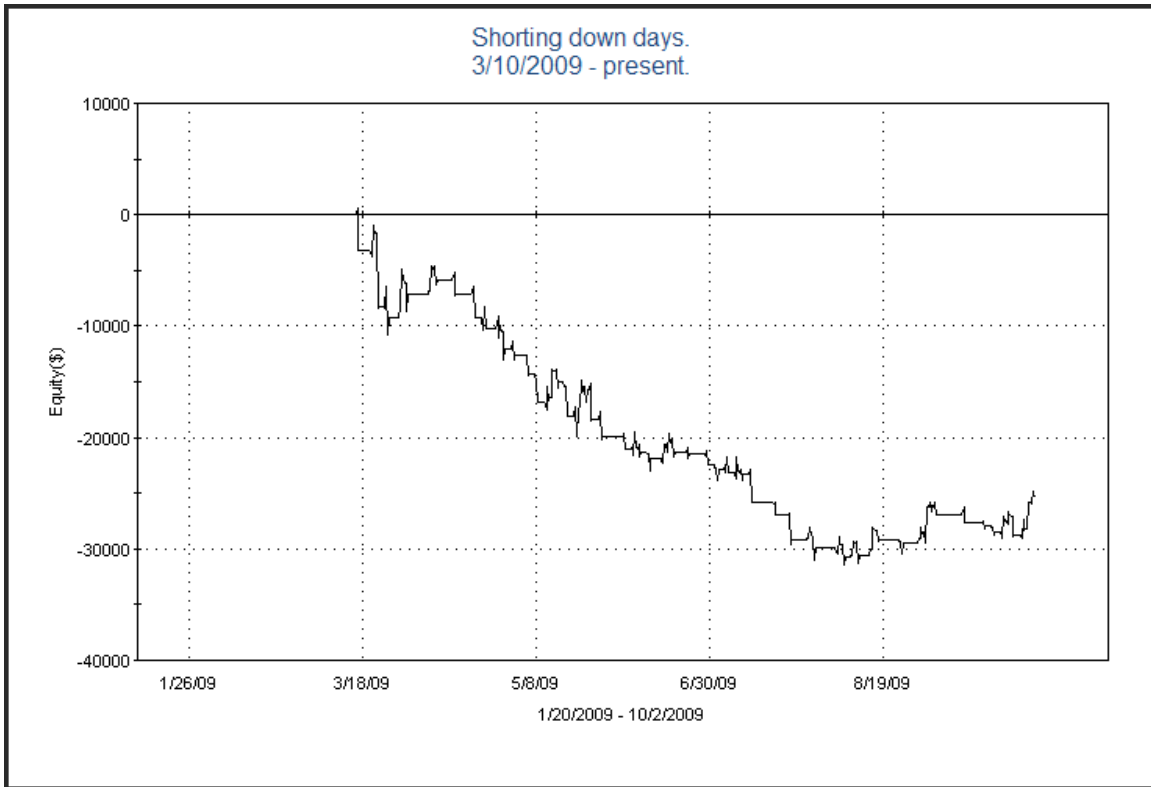
Below is a copy of the Trend vs. Chop chart from the website.



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.

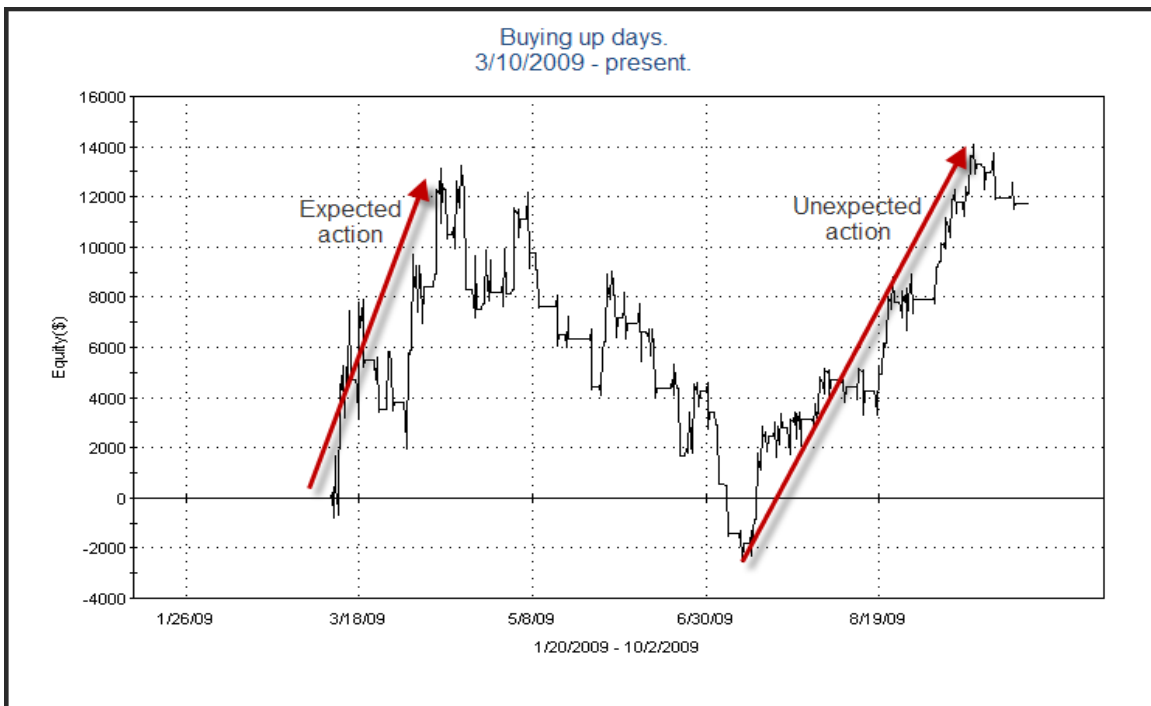
I've broken the above Trend vs. Chop chart down into two separate charts below. The first one looks at performance following down days and the second one looks at performance following up days. They both go back only as far as the March bottom. The primary follow through that has been seen in the last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

none

Catapult for ETF's Trades

none

Broad Market Large Cap CBI -1(XRX)

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 – Without strong conviction I'd prefer to wait for a better entry point than to take pot shots.

Active Trades Table

| Symbol | Entry Date | Entry Price | Current Pr | % Gain/Lo | Stop | Notes |
|---------|------------|-------------|------------|-----------|--------|----------------------|
| IBB | 10/1/2009 | \$81.21 | \$79.13 | -2.56% | | system 80609 |
| XR(1/3) | 10/2/2009 | \$7.32 | \$7.61 | 3.96% | \$7.15 | sold on close |

It was a good small cluster of Catapult trades as all 4 of them have now closed out positively.

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