

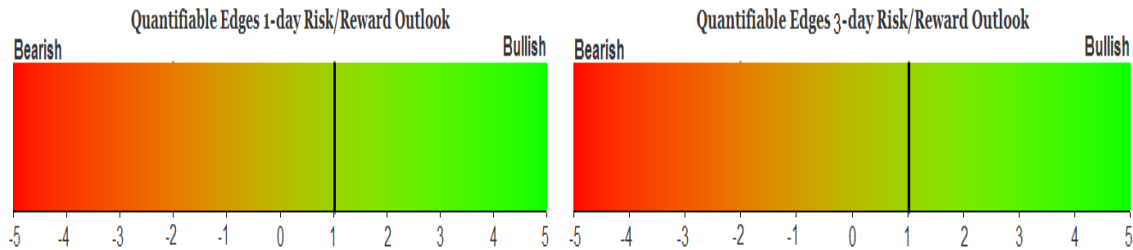
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 12, 2009

Volume 2 Issue 195

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 12, 2009	SPX 5 higher closes over 200ma.	1-5 days	Bullish	1.15%
October 12, 2009	Columbus Day after up week	1 day	Bullish	
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 10/12

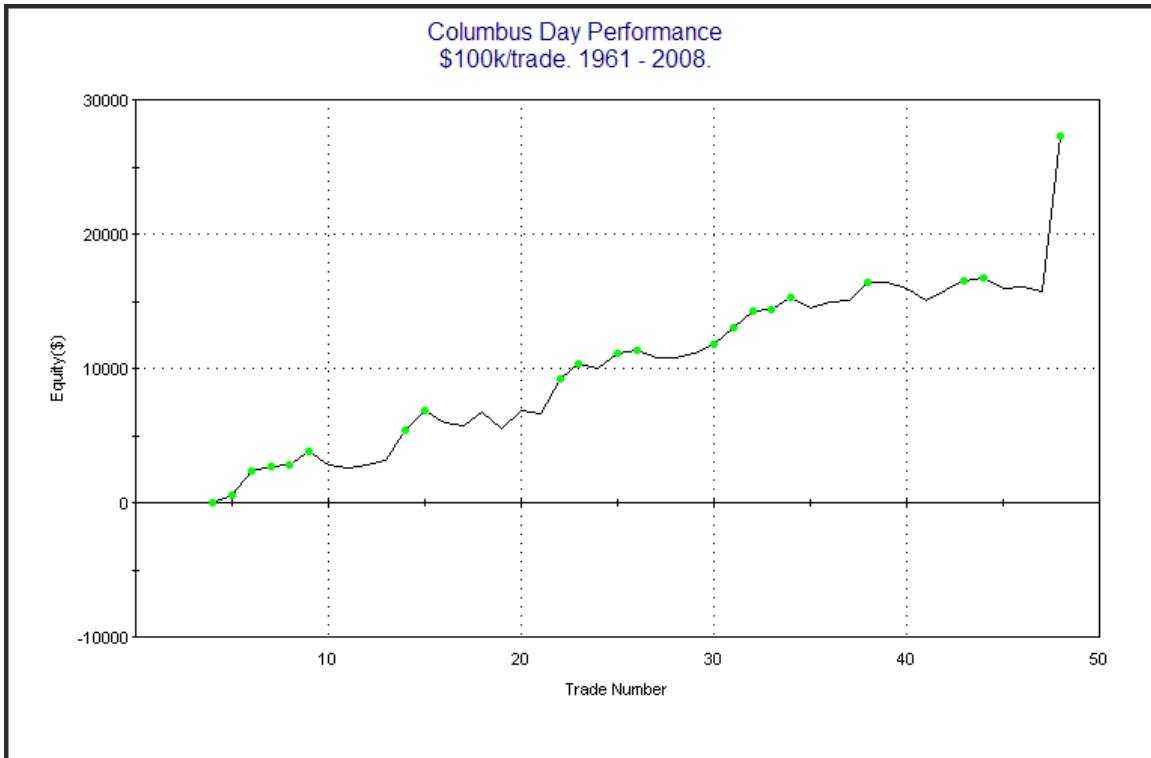
The Bottom Line

Going into the new week we have a combination of momentum and seasonal strength suggesting further gains are more likely than a pullback. The market is quite overbought at this point, though. This creates a risk/reward scenario that isn't substantially favorable. I'm on the sidelines awaiting a stronger edge.

The Evidence

The market opened fairly flat and traded sideways for most of the day. A gentle rally in the last 90 minutes led to decent gains for the major indices. The Nasdaq closed up 0.7% and the S&P up 0.6%. Breadth was mildly positive. The NYSE Up Issues % and Up Volume % both came in at 60%. While the market made a higher high, NYSE new 52-week high's contracted. Volume came in at the lightest level in nearly 2 weeks.

Some of the light volume could be attributed to it being Columbus Day weekend. While the markets are open on Monday, banks, schools, and government offices are closed. In past years, with the bond market closed, the stock market has done quite well on Columbus Day. Last year Columbus Day saw a gain in the S&P of over 11%. Many traders will likely recall it was the week prior that the market suffered its multi-day crash. Stats associated with Columbus Day are now a bit skewed thanks to 2008. Below is a chart from 1961 – present that shows Columbus Day performance.



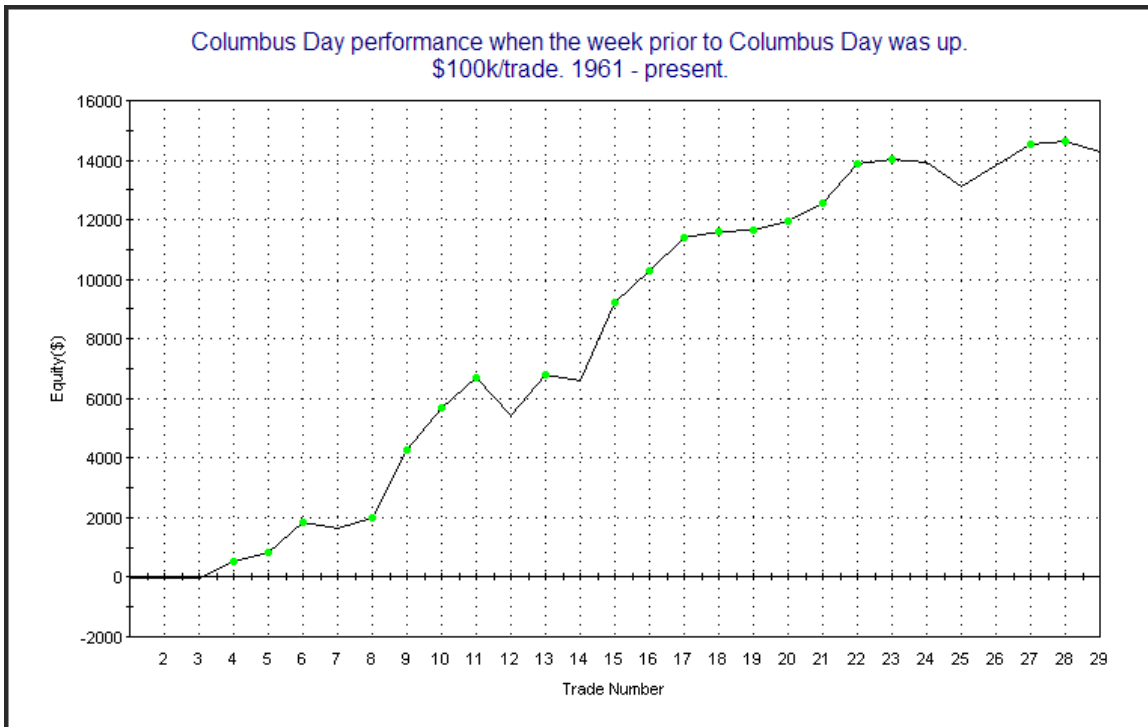
As you can see it has generally been a positive holiday for the market.

Of course the market didn't crash this past week the way it did a year ago. It rose every day. I decided to also look at Columbus Days when the market has risen the week before. Below are some stats of those days:

Columbus Day performance when the week prior to Columbus Day was up.
\$100k/trade. 1961 - present.

TradeStation Performance Summary		Collapse ^	
All Trades			
Total Net Profit	\$14,299.68	Profit Factor	5.94
Gross Profit	\$17,194.52	Gross Loss	(\$2,894.84)
Total Number of Trades	29	Percent Profitable	72.41%
Winning Trades	21	Losing Trades	7
Even Trades	1		
Avg. Trade Net Profit	\$493.09	Ratio Avg. Win:Avg. Loss	1.98
Avg. Winning Trade	\$818.79	Avg. Losing Trade	(\$413.55)
Largest Winning Trade	\$2,609.46	Largest Losing Trade	(\$1,248.22)

I've circled some of the more impressive stats here. With more than 7 out of 10 trades profitable and winners nearly twice the size of losers, the profit factor is fairly gaudy. It appears positive momentum from the prior week has followed through nicely on Columbus Day. Below is the profit curve.



We see a fairly steady upslope here. Combined with the stats above I'd say Columbus Day does seem to come with a true upside edge.

Notable from the charts page is that the 3/10 offset Historical Volatility dropped all the way to 0.15 on Friday. We've seen in the past that [moves below 0.25 often precede a sharp move](#). In the 7/29/2009 Letter I looked at other instances where historical volatility

(HV) was contracted and the market was short-term overbought with the 3-day RSI over 70. When I conducted that test I did not separate the results by looking at long-term uptrends vs. long-term downtrends. At the time the market was extremely overbought, it had recently rallied from its 200ma and the 200ma had yet to curl upwards. Hence the reasons for ignoring it. That was probably a poor decision at the time. Tonight I elected to break it out further and what you'll see are vast differences depending on whether the market is in an uptrend or a downtrend. First I've updated the original test that didn't take into account the 200ma.

SPX 3/10 offset HV closes < 0.25 and RSI(3) > 70. Buy on close. Sell X days later. \$100k/trade. 2000 - 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	-25,730.95	54	27	27	50.00	1,238.77	-2,191.76	0.57	0.57	-476.50
4	-28,381.94	57	25	32	43.86	1,040.96	-1,700.19	0.61	0.48	-497.93
3	-39,722.20	57	22	35	38.60	835.73	-1,660.24	0.50	0.32	-696.88
2	-25,761.95	62	25	37	40.32	740.64	-1,196.70	0.62	0.42	-415.52
1	-16,231.99	77	35	42	45.45	682.19	-954.97	0.71	0.60	-210.81

Here it would appear that there is a decent downside edge – especially over the 1st three days. But now let's break it down. Next I'll show performance during times when the market was trading below its 200ma.

SPX 3/10 offset HV closes < 0.25 and RSI(3) > 70. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 2000 - 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	-31,535.30	22	8	14	36.36	1,565.25	-3,146.95	0.50	0.28	-1,433.42
4	-30,491.15	23	7	16	30.43	1,088.58	-2,381.95	0.46	0.20	-1,325.70
3	-38,970.59	23	5	18	21.74	861.97	-2,404.47	0.36	0.10	-1,694.37
2	-26,563.61	25	5	20	20.00	915.65	-1,557.09	0.59	0.15	-1,062.54
1	-16,739.15	29	10	19	34.48	1,234.20	-1,530.59	0.81	0.42	-577.21

Here the downside edge appears very strong. Only about 20% winners and an average 3-day return of nearly -1.7%. It would seem much of the downside edge appears to occur when the market is experiencing a long-term downtrend.

Let's now look at times the market is above its 200ma.

SPX 3/10 offset HV closes < 0.25 and RSI(3) > 70. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 2000 - 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	3,517.00	33	19	14	57.58	1,101.30	-1,243.41	0.89	1.20	106.58
4	2,109.21	34	18	16	52.94	1,022.45	-1,018.43	1.00	1.13	62.04
3	-751.61	34	17	17	50.00	828.01	-872.22	0.95	0.95	-22.11
2	801.66	37	20	17	54.05	696.89	-772.72	0.90	1.06	21.67
1	507.16	48	25	23	52.08	461.38	-479.45	0.96	1.05	10.57

Results here are actually mildly green. I don't see a clear upside edge here, but certainly there is no advantage to playing the short side.

We've seen this with several studies in the last few weeks. Downside edges are a bit harder to come by when the market is in a long-term uptrend. Here's one more example of a bearish study that appeared in Friday's Quantifinder that isn't as bearish as it first appeared.

Here's the original study, from the 6/29/09 blog:

QQQQ posts the lowest volume in 20 days and close > 10ma. Buy on close. Sell X days later. \$100k/trade. 12/31/99 - 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	-36,296.07	63	35	28	55.56	3,231.77	-5,336.00	0.61	0.76	-576.13
9	-45,372.69	65	37	28	56.92	2,651.63	-5,124.39	0.52	0.68	-698.04
8	-28,437.56	67	34	33	50.75	3,301.03	-4,262.80	0.77	0.80	-424.44
7	-51,851.24	68	35	33	51.47	2,519.50	-4,243.45	0.59	0.63	-762.52
6	-37,931.24	70	32	38	45.71	2,869.40	-3,414.52	0.84	0.71	-541.87
5	-56,143.30	73	34	39	46.58	2,291.03	-3,436.88	0.67	0.58	-769.09
4	-52,287.84	77	36	39	46.75	1,932.91	-3,124.94	0.62	0.57	-679.06
3	-37,356.00	83	38	45	45.78	1,792.48	-2,343.78	0.76	0.65	-450.07
2	-58,993.38	87	38	49	43.68	1,684.35	-2,510.18	0.67	0.52	-678.08
1	-29,094.05	93	44	49	47.31	1,181.28	-1,654.49	0.71	0.64	-312.84

Low QQQQ volume in a short-term uptrend appears to be short-term bearish. What if we again filter by the 200ma?

**QQQQ posts the lowest volume in 20 days and close > 10ma. Close > 200ma.
Buy on close. Sell X days later. \$100k/trade. 12/31/99 - 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: WinLoss Ratio	All: ProfitFactor	All: Avg Trade
10	-7,843.09	35	19	16	54.29	2,778.09	-3,789.17	0.73	0.87	-224.09
9	-8,387.25	36	21	15	58.33	2,534.43	-4,107.35	0.62	0.86	-232.98
8	-1,964.52	37	19	18	51.35	3,143.54	-3,427.32	0.92	0.97	-53.10
7	-4,216.08	38	19	19	50.00	2,764.36	-2,986.26	0.93	0.93	-110.95
6	7,519.26	38	18	20	47.37	2,572.60	-1,939.38	1.33	1.19	197.88
5	-6,091.80	39	19	20	48.72	1,757.10	-1,973.83	0.89	0.85	-156.20
4	1,650.73	42	23	17	54.76	1,432.89	-1,841.51	0.78	1.05	39.30
3	5,597.31	45	24	21	53.33	1,685.33	-1,659.56	1.02	1.16	124.38
2	2,162.71	48	25	23	52.08	1,276.66	-1,293.65	0.99	1.07	45.06
1	3,200.05	51	28	23	54.90	1,013.61	-1,094.83	0.93	1.13	62.75

As you can see the fact that the market is above the 200ma turns a downside edge into a crashshoot.

Of course the market is overbought after rising for 5 days in a row. At some point it is going to pull back here. Trying to pick that spot can be a difficult proposition in and uptrend and it has been especially difficult over the last 6 months. Below is a long-term study that looks at returns after a 5-day run while the SPX > 200ma.

**SPX posts 5 higher closes. Close > 200ma.
Buy on close. Sell X days later. \$100k/trade. 1960 - 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: WinLoss Ratio	All: ProfitFactor	All: Avg Trade
10	104,917.59	182	122	60	67.03	1,702.03	-1,712.17	0.99	2.02	576.47
9	90,473.89	185	114	71	61.62	1,744.90	-1,527.39	1.14	1.83	489.05
8	74,757.48	189	119	70	62.96	1,544.56	-1,557.80	0.99	1.69	395.54
7	82,898.22	195	125	69	64.10	1,471.78	-1,464.84	1.00	1.82	425.12
6	66,805.32	198	124	73	62.63	1,326.08	-1,337.38	0.99	1.68	337.40
5	67,713.38	198	128	70	64.65	1,207.54	-1,240.74	0.97	1.78	341.99
4	44,682.85	198	120	78	60.61	1,057.30	-1,053.75	1.00	1.54	225.67
3	31,066.29	198	118	80	59.60	894.11	-930.48	0.96	1.42	156.90
2	11,989.21	198	115	83	58.08	707.14	-835.33	0.85	1.17	60.55
1	4,470.33	198	109	89	55.05	449.18	-499.89	0.90	1.10	22.58

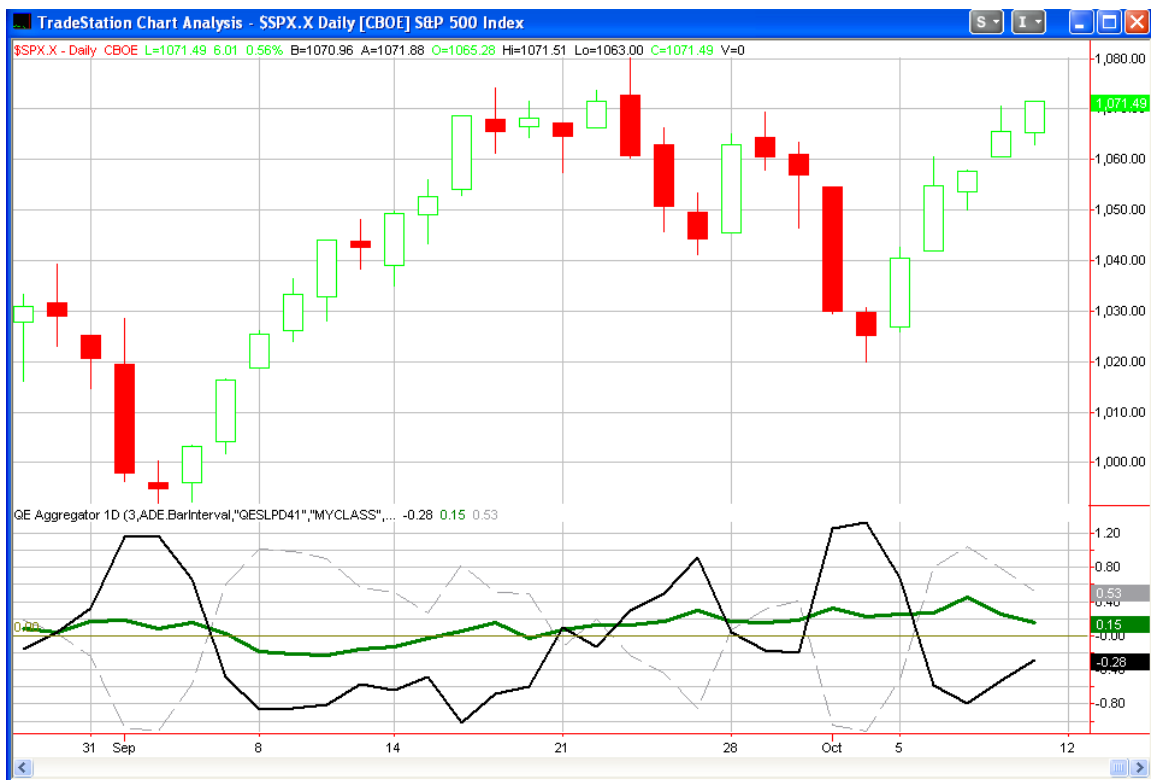
What we see here is a mild upside edge. I'll continue to look for downside edges, and will not hesitate to short if I see one. They're just more difficult to find in an uptrend. The more consistent opportunities are typically in buying pullbacks.

On Tuesday's close last week I exited my long SPY positions that I'd taken on Thursday and Friday of the previous week. I realized some nice gains, though I certainly could have done better if I'd held on. A subscriber asked me why I didn't since I commented at the time that "I expected further upside over the next few days". The reason I didn't hold was that the market was becoming overbought. The Aggregator System Document, which can be found on the [Systems page](#) goes into this in some detail. The black

Differential line on the Aggregator chart measures overbought/oversold versus expectations. By utilizing this line in conjunction with the green Aggregator line, performance is greatly improved. Gains are more substantial, drawdown is less, and the amount of time exposed to the market is greatly decreased. The reason I got out on Tuesday is the same reason I interpret the Aggregator chart below as a neutral configuration. While the studies are suggesting additional upside, it's already overdone and therefore risk/reward isn't favorable in the short-term.

Of course I try and allow my approach to evolve with market conditions. One potential reason for me to change this approach down the road would be if I continue to see the Trend vs. Chop chart rise. Such a thing could suggest an edge in being long when the market is overbought and short when the market is oversold.

The **Aggregator** chart is updated below.



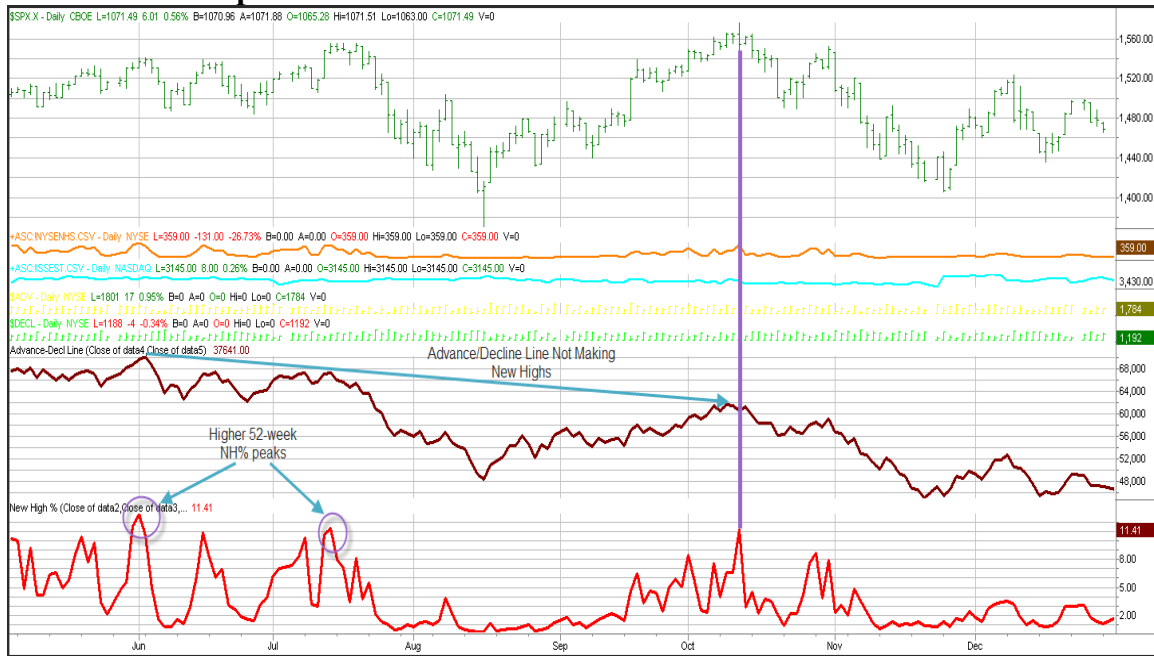
As I mentioned above the green Aggregator line remains squarely above 0 while the black Differential line remains squarely below it. We are overbought with positive expectations. Both lines on the same side of 0 is preferable for taking on exposure. My index exposure is flat and it will stay that way until I perceive a tradable edge.

Intermediate-term Outlook (2 weeks – 2 months)– updated 10/12 – somewhat bullish

Five up days last week has not done anything to damage the idea that the intermediate-term trend is up. I don't see a top just yet. A few years ago, Lowry's did a study on market tops .For those who would like to purchase it, it may be obtained here: http://www.lowrysreports.com/research_studies.cfm The basic finding of the study was

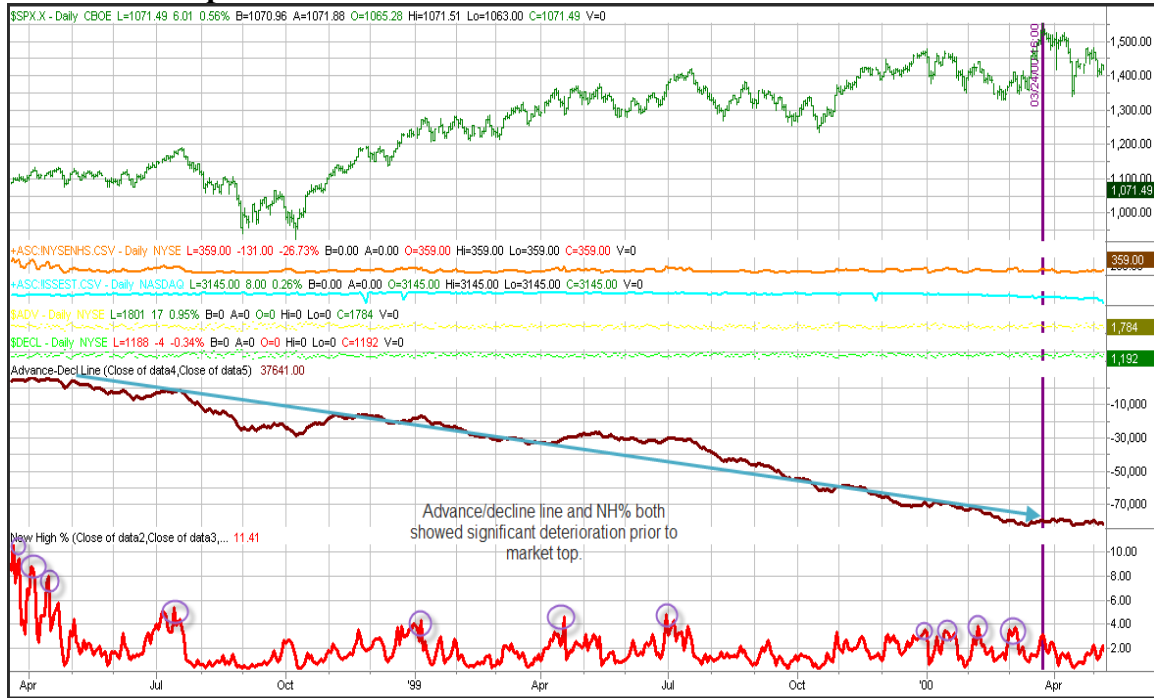
that breadth has consistently topped out before the market. They primarily looked at 52-week new highs and the Dow Jones Industrial Average. I decided to examine this concept this weekend. I used the S&P 500 rather than the DOW. In the charts below the top panel is the S&P 500. The bottom panel is the % of NYSE stocks that are hitting 52-week highs. The panel just above the bottom panel is the NYSE advance/decline line. My breadth data only goes back to 1970, so that's as far as these charts go. Instances are lower than I'd prefer for a complete study, but you'll note there is definitely an underlying theme to the instances that do exist. The 1st chart is the 2007 top.

October 2007 Top



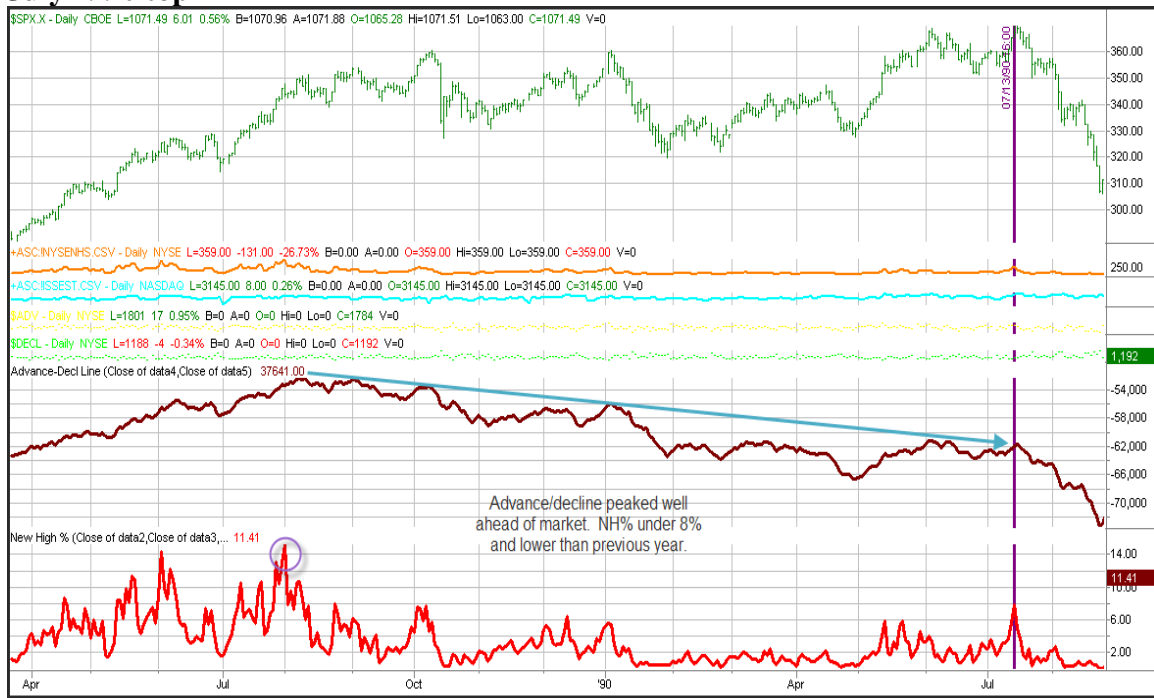
What I note above is a deteriorating a/d line and new highs that are failing to reach prior levels. Next is the 2000 top.

March 2000 top



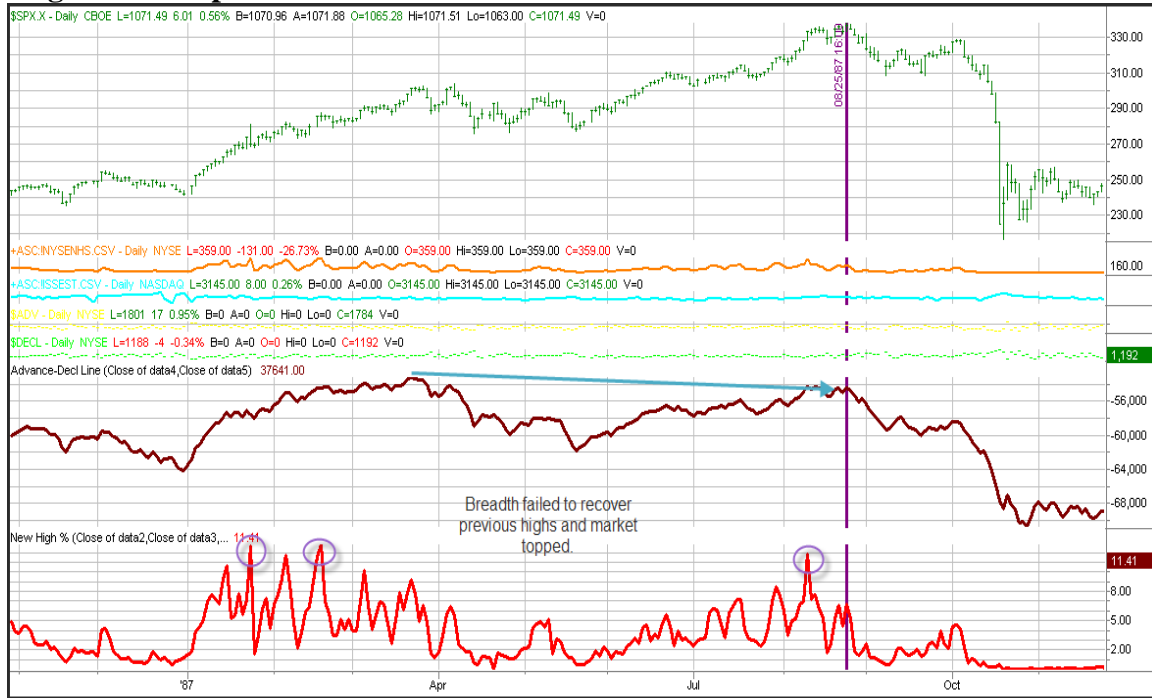
This market was thinning for years before topping. A rather extreme case here. Next is July of 1990.

July 1990 top



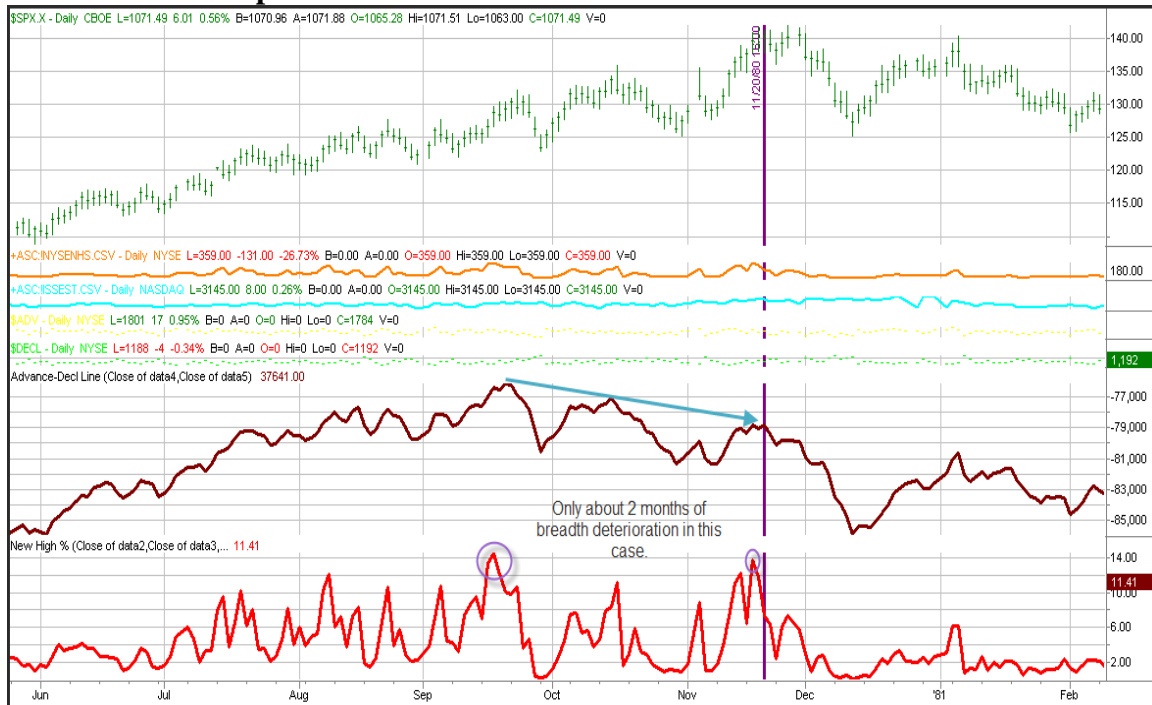
More of the same here. A muted NH % accompanied by a declining a/d line. Now for 1987.

August 1987 top



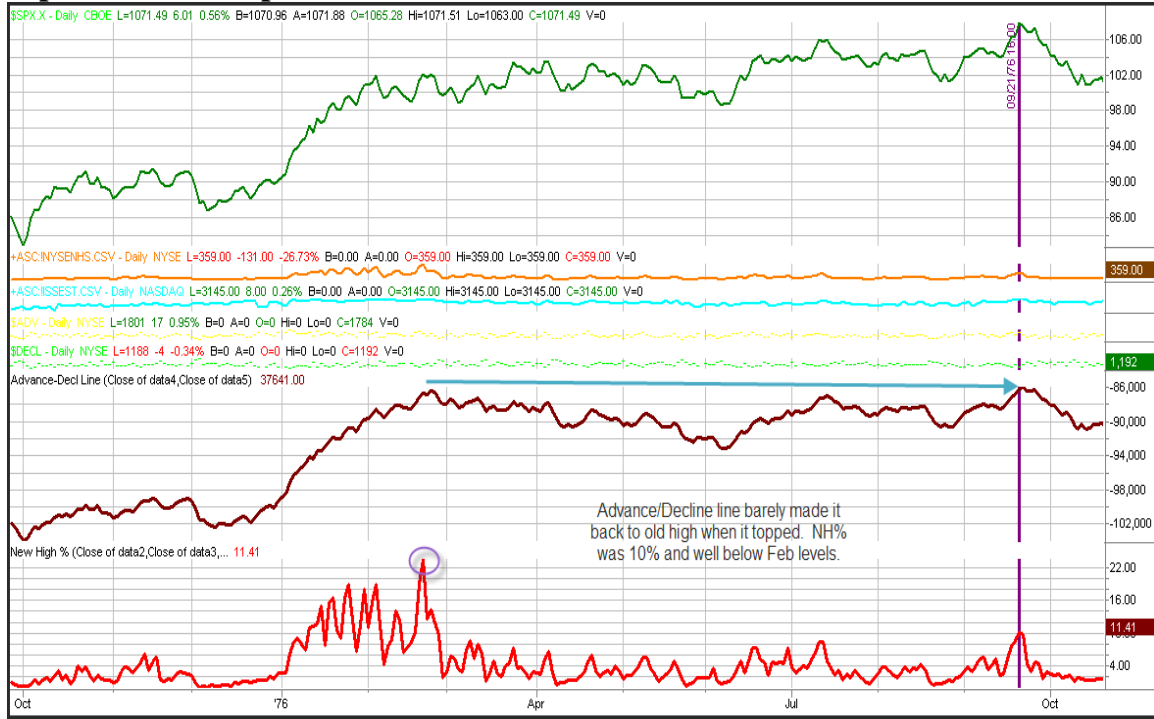
Here again we see a rising market that is accompanied by worsening breadth. Now for November of 1980.

November 1980 top



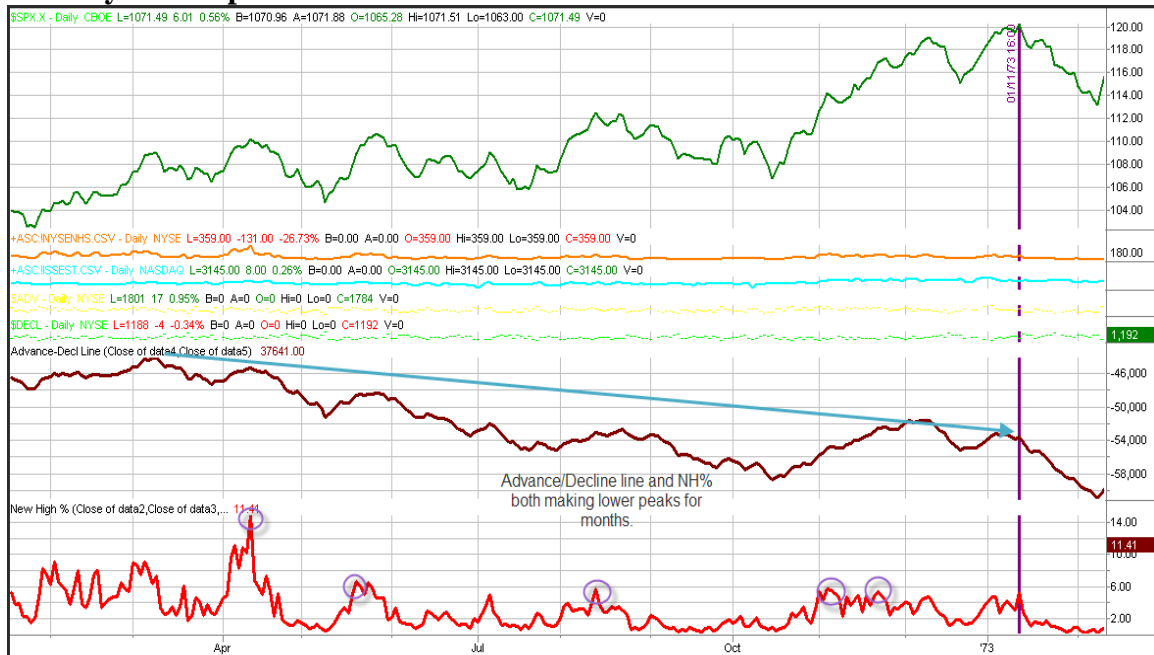
This one is less extreme than some of the others. The breadth decline only occurred over the course of a couple of months before the market topped out. Here's September 1976.

September 1976 top



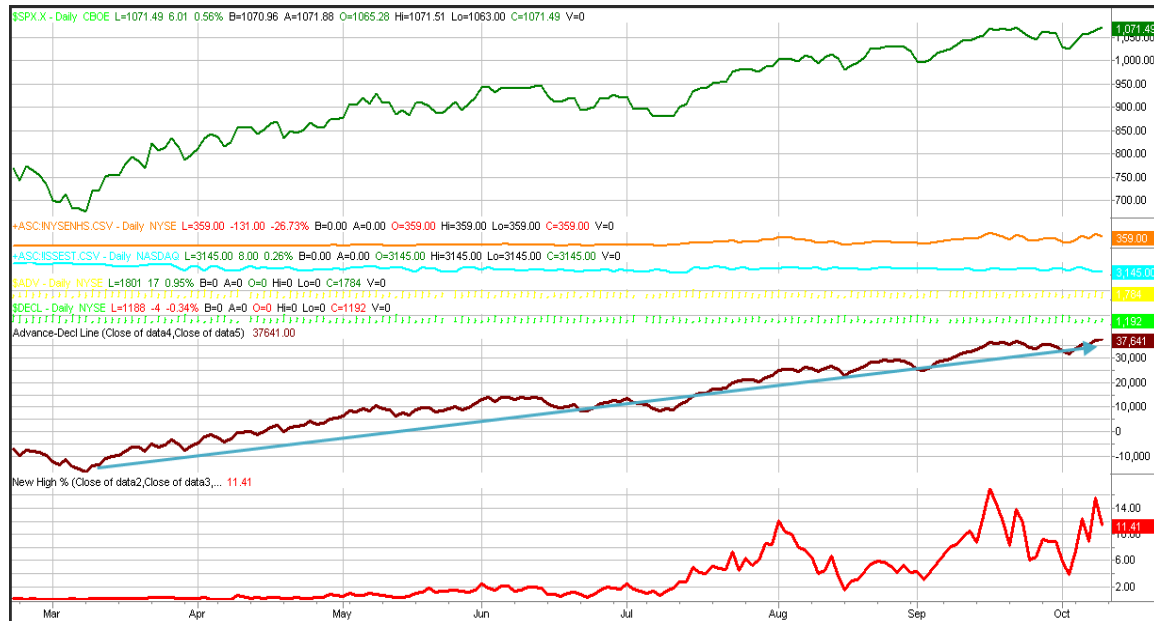
This was the only instance where the a/d line managed to make a new high. It wasn't by much. It didn't last long. It also wasn't confirmed by the NH %. Lastly let's look at January 1973:

January 1973 top



More of the same here. A weakening a/d line and consistently lower peaks in the 52-week NH%. So now that we've seen what all the major tops since 1970 have looked like, let's take a look at the current situation:

Chart as of 10/9/2009



The a/d line hit a new high on Friday. New highs dipped a little and aren't quite at the September high, but it would seem to be quite a stretch to say we're seeing a weakening of breadth that could signal an impending top.

You could argue that the difference between now and all those other tops is that they were at significant highs. The current market is well below the levels it was at 2 years ago. And if there is one thing the last 2 years has taught us it's that just because something has rarely or never happened before, doesn't mean it can't now. That said, the market has run up about 60%. This suggests any top leading to a substantial decline could be considered major. And while history isn't perfect, it's served as a nice guide for Quantifiable Edges so far. It's not advisable to bet against it. I'll continue to watch for weakening breadth before becoming bearish for the intermediate-term.

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 – No strong conviction for the index trades. Additionally, the system triggers page came up blank for the 1st time in about 2 months.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Pr	% Gain/Lo	Stop	Notes
IBB	10/1/2009	\$81.21	\$79.70	-1.86%		sel Mon on close>\$79.68

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