

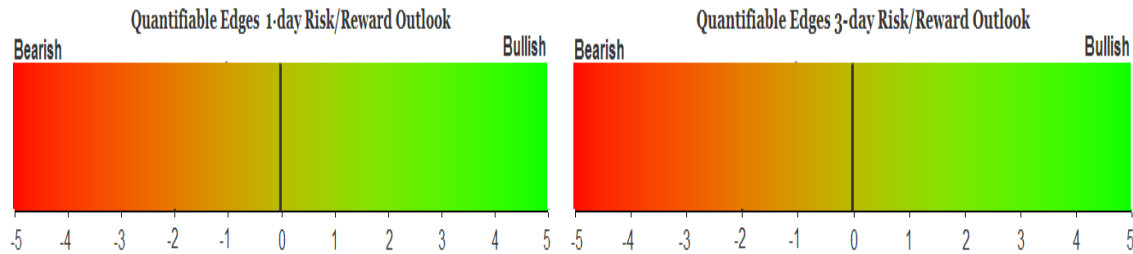
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 19, 2009

Volume 2 Issue 200

Market Overview



Tonight's Research Points

- The net expectation from the studies remains slightly bullish. Despite Friday's drop, SPX has still outperformed expectations over the last few days. This is leaving the Aggregator chart in a neutral state.
- Strong, high-volume drops from 10-day highs have typically come with short-term bearish follow through (1-3 days). This is true even during long-term uptrends.
- The VIX:VXV ratio again falling below 0.9 has been a bearish omen in the past – but not this last few months.
- The Nasdaq/S&P 500 Relative Strength indicator now shows the S&P is leading. This has historically led to inconsistent market conditions in which the market has struggled to make much headway.

Short-term Outlook – updated 10/19

The Bottom Line

After a very strong run of nearly two weeks the market finally pulled back more than 0.5% for the first time since October 1st. There were some indications that the pullback may worsen. Bearish indications from Friday weren't enough to turn net expectations negative, though. With the market still a bit on the overbought side, I'm looking at a neutral bias going into Monday.

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 19, 2009	Big drop from 10-high above 200	1-3 days	Bearish	-1.40%
October 15, 2009	Breakout above 50-day high	1-5 days	Bullish	1.80%
October 14, 2009	SPX 5 up then down while > 200ma	1-9 days	Bullish	2.10%
Active - Long Term				
October 19, 2009	VIX:VXV drops below 0.9	2-5 months	Bearish	
Dropped Tonight				
September 14, 2009	Nasdaq/S&P Lead/Lag Model		Bullish	
October 15, 2009	Gap & Go to new high	1-2 days	Bearish	-1.30%

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

The Evidence

After gapping down and selling off further early in the morning the market made its low after about 45 minutes. It then spent the rest of the day chopping sideways and upwards. It closed near where it opened. The S&P and Nasdaq both closed down about 0.8%. Breadth was strongly negative. The NYSE Up Issues % was 34% and the Up Volume % was 24%. Volume was the highest in two weeks on the NYSE.

While a fair amount of red showed up on the Quantifinder, the setups weren't as bearish as might appear at first glance. Gold subscribers received an email to this effect as we approached the close on Friday. Of the 3 short-term bearish studies listed, the only one whose results actually appear bearish based on the current market condition is the following study from the May 8, 2009 Letter. (I've updated the stats below.)

Yesterday SPX closed at a 10-day high. Today it suffers its largest drop in 10 days on the highest NYSE volume in 10 days.										
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
5	-11,214.20	36	16	20	44.44	1,725.12	-1,940.80	0.89	0.71	-311.51
4	-16,408.95	36	13	23	36.11	1,718.20	-1,684.59	1.02	0.58	-455.80
3	-15,681.10	36	14	22	38.89	1,058.42	-1,386.32	0.76	0.49	-435.59
2	-7,862.15	36	14	22	38.89	872.04	-912.31	0.96	0.61	-218.39
1	-398.92	36	18	18	50.00	584.44	-606.60	0.96	0.96	-11.08

I've shown repeatedly over the last couple of months how some studies that don't have a long-term trend filter may look vastly different if you take the long-term trend into consideration. I therefore added a long-term trend filter to the above test to see what affect that would have. Those results are below:

Yesterday SPX closed at a 10-day high. Today it suffers its largest drop in 10 days on the highest NYSE volume in 10 days. 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: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-1,822.05	30	15	15	50.00	1,832.77	-1,954.24	0.94	0.94	-60.74
4	-6,156.87	30	13	17	43.33	1,718.20	-1,676.08	1.03	0.78	-205.23
3	-8,978.01	30	13	17	43.33	1,131.71	-1,393.55	0.81	0.62	-299.27
2	-5,469.76	30	13	17	43.33	923.47	-1,027.93	0.90	0.69	-182.33
1	-2,038.65	30	14	16	46.67	538.00	-598.17	0.90	0.79	-67.96

67% of instances closed lower than the entry price on one of the next two days.

While results are not quite as bearish with the extra filter, the bearish tendency still holds up fairly well.

Another past study which didn't hold up so well with a trend filter is one I mentioned in the intraday update on Friday. It looked at post op-ex weeks when op-ex week closed higher. The results below are from the 7/20/09 Letter and have not been updated.

Today is option expiration Friday. SPX closes higher than 5 days ago.
Buy SPX on close. Sell X days later. \$100k/trade. 1987-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	-48,586.20	157	69	88	43.95	1,306.43	-1,576.48	0.83	0.65	-309.47
4	-25,958.95	157	67	90	42.68	1,347.37	-1,291.47	1.04	0.78	-165.34
3	-23,790.49	157	70	87	44.59	1,163.03	-1,209.23	0.96	0.77	-151.53
2	-23,472.84	157	74	83	47.13	826.20	-1,019.41	0.81	0.72	-149.51
1	-14,676.80	157	60	97	38.22	905.38	-711.34	1.27	0.79	-93.48

I looking at this further on Friday I found that results changed dramatically if either 1) op-ex Friday was a down day or 2) the market was trading above its 200ma. Below are the results for those times op-ex Friday was down:

Today is op-ex Friday. SPX closes up over 1% for the week but down today.
Buy on close. Sell X days later. \$100k/trade. 1987 - 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	-6,566.98	51	27	24	52.94	1,571.99	-2,042.11	0.77	0.87	-128.76
4	1,996.19	51	28	23	54.90	1,488.35	-1,725.12	0.86	1.05	39.14
3	-2,576.52	51	27	24	52.94	1,192.33	-1,448.73	0.82	0.93	-50.52
2	2,282.32	51	29	22	56.86	920.89	-1,110.16	0.83	1.09	44.75
1	9,905.83	51	21	30	41.18	1,296.70	-577.50	2.25	1.57	194.23

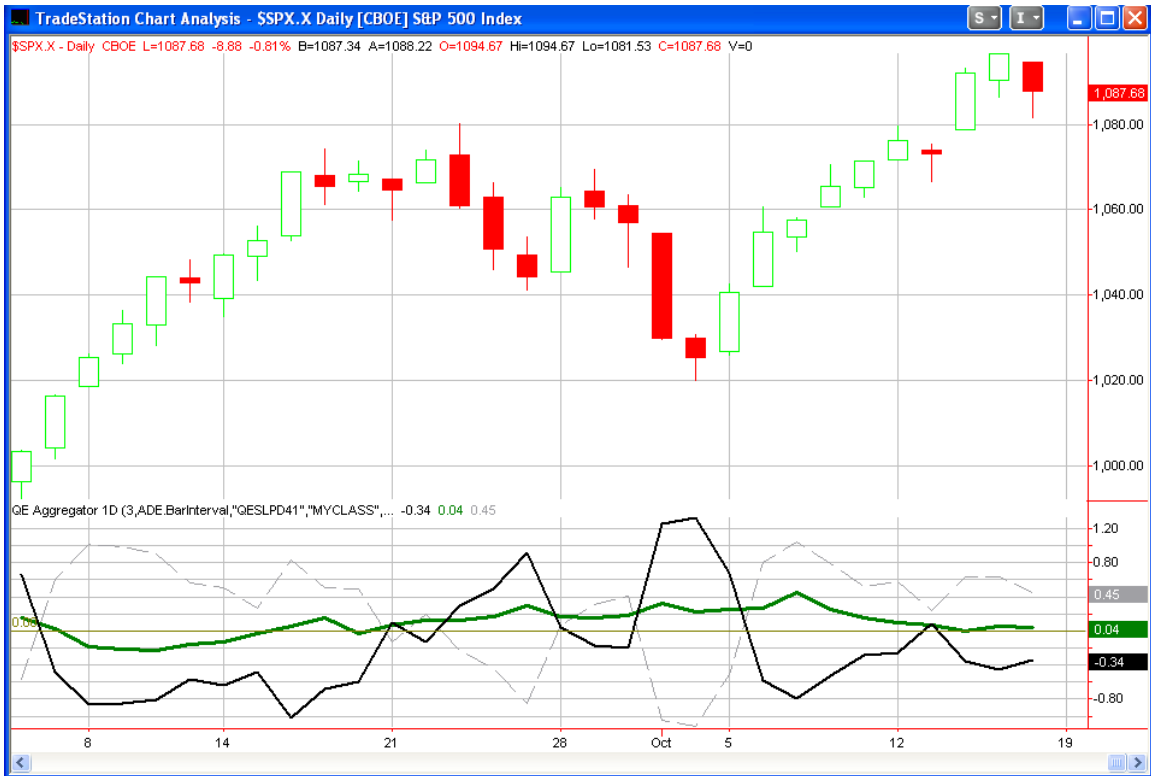
As you can see, this simple tweak changes the results quite a bit. Rather than showing consistently bearish inclination, the results are mixed. What if we also take into account the fact that the SPX is above its 200ma?

Op-ex Friday. SPX closes up over 1% for the week but down today. Close > 200ma.
Buy on close. Sell X days later. \$100k/trade. 1987 - 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
5	6,843.50	35	18	17	51.43	1,453.58	-1,136.53	1.28	1.35	195.53
4	7,388.12	35	20	15	57.14	1,152.67	-1,044.35	1.10	1.47	211.09
3	4,292.24	35	20	15	57.14	910.15	-927.39	0.98	1.31	122.64
2	3,216.28	35	21	14	60.00	743.70	-885.82	0.84	1.26	91.89
1	495.70	35	15	20	42.86	783.22	-562.63	1.39	1.04	14.16

By applying these two filters you can see how the supposed bearish tendencies actually turned slightly bullish. It isn't what I would consider a substantial upside edge, but it no longer conveys a bearish bias.

With the drop from 10-high study now included, the [Aggregator](#) chart is updated below.



The Aggregator formation changed very little from Thursday night. The green Aggregator line is still slightly above 0 as the net expectations from the studies remains positive. Meanwhile, the black Differential line remains squarely below 0, illustrating

the fact that the SPX has outperformed expectations over the last few days. Overbought vs. expectations with an upside bias is generally considered a neutral configuration. I typically prefer both lines to be on the same side of 0 to suggest a strong edge.

Interesting about the current configuration is that the strong move up on Wednesday will fall out of the Differential calculation on Monday. This means that the SPX will need to close at 1094 or higher in order for the Differential line to remain below 0. Otherwise there will be a spike up to positive territory for the Differential line. The Aggregator line is only weakly bullish so the studies that appear over the next few days should have a strong impact on the net expectations. A down close tomorrow would almost certainly lead to a bullish Aggregator formation. A mild up close could as well.

Intermediate-term Outlook (2 weeks – 2 months)– updated 10/19 – slightly bullish

A few studies appeared in the Quantifinder Friday night with unfavorable implications for the intermediate-term.

For one, the VIX:VXV ratio has now fallen back below 0.9. The ratio compares short-term volatility expectations (VIX 30-day) to long-term volatility expectations (VXV 90-day). A low reading suggests that volatility is likely to rise over the next 1-3 months. Rising volatility is often associated with a falling market and therefore a low VIX:VXV ratio can be interpreted as possibly bearish. The VIX:VXV chart is updated on the members' chart page. Below is an excerpt from the 7/14/09 Subscriber Letter that studies this concept:

One system I discussed...that gave some compelling numbers was to short the S&P 500 when the VIX:VXV dropped below 0.9 and then cover the trade when the ratio next crossed 1. (Note: The VXV has only been listed since late 2007. The CBOE back-calculated the data to 2002 and I was fortunate enough to get my hands on this data. Therefore, rather than just using 18 months worth of data I'm able to look back nearly 7 years.)

VIX:VXV Ratio crosses below 0.9. Short S&P 500 on close.
 Cover when ratio crosses above 1. \$100k/trade 8/2002-present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	\$25,318.38	Profit Factor	2.37
Gross Profit	\$43,784.97	Gross Loss	(\$18,466.59)
Total Number of Trades	15	Percent Profitable	73.33%
Winning Trades	11	Losing Trades	4
Even Trades	0		
Avg. Trade Net Profit	\$1,687.89	Ratio Avg. Win:Avg. Loss	0.86
Avg. Winning Trade	\$3,980.45	Avg. Losing Trade	(\$4,616.65)
Largest Winning Trade	\$8,774.18	Largest Losing Trade	(\$7,985.67)
Max. Consecutive Winning Trades	5	Max. Consecutive Losing Trades	1
Avg. Bars in Winning Trades	38.45	Avg. Bars in Losing Trades	89.00
Avg. Bars in Total Trades	51.93		

One thing notable that I've circled above is the length of the trades. This is NOT a short-term system. Even the winning trades averaged close to 1 month. Many of these trades would've required some patience. Even with the extended trading period, the results are fairly strong – especially for a short-based system. Below I've listed all the trades.

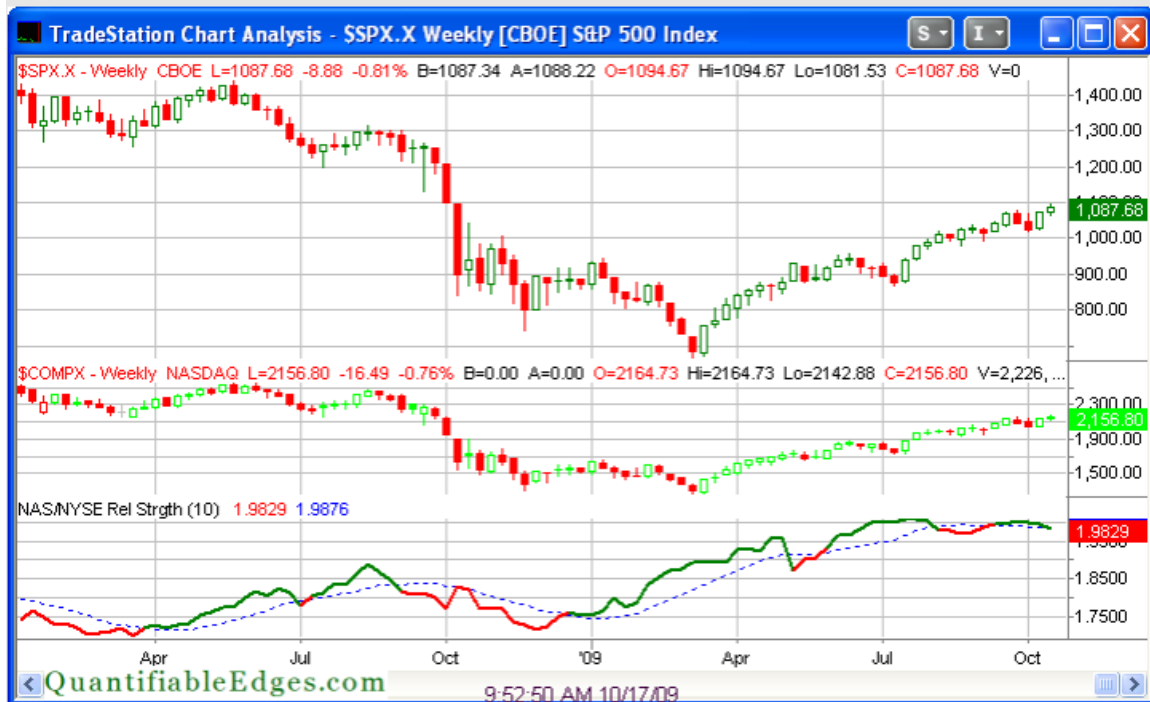
VIX:VXV Ratio crosses below 0.9. Short S&P 500 on close.
Cover when ratio crosses above 1. \$100k/trade 8/2002-present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
01/02/03	Short	\$909.03	5.24%	\$5,425.20
01/24/03	Cover	\$861.40		(\$2,862.20)
08/12/03	Short	\$990.35	(5.38%)	\$999.00
11/17/03	Cover	\$1,043.63		(\$7,330.00)
01/16/04	Short	\$1,139.82	2.90%	\$2,953.65
03/11/04	Cover	\$1,106.79		(\$2,036.67)
03/25/04	Short	\$1,109.28	4.15%	\$4,234.50
08/12/04	Cover	\$1,063.23		(\$3,716.10)
08/25/04	Short	\$1,104.96	(2.28%)	\$1,329.30
10/29/04	Cover	\$1,130.20		(\$3,338.10)
12/09/04	Short	\$1,189.24	3.85%	\$3,974.88
04/15/05	Cover	\$1,143.43		(\$3,349.08)
06/02/05	Short	\$1,204.29	2.28%	\$2,995.47
10/13/05	Cover	\$1,176.84		(\$3,450.31)
11/25/05	Short	\$1,268.25	(2.91%)	\$1,755.78
05/01/06	Cover	\$1,305.19		(\$3,892.98)
07/03/06	Short	\$1,280.19	2.96%	\$3,023.28
07/13/06	Cover	\$1,242.28		\$0.00
08/16/06	Short	\$1,295.43	(8.01%)	\$457.38
02/27/07	Cover	\$1,399.14		(\$12,792.78)
06/19/07	Short	\$1,533.70	2.66%	\$2,805.40
06/26/07	Cover	\$1,492.89		(\$235.30)
10/09/07	Short	\$1,565.15	3.62%	\$4,762.17
11/01/07	Cover	\$1,508.45		(\$689.22)
12/20/07	Short	\$1,460.12	3.32%	\$3,327.24
01/04/08	Cover	\$1,411.62		(\$2,633.64)
05/12/08	Short	\$1,403.58	8.80%	\$9,342.18
06/30/08	Cover	\$1,280.00		(\$2,602.86)
08/21/08	Short	\$1,277.71	4.16%	\$4,717.44
09/09/08	Cover	\$1,224.54		(\$1,975.74)
06/25/09	Short	\$920.26	n/a	\$0.00
open	n/a	\$920.26		\$0.00

It's important to note that the 6/25/09 instance has STILL not closed. It came very close to 1.0 at the beginning of October but began to retreat just shy of the 1.0 level. When the ratio finally closes back above 1 the current instance will have a substantial impact on the results. The market has managed to rally an incredible 18% over that time period – wiping out much of the perceived edge.

The other intermediate-term study that appeared on Friday looked at the Nasdaq/S&P 500 relative strength. Below is a copy of the chart which I snipped from the charts page.

S&P 500/Nasdaq Relative Strength Weekly



It's barely perceptible but there was an RS cross on the bottom panel and the S&P is now leading the Nasdaq. To read more research in this indicator you may refer to the following blog links:

<http://quantifiableedges.blogspot.com/2009/05/simple-powerful-timing-indicator.html>

<http://quantifiableedges.blogspot.com/2009/06/tweaking-nasdaq-leadlag-model.html>

It's important to note the fact that the S&P leading is not necessarily a BEARISH sign. Rather, it is neutral. The market returns under these conditions have been choppy and it has struggled to make any headway. It has not consistently led to negative returns. A leading Nasdaq, on the other hand, has had bullish implications both for the S&P and the Nasdaq.

As a follow-up to last week's study of breadth indicators near market tops, the question was posed as to whether a top from current levels could be considered "major". In last week's study (click here to access [2009-10-12 QE Subscriber Letter.pdf](#)) I looked at 7 major tops from 1970 – present. At current levels the market is still well below the highs set about 2 years ago. Still there has been a 60% rally from the lows. If we fell from here to 800 would that be considered a "major" top? If we rallied from 800 to 1200, would 800 be considered a "major" bottom – since it would be well above the March 666 bottom? In my view a case could be argued either way. The primary point is that as long as breadth continues to expand and the advance/decline line and New High % stats continue to rise, then it appears unlikely the market will undergo a significant correction.

At this point the market has not done anything to suggest we've seen the end of the uptrend. Nasdaq relative strength and the VIX:VXV ratio are giving some warning but it has yet to be confirmed by either price or breadth. I will continue to watch for further signs, but will continue to favor long-side trades for the time being.

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 – buy ¼ index position @ 108.88 LIMIT ON CLOSE. As discussed in the short-term market section above the Differential line will likely flip positive on any close below 1094. Should the market actually close down from Friday's close, then it's likely we'll see some additional bullish studies appear. One that would trigger is the “2 Days down in chop” system. In any event a 2nd down close in a row would seem very unlikely to trigger additional bearish studies.

Active Trades Table

none.

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