

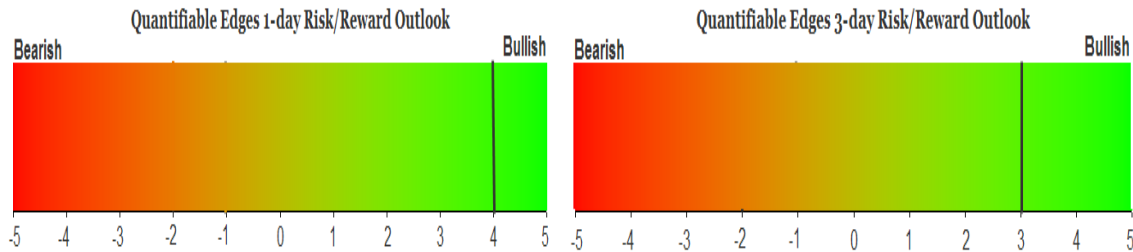
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 26, 2009

Volume 2 Issue 205

## Market Overview



## Tonight's Research Points

- The price drop (1%+) and negative breadth (2:1 negative) Friday were a strong enough combination that an upside edge has exited since 1987.
- Strong selloffs on the 4<sup>th</sup> Friday of the month during a long-term uptrend have led to a bounce in at some point the next week 100% of the time since 1975.
- QQQQ closed at a 5-day low for the 1<sup>st</sup> time since early October. The 1<sup>st</sup> such pullback after such a lengthy drought has historically suggested a bit of a short-term upside edge.
- Nasdaq/SPX relative strength model now favors Nasdaq – a bullish indication.
- The Aggregator System posted a buy signal at the close on Friday.

## Short-term Outlook – updated 10/26

### The Bottom Line

The slightly bearish short-term outlook on Thursday night was followed by some strong selling Friday. At this point it appears the selling was strong enough that a bounce is likely to ensue. I believe the bulls have the edge as the week begins.

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>				
October 26, 2009	4th Friday under 200ma drops 1%	1-2 days	Bullish	2.10%
October 26, 2009	1% Dn Decliners double advancers	1-9 days	Bullish	3.00%
<b>Active - Long Term</b>				
October 26, 2009	Nasdaq/SPX Rel Strength Favors Nas		Bullish	
October 19, 2009	VIX:VXV drops below 0.9	2-5 months	Bearish	
<b>Dropped Tonight</b>				
October 22, 2009	10-day high & 5-day closing low	1-2 days	Bearish	-1.20%

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

### ***The Evidence***

A gap up on Friday morning lasted about 3 minutes. The market spent nearly the entire day stair-stepping lower and never mounted a serious rally attempt. The S&P lost 1.2% and the Russell 2000 was down 2%. The Nasdaq held up better with only a 0.5% drop. NYSE breadth was strongly negative. The Up Issue % came in at 23% and the Up Volume % was 13%. Total volume was up on the Nasdaq but down slightly on the NYSE.

The extremely negative breadth and sizable decline were strong enough that historically the SPX has typically bounced soon after. One study that looked at this was from the 5/12/09 subscriber Letter. Results are updated below.

<p style="text-align: center;">SPX drops at least 1% and decliners more than double advancers. Yesterday the SPX did NOT close at a 20-day high. Buy SPX on close. Sell X days later. \$100k/trade. 10/20/87 - present.</p>											
QE Finder Tester: daysin	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	231,837.73	223	147	76	65.92	2,980.58	-2,714.57	1.10	2.12	1,039.63	
9	269,349.45	232	164	68	70.69	2,811.58	-2,819.86	1.00	2.40	1,160.99	
8	233,751.79	244	162	81	66.39	2,783.99	-2,682.15	1.04	2.08	958.00	
7	230,562.88	261	164	97	62.84	2,664.54	-2,128.06	1.25	2.12	883.38	
6	212,666.00	276	174	102	63.04	2,540.20	-2,248.32	1.13	1.93	770.53	
5	195,880.21	297	181	116	60.94	2,333.68	-1,952.72	1.20	1.86	659.53	
4	147,702.42	317	186	131	58.68	2,137.04	-1,906.77	1.12	1.59	465.94	
3	157,601.35	348	216	132	62.07	1,850.37	-1,833.93	1.01	1.65	452.88	
2	153,057.25	396	226	170	57.07	1,742.38	-1,416.01	1.23	1.64	386.51	
1	102,227.47	443	261	182	58.92	1,151.94	-1,090.28	1.06	1.52	230.76	

**85% of instances closed above the entry price at some point in the next week.**

These results suggest bullish implications over the next several days.

Long-time subscribers may recall I did a good number of studies last year that looked at how strong moves on Fridays often carry through to the next week. When examining this phenomenon at the time I noted that the carry-through was really only prevalent below the 200ma. The follow through was often evident on Mondays and in some cases followed through the rest of the week. Part of the edge depended on time-of-the-month seasonal forces. Since Friday saw fairly strong downside in the SPX I thought it might be worth examining again.

Below are two basic studies showing how the week performed after Fridays that were down more than 1%. The first one shows times were the SPX was trading below its 200ma.

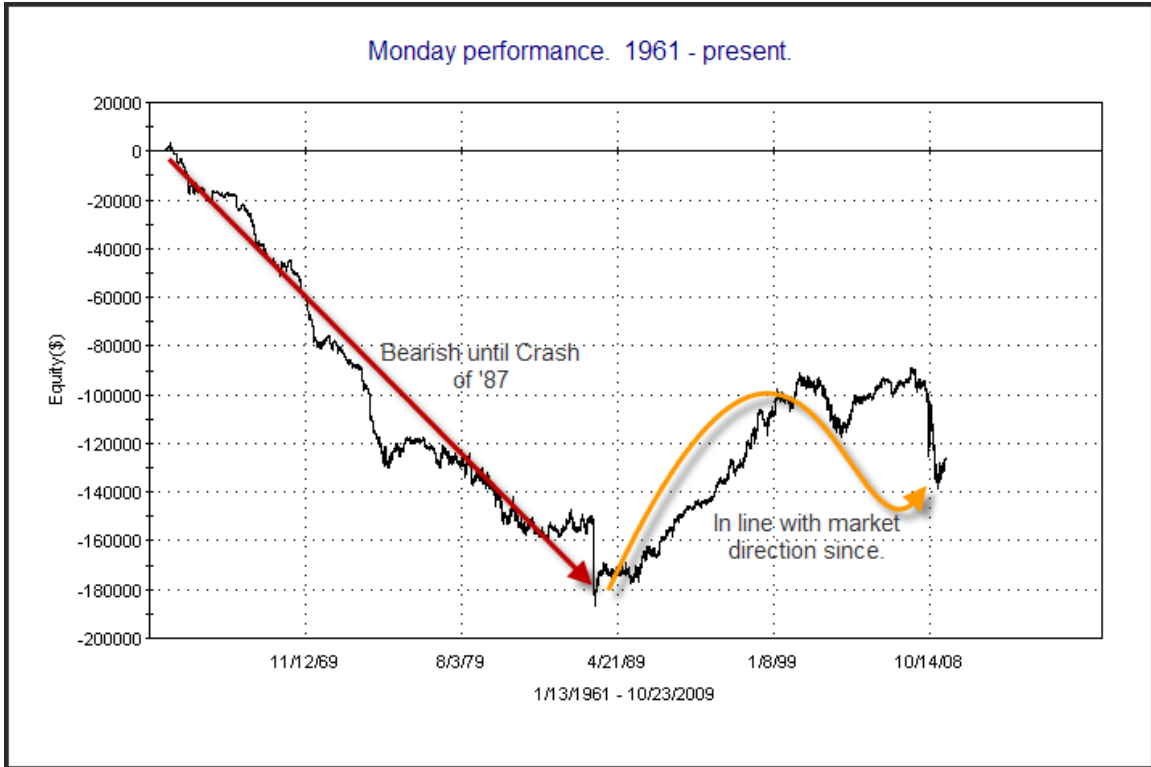
SPX drops more than 1% on Friday. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1988 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-3,298.18	76	42	34	55.26	2,822.06	-3,583.07	0.79	0.97	-43.40
4	-25,601.10	79	39	40	49.37	2,471.27	-3,049.51	0.81	0.79	-324.06
3	-11,793.02	79	43	36	54.43	1,775.00	-2,447.72	0.73	0.87	-149.28
2	14,395.16	79	40	39	50.63	2,110.49	-1,795.50	1.18	1.21	182.22
1	-13,075.32	79	39	39	49.37	1,474.31	-1,809.58	0.81	0.81	-165.51

Here we see 1% down Friday's under the 200ma skew risk/reward negative the following week. Now let's look at 1% down Fridays when SPX is above the 200ma.

SPX drops more than 1% on Friday. Close > 200ma. 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
5	20,600.70	63	36	27	57.14	1,751.99	-1,573.00	1.11	1.49	327.00
4	14,129.74	63	34	29	53.97	1,358.95	-1,106.02	1.23	1.44	224.28
3	9,047.36	63	32	31	50.79	1,320.99	-1,071.76	1.23	1.27	143.61
2	5,872.08	63	30	33	47.62	1,245.33	-954.18	1.31	1.19	93.21
1	7,561.60	63	37	26	58.73	758.14	-788.07	0.96	1.37	120.03

Here the results instead appear mildly bullish.

For Friday-Monday studies I never look back farther than 1988. There are two reasons for this. The first is that the Crash of '87 occurred on a Monday after the previous Friday had dropped about 6%. Including the crash of '87 in any of these studies skews the results dramatically. The 2<sup>nd</sup> reason is that from 1960 up through the Crash, Monday's were generally a bearish market day. For whatever reason, (I have some theories) the bearish tendency of Mondays ceased to exist following the crash. Mondays didn't all of a sudden become bullish, but they did generally begin to align with the market direction. Below is an equity curve that shows the results of buying any Friday and selling the next day's close from 1960 – present.



With all this information in mind, let's now take a look at some more specific data where we see performance following 1% Friday drops while the SPX was over the 200ma since 1988.

SPX drops more than 1% on Friday. Close > 200ma. Today is the 4th Friday of the month.  
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
5	18,290.03	12	10	2	83.33	2,053.15	-1,120.75	1.83	9.16	1,524.17
4	11,178.46	12	10	2	83.33	1,407.73	-1,449.42	0.97	4.86	931.54
3	5,791.60	12	7	5	58.33	1,246.22	-586.39	2.13	2.98	482.63
2	3,177.39	12	7	5	58.33	1,303.25	-1,189.07	1.10	1.53	264.78
1	2,729.03	12	7	5	58.33	1,108.78	-1,006.49	1.10	1.54	227.42

**All 12 instances closed above the Friday close at some point the following week. In fact there has been a profitable close at some point during the week the last 20 times this setup has occurred going all the way back to 1975.**

Instances are a little bit lower than I prefer going back to 1988, but statistics are strongly favorable and suggest a bullish edge.

One other notable study tonight from the Aggregator looked at the fact that the QQQQ closed at a 5-day low for the 1<sup>st</sup> time in at least 10 days. I've updated those results below:

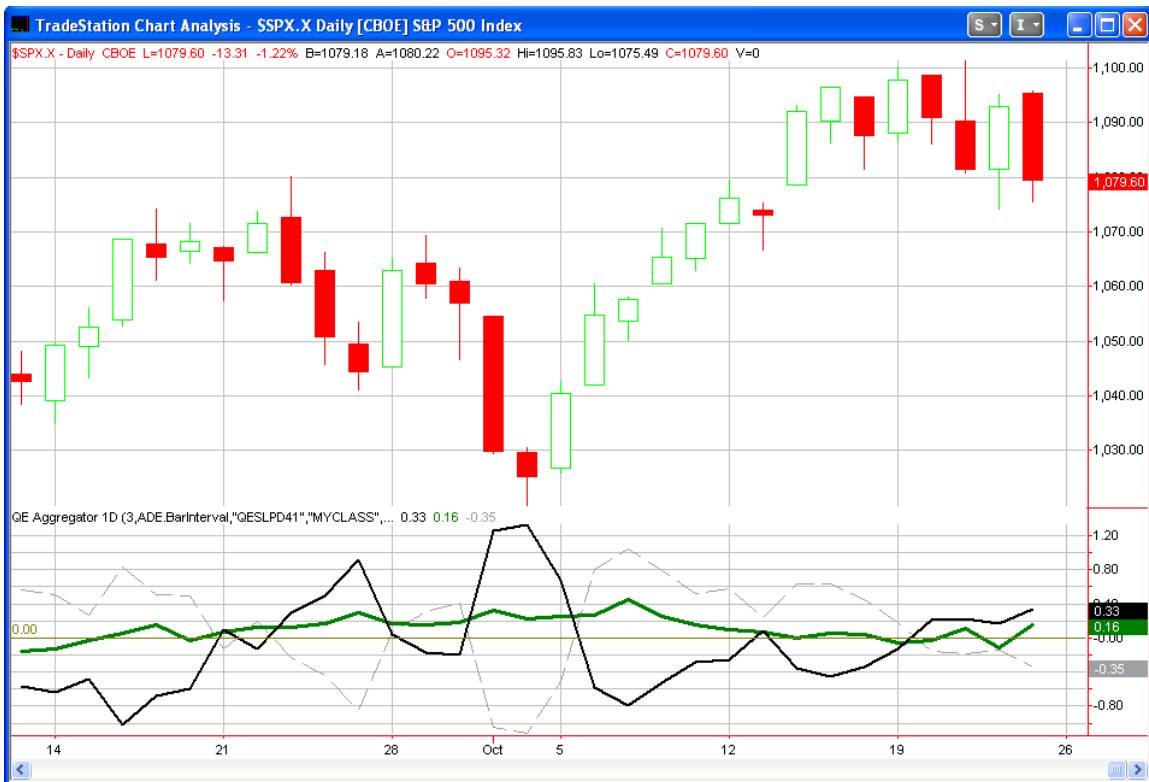
QQQQ closes at a 5-day low after not doing so for at least 10 days.  
Buy on close. Sell X days later. \$100k/trade. 2000 - present.

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
10	52,099.63	56	34	21	60.71	3,685.18	-3,485.54	1.06	1.71	930.35
9	48,677.49	56	32	24	57.14	3,622.81	-2,802.18	1.29	1.72	869.24
8	43,630.04	56	31	24	55.36	3,680.42	-2,935.95	1.25	1.62	779.11
7	41,004.15	56	33	23	58.93	3,611.47	-3,398.88	1.06	1.52	732.22
6	49,691.69	56	31	25	55.36	3,778.88	-2,698.14	1.40	1.74	887.35
5	36,030.91	56	32	24	57.14	3,195.83	-2,759.82	1.16	1.54	643.41
4	13,853.29	56	32	23	57.14	2,500.94	-2,877.25	0.87	1.21	247.38
3	16,076.11	56	30	26	53.57	2,552.84	-2,327.27	1.10	1.27	287.07
2	23,859.29	56	36	20	64.29	1,569.45	-1,632.05	0.96	1.73	426.06
1	11,244.13	56	36	20	64.29	1,062.96	-1,351.13	0.79	1.42	200.79

86% of instances closed above the entry price at some point in the next week. 79% within 2 days.

This study appears to provide a mild upside edge. Much of the edge occurs within the 1<sup>st</sup> two days.

The SPX related studies are now included in the active studies list. The [Aggregator](#) chart is updated below.



There has been quite a bit of wiggle in the Aggregator configuration recently. This past week there were two successful Aggregator System signals. A short signal occurred on the 19<sup>th</sup> and was closed the next day for a 0.6% profit. Then a long signal triggered on the 21<sup>st</sup> and that again only lasted 1 day for a 1.1% gain. Friday afternoon we again had a long signal trigger as both lines are now back above 0. The bullish studies discussed above have flipped the green Aggregator line back positive. This shows the net expectations is bullish over the next few days. Meanwhile, the black Differential line remains positive. This illustrates the fact that SPX has underperformed expectations over the last few days. Basically that means the market is short-term oversold with positive expectations. Both lines above zero have historically led to favorable risk/reward for the long side over the following days.

It's interesting to note that while the black Differential line is suggesting the SPX is more oversold than it has been since the beginning of the month, Wednesday's selloff will be dropping out of the calculation on Monday. This will gravitate the black Differential line back towards 0. To get the Differential line to close below 0 it would only take a 2 point rise in the SPX. What this means is that if Friday's long signal is followed by a close at least 2 points higher on Monday, then we again will be looking at a quick exit. The last few trades have been very quick, and while it would be nice to see quick success again with the current signal, these 1-day trades aren't the norm. Since Feb 2008 the average signal has lasted about 3.5 days.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 10/26 – slightly bullish***

The last few weeks we've had a decent amount to explore from an intermediate-term perspective. This week I'm simply not seeing much.

The market did post a slight decline for the week and the action has turned choppier but I don't see any evidence pointing to a deep or sustained intermediate-term drop at this point in time.

One issue that several people may point to as a warning sign is the fact that there has been high volume occurring on the down days recently. This is often seen as institutional selling and considered a negative. In the past my research has shown that clusters of distribution days are more likely to lead to higher prices over the next 1,2 and 3 months than they are lower prices. One detailed study from August that addresses this may be found using the link below.

<http://quantifiableedges.blogspot.com/2009/08/distribution-days-quantified.html>

One potential positive from this past week is that the Nasdaq/SPX Relative Strength model saw strength shift back to the Nasdaq. I've noted this in the active studies list above.

At this point I'm viewing this past week's choppy action as just that. From a short-term perspective the Aggregator has suggested a bullish edge currently exists. Since the March bottom there has been only one Aggregator buy signal that has lost more than 0.3% on a closing basis. That signal occurred in late August / early September and

suffered a 1.22% loss. Should the current short-term bullish configuration not play out as expected, that may suggest a change of market character which could lead to a deeper correction. It's something I'll have in mind this week when examining action. I see no reason to try and catch a top just yet, though.

### **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 @ \$108.08 limit. Based on short-term outlook and Aggregator signal above. I'm going scale in as I often do. A move below Thursday's lows could lead to a short-term downside acceleration. If that happens I'll want to be able to add more to my long. Intraday traders could play it more aggressively if they note an intraday setup. Recall from above that a close higher by as little as 2 points would turn the black Differential negative and signal an exit on close. Therefore from an intraday standpoint I'd be willing to trade a bit more aggressively off of an intraday bottom reversal pattern. I could utilize a stop and give myself a chance at a much larger profit while knowing that I'm best off getting out at the end of the day.*

*SPY – buy ¼ index position @ \$107.40 LIMIT ON CLOSE. Should the market manage to sell off further on Monday, we're likely to see additional bullish studies. I'd use that opportunity to add more exposure.*

### **Active Trades Table**

*None.*

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