

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

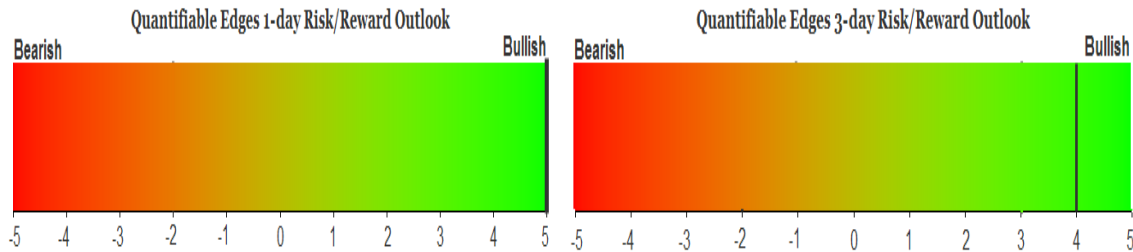
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November 2, 2009

Volume 2 Issue 211

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## Market Overview



## Tonight's Research Points

- VIX spikes more than 25% above the 10ma have consistently led to positive returns the next day – especially when SPX is trading above its 200ma.
- A 2% drop and weak close at a 10-day low during a long-term uptrend has led to bounces within 1-2 days for SPY 100% of the time since 1993.
- Very bad Fridays most often lead to a bounce the next week rather than a Monday crash as happened in '87. Monday has risen 100% of the time Fridays over the 200ma have sold off hard.
- An NYSE Up Volume % under 5% has provided a nice upside edge over the short-term.
- In the intermediate-term section we see recent breadth action as measured by the McClellan Oscillator warns of the possibility of a significantly deeper correction.

## *Short-term Outlook – updated 11/2*

### *The Bottom Line*

The market is extremely oversold. Basically everything I looked at from a short-term perspective suggest a bounce should come – and quickly. Also demonstrated below is that a failure to bounce from Friday's levels could lead to increased selling.

*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 30, 2009	Low vol bounce from ext oversold	1-4 days	Bullish	1.90%
October 29, 2009	VIX > 20% above 10ma	1-4 days	Bullish	3.50%
October 28, 2009	McClellan < -225, SPX > 200ma	1-9 days	Bullish	3.40%
October 28, 2009	SPY selloff decelerating	1-6 days	Bullish	2.50%
October 27, 2009	SPX drops 1% while SOX gains	1-6 days	Bullish	3.00%
October 26, 2009	4th Friday under 200ma drops 1%	1-5 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	

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

***The Evidence***

The market posted a very large loss on Friday. After opening lower and trading down some the SPY spiked up around 9:45 to almost close its gap. It then began forming a series of lower lows and lower highs for most of the rest of the day. It closed weakly and not far off its' low. The S&P lost 2.8%, the Nasdaq lost 2.5% and the Russell 2000 lost 3%. Breadth was extremely negative. The NYSE Up Issues % came in at 12% and the Up Volume % came in at 5%. Total volume rose and was well above average.

Once again I'm seeing numerous indications that the market is severely oversold. I'll look at some studies and give my interpretation of the results below.

First, I wanted to look at the VIX. The VIX rose 24% on Friday and closed over 30 for the 1<sup>st</sup> time since early July. It is now stretched nearly 28% above its 10-day moving average. Several VIX studies appeared in the Quantifinder on Friday including one that looked at stretches of over 25% from the 9/16/08 Subscriber Letter. I've modified it slightly to look at crosses through that level rather than closes above it. Below are updated results:

VIX crosses over 25% above 10ma. Buy on close. Sell X days later. \$100k/trade. 1990 - 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	All: Max Winning Trade	All: Max Losing Trade
5	17,953.03	29	19	10	65.52	2,217.20	-2,417.37	0.92	1.74	619.07	7,070.28	-9,314.08
4	12,227.78	29	21	8	72.41	1,857.84	-3,348.36	0.55	1.46	421.65	5,090.39	-14,820.98
3	7,752.52	29	21	8	72.41	1,442.55	-2,817.63	0.51	1.34	267.33	3,940.55	-13,815.18
2	24,782.34	31	20	11	64.52	2,281.07	-1,894.46	1.20	2.19	799.43	8,484.76	-6,763.30
1	34,610.84	31	25	6	80.65	1,894.51	-1,291.98	1.31	5.46	1,116.48	5,394.60	-5,702.04

**90% of instances closed higher than the entry price at some point in the next 4 days.**

Here we see a pretty strong indication of a reflex bounce in the short-term. 81% of instances closed higher the next day and 90% within the next 4 days. Still, the edge appears very short-lived. The average trade and winning % max out on Day 1. Also notable is the max loss column. When this signal was wrong, it wasn't wrong by just a little bit. Of course all kinds of panic selloffs are included above. What if we also filter by the 200ma, so as to only view those instances that occurred in a long-term uptrend?

**VIX crosses over 25% above 10ma. Close > 200ma.  
Buy on close. Sell X days later. \$100k/trade. 1990 - 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	All: Max Winning Trade	All: Max Losing Trade
5	14,612.57	13	8	5	61.54	2,442.46	-985.42	2.48	3.97	1,124.04	7,070.28	-1,759.84
4	15,982.40	13	9	4	69.23	2,187.25	-925.72	2.36	5.32	1,229.42	4,690.50	-1,776.42
3	13,071.63	13	10	3	76.92	1,563.25	-853.62	1.83	6.10	1,005.51	3,940.55	-1,067.49
2	14,811.13	13	9	4	69.23	1,818.40	-368.62	4.68	10.53	1,139.32	4,809.66	-835.20
1	14,862.10	13	12	1	92.31	1,293.82	-663.78	1.95	23.39	1,143.24	5,117.46	-663.78

**The one instance that didn't close higher the next day was 5/17/06. It didn't close above the trigger price until 6 days later. The max intraday drawdown was about 2.5%**

Again here you'll note that the reflex bounce really only lasts 1 day. The consistency is extremely high, though, and the one instance that didn't bounce right away also didn't suffer a whole lot more downside.

The VIX action appears to be suggesting a good chance of a bounce early in the week.

Another study with compelling results involved simply looking at price action in the SPY. The results below examine Friday's bar in the context of a long-term uptrend.

**SPY drops more than 2%, closes at a 10-day low and in the bottom 10% of its daily range.  
Close > 200ma. 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
5	37,349.95	16	13	3	81.25	3,032.97	-692.88	4.38	18.97	2,334.37
4	27,695.75	16	13	3	81.25	2,576.80	-1,934.22	1.33	5.77	1,730.98
3	30,936.57	16	12	4	75.00	2,852.32	-822.82	3.47	10.40	1,933.54
2	24,302.10	16	13	3	81.25	2,155.28	-1,238.83	1.74	7.54	1,518.88
1	17,462.49	16	14	2	87.50	1,348.13	-705.63	1.91	13.37	1,091.41

**All 16 instances closed higher than the entry price at some point in the next 2 days.**

While the edge seems to carry through here for a few days in terms of Avg Trade, the tendency to bounce is again satisfied almost immediately. If we don't see a close higher than Friday's close on either Monday or Tuesday, it will be the 1<sup>st</sup> time ever.

This last test only went back to 1993, because that was the inception of the SPY. I prefer to use SPY when looking at daily range %'s, because it is more accurate than using the cash S&P 500 Index.

But before 1993, there was 1987. Many traders who are aware of the history of the '87 crash may often think after a bad Friday, "Will this get substantially worse on Monday? Are we setting up for a crash like '87?" It's an interesting question. Was 1987 an anomaly or does a really bad Friday often carry through into the next week? Below I looked at all Fridays since 1960 that closed down at least 2.5%.

SPX drops more than 2.5% on a Friday. 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	26,588.96	23	16	7	69.57	3,469.21	-4,131.19	0.84	1.92	1,156.04
4	12,039.41	23	14	9	60.87	3,362.81	-3,893.33	0.86	1.34	523.45
3	26,826.11	23	18	5	78.26	2,578.35	-3,916.84	0.66	2.37	1,166.35
2	16,071.91	23	16	7	69.57	2,583.71	-3,609.65	0.72	1.64	698.78
1	-9,505.88	23	16	7	69.57	1,449.43	-4,670.96	0.31	0.71	-413.30

**20 of 23 instances (87%) closed higher than the entry price at some point in the next 3 days.**

The "Average Trade" column on the far right is skewed thanks to the '87 crash which saw the market drop 20% on Monday. It appears in the almost all of the cases that the market was set up for a bounce based on Friday's action rather than a crash. Of course while the last week has been bad, the market does remain in a long-term uptrend. I decided to filter the above results again to examine the bad Friday's that appeared in long-term uptrends.

SPX drops more than 2.5% on a Friday. 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	20,579.51	8	7	1	87.50	3,181.91	-1,693.89	1.88	13.15	2,572.44
4	18,568.54	8	7	1	87.50	2,748.10	-668.16	4.11	28.79	2,321.07
3	17,736.53	8	7	1	87.50	2,686.29	-1,067.49	2.52	17.62	2,217.07
2	14,526.45	8	7	1	87.50	2,194.52	-835.20	2.63	18.39	1,815.81
1	10,688.41	8	8	0	100.00	1,336.05	0.00	100.00	100.00	1,336.05

Instances are low here, but for the short-term they really couldn't be more bullish. Again they also suggest the bounce should basically come immediately.

One study that showed up in the Quantifinder looked at extremely negative breadth days where the NYSE Up Volume % was below 5%. The Tradestation data shows Friday barely qualified while another data provider I use shows it barely missing. In any case, below is the study from the 10/2/09 Letter that looked at this (not updated).

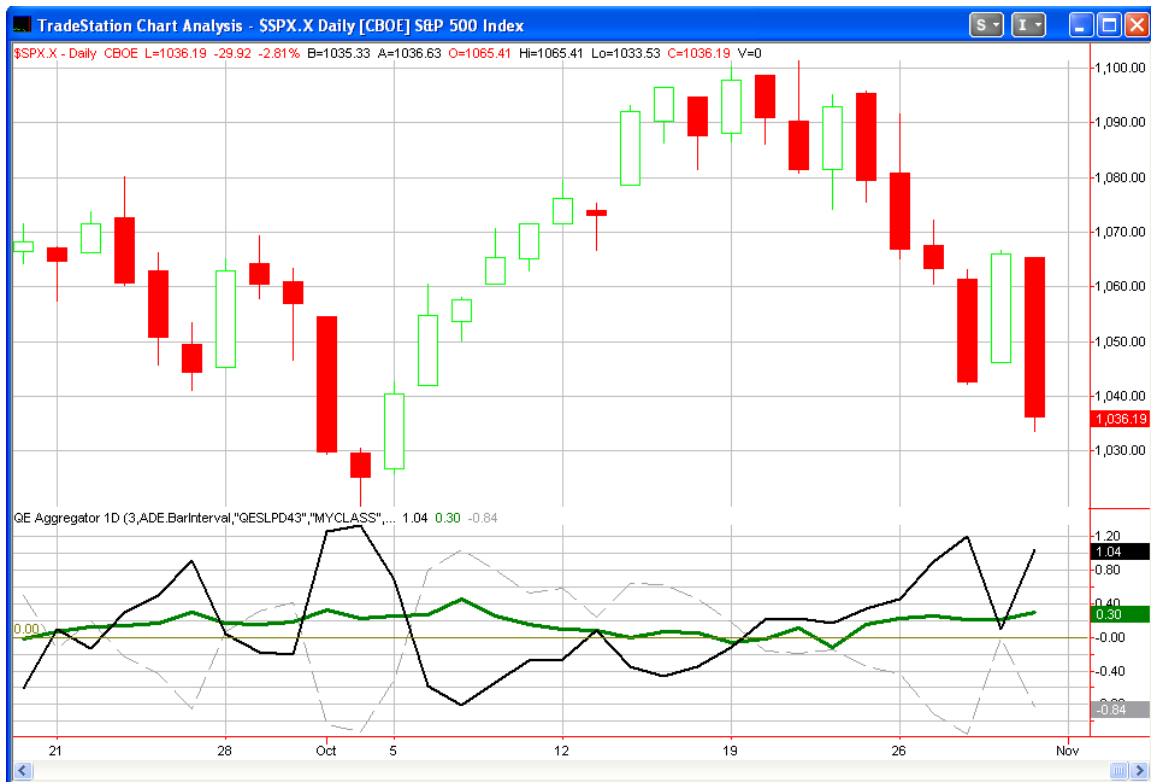
NYSE Up Volume % closes under 5%. Buy SPX on close. Sell X days later. \$100k/trade. 1970 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	55,348.37	34	19	15	55.88	4,968.93	-2,604.09	1.91	2.42	1,627.89
4	36,820.23	36	20	16	55.56	4,111.38	-2,837.96	1.45	1.81	1,022.78
3	19,258.13	37	19	18	51.35	3,501.99	-2,626.65	1.33	1.41	520.49
2	26,345.60	37	25	12	67.57	2,534.47	-3,084.67	0.82	1.71	712.04
1	30,790.01	38	27	11	71.05	2,404.59	-3,103.09	0.77	1.90	810.26

While results aren't quite as compelling as the previous studies, we again see a tendency for an immediate bounce.

The turn of the month is often a seasonally strong period. While I don't put a lot of faith in most seasonals, I was curious to see how the market has performed previous times after there has been such a strong selloff on the last day. What I found was quite surprising. Looking back to 1960, the S&P 500 had never before closed down as much as 2.5% on the last day of the month. Even loosening the requirements to 2% I only found 3 instances. While I wouldn't make anything of just 3 instances, 2 were higher the next day and they were all higher 4 and 5 days later.

So the VIX, the SPY price action, and the big Friday drop are all strongly suggesting the market should bounce immediately. Friday's NYSE Up Volume % is saying the same thing to a lesser degree. While traders may look to play a bounce here, it also needs to be kept in mind that a failure to bounce in the next day or two could be especially ominous. Historical norms were ignored for much of last week, and the market has certainly demonstrated an ability to exhibit historically extreme behavior over the last 2 years. Traders may want to keep nimble and consider trading with reduced position size for a while should we not see an immediate bounce.

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



After Thursday's rally nearly put the Aggregator back into a neutral position, Friday's selloff caused another spike in the black Differential line. The Differential line illustrates how the SPX has done versus expectations over the last few days. What we see here is that there has been strong underperformance. The green Aggregator line is once again curling up as well. This positive number illustrates the strong net positive expectations from the studies over the next few days.

With both lines strongly above zero the Aggregator is viewing the market as oversold with positive expectations. While it hasn't mattered much the last few days, historically this is a setup that has provided a short-term upside edge. As I mentioned above, failure to bounce in accordance with the edge early in the week would be another hint of possibly a much deeper pullback or runaway downmove emerging.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 11/2 – neutral approaching bearish***

Breadth has been a strong tell of the recent rally. While in periods like July and September when price, volume and sentiment-based indications suggested a pullback was likely, breadth studies often provided results suggesting the trend should persist. So when the McClellan Oscillator registered incredibly low readings on Wednesday I took a look at some short-term studies.

I decided this weekend to see if there might be some longer-term implications from such negative readings in the McClellan Oscillator. For these tests, rather than using the standard oscillator, I decided to use the Ratio Adjusted McClellan Oscillator. The ratio adjusted version accounts for the fact that the number of issues trading on the NYSE has

increased over time. When using very a long look-back and wanting to compare readings from decades ago to current readings the ratio adjusted number provides much better comparisons.

I wanted to look and see if very weak readings in an uptrend might be suggestive of intermediate-term weakness. The Ratio Adjusted McClellan Oscillator on Wednesday came in at -113. Using S&P and advance/decline data all the way back to 1950 I constructed the following study.

**Ratio Adjusted McClellan Oscillator crosses below -110. SPX close > 200ma.  
Buy on close. Sell X days later. \$100k/trade. 1950 - 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
55	26,730.54	6	5	0	83.33	5,346.11	0.00	100.00	100.00	4,455.09
50	16,941.16	6	3	3	50.00	7,638.87	-1,991.81	3.84	3.84	2,823.53
45	7,291.78	6	3	3	50.00	6,459.21	-4,028.62	1.60	1.60	1,215.30
40	7,800.71	6	3	3	50.00	6,291.79	-3,691.55	1.70	1.70	1,300.12
35	2,986.94	6	3	3	50.00	5,450.71	-4,455.07	1.22	1.22	497.82
30	1,197.12	6	3	3	50.00	5,442.28	-5,043.24	1.08	1.08	199.52
25	-3,018.21	6	1	5	16.67	9,323.60	-2,468.36	3.78	0.76	-503.04
20	-3,180.62	6	2	4	33.33	6,513.78	-4,052.05	1.61	0.80	-530.10
15	-5,714.61	6	3	3	50.00	3,875.56	-5,780.43	0.67	0.67	-952.44
10	-3,649.07	6	3	3	50.00	2,530.88	-3,747.23	0.68	0.68	-608.18
5	-2,400.54	6	2	4	33.33	2,853.07	-2,026.67	1.41	0.70	-400.09

As you might have suspected it appears very strong negative breadth readings in a supposed uptrend often led to difficulties – at least for the next 5 weeks. Below is the list of instances along with their 25-day returns.

**Ratio Adjusted McClellan Oscillator crosses below -110. SPX close > 200ma.  
Buy on close. Sell 25 days later. \$100k/trade. 1950 - present.**

Date/Time	Signal	Price	% Profit	Run-up DrawDown
10/22/51	Buy	\$22.75	(0.35%)	\$1,538.25
11/29/51	Sell	\$22.67		(\$1,538.25)
03/14/55	Buy	\$34.96	9.32%	\$9,466.60
04/19/55	Sell	\$38.22		\$0.00
07/28/75	Buy	\$88.69	(3.62%)	\$1,555.26
09/02/75	Sell	\$85.48		(\$7,302.96)
10/19/78	Buy	\$99.33	(3.56%)	\$0.00
11/24/78	Sell	\$95.79		(\$7,726.08)
03/06/80	Buy	\$108.65	(4.47%)	\$285.20
04/11/80	Sell	\$103.79		(\$13,266.40)
04/14/87	Buy	\$279.16	(0.34%)	\$6,991.74
05/20/87	Sell	\$278.21		(\$1,052.52)
10/28/09 open	Buy n/a	\$1,042.63 \$1,036.19	n/a	\$2,299.00 (\$878.75)

The 1955 instance led to a very big rally over the next 5 weeks. Other than that the market struggled.

The problem with the above is that the study has a small sample size. I lowered the requirement for the McClellan reading and found it wasn't robust either. Below are the results for drops below -105 that didn't hit and didn't overlap any of the -110 results.

<b>Ratio Adjusted McClellan Oscillator crosses below -105 but not -110.</b> <b>SPX close &gt; 200ma. Buy on close. Sell 25 days later. \$100k/trade. 1950 - present.</b>				
Date/Time	Signal	Price	% Profit	Run-up DrawDown
08/31/54	Buy	\$29.83	9.82%	\$9,821.36
10/06/54	Sell	\$32.76		\$0.00
09/29/80	Buy	\$123.54	4.45%	\$9,983.06
11/03/80	Sell	\$129.04		\$0.00
12/11/80	Buy	\$127.36	5.50%	\$10,173.60
01/19/81	Sell	\$134.37		(\$164.85)
05/10/04	Buy	\$1,087.12	4.27%	\$5,010.46
06/16/04	Sell	\$1,133.56		(\$982.80)

In this case all 4 instances put in very strong performances over the next 5 weeks. In looking at the winning trades – both here and the one in the -110 study, I see a common theme that could be worth considering. In no (winning) case did the S&P drop even as much as 1% from the oversold trigger during the next 25 days.

Now recall the McClellan trigger I'm using above didn't occur on Friday. It occurred Wednesday. Friday's action saw the S&P hit a low about 0.87% below Wednesday's closing level. In other words, if the market can't hold above Friday's low, this study hints at more pain in the coming weeks.

How much pain is impossible to tell, but 3 of the 5 losers saw drops of between 7.3% and 13.3%, so there is certainly some large downside potential.

Some people might point to the 10/2 lows around 1020 in the SPX as important support. If the market breaks Friday's low, I personally don't think those will provide much support. The SPX is one of the few indices that hasn't broken through them at this time. The Nasdaq Composite (barely) took the October lows out on Friday. The S&P midcaps are below them. The Russell 2000 is far below them, and so are former rally leaders the SOX(semis) and the BKX(banks).

This market was SUPPOSED to bounce last week. It did on Thursday after getting extremely oversold but that bounce only lasted 1 day. The current studies are all suggesting now that it's SUPPOSED to bounce Monday (Tuesday at the latest). Again, if it doesn't, and if Friday's lows can't hold, then extra longside caution would seem warranted.

## **Catapult and Capitulative Breadth Statistics**

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

### ***Open Catapult Triggers***

WAG(1/3) @ \$37.70

WAG(1/3) @ \$37.09(no fill)

**NEW**

AVP(1/3)@32.05

### ***Catapult for ETF's Trades***

*none*

### ***Broad Market Large Cap CBI – 3 (WAG-2, AVP)***

### **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.*

*AVP – buy 1/3 position@ \$32.05 limit. From Catapult section above.*

I am not going to track another lot of SPY yet. While the environment is ripe for a bounce and I will personally look to play it, the market's precarious position will require close intraday management if one is looking to trade in any size. An accelerated drop down further may be bought into over the next few days for a short-term swing trade.

### **Active Trades Table**

Symbol	Entry Date	Entry Price	Current Pr	% Gain/Lo	Stop	Notes
SPY(1/4)	10/26/2009	\$106.91	\$103.56	-3.13%		Aggregator
SPY(1/4)	10/27/2009	\$106.42	\$103.56	-2.69%		Aggregator
WAG(1/3)	10/28/2009	\$37.70	\$37.83	0.34%		Catapult

Thursday night I indicated a stop on one of the 2 remaining lots would be appropriate for Friday as I was leary of the markets ability to follow through on Thursday's gains. Unfortunately for me some issues cropped up Friday morning and I wasn't able to get an email out with a set stop. I probably should have just laid out something in the Thursday night letter. In any case, the Subscriber Letter is long 2 lots.

I again think a stop on at least one of them would be appropriate given the precarious nature of the current market. Should the market gap up I'll place a stop on 1 lot \$0.10 below Friday's low. Should it hold above there and form a rally, intraday traders could consider trailing a stop. Expecting a bounce of some size, though, I'd be sure to trail any stop fairly loosely.

### **Quick note for intraday traders**

With the current bias and increasing volatility intraday long opportunities could be taken advantage of. There's a decent chance of a strong move up either Monday or Tuesday. With potential for increased volatility high here, it will be important to consider position sizes and to remain nimble. A drop below Friday's lows could lead to a downside acceleration. Very aggressive and nimble intraday traders could also consider the possibility of short trades should Friday's lows break.

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