

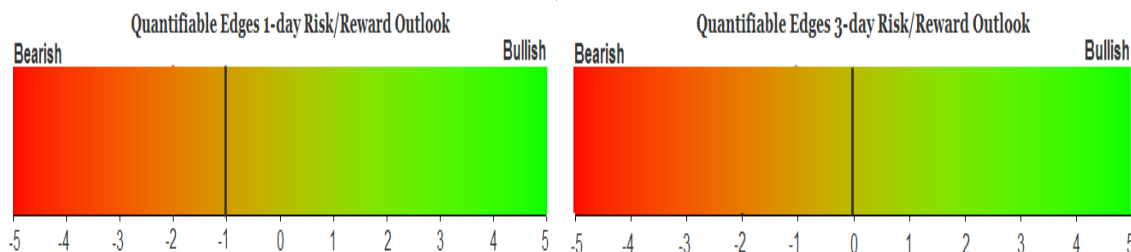
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

November 27, 2009

Volume 2 Issue 229

Market Overview



Tonight's Research Points

- Gaps down of 1% or more from 10-day highs have a negative expectation for the remainder of the day.
- The rise in both the SPX and VIX Wednesday suggested some selling.
- The Aggregator System is flat but will likely trigger a long signal with a down close on Friday.

Short-term Outlook – updated 11/27

The Bottom Line

It appears the gap down that is setting up for Friday stands a good chance of leading to more intraday selling. Should it close lower as expected then the Aggregator chart would likely finish with a bullish configuration.

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 | | | | |
| November 27, 2009 | SPX up VIX up | 1-2 days | Bearish | -0.80% |
| November 25, 2009 | Thanksgiving Bias | 2 days | Bullish | |
| November 20, 2009 | SPX 1% drop & Advancers 2x Decliners | 1-9 days | Bullish | 2.90% |
| November 17, 2009 | 70% Up Issues 2 in row & SPX 50 high | 1-8 days | Bullish | 2.40% |
| Active - Long Term | | | | |
| November 10, 2009 | 75% Up Issues 2 of 3 above 200 & 10 hi | 1-20 days | Bullish | 5.90% |
| November 23, 2009 | VIX:VXV Ratio < 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.

The Evidence

I always start this section off with a review of the previous day's action. I then examine the action to see if it can provide us any hints for the next few days or weeks. No need tonight. Wednesday is long forgotten. Dubai made sure of that. While the U.S. enjoyed Thanksgiving, turkey, cranberry sauce, pie, football, and family, the overseas market took a beating. The U.S. futures markets sank with them. Futures are down about 2% as I begin to write this Thanksgiving night. The question to ask, I believe, is not "What typically happens after days like Wednesday?", but rather "What happens after the market has gapped down big under similar circumstances?"

Of course "similar circumstances" is always a debatable grey area. I took a few cracks at it tonight.

I've discussed in the past that gaps occurring in a market that is extended up often receive a much different reaction than gaps from a market extended down. Most often what you see is the gap leads to a move against the trend. I'll keep it simple tonight and just review 1% gaps down. First I'll show what happens when they occur after a 10-day closing low. Then I'll show what happens under conditions like the present when they follow a 10-day closing high.

| | |
|--|--------|
| <i>SPY closes at a 10-day low last night.</i> | |
| 1993 - present. | |
| 1% Gaps Down | |
| <i>Performance from open to close</i> | |
| Winners | 17 |
| Losers | 20 |
| Avg Win | 3.16% |
| Avg Loss | -2.08% |
| Avg Trade | 0.33% |
| Win % | 45.95% |
| % Gaps Filled | 56.76% |

Here we see a bit of a crapshoot. There were slightly more instances with further selling, but the higher average win created slightly positive risk/reward.

Now let's look at large gaps down from 10-day highs.

SPY closes at a 10-day high last night.

1993-present

1% Gaps Down

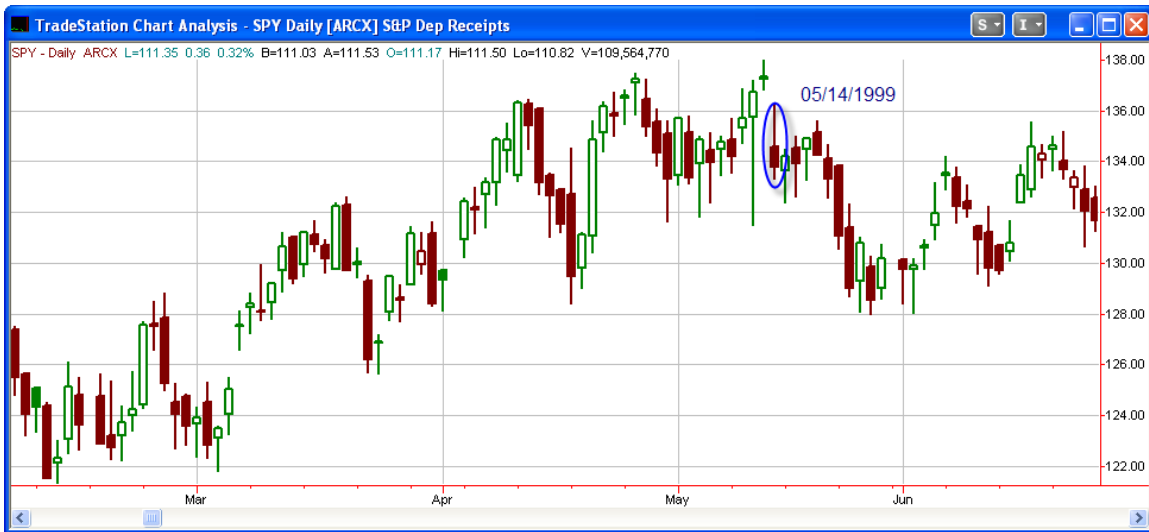
Performance from open to close

| | |
|---------------|---------------|
| Winners | 10 |
| Losers | 16 |
| Avg Win | 0.67% |
| Avg Loss | -1.60% |
| Avg Trade | -0.72% |
| Win % | 38.46% |
| % Gaps Filled | 19.23% |

In cases like the present where you are coming off a 10-day high, the chances of a decent bounce were greatly reduced. The % of instances that closed their gap went from 57% when coming off a 10-day low to only 19% when coming off a 10-day high. Losers outnumber winners by a decent amount and the average loss is twice the size of the average gain. This would all suggest a downside edge from the open to the close on Friday based on the above criteria.

I examined it a few other ways as well. Requiring the high to be a 20-day or 50-day high lowered the instances greatly and didn't provide any better clarity. I also checked to see times it came off a 10-day high and the gap was at least 2%. Only three instances appeared. None of them finished the day above the open. They were 9/17/98, 5/14/99, and 12/1/08. The first 2 sold off rather mildly from open to close. The last one dropped over 6%. Visually the 5/14/99 instance looks the most similar to the current situation because it was the only time the market wasn't locked in a downtrend. Not that I'd suggest drawing any conclusions from only 3 instances but I thought people might want to take a peak. Charts below:





One thing that is a bit different about this instance is that it is coming after a day where the US market was closed while most other markets were open. I also decided to look for gaps down on mornings after U.S. holidays that aren't celebrated globally. I was able to check back to 1998 for this one and I looked at MLK Day, Presidents Day, Memorial Day, Independence Day, Labor Day, and Thanksgiving. I checked for any time the SPY gapped lower more than 1% following one of these holidays. Again there were only 3 instances. Again I'll show them below:



None of these cases occurred when the market was extended up, so I'm not sure a whole lot can be gleaned from them.

My best guess, which is based primarily on the "1% Gap Down from a 10-day High" study, is that there will be a bit of a downside edge tomorrow. People that bought anytime in the last week or so may well find themselves suddenly underwater in their new positions. There appears to be a decent likelihood that this could generate a bit of a scare which would lead to additional intraday selling.

Should we get an early morning bounce I'll likely look for an opportunity to sell into that bounce. I won't be looking to do this as a short "trade idea" in the subscriber letter. I'm not comfortable considering a swing position just yet. The reaction to the gap down tomorrow may provide some hints and that is what I'll likely focus on for the next Letter over the weekend.

Most of the studies that showed up in the Quantifinder had to do with the low volume. Like I mentioned in the last Letter, low volume on the holiday is expected, so I wasn't going to concern myself with it. The one study that didn't look at low volume was the VIX up SPX up study. It's from the 8/3/09 Letter and shown below. (Stats not updated.)

| SPX and VIX both close up. Today is NOT Monday. Buy SPX on close. Sell X days later. \$100k/trade. 1998-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 | -45,237.46 | 115 | 55 | 60 | 47.83 | 1,200.20 | -1,854.15 | 0.65 | 0.59 | -393.37 |
| 4 | -67,883.36 | 121 | 46 | 75 | 38.02 | 1,337.70 | -1,725.57 | 0.78 | 0.48 | -561.02 |
| 3 | -56,045.23 | 129 | 56 | 73 | 43.41 | 1,089.09 | -1,603.21 | 0.68 | 0.52 | -434.46 |
| 2 | -53,634.95 | 137 | 49 | 88 | 35.77 | 1,032.43 | -1,184.36 | 0.87 | 0.49 | -391.50 |
| 1 | -43,161.75 | 148 | 63 | 85 | 42.57 | 590.83 | -945.70 | 0.62 | 0.46 | -291.63 |

80% of instances closed below the trigger day close at some point in the next 3 days.

Tonight I filtered to look at times where an uptrend was present and those results are below:

SPX and VIX both close up. Today is NOT Monday. SPX closes > 200ma and at 10-day high.
Buy on close. Sell X days later. \$100k/trade. 1998 - 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 | -14,090.20 | 60 | 28 | 32 | 46.67 | 1,124.14 | -1,423.94 | 0.79 | 0.69 | -234.84 |
| 4 | -16,529.58 | 62 | 23 | 39 | 37.10 | 1,212.27 | -1,138.76 | 1.06 | 0.63 | -266.61 |
| 3 | -12,106.22 | 63 | 28 | 35 | 44.44 | 851.19 | -1,026.84 | 0.83 | 0.66 | -192.16 |
| 2 | -18,457.77 | 65 | 18 | 47 | 27.69 | 820.31 | -706.88 | 1.16 | 0.44 | -283.97 |
| 1 | -9,644.89 | 73 | 31 | 42 | 42.47 | 358.97 | -494.59 | 0.73 | 0.54 | -132.12 |

Results aren't quite as strong but still suggest some downside over the next couple of days. The average max downside is about 0.8% over the next couple of days. Therefore, this study will likely fulfill its target as soon as the market opens and isn't worth considering too deeply.

I have updated the [Aggregator](#) chart below.



The Aggregator chart remained in a neutral configuration Wednesday. The green Aggregator line above 0 indicates the net expectations from the “active” studies is for upside over the next few days. The negative value for the black Differential line illustrates the fact that the SPX has outperformed expectations over the last few days. Overbought with positive expectations is a neutral configuration and it left the Aggregator System flat.

It appears at this point that the black Differential line has a very good chance to flip positive on Friday. In fact ANY negative close would see this happen. So unless the market manages to rally strongly between now and the 1pm early close, the black Differential line will show recent underperformance versus expectations for the SPX. Should Friday's action not generate some strongly negative studies that would mean both lines could easily close above 0 and a long signal would be triggered by the Aggregator System.

As far as handling the trade ideas for the Subscriber Letter I won't be looking to rush in prior to having more time to evaluate over the weekend. Still with the strong chance of a long Aggregator signal, I also won't be looking to sell the small 1/8th position near the end of the day. I may look for an exit early in the day in anticipation of further downside. There's a fair amount to consider. I'd suggest traders develop a plan of action prior to the open. If you also hold a small position, you don't want to panic sell, but you also may want to exercise caution about putting more long exposure on too quickly. A higher percentage long-side play might occur early next week.

Intermediate-term Outlook (2 weeks – 2 months)– updated 11/23 –slightly bullish

The pullback of the last 3 days is nearing the 1st level of minor price support, which is around 1085. This marks the Nov 13th swing low. Below that I am looking at the Nov 1st lows around 1030 as a major support level. Having not broken any kind of support at this point it would seem very early to try and call a top.

The negative divergences I noted last week in the Advance/Decline line and the New 52-week Highs persisted this week. Until these resolve themselves the narrowing breadth puts the market in danger of topping out. In most cases major tops have not occurred until such divergences were in place for between 2-12 months. At this point it is just over a month.

The VIX:VXV Ratio plunged below 0.9 this week. In the past when this ratio has gone below 0.9, it has suggested an intermediate-term sell signal for the S&P 500 until the ratio moves back above 1 again. Of course the last instance which triggered in July and didn't close until late October was a monumental failure. I'll be watching to see if this instance is effective or whether perhaps the edge has been eliminated from this particular indicator. See the link below for more discussion. (Scroll down to the intermediate-term section.)

[2008-08-25 QE Weekly Research Letter.pdf](#)

The bottom line is we have some bearish warnings at this point, but not bearish action. Before I get more concerned I'll need to see some of the following:

- 1) Support levels being broken.
- 2) SPX failing to bounce following bullish studies.
- 3) Bearish studies emerging.

For now I'm content to cautiously favor the long side.

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 tonight. I'll wait and see how this gap down business plays out.

Active Trades Table

| Symbol | Entry Date | Entry Price | Current Pr | % Gain/L | Stop | Notes |
|---------------|-------------------|--------------------|-------------------|-----------------|-------------|-----------------------------|
| SPY(1/4) | 11/20/2009 | \$109.25 | \$111.38 | 1.95% | | sold 1/2 at \$110.99 |
| | | | | | | |
| | | | | | | |
| | | | | | | |

I mentioned I'd be looking for an exit on the remaining either Thursday or Friday. Hopefully some subscribers were a bit more conservative than me and got out Thursday. If I can spot a decent exit Friday (either selling into morning strength or placing a stop in a reasonable area early on), I'll take it. I'd probably put an expiration on any stop orders. A late day selloff wouldn't scare me as much because it would likely lead to bullish expectations over the next few days. An early break of support could lead to a bad Friday and I wouldn't want to sit all day in a position that's trending lower.

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