

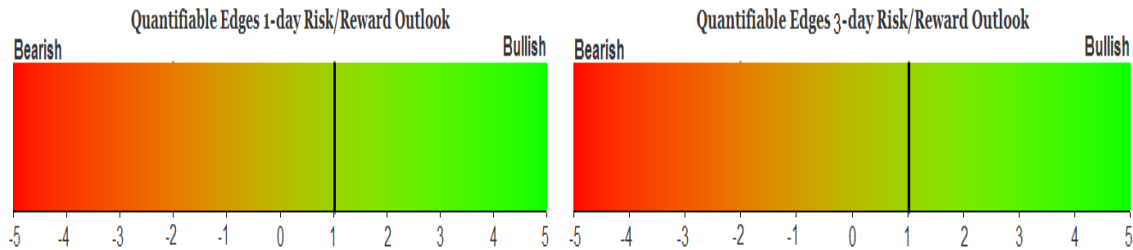
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 2, 2009

Volume 2 Issue 232

## Market Overview



## Tonight's Research Points

- Average gap size is unusually large based on market position and intraday range. Could be indicative of increased reliance on outside forces.
- The Aggregator System remains long from Friday's close. The long will close out tomorrow unless SPX closes below 1100.92. A close above there would move the system to flat or short.

## Short-term Outlook – updated 12/02

### The Bottom Line

After 2 strong up days I'm looking forward to taking some profits. There still may be a bit of an upside edge, but short-term that edge is rather meek.

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>				
November 20, 2009	SPX 1% drop & Decliners 2x Advancers	1-9 days	Bullish	2.90%
<b>Active - Long Term</b>				
November 10, 2009	75% Up Issues 2 of 3 above 200 & 10 hi	1-20 days	Bullish	5.90%
December 2, 2009	VIX:VXV crosses below 0.9	2-5 months	Bearish	
<b>Dropped Tonight</b>				
November 30, 2009	5% Up Vol & Close > Lowest In 10 days	1-2 days	Bullish	3.70%
November 30, 2009	2% Gap Dn. Close > open & < yesterday	1-2 days	Bullish	3.70%

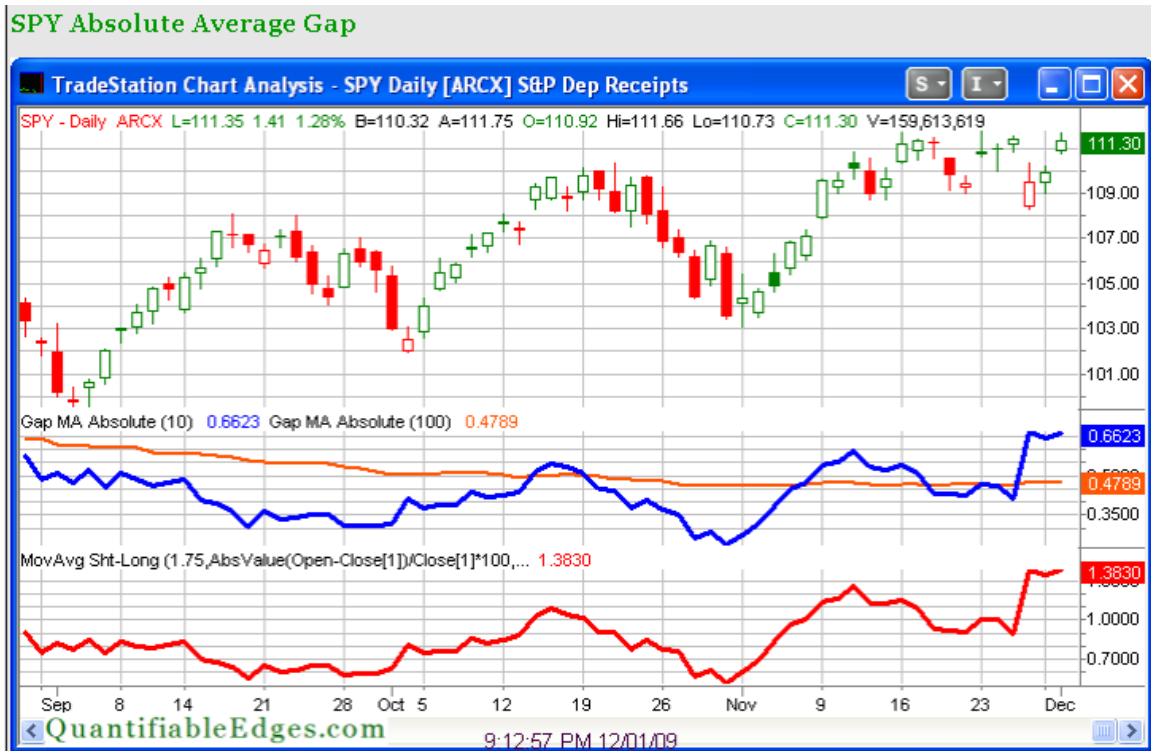
If the avg max move is achieved the study will appear in **bold italic blue** and no longer be active.

### *The Evidence*

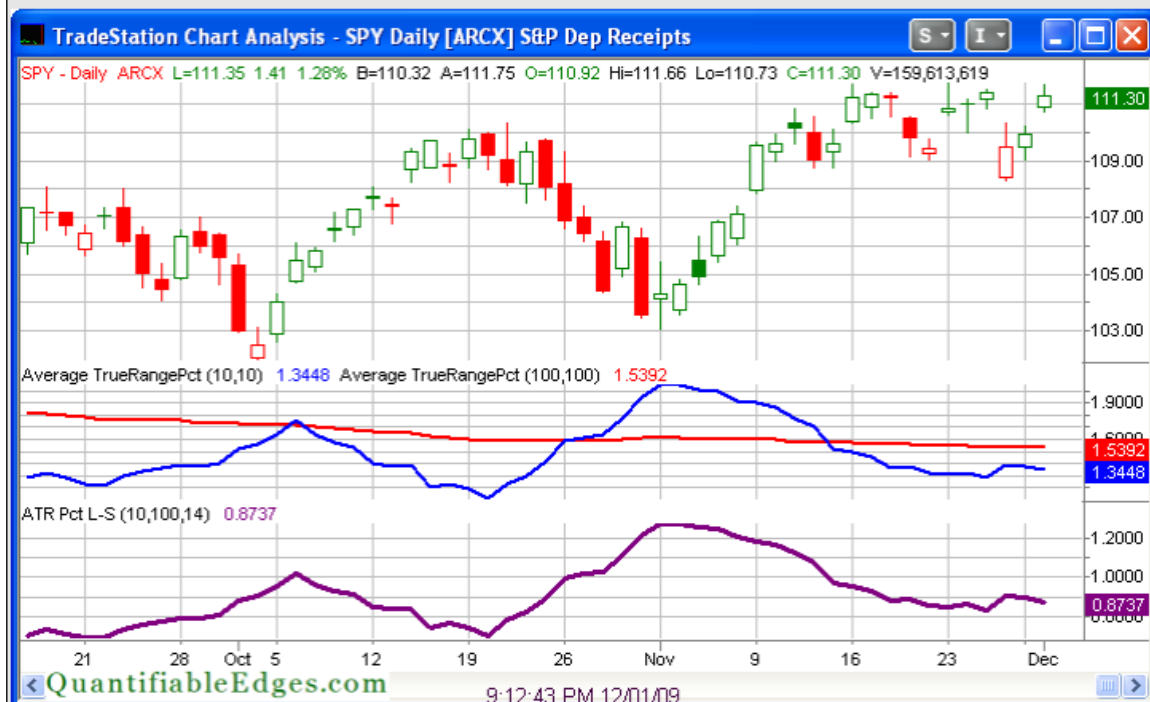
A large gap up on Tuesday saw some further buying and the indices all closed nicely higher. The SPX was up 1.2%, the Nasdaq 1.5% and the Russell 2000 rose 1.6%. Breadth was very strong with the NYSE Up Issues % coming in at 80% and the NYSE Up Volume % was 82%. NYSE volume sank slightly while Nasdaq volume rose slightly.

Not much in the way of hints tonight from what I'm seeing, but I do have a few observations for traders to consider.

First, one trader I know pointed out the unusually large gap activity lately. This can be seen on the charts page. The 10-day absolute average gap of the SPY has spiked higher. Meanwhile I observed the average true range is still below normal. I've copied the two charts from the website to illustrate.



## SPY Average True Range



The real odd behavior here is with the average gap size. Such gappy behavior is unusual with the market near new highs. It's also unusual when there isn't also a substantial increase in the intraday range. I looked at this a number of different ways this evening. The 10/100 Absolute Avg Gap is 1.38 (meaning the 10ma is 38% larger than the 100ma of the overnight gap size). I looked at other instances where similar levels were approached and the market was near a new high. It's been fairly unusual over the last 15 years and results were inconclusive.

I then look at comparing the size of the average gap to the size of the average intraday range (not the true range as shown above). Here again I found we are at very high levels but past history was choppy and inconclusive.

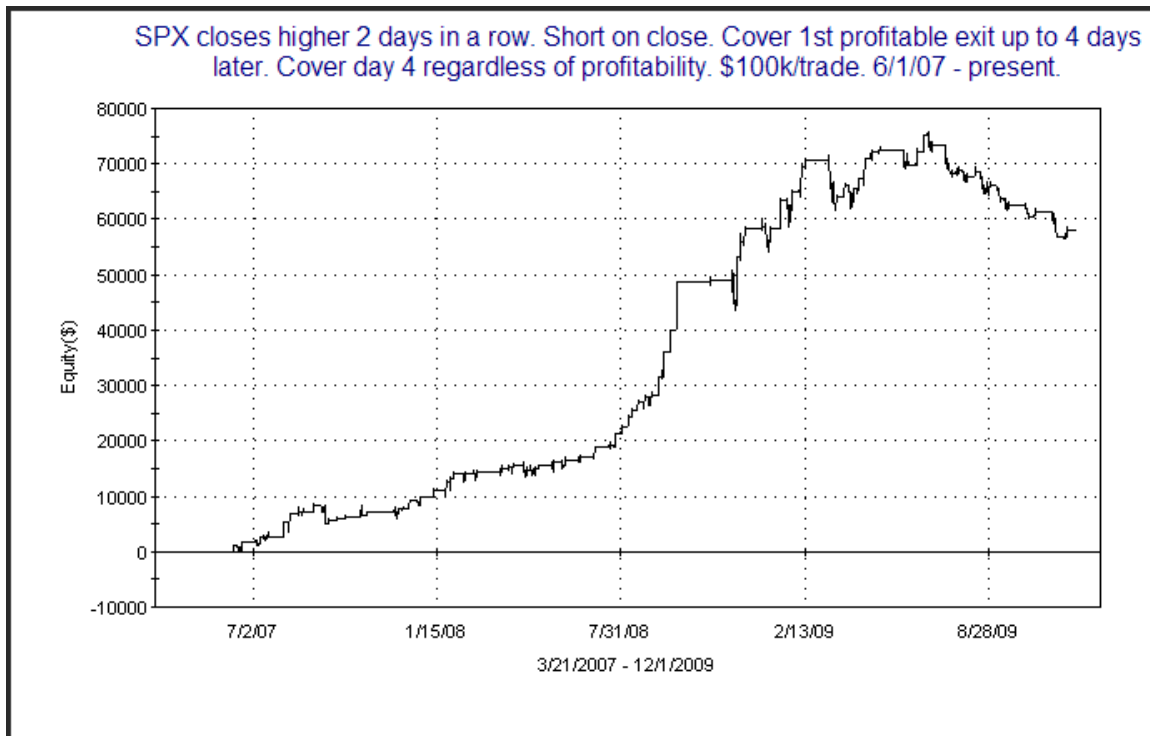
Lastly I looked at times where the 10-day average gap was well above normal and the 10-day average intraday range was well below normal. Again I could find nothing suggesting a significant directional edge.

So is this activity suggestive of anything? Perhaps. While the readings themselves don't seem to help greatly in predicting direction, they do indicate some unusual behavior. My take is that the market is being influenced more by outside forces than is customary. It's been noted by many that the dollar has been leading everything by the nose lately. Outside influences like Dubai debt have also had an overnight influence lately. This would seem to explain why such a large percentage of action is occurring overnight.

So what should we do about it as traders? Two things come to mind – 1) Be more cognizant of dollar and other intramarket action. 2) Perhaps don't put quite as much weight on standard price, volume and breadth indicators as usual. The studies have done

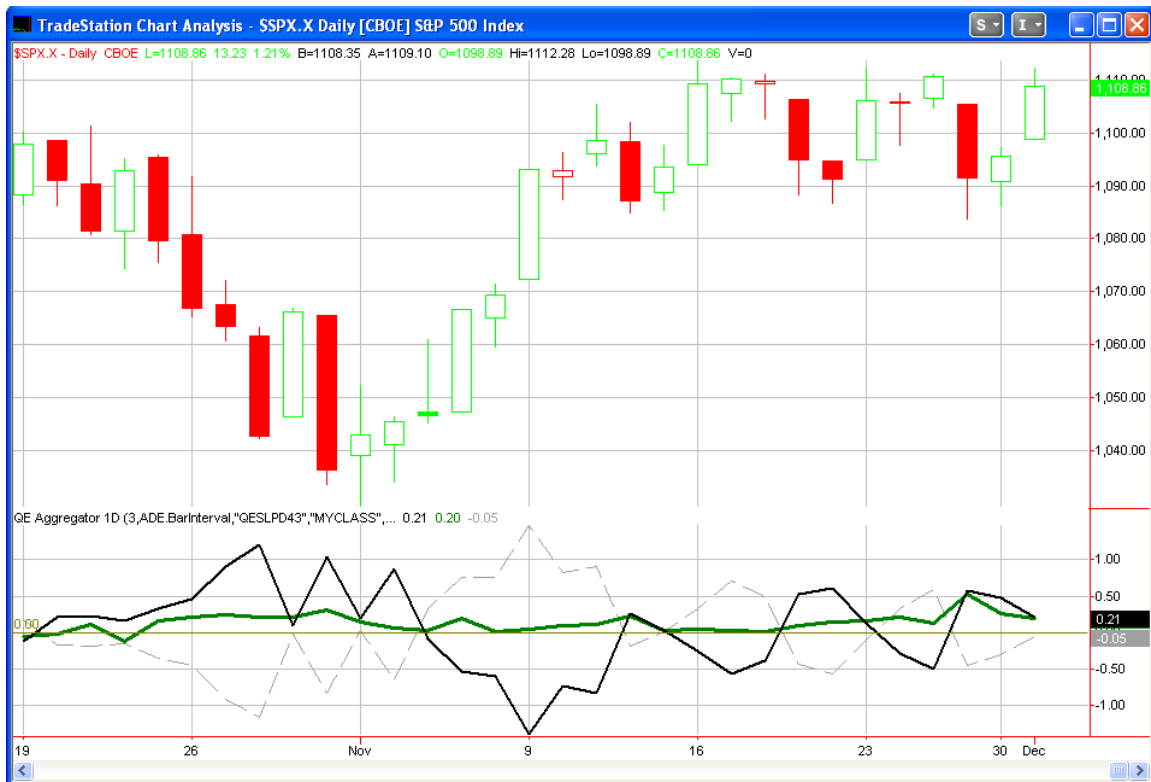
quite well as of late. Still, it may be worth trading with a bit more caution than usual until the stock market manages to decouple from the dollar a little bit.

One study that popped up on the Quantifinder tonight was the old “2 Days Up In Chop” strategy. I’ve ignored this strategy since August and have not included it in the Aggregator over the last several months. Below is an updated profit curve for the System:



I identified and began using the system as an indicator back in August of '08. For 6 months or so it was very reliable and very good. After that it began to chop around. In July the profit curve began to head south. At some point it will likely begin to work again. I see no need to consider it as providing an edge until a sustained improvement in the curve becomes apparent. This is a nice example of how a system can stop working. Much is made these days of building “adaptive” systems that will change with the market environment. Personally I think adaptive design is a bit overrated. The profit curve tells me it is not working in the current environment and that is all I need to know. All systems can be termed “adaptive” if you just monitor the profit curve and stop using them when they aren’t performing well. Essentially that is what an adaptive system tries to do. As traders we need to recognize what is working and what isn’t and try and focus on trading those strategies (automated or not) that ARE working. It sounds simpler than it sometimes is, but I’ve found that monitoring some simple systems and indicators can offer a good amount of information. This is one such example.

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



The expiration of Sunday's bullish studies combined with Tuesday's strong move up led to slight declines in both the green Aggregator line and the black Differential line. Both remain above zero, though. The Aggregator is showing the net expectations from the active studies remains positive over the next few days. The Differential is illustrating the SPX's relative underperformance versus expectations over the last few days. Oversold with positive expectations translates to a bullish configuration. The Aggregator System remains long this evening.

In Tuesday's intraday update I noted that it will become very easy for the Differential line to drop below zero tomorrow. In fact any SPX close above 1100.92 tomorrow will do it. Therefore, barring a sizable drop tomorrow the Aggregator System will exit its long position at the close. The intraday Quantifinder studies will provide clues as to whether some solid bearish edges will suggest shorting or whether the system will go flat. Of course a sharp drop below 1100.92 could keep the system long.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 11/30 –slightly bullish***

Very little changed this week from an intermediate-term perspective. The S&P tested the lower end of its recent range on Friday but closed above it. The potentially bearish breadth divergences I've noted recently in the A/D line and the New 52-week Highs % remain in place. It's now been about a month and a half since those measures have hit new highs. So there remains a yellow flag there.

Still I am void of any strongly bearish studies and prices haven't yet begun to breakdown in earnest. Until I see more evidence of bearish inclinations I'll remain cautiously bullish.

December is about to start, which means it is about time to prepare for the January effect. The January effect actually is strongest in the last 2 weeks of December. It suggests that smallcaps are likely to outperform large-cap over this period of time. I did a short study last year that addressed the January effect. I've reprinted that study below for any traders who may want to review and strategize over the next couple of weeks.

### ***January Effect***

*One seasonal tendency that you may see mentioned in the next few weeks is the January Effect. The January Effect suggests that small caps (especially beaten down ones) tend to outperform large caps in January (and part of December). I decided to run some simple tests based on this hypothesis.*

*I found that over the last 20 years from December 15th (or the next trading day if that is a weekend) to February 1st the Russell 2000 has outperformed the S&P 500 12 times. While that isn't a sizeable winning percentage the total gains have outsized the total losses by about 5 to 1.*

*Even more interesting is the action the last few weeks of December. Again buying at the close on the 15th and this time selling at the close of the 1st day of the New Year, the Russell 2000 has outperformed the S&P 500 15 of the last 20 years. Gross gains have been 27.61% or 1.84%/win average. Gross losses have been only -5.15%, or -1.03% per average loss. The net gain was 22.46% or 1.12% per trade. This is a sizable difference when talking about a relatively short-term spread between 2 indices.*

*There are a number of ways to play this. The simplest of which perhaps would be to wait for a day or two of outperformance by the S&P and then enter a spread transaction in anticipation of both a mean reversion and a seasonal tendency.*

### **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.*

I mentioned the large number of 90609 setups last night and how that may be a bullish indication for the market. Unfortunately I didn't grab any of them. Of course with Tuesday's gap up there may not have been anything to grab that turned out well. Few setups tonight. I'm not looking to take on more exposure here.

### **Active Trades Table**

Symbol	Entry Date	Entry Price	Current Pr	% Gain/Lo	Stop	Notes
SPY(1/4)	11/20/2009	\$109.25	\$110.955	1.56%		out - avg price shown
SPY(1/4)	11/30/2009	\$109.48	\$111.15	1.53%		sold 1/2 @ \$111.15

The intraday stop was hit for 1/2 the 2<sup>nd</sup> lot. Unless there is a close below 1100.92 in the SPX I will exit the remaining at the close. Should the market rally in the morning, knowing I'll be exiting at the close anyway, I may look to trail a stop intraday.

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