

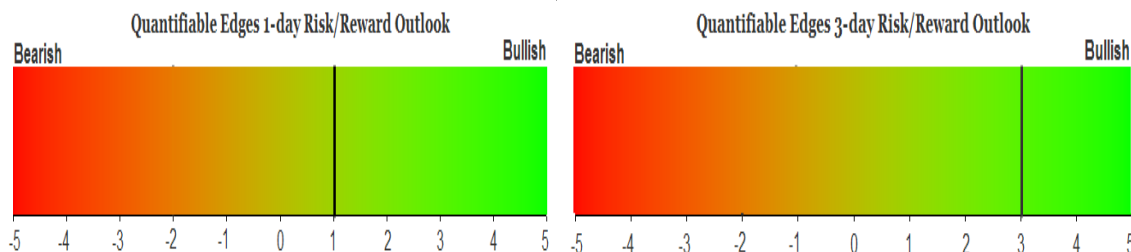
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 4, 2009

Volume 2 Issue 234

Market Overview



Tonight's Research Points

- Failed gap up with poor finish suggests upside edge over the next few days.
- Bearish engulfing bar suggests very short term bearish influence.
- The Aggregator System turned long at the close.

Short-term Outlook – updated 12/4

The Bottom Line

Some mixed signals tonight are leaving the studies still leaning to the bullish side. The jobs report should move the markets in the morning. I'm slightly long-biased and will likely become more so should the jobs report spark a substantial down day.

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				
December 4, 2009	"Bearish Engulfing" from a high	1-2 days	Bearish	-1.70%
December 4, 2009	Gap up, reverse down close bottom10%	1-5 days	Bullish	2.90%
December 3, 2009	Rally fading with volume & price	1-5 days	Bearish	-1.70%
Active - Long Term				
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	
Dropped Tonight				
November 20, 2009	SPX 1% drop & Decliners 2x Advancers	1-9 days	Bullish	2.90%

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

The Evidence

As last night's study suggested was likely, the 3-day rally ran out of gas today. A good start didn't inspire buying and in the last half hour of the day sellers pushed fairly hard. The broad indices all finished lower. The SPX dropped 0.8%, the Nasdaq was down 0.5% and the Russell 2000 fell 1.2%. Breadth was solidly negative as the NYSE Up Issues % was 35% and the Up Volume % 28%.

I saw a lot written tonight about how Thursday marked a key reversal day and how the late day selling was a bearish sign. Let's consider the action a few different ways.

Late-day selloffs are something I've discussed several times in the past. Much of the time panic selling near the close will lead to a bullish edge over the next few days. A strong late-day reaction is often an overreaction. I ran some tests tonight and though I found some mild edges, today's selloff was not extreme enough to suggest any substantial edge over the next few days.

The Quantifinder identified some studies from the 5/21/09 Letter that looked at failed gap patterns like today. Below is an excerpt. (The 1st study is not updated. The other 2 are.)

Bars like the one put in today where the market gaps higher and then closes down and near its lows are generally considered bearish by most analysts. Some might consider it a bearish key reversal. When I've studied gap failures like this in the past I've found them to normally be short-term bullish rather than bearish. [This blog post](#) from February of last year is an example.

I ran a few studies on Wednesday's bar pattern. For this 1st test I simply used a requirement that the SPY had to gap higher, trade a bit above the open and then close a bit below the open. Results below:

SPY gaps up 0.25%, makes a high at least 0.5% above the open, then closes down on the day										
Buy SPY on close. Sell X days later. \$100k/trade. 1993-present.										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
5	\$27,421.83	48	32	16	66.67	\$2,998.58	(\$4,283.29)	0.70	1.40	\$571.29
4	\$34,684.31	50	31	19	62.00	\$2,789.22	(\$2,725.34)	1.02	1.67	\$693.69
3	\$41,343.58	51	31	20	60.78	\$2,839.83	(\$2,334.56)	1.22	1.89	\$810.66
2	\$39,559.87	52	35	17	67.31	\$2,339.43	(\$2,489.43)	0.94	1.93	\$760.77
1	(\$6,486.59)	52	30	22	57.69	\$1,259.24	(\$2,011.99)	0.63	0.85	(\$124.74)

Here we see a tendency to bounce back over the next few days. Next I added the condition that the SPY needed to close in the bottom 25% of its daily range:

SPY gaps up at least 0.25%, makes a high at least 0.5% above the open, then closes down and in the bottom 10% of the daily range. 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	25,783.69	40	27	13	67.50	3,124.56	-4,506.10	0.69	1.44	644.59
4	29,692.31	43	26	17	60.47	2,891.72	-2,676.03	1.08	1.65	690.52
3	43,955.65	43	28	15	65.12	2,761.41	-2,224.26	1.24	2.32	1,022.22
2	41,623.17	43	29	14	67.44	2,506.72	-2,219.41	1.13	2.34	967.98
1	8,811.04	43	25	18	58.14	1,290.44	-1,302.77	0.99	1.38	204.91

37 of 43 instances (86%) closed above the entry price at some point in the next 4 days.

Most instances did close in the bottom 25%. As you can see, adding this filter improves the results even further. What if we require it closes very close to the low of the day as happened on Wednesday? Below are those results:

SPY gaps up at least 0.25%, makes a high at least 0.5% above the open, then closes down and in the bottom 10% of the daily range. 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	40,964.18	24	18	6	75.00	3,463.58	-3,563.38	0.97	2.92	1,706.84
4	28,445.62	24	14	10	58.33	3,341.50	-1,833.53	1.82	2.55	1,185.23
3	29,833.11	24	16	8	66.67	2,834.37	-1,939.61	1.46	2.92	1,243.05
2	27,560.41	24	16	8	66.67	2,595.94	-1,746.83	1.49	2.97	1,148.35
1	6,827.86	24	14	10	58.33	1,382.51	-1,252.73	1.10	1.55	284.49

21 of 24 instances (87.5%) closed above the entry price at some point in the next 4 days.

Instances are a little low here, but as you can see, the worse the finish, the better the setup. While this may fly in the face of what some believe it is consistent with past studies I've conducted on failed gaps.

While today's action did qualify using the above conditions, it also included a short-term high and an outside day. The fact that it was an outside day would also qualify it as a Bearish Engulfing Day. Below is one way that such a day could be described.

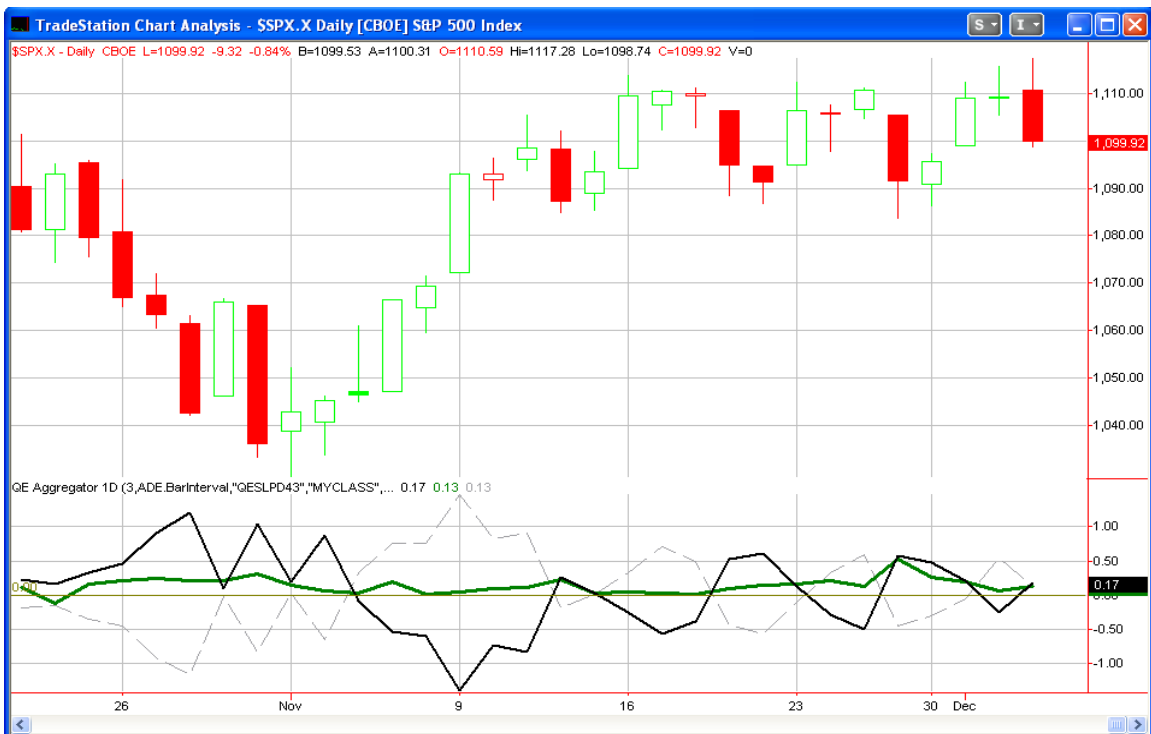
SPY makes a 10-day high, a lower low than yesterday and closes down on the day and in bottom 25% of its daily range. Close > 200ma.
Buy on close. Sell x days later. \$100k/trade. 1993 - present.

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
10	26,248.27	27	19	8	70.37	2,227.56	-2,009.42	1.11	2.63	972.16
9	10,671.09	27	18	9	66.67	1,740.56	-2,295.44	0.76	1.52	395.23
8	11,168.27	27	18	9	66.67	1,736.37	-2,231.82	0.78	1.56	413.64
7	7,012.98	27	18	9	66.67	1,487.11	-2,194.99	0.68	1.35	259.74
6	8,697.96	27	17	10	62.96	1,427.71	-1,557.31	0.92	1.56	322.15
5	-5,605.22	28	13	15	46.43	1,396.90	-1,584.33	0.88	0.76	-200.19
4	-14,233.23	28	14	14	50.00	1,038.51	-2,055.17	0.51	0.51	-508.33
3	-11,396.51	28	12	16	42.86	916.27	-1,399.48	0.65	0.49	-407.02
2	-15,464.10	28	11	17	39.29	563.70	-1,274.40	0.44	0.29	-552.29
1	-4,939.84	29	14	15	48.28	553.95	-846.34	0.65	0.61	-170.34

Based on this study it appears Bearish Engulfing days near short-term highs could provide a downside edge – at least for 2 days. After you get beyond a week, though the stats appear fairly bullish.

The requirements for this study seem somewhat similar to the gap reversal study above. I decided to see what happened when the two overlapped, figuring there might be a decent amount of instances. I took the gap study from before and added the 10-day high, outside bar, and close > 200ma requirements. I was very surprised to find that there was only 1 instance that qualified. The studies are almost completely exclusive of each other, and therefore I will include them both in the Active List.

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



The Active Studies list has some real conflict at the moment as we're seeing a mix of bullish and bearish studies. Currently the bullish studies are a bit stronger and the green Aggregator line is still showing a positive value. The selloff Thursday flipped the black Differential line back to positive as the SPX has now underperformed expectations over the last few days. This puts the Aggregator chart back into a bullish formation and triggered a long signal for the Aggregator System at the close on Thursday. This long was noted a few minutes before the bell on the Systems page and a tweet was sent out alerting subscribers that the page was updated.

Personally I was hoping to remain flat going into the jobs report. There's always a bit of risk with this report. The long Aggregator signal did convince me to take some long exposure, though a bit less than usual. I'll likely look to add to it tomorrow on any weakness. I will also look to begin scaling into a trade idea position in the letter.

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 in 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.

SPY – buy 1/4 index position @ \$110.38 limit. Based on short-term outlook and Aggregator System.

SPY buy 1/4 index position @ \$109.30 limit ON CLOSE. Should the market close substantially lower Friday I'll look to add another piece.

Active Trades Table

None.

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