

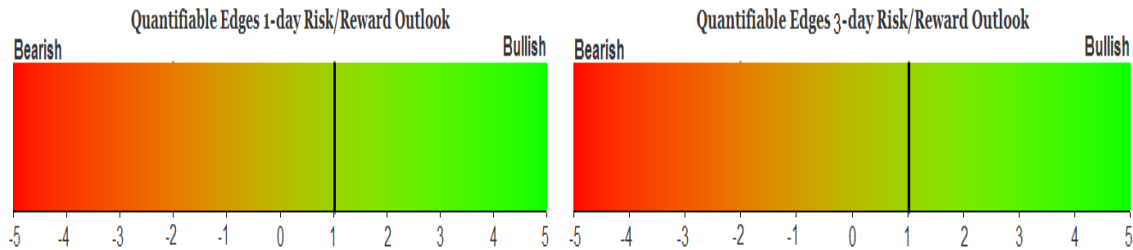
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 15, 2010

Volume 3 Issue 10

Market Overview



Tonight's Research Points

- "2 Days Up" has led to further gains on a consistent basis since August.
- The Aggregator System is now flat.

Short-term Outlook – updated 1/15

The Bottom Line

The market is getting overbought. In the current environment overbought does not suggest an immediate pullback. I'm currently neutral.

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				
January 15, 2010	2 Days Up In Uptrend	1 day	Bullish	
Active - Long Term				
January 13, 2010	No bearish divergence at high	int. term	Bullish	
December 23, 2009	SPX and TNX hit 50-day high	1-10 weeks	Bearish	
December 23, 2009	Low p/c without strong SPX rise	1-5 weeks	Bearish	
December 7, 2009	Nasdaq Leading S&P	int. term	Bullish	
December 2, 2009	VIX:VXV crosses below 0.9	2-5 months	Bearish	
Dropped Tonight				
January 13, 2010	2:1 Neg brdth from 50-hi. No 1% drop	1-2 days	Bearish	-1.80%

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

The Evidence

Thursday saw a mild move higher on low volume for the indices. The SPX rose 0.2% while the Nasdaq and Russell were up about 0.4%. Breadth was mildly positive with the NYSE Up Issues % at 57% and the Up Volume % at 56%. Total volume came in light.

Long-time subscribers will recall that from August 2008 to August 2009 I frequently discussed the “2 Days In Chop” strategies. During (most of) that time period the tendency for the market to chop back and forth on a daily basis made betting against any 2-day move in one direction a very profitable endeavor. I spoke of “2 Days In Chop” as environmental strategies. In other words, they should work nicely until the market stops chopping quite so much. We saw evidence in July and August that the market was becoming less choppy and we were beginning to see more follow through on a day to day basis. I abandoned “2 Days Up In Chop” in mid to late August when it was becoming evident that it was losing its edge.

Since then we have continued to see strong follow through to the upside and a low tendency to chop. As a way of illustrating this I decided to look and see if instead of abandoning the “2 Days Up In Chop” strategy, I simply flipped the strategy. The original strategy called for shorting the market after 2 up days and then covering at the 1st profitable exit up to 4 days later. If not profitable by the end of that period, then simply exit the trade. So flipping this strategy would entail buying any 2 day upmoves, and then rather than looking for a reversal, look for a continuation and sell the 1st profitable exit in my direction.

Below is the list of trades since mid-August.

SPX closes higher 2 days in a row. Buy on close. Sell 1st profitable exit up to 4 days later. Sell day 4 close regardless. August 15, 2009 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
08/19/09	Buy	\$996.46	1.09%	\$1,246.00
08/20/09	Sell#2	\$1,007.37		(\$7.00)
08/26/09	Buy	\$1,028.12	0.28%	\$505.37
08/27/09	Sell#2	\$1,030.98		(\$1,156.24)
09/04/09	Buy	\$1,016.40	0.88%	\$947.66
09/08/09	Sell#2	\$1,025.39		\$0.00
09/15/09	Buy	\$1,052.63	1.53%	\$1,532.35
09/16/09	Sell#2	\$1,068.76		\$0.00
10/06/09	Buy	\$1,054.72	0.27%	\$310.20
10/07/09	Sell#2	\$1,057.58		(\$434.28)
10/15/09	Buy	\$1,096.56	0.12%	\$328.51
10/19/09	Sell#2	\$1,097.91		(\$1,367.73)
11/03/09	Buy	\$1,045.41	0.10%	\$1,481.05
11/04/09	Sell#2	\$1,046.50		(\$24.70)
11/16/09	Buy	\$1,109.30	0.09%	\$109.80
11/17/09	Sell#2	\$1,110.32		(\$639.90)
12/01/09	Buy	\$1,108.86	0.03%	\$604.80
12/02/09	Sell#2	\$1,109.24		(\$321.30)
12/10/09	Buy	\$1,102.35	0.37%	\$553.50
12/11/09	Sell#2	\$1,106.41		(\$90.90)
12/21/09	Buy	\$1,114.05	0.36%	\$553.58
12/22/09	Sell#2	\$1,118.02		\$0.00
01/05/10	Buy	\$1,136.52	0.05%	\$232.29
01/06/10	Sell#2	\$1,137.14		(\$223.59)

As you can see, all 12 instances since mid-August have seen additional follow through during the next 4 days.

I've discussed the "next profitable close" exit before. My feeling is that it may be appropriate for chop-based strategies in a choppy environment. The primary reason is that once the move goes in your direction the "choppy" environment suggests you immediately lose your edge. This is because the choppy environment is already suggesting a move back the other way contains the edge. For a trade that is looking to take advantage of a trending move in a trendy environment, "1st profitable exit" doesn't make sense. In this case we're buying into strength expecting more strength. The last thing a trader wants to do when trying to capture a trend is to cut winners short.

When trying to capture a trend I strongly believe stops work better than targets. Targets are better for mean reversion strategies. Let me illustrate a few different ways. First, below are the results as designed above where every trade was a winner.

SPX closes higher 2 days in a row. Buy on close. Sell 1st profitable exit up to 4 days later. Sell day 4 close regardless. August 15, 2009 - present.

TradeStation Performance Summary Collapse ▲			
All Trades			
Total Net Profit	\$5,175.70	Profit Factor	n/a
Gross Profit	\$5,175.70	Gross Loss	\$0.00
Total Number of Trades	12	Percent Profitable	100.00%
Winning Trades	12	Losing Trades	0
Even Trades	0		
Avg. Trade Net Profit	\$431.31	Ratio Avg. Win:Avg. Loss	n/a
Avg. Winning Trade	\$431.31	Avg. Losing Trade	\$0.00
Largest Winning Trade	\$1,532.35	Largest Losing Trade	\$0.00

So our environmental edge looks pretty good based on this. Now let's use a simple trailing stop instead.

SPX closes higher 2 days in a row. Buy on close. Use yesterday's low as a trailing stop. August 15, 2009 - present.

TradeStation Performance Summary Collapse ▲			
All Trades			
Total Net Profit	\$11,242.27	Profit Factor	5.17
Gross Profit	\$13,940.16	Gross Loss	(\$2,697.89)
Total Number of Trades	12	Percent Profitable	58.33%
Winning Trades	7	Losing Trades	5
Even Trades	0		
Avg. Trade Net Profit	\$936.86	Ratio Avg. Win:Avg. Loss	3.69
Avg. Winning Trade	\$1,991.45	Avg. Losing Trade	(\$539.58)
Largest Winning Trade	\$4,598.00	Largest Losing Trade	(\$923.65)

Here you see that although the winning % dropped quite a bit, the ability to capture an extended move more than doubled the profits. What if we used a 2-day low as the trail?

SPX closes higher 2 days in a row. Buy on close. Use the lowest low of the last 2 days as a trailing stop. August 15, 2009 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	\$12,850.10	Profit Factor	6.84
Gross Profit	\$15,048.75	Gross Loss	(\$2,198.65)
Total Number of Trades	10	Percent Profitable	60.00%
Winning Trades	6	Losing Trades	4
Even Trades	0		
Avg. Trade Net Profit	\$1,285.01	Ratio Avg. Win:Avg. Loss	4.56
Avg. Winning Trade	\$2,508.13	Avg. Losing Trade	(\$549.66)
Largest Winning Trade	\$4,390.40	Largest Losing Trade	(\$897.30)

Not a huge difference here from the 1st stop technique. Profits and profit factor did improve some though. How about if we just sell the next down close?

SPX closes higher 2 days in a row. Buy on close. Sell if SPX closes down on the day. August 15, 2009 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	\$13,039.56	Profit Factor	8.96
Gross Profit	\$14,678.34	Gross Loss	(\$1,638.78)
Total Number of Trades	12	Percent Profitable	75.00%
Winning Trades	9	Losing Trades	3
Even Trades	0		
Avg. Trade Net Profit	\$1,086.63	Ratio Avg. Win:Avg. Loss	2.99
Avg. Winning Trade	\$1,630.93	Avg. Losing Trade	(\$546.26)
Largest Winning Trade	\$4,522.00	Largest Losing Trade	(\$808.08)

Again, we're blowing away the quick targeted exit here.

Lastly let's look at the time based exit I most often use when showing studies.

SPX closes higher 2 days in a row. Buy on close. Sell X days later. \$100k/trade. August 15, 2009 - present.

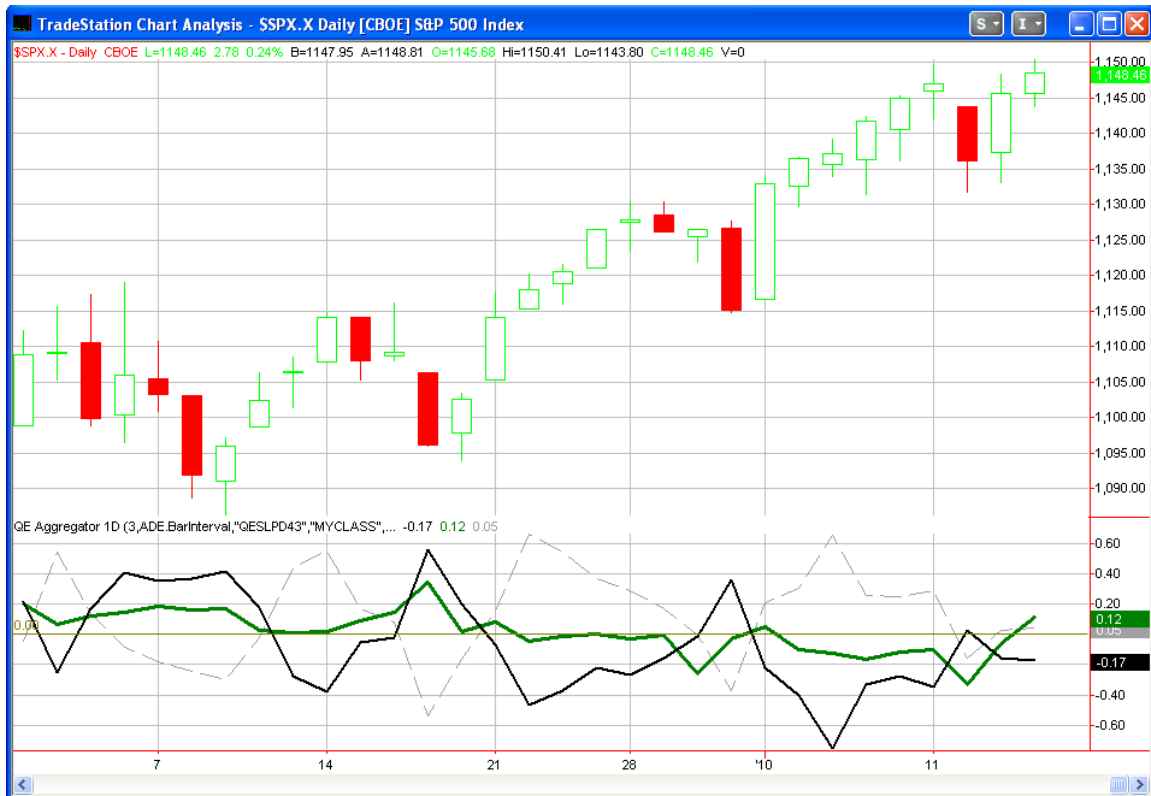
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	9,583.86	12	6	6	50.00	2,590.25	-992.94	2.61	2.61	798.66
4	9,755.69	12	8	4	66.67	2,021.34	-1,603.76	1.26	2.52	812.97
3	10,525.39	12	8	4	66.67	1,663.57	-695.80	2.39	4.78	877.12
2	10,411.17	12	11	1	91.67	1,019.62	-804.60	1.27	13.94	867.60
1	4,244.77	12	11	1	91.67	459.35	-808.08	0.57	6.25	353.73

We see here that since the middle of August, 11 of the 12 times the market has gone up 2 days in a row it has managed to follow through the next day. It's also shown a profit 2 days later.

Here's the point. The market may be overbought but being overbought on its own is no reason to short in this environment. We need more convincing evidence and right now I don't have it. Long entries are easier to come by – or would be if we ever get a decent pullback.

Breadth and volume have not been as strong in recent weeks and that is what has led to a few short trades. Should we see a thrust of either that could very well spark some bullish studies as it did for much of the fall.

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



With our environmental edge this evening the green Aggregator value is back above 0. Meanwhile the black Differential line is a bit below 0. In other words the studies are suggesting upside but the market has already outperformed expectations over the last few days. Both lines on opposite sides of 0 suggest a neutral configuration. The Aggregator System has moved to flat.

The Aggregator value is again wide open tomorrow. The number of clues I've been identifying the last couple of weeks has been exceptionally low. This slow drift higher hasn't provided much. The pivot level for the black Differential line tomorrow is

1,129.83. This level or below would flip the Differential value positive. A close above here would keep the Differential in negative territory.

Intermediate-term Outlook (2 weeks – 2 months)– updated 1/11 –slightly bullish

On Wednesday the NYSE New Highs reached 588. This was the highest level since 596 in October. It was also a good sign for the market. In the 10-12-09 Subscriber Letter I conducted a study of all the major market tops in the S&P 500 since 1970. What I found was that there was breadth deterioration evident in every case in either the advance/decline line, the new high %, or most often both. The advance/decline lines stopped showing a negative divergence a few weeks ago. Wednesday's move came within a whisker of eliminating the NH % divergence. You'd need to draw the trendline with an exceptionally sharp pencil to detect any kind of divergence at this point. In the study I showed that every major market top had a divergence in place for at least 2 months before price topped out. In most cases the divergence lasted significantly longer than that. Should we see new highs make a new high this week that should end all doubt about a divergence. It would also suggest we have at least 2 months before a significant price high will be established. A link to the 10/12/09 Letter is below.

[2009-10-12 QE Weekly Research Letter.pdf](#)

The Nasdaq continued to hold on to its leadership position this week although it looked dicey at times. As I often discuss, this is a positive.

On the negative side we still are showing some outstanding intermediate-term studies that suggest a pullback appears likely. These include studies related to volatility, bonds, and options action.

Even with these negatives the trend remains up, breadth is not diverging, and Nasdaq leadership remains in tact. That's not often a good combination to bet against. I'll exhibit a slightly bullish outlook for the time being.

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 trade ideas tonight.

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