

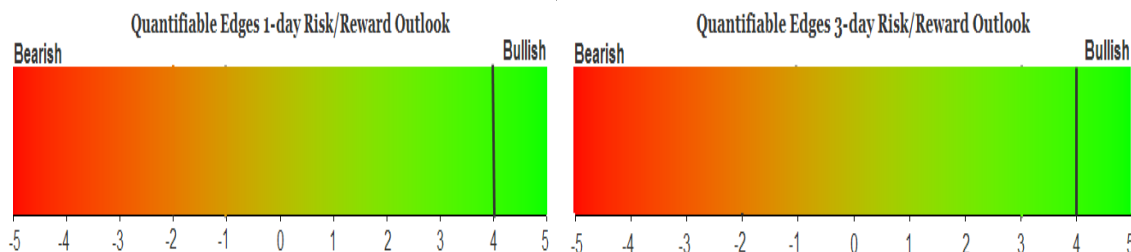
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 25, 2010

Volume 3 Issue 15

Market Overview



Tonight's Research Points

- The VIX being 40%+ above its 10ma is very rare and has previously been followed by a short-term market rise..
- Such sharp pullbacks from 100-day highs are often followed by a bounce.
- Strongly negative McClellan Oscillator readings following a new high in the A/D line are often followed by a bounce.
- The Aggregator System remains long.

Short-term Outlook – updated 1/25

The Bottom Line

VIX action, price action and breadth are all suggesting a bounce is likely. The market is exhibiting behaviors that have rarely been seen before. While the market should bounce based on tonight's research risks are elevated under such abnormal conditions.

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 25, 2010 | VIX, price, or breadth studies | 1-7 days | Bullish | 4.20% |
| January 22, 2010 | 2:1 negative breadth for 2 days | 1-8 days | Bullish | 2.10% |
| January 22, 2010 | 50 high to 8 low in 2 days | 1-4 days | Bullish | 1.60% |
| January 22, 2010 | VIX 20% above 10ma. | 1-7 days | Bullish | 2.50% |
| 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 7, 2009 | Nasdaq Leading S&P | int. term | Bullish | |
| Dropped Tonight | | | | |
| December 2, 2009 | VIX:VXV crosses below 0.9 | 2-5 months | Bearish | |
| December 23, 2009 | Low p/c without strong SPX rise | 1-5 weeks | Bearish | |

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

The Evidence

The selling that began on Wednesday accelerated over the last 2 days and Friday saw some sizable drops for the major indices. The SPX fell 2.2%, the Nasdaq lost 2.7% and the Russell 2000 fell 1.8%. Breadth was again extremely weak. The NYSE Up Issues % came in at 18% and the Up Volume % was 12%. Total volume was down a little from Thursday's levels, but still above average.

Thursday night I was of the opinion that the market was nearing a bounce and I began getting positioned to take advantage of it. Friday proved me early. I spent a good amount of time this weekend examining a multitude of studies. The evidence all suggests this move is already overdone. Based on what I saw it appears there is a strong chance a bounce will happen very soon. Not only has the price move quickly become extended, but breadth measures and the VIX are also strongly suggesting an upside edge. I'll go through some of the more compelling studies and charts below.

After spiking higher for 2 days in a row the VIX is now more than 40% above its 10-day moving average. While not unprecedented, this is highly unusual. It has only happened 4 other times. Twice it occurred while the SPX was trading below its 200ma, and twice above. Rather than examine the stats of the very few instances, I thought charts might be more helpful.

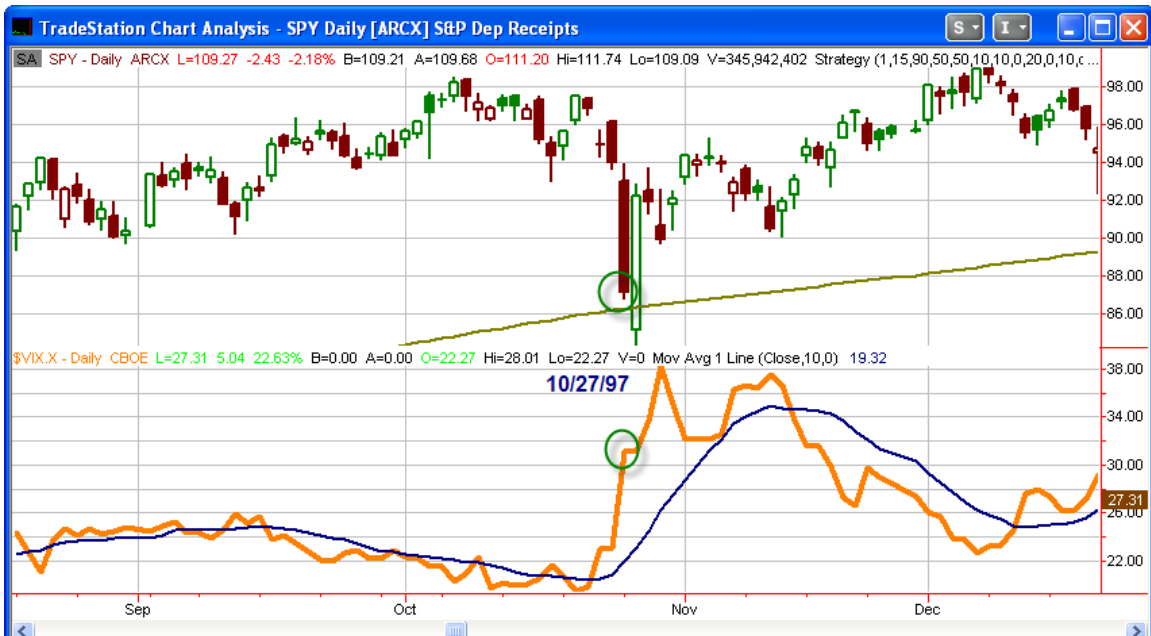
Although I don't consider these great comparisons to the current environment I'll first show the 2 instances where the SPX was already in a downtrend. These were 4/4/94 and 9/17/2001.

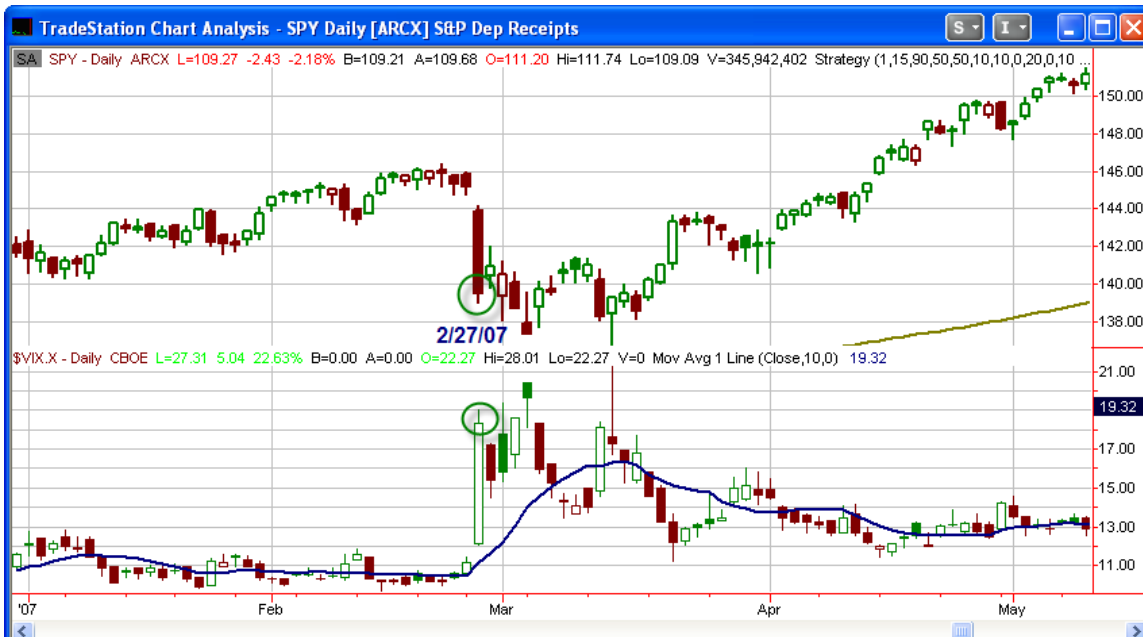




September 17th was the 1st day the market opened following the 9/11 attacks, so a massive VIX spike there was certainly not a surprise. This instance saw 4 more days of selling but in both cases above the market was very close to a short-term bottom.

Let's now look at the 2 instances that occurred above the 200ma – which in my opinion are more relevant. These are 10/27/97 and 2/27/07.





This 2/27/07 incident saw a bit more selling in the few days that followed and the initial bounce quickly led to a retest, but in both cases the selling was very near an end.

In the past we see that such spikes have 1) been rare, and 2) have shortly been followed by a rally. What needs to be kept in mind is that we've already stepped into some rarified air. The market SHOULD have bounced on Friday. It didn't. It SHOULD bounce in the next few days. There's no guarantee when you get into situations like this where historical precedents are few.

Let's look at the current selloff a few different ways as well. You'll see this theme of SHOULD bounce, but with few precedents, is consistent across several types of indicators.

First let's just look at other sizable price drops from 100-day highs. Again, you'll see this sharp move down has little company.

SPX 5-day intraday high = 100 day high. Today SPX closed 5% below its 5-day intraday high.
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 | All: Max Losing Trade | All: Max Winning Trade |
|--------|-----------------|-------------------|---------------------|--------------------|-------------------|------------------------|-----------------------|---------------------|-------------------|----------------|-----------------------|------------------------|
| 12 | 23,086.72 | 9 | 8 | 1 | 88.89 | 3,446.94 | -4,488.77 | 0.77 | 6.14 | 2,565.19 | -4,488.77 | 8,219.44 |
| 11 | 21,573.37 | 9 | 7 | 2 | 77.78 | 3,852.94 | -2,698.60 | 1.43 | 5.00 | 2,397.04 | -5,029.70 | 7,275.00 |
| 10 | 23,351.48 | 9 | 7 | 2 | 77.78 | 4,150.30 | -2,850.32 | 1.46 | 5.10 | 2,594.61 | -4,612.14 | 6,868.41 |
| 9 | 19,213.68 | 9 | 7 | 2 | 77.78 | 3,616.24 | -3,049.99 | 1.19 | 4.15 | 2,134.85 | -4,773.47 | 6,630.00 |
| 8 | 20,110.17 | 9 | 6 | 3 | 66.67 | 4,405.15 | -2,106.92 | 2.09 | 4.18 | 2,234.46 | -4,355.91 | 6,397.50 |
| 7 | 24,530.69 | 9 | 7 | 2 | 77.78 | 4,104.19 | -2,099.33 | 1.96 | 6.84 | 2,725.63 | -3,511.30 | 7,155.00 |
| 6 | 18,844.96 | 9 | 7 | 2 | 77.78 | 3,260.84 | -1,990.47 | 1.64 | 5.73 | 2,093.88 | -2,377.12 | 6,043.23 |
| 5 | 20,879.62 | 9 | 7 | 2 | 77.78 | 3,455.85 | -1,655.68 | 2.09 | 7.31 | 2,319.96 | -1,822.08 | 6,625.71 |
| 4 | 15,321.82 | 9 | 7 | 2 | 77.78 | 2,911.65 | -2,529.86 | 1.15 | 4.03 | 1,702.42 | -3,057.32 | 5,187.49 |
| 3 | 13,778.48 | 9 | 7 | 2 | 77.78 | 2,674.26 | -2,470.67 | 1.08 | 3.79 | 1,530.94 | -3,100.28 | 5,339.18 |
| 2 | 10,917.97 | 9 | 6 | 3 | 66.67 | 2,278.53 | -917.74 | 2.48 | 4.97 | 1,213.11 | -1,568.04 | 3,591.28 |
| 1 | 6,964.69 | 9 | 7 | 2 | 77.78 | 1,352.35 | -1,250.88 | 1.08 | 3.78 | 773.85 | -2,264.50 | 2,753.79 |

Most compelling about these stats are the profit factors. Not only do the winners swamp the losers but the wins are also much bigger. This is reflected in the profit factors and suggest that in similar cases upside rewards have largely outsized downside risks. Here too I thought subscribers would get a better feel for potential action by looking at past charts rather than just a stats table. All 9 instances are shown below along with some brief notes.









So what do I find notable about the above? In no case are you seeing the beginning of a bear market. Most of the time the selling has been just about done. 10/79 and 12/82 would have caused the most short-term anxiety. 2000 and to a lesser degree 4/99 were a bit of a warning of things to come as the market struggled soon after. The song remains the same as with the VIX. These times are rare. The market SHOULD bounce. Without a lot of precedent, there is some extra risk, though.

I did look at price action one other way as well. In [the November 2, 2009 blog post](#) I examined whether a very bad Friday might lead to a Monday crash, as happened in 1987. This Friday didn't quite qualify for those parameters, but I instead decided to examine the Friday drop in terms of ATR. I don't use ATR as often as % move. The primary reason is that when trying to generate expectations, ATR isn't usually as predictive. It's tough to know how volatile the previous markets were. Often big ATR moves happen in environments with low volatility. Anyway, I found the test below interesting enough.

**Today is Friday. The SPX falls more than 1.5 times yesterday's 20-day ATR.
Buy on close. Sell X days later. \$100k/trade. 1989 - 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 | 16,565.48 | 20 | 13 | 7 | 65.00 | 2,160.77 | -1,646.36 | 1.31 | 2.44 | 828.27 |
| 4 | 12,036.52 | 20 | 12 | 8 | 60.00 | 1,758.52 | -1,133.21 | 1.55 | 2.33 | 601.83 |
| 3 | 8,644.12 | 20 | 11 | 9 | 55.00 | 1,650.79 | -1,057.17 | 1.56 | 1.91 | 432.21 |
| 2 | 6,713.08 | 20 | 12 | 8 | 60.00 | 1,225.39 | -998.95 | 1.23 | 1.84 | 335.65 |
| 1 | 7,983.87 | 20 | 16 | 4 | 80.00 | 704.15 | -820.62 | 0.86 | 3.43 | 399.19 |

With so few parameters seeing an 80% win rate on day 1 is quite impressive.

So price action and VIX action both are suggesting the market should bounce. But the most compelling argument for the bull side in my eyes is breadth. Just a few short days ago the A/D line was hitting new highs along with price. The % of new 52-week highs was also hitting new highs. I spoke of how previous bear markets have always begun well after there has been a divergence in at least one of these measures. This implied an immediate top was unlikely.

One of my favorite breadth indicators is the McClellan Oscillator. When doing long-term analysis the Ratio Adjusted McClellan Oscillator is more useful, so that is what I used below. For those unfamiliar with the McClellan Oscillator, or if you just want to learn more about it, I'd suggest checking out the McClellan's site. The learning center has a bevy of information, and the work done there is very good. Here's a link to the learning center:

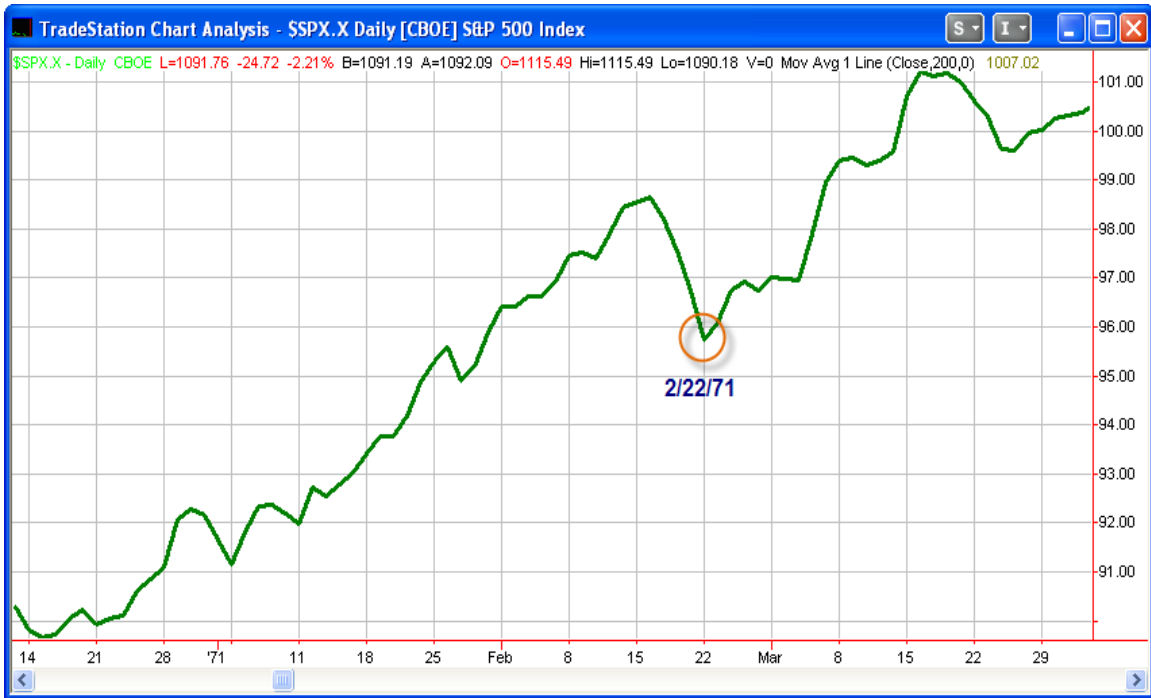
http://www.mcoscillator.com/learning_center/

The Ratio Adjusted McClellan Oscillator fell to about -78 on Friday (using Tradestation data). I decided to look at other times a reading this low was achieved so soon after the A/D line had made a new high. Results below.

| SPX closes above 200ma. Ratio adjusted McClellan Oscillator < -75. The NYSE Adv/Decl line 5-day high = the adv/decl line 50-day high. Buy SPX on close. Sell X days later. \$100k/trade. 1969 - 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 Losing Trade | All: Max Winning Trade | |
| 10 | 13,870.11 | 4 | 4 | 0 | 100.00 | 3,467.53 | 0.00 | 100.00 | 100.00 | 3,467.53 | 0.00 | 7,074.00 | |
| 9 | 12,847.36 | 4 | 4 | 0 | 100.00 | 3,211.84 | 0.00 | 100.00 | 100.00 | 3,211.84 | 0.00 | 7,401.00 | |
| 8 | 11,727.01 | 4 | 4 | 0 | 100.00 | 2,931.75 | 0.00 | 100.00 | 100.00 | 2,931.75 | 0.00 | 5,788.00 | |
| 7 | 10,939.02 | 4 | 4 | 0 | 100.00 | 2,734.76 | 0.00 | 100.00 | 100.00 | 2,734.76 | 0.00 | 5,459.00 | |
| 6 | 10,652.12 | 4 | 4 | 0 | 100.00 | 2,663.03 | 0.00 | 100.00 | 100.00 | 2,663.03 | 0.00 | 4,798.00 | |
| 5 | 8,422.94 | 4 | 3 | 1 | 75.00 | 2,812.02 | -13.13 | 214.17 | 642.50 | 2,105.74 | -13.13 | 4,939.00 | |
| 4 | 7,303.85 | 4 | 4 | 0 | 100.00 | 1,825.96 | 0.00 | 100.00 | 100.00 | 1,825.96 | 0.00 | 3,862.00 | |
| 3 | 5,113.94 | 4 | 4 | 0 | 100.00 | 1,278.49 | 0.00 | 100.00 | 100.00 | 1,278.49 | 0.00 | 3,064.00 | |
| 2 | 4,156.31 | 4 | 3 | 1 | 75.00 | 1,484.08 | -295.93 | 5.01 | 15.04 | 1,039.08 | -295.93 | 2,165.00 | |
| 1 | 3,541.52 | 4 | 4 | 0 | 100.00 | 885.38 | 0.00 | 100.00 | 100.00 | 885.38 | 0.00 | 1,170.59 | |

Dates were 2/22/71, 7/17/03, 6/7/07, and 9/2/09.

Recognize the theme? Very few instances. Strongly bullish implications. Here's the charts again.





These pictures look generally similar to the earlier tests and suggest a bounce is near. I also decided to loosen the parameters and test varying levels for the McClellan Oscillator using a 3-day exit strategy. Those results are below:

| SPX closes above 200ma. Ratio adjusted McClellan Oscillator < X. The NYSE Adv/Decl line 5-day high = the adv/decl line 50-day high. Buy SPX on close. Sell 3 days later. \$100k/trade. 1969 - present. | | | | | | | | | | |
|--|-----------------|-------------------|---------------------|--------------------|-------------------|------------------------|-----------------------|---------------------|-------------------|----------------|
| X | 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 |
| -75 | 5,113.94 | 4 | 4 | 0 | 100.00 | 1,278.49 | 0.00 | 100.00 | 100.00 | 1,278.49 |
| -70 | 6,775.97 | 5 | 5 | 0 | 100.00 | 1,355.19 | 0.00 | 100.00 | 100.00 | 1,355.19 |
| -65 | 7,692.48 | 8 | 7 | 1 | 87.50 | 1,100.40 | -10.33 | 106.52 | 745.67 | 961.56 |
| -60 | 10,511.76 | 9 | 8 | 1 | 88.89 | 1,315.26 | -10.33 | 127.32 | 1,018.60 | 1,167.97 |
| -55 | 11,956.49 | 12 | 10 | 2 | 83.33 | 1,206.31 | -53.29 | 22.64 | 113.18 | 996.37 |

Even with a less extreme McClellan Oscillator you're looking at a good chance of a quick bounce.

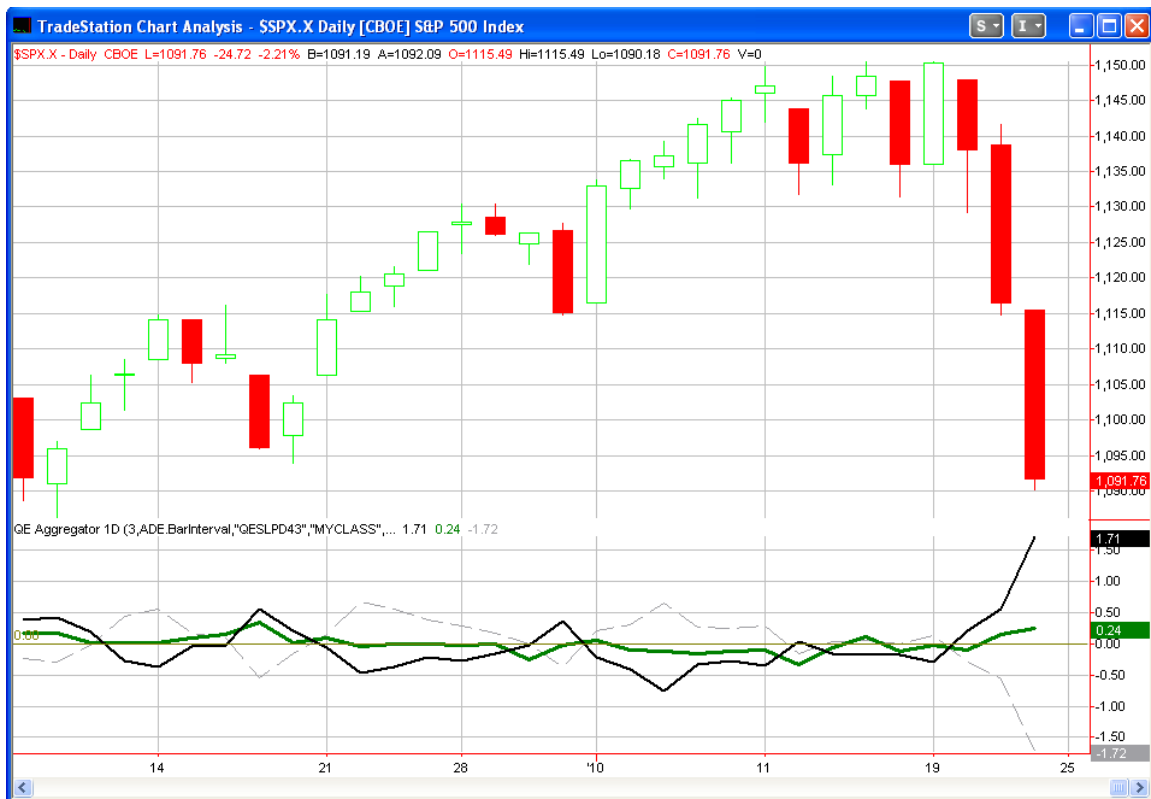
So price, breadth and VIX action are all suggesting a bounce is imminent. There has never been such a confluence of these indicators as we are seeing right now. To get some kind of risk/reward estimate I ran a study using all 3 of the above tests (VIX 40% > ma, the 5% price drop and the McClellan < -75). Those combined results are below:

| VIX, price, or breadth study from above triggers. Buy on close. Sell X days later. \$100k/trade. 1969 - 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 |
| 11 | 37,953.10 | 15 | 11 | 4 | 73.33 | 4,032.70 | -1,601.66 | 2.52 | 6.92 | 2,530.21 |
| 10 | 40,751.34 | 15 | 12 | 3 | 80.00 | 3,996.37 | -2,401.71 | 1.66 | 6.66 | 2,716.76 |
| 9 | 38,352.26 | 15 | 13 | 2 | 86.67 | 3,419.40 | -3,049.99 | 1.12 | 7.29 | 2,556.82 |
| 8 | 39,061.43 | 15 | 12 | 3 | 80.00 | 3,781.85 | -2,106.92 | 1.79 | 7.18 | 2,604.10 |
| 7 | 43,165.02 | 15 | 13 | 2 | 86.67 | 3,643.36 | -2,099.33 | 1.74 | 11.28 | 2,877.67 |
| 6 | 36,260.07 | 15 | 12 | 3 | 80.00 | 3,395.84 | -1,496.67 | 2.27 | 9.08 | 2,417.34 |
| 5 | 36,108.01 | 15 | 11 | 4 | 73.33 | 3,608.85 | -897.33 | 4.02 | 11.06 | 2,407.20 |
| 4 | 27,750.02 | 16 | 13 | 3 | 81.25 | 2,660.47 | -2,278.71 | 1.17 | 5.06 | 1,734.38 |
| 3 | 21,835.02 | 16 | 13 | 3 | 81.25 | 2,125.09 | -1,930.40 | 1.10 | 4.77 | 1,364.69 |
| 2 | 22,051.77 | 19 | 13 | 6 | 68.42 | 2,135.84 | -952.36 | 2.24 | 4.86 | 1,160.62 |
| 1 | 17,883.41 | 23 | 18 | 5 | 78.26 | 1,317.91 | -1,167.80 | 1.13 | 4.06 | 777.54 |

Bottom line here is that I'm very bullish on the short-term prospects. I think we are going to see a bounce this week and I think it will start in the next 1-2 days in all likelihood. I think if you're a short-tem trader then being short at this point in time carries huge risk. If you're long then you need to keep in mind that we are far beyond "normal" market conditions already. Once you reach such rarified air, risks tend to rise. Don't overbet here. There's nothing wrong with reducing position size when things get hairy. That said, it isn't my style and I'll be looking to get all-in from an index trading standpoint.

I strongly recommend traders take a good look at the above charts when considering how aggressively they'd like to be positioned – if at all.

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



With all the bullish studies now active the green Aggregator line is solidly above 0. This illustrates net expectations over the next few days are positive. The big decline the last 3 days has caused the black differential line to spike dramatically. This shows that the SPX has severely underperformed expectations over the last few days. Both lines above 0 has historically provided a short-term bullish edge. This configuration leaves the Aggregator System long.

Barring some big moves and strongly bearish studies the Aggregator is expected to remain in a bullish configuration tomorrow. The green Aggregator line is currently projected to remain close to its current level. For the black Differential line to flip negative it would take a close at or above 1,133.75 on Monday. I'm looking for a multi-day bounce at this point.

Intermediate-term Outlook (2 weeks – 2 months)– updated 1/25 –somewhat bullish

With all the charts we looked at in the short-term section I don't intend to delve into great detail here tonight. Just a few quick points.

Bear markets typically don't begin when 1) breadth stats have been solid and the uptrend has been hitting new highs, or 2) the VIX spikes anywhere near the amount it already has.

Uptrend lines and some key moving averages (20, 50) have quickly been broken. This could be a warning similar to the 1/4/2000 selloff we looked at above. The market didn't top for another few months there, but that was the 1st sign of weakness.

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

The action the last 2 days would often bring about a few Catapult trades. To this point nothing has appeared. If the market were locked in a long-term downtrend, this would concern me and I would wait for the CBI to spike a bit before allocating aggressively. Large CBI spikes in long-term uptrends are quite rare and I don't find the lack of Catapults discouraging.

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.

VXX – short @ \$31.89 limit. This is another way to play a possible market bounce. Even a very slight SPX bounce should lead to a drop off in the VIX over the next few days. Careful with size here. Keep in mind VXX rose almost 9% on Friday. It's capable of strong moves.

SPY – buy ¼ index position @ \$109.50

SPY – buy ¼ index position @ \$109.21.

I want to get longer and if we gap up Monday I'll be looking to enter even prior to a gap fill. The 2nd lot I will demand a decent price for.

Active Trades Table

| Symbol | Entry Date | Entry Price | Current Pr | % Gain/Lo | Stop | Notes |
|---------------|-------------------|--------------------|-------------------|------------------|-------------|--------------|
| SPY(1/4) | 1/22/2010 | \$111.20 | \$109.21 | -1.79% | | Aggregator |
| SPY(1/4) | 1/22/2010 | \$111.20 | \$109.21 | -1.79% | | Aggregator |

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