

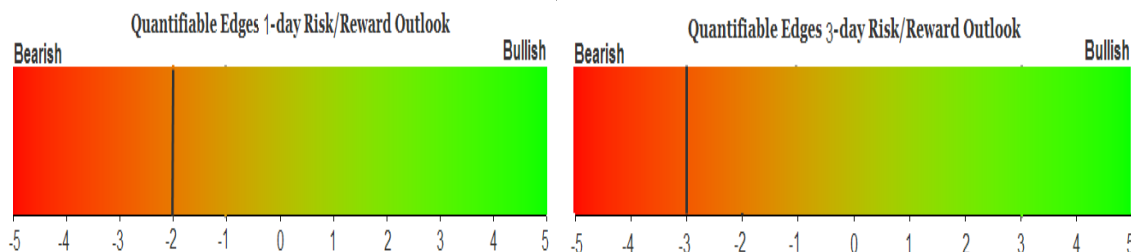
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 19, 2010

Volume 3 Issue 33

Market Overview



Tonight's Research Points

- VXO 15% below 10ma suggests a bearish market edge.
- The Aggregator System triggered a short at the close.
- The NDX Aggressive Trend Timer remains flat.

Short-term Outlook – updated 2/19

The Bottom Line

Overbought is now more overbought. The VXO is showing signs of complacency, and our short-term bullish studies have all reached their target prices. This all suggests the short side is the place to be. That's where I'm positioned. At this point I'll stick with a conservative position size since it's a counter-trend trade.

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 | | | | |
| February 19, 2010 | VXO 15% under 10ma. SPX > 200ma | 1-5 days | Bearish | -1.80% |
| February 12, 2010 | 2 of 3 75% Up Issues % No 10-day high | 1-9 days | Bearish | -4.40% |
| Active - Long Term | | | | |
| February 16, 2010 | Nasdaq/S&P RS Indicator Positive | int. term | Bullish | |
| February 12, 2010 | IBD Follow Through Day | int. term | Bullish | |
| February 8, 2010 | Worden %>200ma - %>40ma > 40 | 3 - 7 weeks | Bullish | |
| February 1, 2010 | McClellan -60 for 6 days in a row | 1-20 days | Bearish | |
| January 13, 2010 | No bearish divergence at high | int. term | Bullish | |
| Dropped Tonight | | | | |
| February 17, 2010 | 90% Up Vol on low Vol > 200ma | 1-2 days | Bullish | |
| February 12, 2010 | IBD Follow Through Day | 1-6 days | Bullish | 2.70% |

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

The Evidence

A slow start was followed by a strong finish for the market. The SPX, Nasdaq, and Russell 200 all closed up 0.7%. Breadth was positive with the NYSE Up Issues % coming in at 68% and the Up Volume % at 74%. Total volume was light and was down from Wednesday's levels.

One indicator that gave a significant reading tonight was the VXO as it fell more than 15% below its 10ma. This can be viewed as a sign of complacency among options traders. In the 1/29/09 Letter I demonstrated how stretches of this magnitude produced negative expectations for the S&P 500. I've updated those results below.

| VXO crosses more than 15% below the 10ma on a closing basis. Buy SPX on close. Sell X days later. \$100k/trade. 1987 - 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 | -51,438.22 | 50 | 18 | 32 | 36.00 | 1,632.60 | -2,525.78 | 0.65 | 0.36 | -1,028.76 |
| 4 | -38,630.62 | 51 | 19 | 32 | 37.25 | 1,267.18 | -1,959.60 | 0.65 | 0.38 | -757.46 |
| 3 | -34,459.26 | 52 | 25 | 27 | 48.08 | 992.94 | -2,195.66 | 0.45 | 0.42 | -662.68 |
| 2 | -24,629.96 | 54 | 24 | 30 | 44.44 | 1,202.05 | -1,782.64 | 0.67 | 0.54 | -456.11 |
| 1 | -4,158.75 | 54 | 22 | 32 | 40.74 | 916.40 | -759.98 | 1.21 | 0.83 | -77.01 |

This appears to suggest a substantial short-term bearish edge. I also checked to see whether the edge held up when the SPX was in a long-term uptrend.

| VXO crosses more than 15% below the 10ma on a closing basis. SPX > 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1987 - 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 | -15,586.28 | 25 | 8 | 17 | 32.00 | 1,306.71 | -1,531.76 | 0.85 | 0.40 | -623.45 |
| 4 | -5,047.41 | 25 | 10 | 15 | 40.00 | 1,119.60 | -1,082.89 | 1.03 | 0.69 | -201.90 |
| 3 | -3,416.01 | 25 | 15 | 10 | 60.00 | 712.43 | -1,410.25 | 0.51 | 0.76 | -136.64 |
| 2 | -5,020.73 | 27 | 11 | 16 | 40.74 | 915.92 | -943.49 | 0.97 | 0.67 | -185.95 |
| 1 | -4,142.74 | 27 | 9 | 18 | 33.33 | 642.18 | -551.24 | 1.16 | 0.58 | -153.43 |

85% of instances closed below the entry price at some point in the next 4 days.

The downside potential wasn't quite as strong but there still appears to be a solid edge.

Today's move higher allowed both bullish studies to achieve their target prices and they have been removed from the Active Studies list.

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



With one bearish study being added and two bullish studies being removed tonight the green Aggregator line has sunk further below 0, indicating fairly strong bearish inclinations. Meanwhile the black Differential line also dipped further. The SPX has strongly outperformed expectations over the last few days. Negative expectations and recent SPX outperformance combine to suggest a downside edge. The Aggregator System remains short.

Looking ahead to Friday the Aggregator line is scheduled to remain bearish unless some strongly bullish studies appear. The pivot level for the Differential line is 1096.08. A close below this level would flip the Differential line into positive territory. So at this point it appears the market would need to sell off quite a bit Friday in order for the bearish bias to change.

Intermediate-term Outlook (2 weeks – 2 months)– updated 2/16 –slightly bullish

I discussed on Friday in the Subscriber Letter and the blog that Thursday's action qualified as a follow through day (FTD) under Investors Business Daily's classic definition in which a rise of 1% or more in one of the major indices is required. Apparently IBD didn't count it since it didn't quite meet their new 1.7% rise definition. I'm not a big fan of the new rule and believe the 1% requirement is more useful than the new 1.7%. For details on why I feel this way you may refer to this old blog post on the subject:

<http://quantifiableedges.blogspot.com/2008/01/follow-through-days-pt-2-does-every.html>

I thought it might be interesting to examine a few new ideas with regards to FTD's today. Before I do that I'll first point you to the post where I defined the rules of the tests. I basically followed all of the rules as IBD laid them out. Two rules that IBD has never clearly defined are what entails "success" or "failure". I defined "failure" to be a close below the intraday low of the bottom prior to the FTD. I defined "success" as a move either 1) twice a large as the distance from the low of the potential bottom to the close of the FTD, or 2) a new 52-week high. More detailed explanations of the rules may be found using the link below:

<http://quantifiableedges.blogspot.com/2008/01/ibd-follow-through-days-pt-1-are-they.html>

Under these rules, and requiring an 8% pullback before looking for a FTD, there have now been 71 FTD's since 1971. 37 have been "successes" and 34 have been "failures" for a winning % of 52%. One of the findings I published during the 2008 series on FTDs was that [FTD's coming after smaller pullback had a better success rate than FTD's coming after larger pullbacks](#). It was this research that led me to ponder whether this FTD may have a better chance of success because the rally attempt is occurring while the SPX is above its 200ma. It would seem to make sense that there might be a better chance of success since the long-term uptrend has not clearly turned down at this point. What I found when examining the 71 follow through days that now qualify based on the original study was that only 23 closed above the 200ma. Of those 23, 14 turned out to be winners and 9 losers. This 61% success rate is better than the 48% success rate that has occurred below the 200ma with 23 winners and 25 losers. It isn't overwhelmingly better, though. I'm not sure the distinction is worth making.

I received an interesting note from Mark Minervini this week who said that he's heard that the Nasdaq has had better success with FTD rallies than the S&P. Mark is a former U.S. investing champion and was featured in the book "Market Wizards" by Jack Schwager. You can find Mark's thoughts these days on his blog at <http://markminerviniblog.blogspot.com> While he didn't have details on how the study he cited was set up, it did seem to be a reasonable claim and one worth pursuing. I've found in the past that the Nasdaq often takes on a leadership position when the market emerges from an extended downtrend. I thought perhaps this might explain the phenomenon.

I put the claim to the test. To do so I decided to use the 71 FTD rally attempts identified in the original study. In order to fairly compare S&P versus Nasdaq performance I decided I would enter and exit the Nasdaq on the same days that the S&P was entered and exited based on the original definitions of "success" and "failure". By using the same entry and exit dates we could easily compare performance between the two indices.

These first results show the performance of the S&P from the FTD date to the "success" date.

SPX performance on "successful" FTD rally attempts.

| TradeStation Performance Summary Collapse ^ | | | |
|--|--------------|--------------------------|---------|
| All Trades | | | |
| Total Net Profit | \$285,723.45 | Profit Factor | n/a |
| Gross Profit | \$285,723.45 | Gross Loss | \$0.00 |
| Total Number of Trades | 37 | Percent Profitable | 100.00% |
| Winning Trades | 37 | Losing Trades | 0 |
| Even Trades | 0 | | |
| Avg. Trade Net Profit | \$7,722.26 | Ratio Avg. Win:Avg. Loss | n/a |
| Avg. Winning Trade | \$7,722.26 | Avg. Losing Trade | \$0.00 |
| Largest Winning Trade | \$22,449.07 | Largest Losing Trade | \$0.00 |

Keep in mind that these results do not encompass the entire rally but only the time it took to get from the FTD to the success target. Now let's look and see how the Nasdaq performed over the exact same time periods.

Nasdaq performance on "successful" FTD rally attempts.

| TradeStation Performance Summary Collapse ^ | | | |
|--|--------------|--------------------------|--------------|
| All Trades | | | |
| Total Net Profit | \$341,981.97 | Profit Factor | 106.74 |
| Gross Profit | \$345,216.21 | Gross Loss | (\$3,234.24) |
| Total Number of Trades | 37 | Percent Profitable | 94.59% |
| Winning Trades | 35 | Losing Trades | 2 |
| Even Trades | 0 | | |
| Avg. Trade Net Profit | \$9,242.76 | Ratio Avg. Win:Avg. Loss | 6.10 |
| Avg. Winning Trade | \$9,863.32 | Avg. Losing Trade | (\$1,617.12) |
| Largest Winning Trade | \$26,572.44 | Largest Losing Trade | (\$2,098.80) |

Here we see that while the Nasdaq actually had two losers, it still averaged about 1.5% better per trade on the whole. Not shown in the above tests it that the average trade lasted just over 9 weeks.

So as was suggested earlier it appears the Nasdaq has done better when the FTD led to a successful rally. But what of those times when the rally attempt failed? Let's start again by examining the stats of the S&P FTD losers:

SPX performance of "failed" FTD rally attempts.

| TradeStation Performance Summary Collapse ^ | | | |
|--|----------------|--------------------------|----------------|
| All Trades | | | |
| Total Net Profit | (\$177,044.99) | Profit Factor | 0.00 |
| Gross Profit | \$0.00 | Gross Loss | (\$177,044.99) |
| Total Number of Trades | 31 | Percent Profitable | 0.00% |
| Winning Trades | 0 | Losing Trades | 31 |
| Even Trades | 0 | | |
| Avg. Trade Net Profit | (\$5,711.13) | Ratio Avg. Win:Avg. Loss | 0.00 |
| Avg. Winning Trade | \$0.00 | Avg. Losing Trade | (\$5,711.13) |
| Largest Winning Trade | \$0.00 | Largest Losing Trade | (\$11,565.12) |

Here we see the average loser lost about 5.7% from the FTD close to the point of failure. So how did that Nasdaq do?

Nasdaq Performance on "failed" FTD's.

| All Trades | | | |
|------------------------|----------------|--------------------------|----------------|
| Total Net Profit | (\$167,303.06) | Profit Factor | 0.09 |
| Gross Profit | \$16,175.91 | Gross Loss | (\$183,478.97) |
| Total Number of Trades | 31 | Percent Profitable | 19.35% |
| Winning Trades | 6 | Losing Trades | 25 |
| Even Trades | 0 | | |
| Avg. Trade Net Profit | (\$5,396.87) | Ratio Avg. Win:Avg. Loss | 0.37 |
| Avg. Winning Trade | \$2,695.98 | Avg. Losing Trade | (\$7,339.16) |
| Largest Winning Trade | \$4,919.46 | Largest Losing Trade | (\$26,335.19) |

These results were actually quite impressive. Almost 20% of the time when the S&P had clearly failed, the Nasdaq was still positive on its rally attempt. And even with the largest losing trade substantially bigger than the S&P's, the average trade actually lost less.

So not only has the Nasdaq offered more substantial rewards following FTD's, but the risks have historically been lower as well. This confirms the claim that the Nasdaq is a better place to be when a rally is being attempted. It suggests traders may be better served focusing on areas like smallcap and technology than on large caps.

It's also notable that the S&P/Nasdaq Relative Strength Indicator shown on the website flipped on Friday so that relative strength is now favoring the Nasdaq. I've pasted a copy of that indicator below. The line will appear in green just like the result next week. It is imperceptible at this point because it just turned green at the close.

S&P 500/Nasdaq Relative Strength Weekly



Historically when this configuration has been in place it has been a bullish sign for the market as measured by the S&P 500. And if you invested in the Nasdaq rather than the S&P you'd see results were even better. More information on this indicator may be found using the link below:

<http://quantifiableedges.blogspot.com/2009/06/tweaking-nasdaq-leadlag-model.html>

I'm optimistic that the current rally attempt will have some legs. Not just because we have the Nasdaq now in position, but more so because of some of the breadth studies I've cited the last few weeks that are listed in the Active Studies table at the top of this Letter. I would also suggest that the Nasdaq may have better potential than the S&P based on the Nasdaq/S&P research discussed above.

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'm half in with the SPY position and I likely won't increase it without some very compelling evidence. I'm not crazy about getting too aggressive with a counter-trend trade – especially just after a follow-through day.

Active Trades Table

| Symbol | Entry Date | Entry Price | Current Price | % Gain/Loss | Stop | Notes |
|-------------|------------|-------------|---------------|-------------|------|--------------------------|
| VXX(s) | 2/8/2010 | \$33.31 | \$29.98 | 10.01% | | closed - avg price shown |
| SPY(1/4)(s) | 2/18/2010 | \$110.26 | \$110.91 | -0.59% | | short @ limit |
| SPY(1/4)(s) | 2/18/2010 | \$110.91 | \$110.91 | 0.00% | | short @ close |

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