

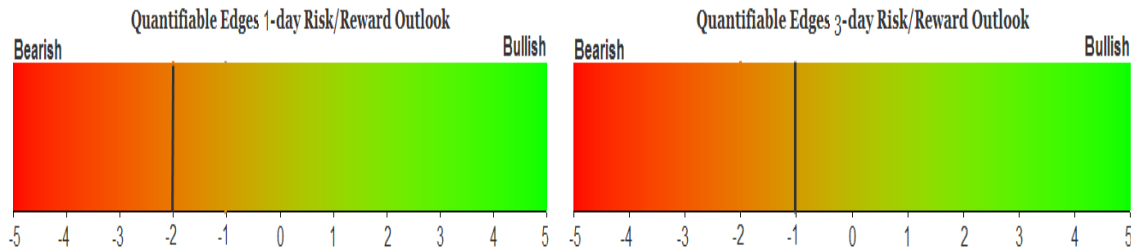
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 25, 2010

Volume 3 Issue 37

Market Overview



Tonight's Research Points

- The SPY had an unfilled gap up, a close above the open and posted an inside day. Historically this has been followed by moderate weakness.
- The Aggregator System switched back to a short signal.
- The NDX Aggressive Trend Timer remains flat.

Short-term Outlook – updated 2/25

The Bottom Line

There are still a fair amount of short-term bearish studies active. They are going to expire in the next couple of days. The Aggregator is suggesting a downside edge for Thursday but in all likelihood that will switch to flat or long on Friday.

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 25, 2010	SPY Unfilled Gap Up Lower High>200	1-2 days	Bearish	-1.00%
February 24, 2010	1% drop and up issue % < 33.33%	1-9 days	Bullish	3.00%
February 23, 2010	SPY Lowest Vol 20 & Close > 10ma	1-5 days	Bearish	-2.10%
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 22, 2010	VIX:VXV Ratio falls below 0.9	int. term	Bearish	
February 22, 2010	Good 5 days after FTD	int. term	Bullish	
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	

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

The Evidence

After a decent sized gap up there was generally muted but positive action on Wednesday. The major indices all closed higher with the SPX, Nasdaq, and Russell 2000 all up about 1%. Breadth was firmly positive with the NYSE Up Issue % at 71% and the Up Volume % at 75%. Total volume declined from Tuesday's levels.

The action was a bit odd in that the SPY left an unfilled gap up on Wednesday, rose from open to close, and still couldn't manage to move above Tuesday's high, making it an unusual inside day. As you can see below this mix has led to weakness more often than additional strength.

SPY posts unfilled gap up but a lower high than yesterday. Close > open. 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	-33,465.26	41	17	24	41.46	1,684.50	-2,587.57	0.65	0.46	-816.23
9	-39,275.82	43	15	28	34.88	1,868.75	-2,403.82	0.78	0.42	-913.39
8	-42,968.03	45	18	27	40.00	1,932.36	-2,879.65	0.67	0.45	-954.85
7	-36,262.43	46	21	25	45.65	1,907.62	-3,052.90	0.62	0.52	-788.31
6	-28,627.31	47	23	24	48.94	1,390.60	-2,525.46	0.55	0.53	-609.09
5	-31,297.28	47	20	27	42.55	1,336.06	-2,148.83	0.62	0.46	-665.90
4	-14,017.65	47	23	24	48.94	1,279.61	-1,810.36	0.71	0.68	-298.25
3	-4,630.80	48	23	25	47.92	1,163.67	-1,255.81	0.93	0.85	-96.48
2	-6,448.32	49	20	29	40.82	1,241.77	-1,078.75	1.15	0.79	-131.60
1	536.66	49	22	27	44.90	975.85	-775.26	1.26	1.03	10.95

In the past I have found that inside days during long-term downtrends suggest weakness but when the market is above the 200ma, there isn't much of an edge. This isn't the case when considering the gap up and close higher than the open. Below are the results with the 200ma filter added.

SPY posts unfilled gap up but a lower high than yesterday. Close > open & 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	-10,851.69	32	14	18	43.75	1,442.52	-1,724.83	0.84	0.65	-339.12
9	-13,344.92	33	11	22	33.33	1,624.49	-1,418.83	1.14	0.57	-404.39
8	-11,352.43	35	14	21	40.00	1,583.18	-1,596.04	0.99	0.66	-324.36
7	-3,746.52	36	17	19	47.22	1,733.09	-1,747.84	0.99	0.89	-104.07
6	-6,396.42	37	19	18	51.35	1,262.15	-1,687.63	0.75	0.79	-172.88
5	-9,072.88	37	15	22	40.54	1,266.77	-1,276.11	0.99	0.68	-245.21
4	-3,686.84	37	17	20	45.95	1,095.96	-1,115.91	0.98	0.83	-99.64
3	-2,824.31	38	17	21	44.74	927.51	-885.33	1.05	0.85	-74.32
2	-6,235.67	39	14	25	35.90	1,093.30	-861.67	1.27	0.71	-159.89
1	-4,573.05	39	15	24	38.46	918.24	-764.44	1.20	0.75	-117.26

87% of instances posted a close below the entry price at some point in the next week.

The edge isn't terribly strong, but it is fairly consistent and worth considering.

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



Even without tonight's bearish study the green Aggregator line was poised to remain below zero tonight. This shows the net expectation from the current active studies is for downside over the next few days. The rally on Wednesday pushed the SPX up above the 1,103.55 pivot level I published in last night's Letter. This caused the black Differential

line to drop back below the zero line illustrating the fact that the SPX has outperformed expectations over the last few days. Negative expectations and recent outperformance are the recipe for a downside edge and the Aggregator System is again short. Subscribers were alerted to the likely short signal about 15 minutes before the bell when the Systems Page was updated. The page is typically updated between 10-15 minutes before the bell, but if you'd like a reminder when the updates occur you may follow me on twitter at <http://twitter.com/qerob>

Looking ahead the green Aggregator line is currently set to move above the zero line tomorrow unless there is additional bearish evidence to keep it below 0. This alone means the short signal is likely to expire at Thursday's close. The pivot level for the Differential line tomorrow will be 1,101.52. This means a close at or below 1,101.52 would pop the Differential line back above zero. So if the selloff the Aggregator is expecting tomorrow actually occurs there stands a decent chance it will then trigger a long signal. I'll be monitoring the Quantifinder closely and posting the probable signal to the Systems page.

Intermediate-term Outlook (2 weeks – 2 months)– updated 2/22 – bullish

It has now been 5 trading days since the 2/11 classic Follow Through Day (a gain of 1% or more on higher volume). In the February 1, 2008 blog post I examined implications of market action directly after FTD's. In that post I found this early action to be a strong indication of whether a FTD was likely to succeed or not. I've pasted the pertinent information from that post below:

Is short-term success or failure indicative of long-term success or failure?

One interesting claim that IBD sometimes makes about Follow Through Days is that those that fail normally do so shortly after the Follow Through Day. I decided to also look at this concept tonight.

I broke the 64 Follow Through Days in my study up into two groups – the successful ones and the unsuccessful ones – to see if their early performance hinted at their chance of longer-term success. Below are the breakdowns – same as above - \$100,000/trade, long at the close of the Follow Through Day, and exit X days later.

Early action after Follow Through Days that eventually “succeeded”:

Successful FTD's											
Days Held	Net Profit	Trades	% Profitable	Wins	Losses	Avg Win	Avg Loss	Win/Loss Ratio	Avg Trade	ProfitFactor	
10	\$78,896.61	35	71.43	25	10	\$3,547.95	(\$980.23)	3.62	\$2,254.19	9.05	
5	\$62,786.42	35	77.14	27	8	\$2,795.15	(\$1,585.33)	1.76	\$1,793.90	5.95	
4	\$53,316.64	35	68.57	24	11	\$2,754.82	(\$1,163.56)	2.37	\$1,523.33	5.17	
3	\$52,666.31	35	65.71	23	12	\$2,773.65	(\$927.31)	2.99	\$1,504.75	5.73	
2	\$52,742.34	35	71.43	25	10	\$2,508.30	(\$996.53)	2.52	\$1,506.92	6.29	
1	\$25,494.79	35	57.14	20	15	\$1,690.62	(\$554.51)	3.05	\$728.42	4.07	

Right off the bat most of these posted nice gains. The short-term winners among the group averaged another 2-3% upside in the first week. The short-term losers suffered 1-

1.5% drops on average. Net profits were substantial.

Early action after Follow Through Days that eventually “failed”:

Unsuccessful FTD's										
Days Held	Net Profit	Trades	% Profitable	Wins	Losses	Avg Win	Avg Loss	Win/Loss Ratio	Avg Trade	ProfitFactor
10	(\$46,481.75)	29	34.48	10	19	\$1,818.19	(\$3,403.35)	0.53	(\$1,602.82)	0.28
5	(\$17,048.80)	29	48.28	14	15	\$1,651.24	(\$2,677.74)	0.62	(\$587.89)	0.58
4	(\$15,244.85)	29	44.83	13	16	\$1,465.84	(\$2,143.80)	0.68	(\$525.68)	0.56
3	(\$18,577.18)	29	44.83	13	16	\$1,358.57	(\$2,264.91)	0.60	(\$640.59)	0.49
2	(\$22,069.98)	29	37.93	11	18	\$764.94	(\$1,693.58)	0.45	(\$761.03)	0.28
1	(\$7,847.64)	29	41.38	12	17	\$425.76	(\$762.16)	0.56	(\$270.61)	0.39

Those that eventually failed tended to show signs of failure right away. Notable here is the average loss was appreciably higher than the average gain.

A basic rule of thumb is that the success or failure was determined with about 67% reliability within the first week after a Follow Through Day. For instance, note there were 41 total trades that were in the black after 5 days. About 2/3 of them went on to “successful” rallies. The same ratio applies for the losers. There were 23 losers after 5 days. 15 of them ended up with “failed” rallies and the other 8 were “successful”. The 2/3 rule holds fairly accurate whether you are looking at winners or losers over any period from 1-5 days after the Follow Through Day.

In the current situation “success” would be a move to 1,147.41 or higher. This is just barely under the recent high of 1,150.45. In other words, based on this study, there appears to be a good chance the market will at least test its January highs before it breaks its February lows. This is consistent with what some breadth-based studies have been suggesting as well. One thing to note is that there still has not been a FTD under the current IBD definition, so it will be interesting to see what happens here.

In the 8/25/08 Letter I took a look at the VIX:VXV Ratio. The VIX measures option volatility out 30 days. The VXV uses the same calculation but measures out 90 days. Their values and movement are frequently quite close. When the VIX moves significantly above or below the VXV then that can provide us clues about volatility expectations for the short and intermediate-term. It can also serve as a directional indicator.

Below is a study which shows how the market has performed in the past when the ratio has closed below 0.90. The VXV has only been around since December of 2006. The CBOE did calculate it back several more years though. I have been able to acquire their data back to 2002 and have included that in the below test. (This test is updated this evening.)

VIX:VXV Ratio closes below 0.9.
Buy SPX on close. Sell X days later. \$100k/trade. 2002 - 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
20	-4,442.58	43	22	21	51.16	2,186.37	-2,502.04	0.87	0.92	-103.32
19	-10,329.29	43	21	22	48.84	2,220.84	-2,589.40	0.86	0.82	-240.22
18	-10,876.03	44	24	20	54.55	1,905.02	-2,829.82	0.67	0.81	-247.18
17	-14,987.62	47	21	26	44.68	2,028.94	-2,215.21	0.92	0.74	-318.89
16	-16,199.26	48	23	25	47.92	1,912.11	-2,407.11	0.79	0.73	-337.48
15	-21,761.97	50	21	29	42.00	1,949.85	-2,162.37	0.90	0.65	-435.24
14	-10,729.05	51	27	24	52.94	1,448.82	-2,076.96	0.70	0.78	-210.37
13	-13,941.59	53	27	26	50.94	1,456.47	-2,048.71	0.71	0.74	-263.05
12	-15,839.97	58	28	30	48.28	1,658.39	-2,075.83	0.80	0.75	-273.10
11	-17,699.50	64	29	35	45.31	1,562.96	-1,800.73	0.87	0.72	-276.55
10	-12,567.24	66	32	34	48.48	1,488.73	-1,770.78	0.84	0.79	-190.41
9	-14,368.33	69	34	35	49.28	1,367.34	-1,738.79	0.79	0.76	-208.24
8	-13,688.32	79	39	40	49.37	1,388.88	-1,696.36	0.82	0.80	-173.27
7	-9,774.28	85	41	44	48.24	1,391.65	-1,518.90	0.92	0.85	-114.99
6	2,022.44	94	54	40	57.45	1,072.94	-1,397.90	0.77	1.04	21.52
5	-3,073.73	112	59	53	52.68	1,077.12	-1,257.06	0.86	0.95	-27.44
4	-13,685.22	132	64	68	48.48	975.78	-1,119.64	0.87	0.82	-103.68
3	-3,066.23	165	82	83	49.70	907.91	-933.92	0.97	0.96	-18.58
2	-461.82	224	117	107	52.23	692.06	-761.05	0.91	0.99	-2.06
1	-2,914.87	408	223	185	54.66	452.16	-560.79	0.81	0.97	-7.14

In the 8/25/08 Letter the results appeared substantially more bearish. What we see here is a market that is more likely to struggle rather than a suggestion of a strong selloff. In that Letter I also looked at a strategy that would sell short the SPX on a cross below 0.9 and would cover the position only when the ratio moved back above 1. I have updated those results below:

VIX:VXV Ratio closes below 0.9. Buy SPX on close.
Sell when VIX:VXV ratio closes > 1. \$100k/trade. 2002 - present.

TradeStation Performance Summary Collapse ▲			
All Trades			
Total Net Profit	\$15,335.22	Profit Factor	1.48
Gross Profit	\$47,017.77	Gross Loss	(\$31,682.55)
Total Number of Trades	18	Percent Profitable	72.22%
Winning Trades	13	Losing Trades	5
Even Trades	0		
Avg. Trade Net Profit	\$851.96	Ratio Avg. Win:Avg. Loss	0.57
Avg. Winning Trade	\$3,616.75	Avg. Losing Trade	(\$6,336.51)
Largest Winning Trade	\$8,774.18	Largest Losing Trade	(\$13,215.96)

While these appear to suggest a mild downside edge the stats are not nearly as convincing as they were a year and a half ago. If we look at the individual trade breakdown we can easily see why the stats have changed so dramatically.

VIX:VXV Ratio closes below 0.9. Buy SPX on close.
 Sell when VIX:VXV ratio closes > 1. \$100k/trade. 2002 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
01/02/03	Short	\$909.03	5.24%	\$5,425.20
01/24/03	Cover	\$861.40		(\$2,862.20)
08/12/03	Short	\$990.35	(5.38%)	\$999.00
11/17/03	Cover	\$1,043.63		(\$7,330.00)
01/16/04	Short	\$1,139.82	2.90%	\$2,953.65
03/11/04	Cover	\$1,106.79		(\$2,036.67)
03/25/04	Short	\$1,109.28	4.15%	\$4,234.50
08/12/04	Cover	\$1,063.23		(\$3,716.10)
08/25/04	Short	\$1,104.96	(2.28%)	\$1,329.30
10/29/04	Cover	\$1,130.20		(\$3,338.10)
12/09/04	Short	\$1,189.24	3.85%	\$3,974.88
04/15/05	Cover	\$1,143.43		(\$3,349.08)
06/02/05	Short	\$1,204.29	2.28%	\$2,995.47
10/13/05	Cover	\$1,176.84		(\$3,450.31)
11/25/05	Short	\$1,268.25	(2.91%)	\$1,755.78
05/01/06	Cover	\$1,305.19		(\$3,892.98)
07/03/06	Short	\$1,280.19	2.96%	\$3,023.28
07/13/06	Cover	\$1,242.28		\$0.00
08/16/06	Short	\$1,295.43	(8.01%)	\$457.38
02/27/07	Cover	\$1,399.14		(\$12,792.78)
06/19/07	Short	\$1,533.70	2.66%	\$2,805.40
06/26/07	Cover	\$1,492.89		(\$235.30)
10/09/07	Short	\$1,565.15	3.62%	\$4,762.17
11/01/07	Cover	\$1,508.45		(\$689.22)
12/20/07	Short	\$1,460.12	3.32%	\$3,327.24
01/04/08	Cover	\$1,411.62		(\$2,633.64)
05/12/08	Short	\$1,403.58	8.80%	\$9,342.18
06/30/08	Cover	\$1,280.00		(\$2,602.86)
08/21/08	Short	\$1,277.71	4.16%	\$4,717.44
09/09/08	Cover	\$1,224.54		(\$1,975.74)
06/25/09	Short	\$920.26	(13.30%)	\$5,501.52
10/28/09	Cover	\$1,042.63		(\$19,558.80)
11/17/09	Short	\$1,110.32	1.70%	\$2,392.20
11/27/09	Cover	\$1,091.50		(\$185.40)
12/01/09	Short	\$1,108.86	1.54%	\$2,034.00
01/22/10	Cover	\$1,091.76		(\$3,743.10)
02/19/10	Short	\$1,109.17	n/a	\$0.00
open	n/a	\$1,109.17		\$0.00

From the end of June to the end of October there was a strong rally in the face of a low VIX:VXV ratio. Was this rally an anomaly or has the indicator lost its edge? It's tough to tell. My inclination is that the rally over this time period was unusually strong in many ways and just because this indicator got run over then doesn't mean it's entirely useless. So I'll add it to the intermediate-term active studies as something to keep in mind but it won't be factoring in to the Aggregator calculation at this point.

So while we are short-term overbought and a pullback appears imminent, my intermediate-term bias is to the long side. I'm of the opinion that the market will at least test the January highs. If I'm right then I'll be looking for more clues as we approach that level that may hint whether the recent selloff was a warning shot and we're likely in a topping pattern, or whether the rally can gain enough momentum to put in another leg higher beyond the January highs.

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 – short @ \$111.00 LIMIT ON OPEN. The current Aggregator signal is only likely to last 1 day. If we get a gap up I'll look to try and take advantage of it. Otherwise I'll sit this one out and wait to for more convincing setup for the next Subscriber Letter trade idea.

Active Trades Table

None.

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