

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

March 5, 2010

Volume 3 Issue 43

Market Overview



Tonight's Research Points

- The consolidation while short-term overbought in a long-term uptrend is a situation that could break either way.
- One way to play the move would be by trading an opening range breakout.
- 5 higher closes above the 200ma but below a 50-day high has led to bullish results in the past.
- The Aggregator System changed to flat on Thursday.
- The NDX Aggressive Trend Timer remains flat.

Short-term Outlook – updated 3/5

The Bottom Line

Bullish studies have taken control of the Active List. This has caused the Aggregator system to turn neutral as the market is now overbought with positive expectations. The tight range in recent days suggest we may see a volatility expansion here very soon.

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				
March 5, 2010	5 up close > 200ma & no 50-day high	1-10 days	Bullish	2.00%
March 4, 2010	2-days gap up close pos but under open	1-5 days	Bullish	2.20%
March 3, 2010	No up vol pattern 3 up days > 200ma	1-4 days	Bearish	-1.40%
March 2, 2010	75% Up Issue % on 1st day then up	1-5 days	Bearish	-1.70%
February 24, 2010	1% drop and up issue % < 33.33%	1-9 days	Bullish	3.00%
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	
January 13, 2010	No bearish divergence at high	int. term	Bullish	
Dropped Tonight				
March 4, 2010	NH's contract while SPX posts higher hi	1 day	Bearish	
March 1, 2010	VIX 3 lows SPX 0 highs last 10 days	1-4 days	Bearish	-2.00%

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

The Evidence

Thursday was pretty sleepy. After gapping less than 2 points higher the market ran up a little...then down...then up...and did it all within the previous day's range. The close was near the high of the day so the indices final numbers looked like respectable gains. The S&P rose 0.4% and the Nasdaq and Russell gained 0.5%. Breadth was mildly positive as the NYSE Up Issues % closed at 58% and the Up Volume % was 62%. Total volume rose slightly but was still below average.

There were a sizable number of studies that appeared in the Quantifinder tonight. Several of them were focused around the fact that the market is overbought on a short-term basis and there has been a consolidation the last few days. In general when this is seen in a downtrend it is often a sign that a bounce is weakening and likely to roll over. But in an uptrend the studies results are often fairly neutral, suggesting the pause could break either way. Below is an excerpt from the 10/8/09 Subscriber Letter that exemplifies this.

Tonight's studies are a clear example of why it is important to keep the long-term trend in mind when evaluating results. In April I did a study that appeared in the Quantifinder tonight. It looked at inside days when the SPY had closed higher for at least 3 days in a row.

SPY has inside day and has closed higher at least 3 days in a row. Buy on close. Sell X days later. \$100k/trade. 2001 - 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	-47,263.01	24	12	12	50.00	1,533.07	-5,471.65	0.28	0.28	-1,969.29
9	-39,539.26	24	14	9	58.33	1,442.13	-6,636.56	0.22	0.34	-1,647.47
8	-26,800.23	24	13	11	54.17	1,588.08	-4,313.21	0.37	0.44	-1,116.68
7	-35,226.98	24	13	11	54.17	1,182.96	-4,600.50	0.26	0.30	-1,467.79
6	-29,531.60	24	10	14	41.67	1,031.44	-2,846.14	0.36	0.26	-1,230.48
5	-22,357.24	24	9	15	37.50	1,197.58	-2,209.03	0.54	0.33	-931.55
4	-23,675.20	24	9	15	37.50	993.87	-2,174.67	0.46	0.27	-986.47
3	-27,490.35	24	6	18	25.00	1,312.21	-1,964.65	0.67	0.22	-1,145.43
2	-11,555.58	25	10	15	40.00	743.03	-1,265.73	0.59	0.39	-462.22
1	-5,002.22	25	12	13	48.00	945.29	-1,257.36	0.75	0.69	-200.09

From these results it appears that a consolidation day provided a significant hint that the run-up is running out of steam and the market is likely to drop. But what if we take these results and break them out by those times the market was in a long-term uptrend vs. a long-term downtrend? I used the 200-day moving average to measure trend. Downtrending situations first:

SPY has inside day and has closed higher at least 3 days in a row. Close < 200ma.
Buy on close. Sell X days later. \$100k/trade. 2001 - 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	-55,854.65	9	1	8	11.11	1,459.77	-7,164.30	0.20	0.03	-6,206.07
9	-45,743.07	9	3	5	33.33	1,844.66	-10,255.41	0.18	0.11	-5,082.56
8	-34,994.47	9	3	6	33.33	1,841.00	-6,752.91	0.27	0.14	-3,888.27
7	-41,745.49	9	3	6	33.33	719.10	-7,317.13	0.10	0.05	-4,638.39
6	-29,956.59	9	3	6	33.33	798.80	-5,392.17	0.15	0.07	-3,328.51
5	-24,450.03	9	2	7	22.22	1,004.43	-3,779.84	0.27	0.08	-2,716.67
4	-22,191.81	9	2	7	22.22	603.80	-3,342.77	0.18	0.05	-2,465.76
3	-25,382.91	9	1	8	11.11	1,455.52	-3,354.80	0.43	0.05	-2,820.32
2	-11,820.10	9	3	6	33.33	616.23	-2,278.13	0.27	0.14	-1,313.34
1	-4,141.93	9	4	5	44.44	1,825.69	-2,288.94	0.80	0.64	-460.21

While instances are a bit low, the stats are extremely skewed to the bearish side. So how does this leave the instances above the 200ma?

SPY has inside day and has closed higher at least 3 days in a row. Close > 200ma.
Buy on close. Sell X days later. \$100k/trade. 2001 - 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	8,591.64	15	11	4	73.33	1,539.73	-2,086.35	0.74	2.03	572.78
9	6,203.81	15	11	4	73.33	1,332.35	-2,113.00	0.63	1.73	413.59
8	8,194.24	15	10	5	66.67	1,512.21	-1,385.57	1.09	2.18	546.28
7	6,518.51	15	10	5	66.67	1,322.12	-1,340.54	0.99	1.97	434.57
6	424.99	15	7	8	46.67	1,131.14	-936.63	1.21	1.06	28.33
5	2,092.79	15	7	8	46.67	1,252.77	-834.58	1.50	1.31	139.52
4	-1,483.39	15	7	8	46.67	1,105.32	-1,152.58	0.96	0.84	-98.89
3	-2,107.44	15	5	10	33.33	1,283.55	-852.52	1.51	0.75	-140.50
2	264.52	16	7	9	43.75	797.37	-590.79	1.35	1.05	16.53
1	-860.29	16	8	8	50.00	505.09	-612.63	0.82	0.82	-53.77

What we see here is that there really isn't a substantial edge when the market is in an uptrend. Over the last few months we certainly have been in an uptrend. I don't see today's action as particularly significant based on this.

One study from the Quantifinder that did show a bit of an edge was from the 1/11/10 Subscriber Letter. It exemplifies why there often just isn't an advantage to shorting into an uptrend despite price being in an overbought state.

SPX closes up 5 days in a row. Close > 200ma but < 50-day 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
10	71,010.00	74	53	21	71.62	1,838.78	-1,259.29	1.46	3.69	959.59
9	65,557.49	74	49	25	66.22	1,914.69	-1,130.50	1.69	3.32	885.91
8	60,308.17	75	52	23	69.33	1,632.49	-1,068.76	1.53	3.45	804.11
7	52,813.69	75	49	26	65.33	1,666.64	-1,109.68	1.50	2.83	704.18
6	44,817.28	75	53	22	70.67	1,395.09	-1,323.75	1.05	2.54	597.56
5	36,531.32	75	52	23	69.33	1,222.58	-1,175.77	1.04	2.35	487.08
4	25,160.84	75	49	26	65.33	1,057.02	-1,024.35	1.03	1.94	335.48
3	23,846.29	75	49	26	65.33	1,010.88	-987.95	1.02	1.93	317.95
2	12,078.36	75	49	26	65.33	761.35	-970.30	0.78	1.48	161.04
1	7,239.92	75	47	28	62.67	499.21	-579.39	0.86	1.45	96.53

Sometimes strength begets more strength and this may be one of those times.

With the tight consolidation the last 3 days the 3/10 Offset Historical Volatility indicator is at extremely low levels. This suggests an increase in volatility is likely in the next few days. One way to play this for intraday traders is by looking to trade an Opening Range Breakout (ORB) in the morning. Below is a link to the ORB's study from last fall, which can also be found on the subscriber downloads page.

[ORBs Study.pdf](#)

Generally when I look to trade ORBs I like to see a fairly tight early morning consolidation. If the market opens and then runs quickly and steadily in one direction for the 1st 20 minutes of the day there really isn't much of a chance I'm going to look to trade an ORB. Give me some wiggling after the open and I'm much more prone to try and make something of a breakout. I typically only trade ORB's if they occur in the direction of my short-term bias. There are 2 reasons for this. 1) It puts the wind at my back for the trade and increases the odds of success. 2) If the trade does work well then there is a possibility I could try and hold on to a portion of the position for a multi-day trade rather than just treating it as an intraday opportunity. Both of these considerations help to increase my overall risk/reward ratio.

In this case my bias going into tomorrow is neutral, so I'm willing to consider playing an early breakout in either direction. I'll also check the Quantifinder and monitor the market relative to the Differential pivot during the day to determine whether I'd consider holding a portion of the position overnight and beyond.

Speaking of which, I've updated the [Aggregator](#) chart below.



I discussed last night that barring strong bearish evidence the green Aggregator line was likely to flip to positive. Strongly bearish indications did not arrive and in fact the net expectations are now for upside over the next few days. While the Aggregator is now positive the black Differential line is still below 0, illustrating the fact that the SPX has solidly outperformed expectations over the last few days and is in an overbought state. Both lines on opposite sides of zero is considered a neutral configuration. This caused the Aggregator System to move from a short signal to a cash signal at the close on Thursday.

Bullish studies are now beginning to dominate the Active Studies list. The green Aggregator line is projected to remain positive for the foreseeable future. The Differential pivot level for Friday is 1116.99. In other words it will take a close under 1,117 to flip the Differential line into positive territory at Friday's close.

As I mentioned in the intraday update to subscribers, I can't recall another time in the last few years where I have closed out a short trade with the market so extended to the upside. Most of the Aggregator trades tend to be short-term contrarian in nature and when they initially go against the signal that will frequently lead to an even greater edge. That just wasn't the case here. I don't use stops and I have no problem letting a trade play itself out. I do take a fresh look at the market each night and I do so with an open mind that will allow me to consider any evidence that presents itself - not just those pieces that support my current position. So when the bullish evidence began to mount last night and continued to do so today, it simply became time to step out of the position and wait for a better edge to assert itself. At its core the philosophy I use to trade using the studies and the Aggregator is simple: When there is an edge, take a position. When the edge is no

longer there, get out. Anything other than taking the loss and moving to cash would have been poor execution on my part.

Intermediate-term Outlook (2 weeks – 2 months)– updated 3/1 – bullish

In the last couple of weeks we've seen several studies that have suggested intermediate-term implications. This week I am not seeing any new compelling intermediate-term evidence. There is a fair amount listed on the active studies list, though and I thought it might be a good idea to go over some of it.

I'll first discuss the bearish studies. The 1st one to note was from the February 1st letter. It examined the persistently weak breadth that was evident at the time as measured by the Ratio Adjusted McClellan Oscillator. Time has run out on that study as the month is now over. It was followed by another leg down but the market turned soon after and the intermediate-term influence was never exerted.

The other bearish study on the intermediate-term list is the VIX:VXV ratio dropping below 0.9. This study was discussed and updated in detail last week. It hasn't been a great timing device but rather has provided hints of downside to come. It also hasn't performed as well over the last year and a half as it had before that.

There are two bullish studies active that examined market breadth. The first was from mid-January. It suggested that since there was no breadth divergence when the January highs were hit that it was unlikely a significant top was being put in. The 2nd breadth related study was from the Feb 8th Letter and looked at the extremely low number of stocks trading above their 40ma versus those above their 200ma. This ratio suggested that the longer-term upmove was likely to re-exert itself over the shorter-term selloff.

There are also two studies listed that relate to IBD follow through days (FTD). February 11th gave us a valid follow FTD using the classic IBD definition which requires a 1% rise on higher volume. In recent years they have changed that requirement to several times and it now sits at 1.7% in their latest version. [My testing suggested that changing of this requirement was not an effective idea.](#) Interestingly, there still has not been a FTD based on the new definition but the Feb 11th classic FTD is still in effect. The other FTD study shown above was from last week and it suggested that the market rising in the week after the classic FTD was a good sign.

The last study shown above is the Nasdaq/S&P 500 Relative Strength Indicator which is shown on the charts page and updated each week. Currently the indicator is suggesting the Nasdaq is exerting relative strength over the S&P 500. This has historically been a good sign for the market and accounted for most of the gains in the S&P since 1971. Unfortunately we are not getting confirmation of this model from the NDX Aggressive Trend Timer System. February was a slow month for the system as it was in cash all but 1 day. It was a good 1 day as the NDX gained 1.29% on that day while the system was long. So while the Nasdaq/S&P RS Indicator from above is positive, I would prefer if it was confirmed by the NDX Aggressive Timer System.

So similar to last week we have a short-term sell signal from the Aggregator, but the intermediate-term still looks fairly bright. I still expect that we will be testing the January highs. For me to remove that expectation I'll need to see some additional bearish evidence of intermediate-term consequence or at the very least some elimination of the current bullish evidence.

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 – though intraday traders could consider playing an ORB. The chance of a tight opening range isn't too great, though since we have the employment report being released before the bell.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	3/1/2010	\$111.20	\$112.64	-1.29%		covered on close
SPY(1/4)(s)	3/2/2010	\$112.37	\$112.64	-0.24%		covered on close

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