

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

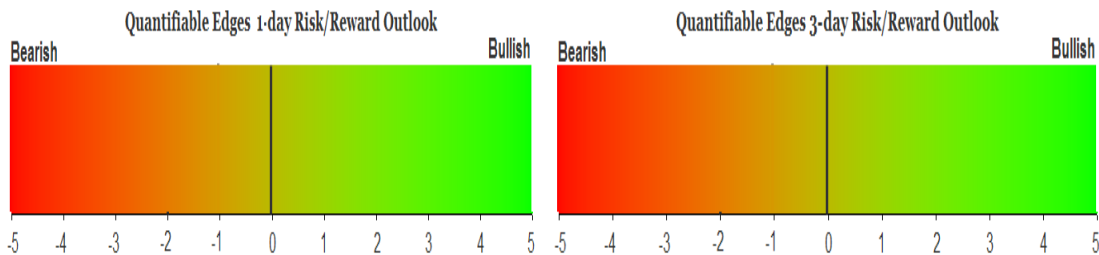
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June 1, 2010

Volume 3 Issue 103

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## Market Overview



## Tonight's Research Points

- Memorial Day week has had an upside tendency over the last 40 years or so.
- Inside days with a relatively small range like Friday have had short-term bearish implications in the past.
- The Aggregator System remained flat at the close.
- The NDX Aggressive Trend Timer remained long.

## *Short-term Outlook – updated 6/1*

### *The Bottom Line*

Some hints of more short-term downside on Tuesday but by the end of the week the studies are suggesting upside. The Aggregator remains neutral while the NDX timer remains long.

*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
<b>Active</b>				
June 1, 2010	Low range inside day	1-2 days	Bearish	
May 28, 2010	2.5% Rally on Low Volume	1-2 days	Bearish	
May 28, 2010	2.5% Rise CBI Still Over 5	1-5 days	Bullish	
May 28, 2010	Double 90% Up Vol	1-9 days	Bullish	
May 18, 2010	1% drop on 2:1 neg breadth	1-10 days	Bullish	
<b>Active - Long Term</b>				
June 1, 2010	Nas/S&P Relative Strength favors Nas	int. term	Bullish	
May 25, 2010	Rat Adj McClellan < -60 for 6 in row	1-20 days	Bearish	-5.80%
April 26, 2010	No breadth divergence at new high	int. term	Bullish	
<b>Dropped Tonight</b>				
<b>May 28, 2010</b>	<b>0.75% Unfilled Gap from low</b>	<b>1-2 days</b>	<b>Bearish</b>	
<b>May 28, 2010</b>	<b>VXO 15% drop. SPX 50-low yest</b>	<b>1 day</b>	<b>Bearish</b>	
<b>May 28, 2010</b>	<b>90% Up Vol After 50 low</b>	<b>1 day</b>	<b>Bearish</b>	
May 26, 2010	NYSE Up Issues < 40% on up day	1-2 days	Bearish	
May 27, 2010	Failed Gap higher close bottom of range	1-2 days	Bullish	

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

### ***The Evidence***

Thursday's positive vibes couldn't follow through on Friday. The SPY opened down slightly and never got back to breakeven. Trading was choppy but the end results were decidedly negative. The SPX and Russell 2000 closed down 1.3% while the Nasdaq lost 0.9%. Breadth was strongly negative as the NYSE Up Issue % came in at 32% and the Up Volume % was 17%. Total volume was a little light ahead of the long weekend.

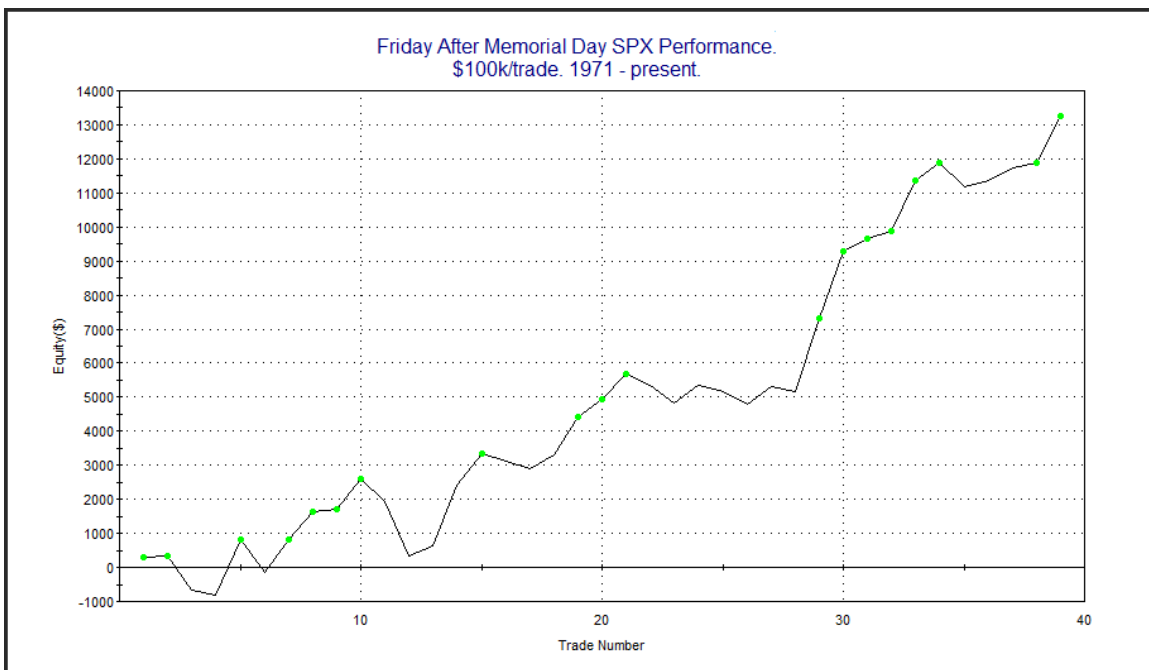
I looked at Memorial Day returns last year and thought I might as well revisit those findings tonight. Unlike many other holidays there doesn't seem to be a strong bias on the days immediately before or after the Memorial Day. Looking back to 1971 when Memorial Day began occurring on the last Monday of May I found a few apparent edges for the upcoming week.

First, it appears the strongest and most consistent day of the week following Memorial Day has been Friday. Below are the stats associated with holding the SPX on the Friday after Memorial Day.

Friday After Memorial Day SPX Performance.  
\$100k/trade. 1971 - present.

TradeStation Performance Summary		Collapse ^	
All Trades			
Total Net Profit	\$13,252.33	Profit Factor	2.87
Gross Profit	\$20,320.92	Gross Loss	(\$7,068.59)
Total Number of Trades	39	Percent Profitable	66.67%
Winning Trades	26	Losing Trades	13
Even Trades	0		
Avg. Trade Net Profit	\$339.80	Ratio Avg. Win:Avg. Loss	1.44
Avg. Winning Trade	\$781.57	Avg. Losing Trade	(\$543.74)
Largest Winning Trade	\$2,140.16	Largest Losing Trade	(\$1,589.54)

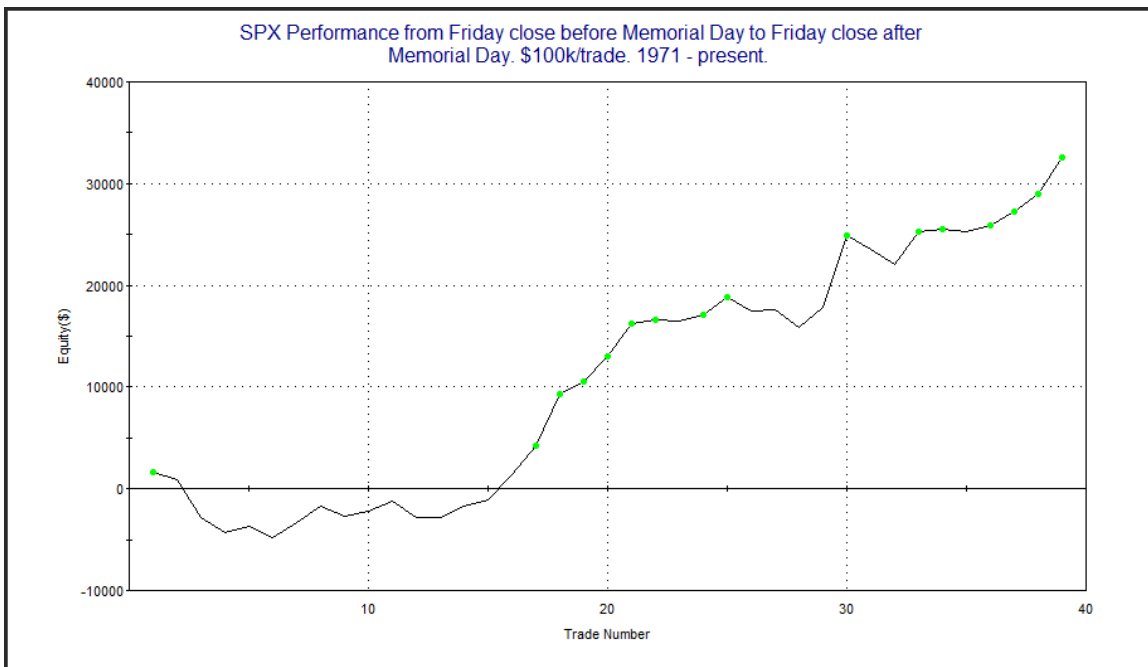
This appears to be a decent edge with the 1-day returns close to 10x the average 1-day return over the period. Below is an equity curve showing the year by year progress.



As a whole the 4-day week following Memorial Day has had a positive bias as well. Below are the stats for buying the close on the Friday prior to Memorial Day and exiting the close on Friday after Memorial Day.

SPX Performance from Friday close before Memorial Day to Friday close after Memorial Day. \$100k/trade. 1971 - present.			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	\$32,578.54	Profit Factor	3.03
Gross Profit	\$48,599.75	Gross Loss	(\$16,021.21)
Total Number of Trades	39	Percent Profitable	66.67%
Winning Trades	26	Losing Trades	13
Even Trades	0		
Avg. Trade Net Profit	\$835.35	Ratio Avg. Win:Avg. Loss	1.52
Avg. Winning Trade	\$1,869.22	Avg. Losing Trade	(\$1,232.40)
Largest Winning Trade	\$7,145.28	Largest Losing Trade	(\$3,713.26)

Another apparently solid edge as the average Memorial Day week has made over 0.8% over the test period. Below is an equity curve for this study.



While Friday's selloff was fairly strong, it didn't even give back 1/2 of Thursday's gains. I decided to look at other times a strong down day of 1% or more failed to erase much of the previous day's gains. To get a decent sample size I made the requirement a fairly loose 3/4 of the previous day's gain.

SPX falls more than 1% but gives back less than 3/4 of yesterday's gains.  
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	-8,350.52	35	20	15	57.14	4,107.21	-6,032.99	0.68	0.91	-238.59
9	-21,146.24	35	18	17	51.43	4,052.24	-5,534.50	0.73	0.78	-604.18
8	-19,551.64	35	18	17	51.43	3,531.32	-4,889.14	0.72	0.76	-558.62
7	-22,146.27	35	16	19	45.71	3,159.45	-3,826.19	0.83	0.70	-632.75
6	-21,391.12	36	15	21	41.67	3,164.79	-3,279.19	0.97	0.69	-594.20
5	-6,512.14	37	17	20	45.95	3,444.07	-3,253.06	1.06	0.90	-176.00
4	-27,439.52	39	19	20	48.72	3,114.92	-4,331.15	0.72	0.68	-703.58
3	-13,409.96	41	22	19	53.66	2,301.17	-3,370.30	0.68	0.79	-327.07
2	-14,187.77	41	20	21	48.78	2,225.06	-2,794.72	0.80	0.76	-346.04
1	-16,273.04	41	18	23	43.90	1,049.06	-1,528.53	0.69	0.54	-396.90

Not overwhelming but certainly a suggestion of a downside edge over the next several days. The edge pretty much plays out over the first 4 days.

The Quantifinder also identified another study that looked at performance following days that sold off strongly. The table below is from the 2/24/10 Subscriber Letter and has not been updated.

SPX closes down over 1% and decliners double advancers. Yesterday did not close at a 20-day high. Buy on close. Sell X days later. \$100k/trade. 10/20/87 - 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	235,725.27	229	151	78	65.94	2,965.10	-2,718.01	1.09	2.11	1,029.37
9	275,998.54	238	168	70	70.59	2,801.49	-2,780.75	1.01	2.42	1,159.66
8	237,952.84	250	166	83	66.40	2,767.61	-2,668.33	1.04	2.07	951.81
7	234,252.83	268	169	99	63.06	2,640.53	-2,141.38	1.23	2.10	874.08
6	214,029.46	283	179	104	63.25	2,516.92	-2,274.03	1.11	1.90	756.29
5	198,277.21	306	186	120	60.78	2,332.79	-1,963.51	1.19	1.84	647.96
4	157,396.16	326	193	133	59.20	2,124.88	-1,900.04	1.12	1.62	482.81
3	160,749.71	357	223	134	62.46	1,831.31	-1,848.01	0.99	1.65	450.28
2	155,449.73	406	232	174	57.14	1,726.78	-1,408.99	1.23	1.63	382.88
1	103,402.22	455	268	187	58.90	1,144.88	-1,087.83	1.05	1.51	227.26

So from this angle it would appear that the Friday selloff is bullish. So the bottom line for me is that the Friday drop doesn't appear to be providing a clear edge. Therefore I'll just ignore both studies.

Another Quantifinder study that appeared was from the 1/23/09 Letter. It looked at low-range inside days that occurred below the 200ma. I've updated the results of that study below.

SPY posts an inside day under the 200ma. Range is the smallest in 3 days. Buy on close. Sell X days later. \$100k/trade. 1994 - 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	-43,740.34	72	32	39	44.44	2,012.88	-2,773.14	0.73	0.60	-607.50
4	-31,012.46	79	38	41	48.10	1,948.92	-2,562.72	0.76	0.70	-392.56
3	-44,565.66	86	39	47	45.35	1,947.69	-2,564.37	0.76	0.63	-518.21
2	-32,539.89	92	42	48	45.65	1,277.67	-1,795.88	0.71	0.62	-353.69
1	-24,713.97	94	42	52	44.68	995.44	-1,279.28	0.78	0.63	-262.91

These appear to be some fairly solid results for the short-term bearish case. One caveat is that the setup requires a close below the 200ma. And while the SPX is below the 200ma, it isn't by much. So I looked to see how the results would look without this requirement.

SPY posts an inside day. Range is the smallest in 3 days. Buy on close. Sell X days later. \$100k/trade. 1994 - 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	-5,310.53	259	133	125	51.35	1,634.43	-1,781.52	0.92	0.98	-20.50
4	-1,048.89	276	146	130	52.90	1,521.82	-1,717.18	0.89	1.00	-3.80
3	-28,833.41	298	146	150	48.99	1,419.63	-1,574.00	0.90	0.88	-96.76
2	-25,998.24	315	161	151	51.11	1,021.97	-1,261.82	0.81	0.86	-82.53
1	-34,734.16	319	153	165	47.96	805.40	-957.33	0.84	0.78	-108.88

Day 1 shows more total losses, but after you get out more than 3 days any downside edge is pretty well eliminated. For purposes of estimating a projection I decided to split the difference between these two studies over the next 2 days.

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



The green Aggregator line again remained above zero tonight as the net expectations from the active studies is for upside over the next few days. Meanwhile the black Differential line illustrates the SPX has outperformed expectations over the last few days. So while the studies expect more upside the SPX is already overbought versus expectations. This is considered a neutral configuration. Based on this the Aggregator System remains flat.

Looking ahead more bearish studies will need to emerge if the green Aggregator line is going to turn negative tomorrow. The Differential pivot for tomorrow is 1,072.76. This means it would take an SPX close at or below this level in order for the Differential line to turn positive.

I have some long exposure already. I am not looking to get Aggressive at this point with the Aggregator neutral.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 6/1 neutral***

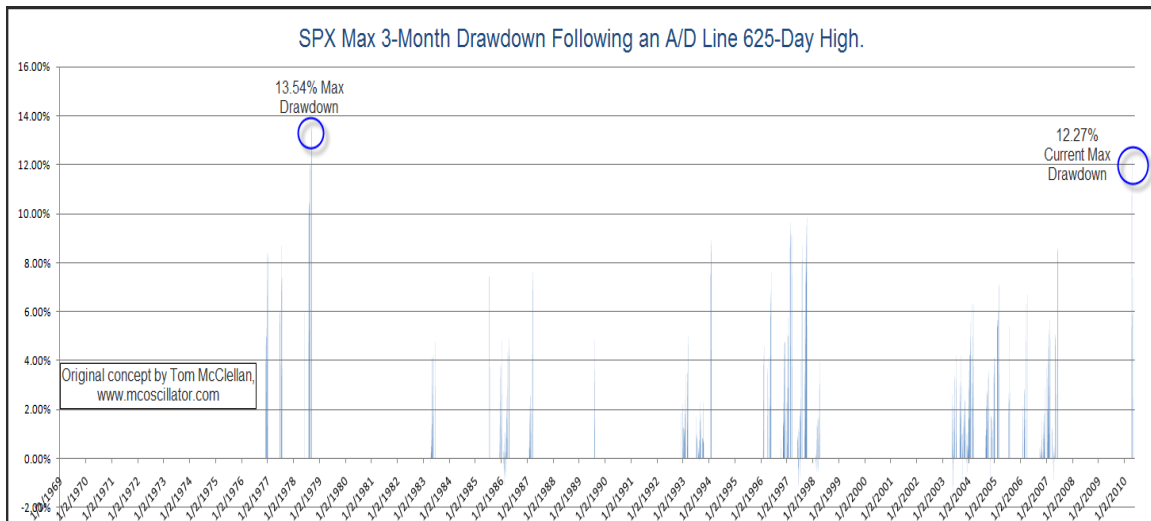
Over the past few weeks I've discussed repeatedly my inclination that the current selloff was unlikely to immediately turn into a full-fledged bear market. A primary reason for that was prior to the beginning of the decline about a month ago there had been no deterioration in breadth. I cited some studies done over the last few months that showed every major decline since 1970 has been accompanied by a negative divergence in either the new 52-week high %s or the NYSE Advance/Decline line.

This past week I had the pleasure of interacting with Tom McClellan of McClellan Financial Publications ([www.mcoscillator.com](http://www.mcoscillator.com)). Tom's parents created the McClellan Oscillator and the McClellan Summation Index many years ago. They remain two of the

most widely used breadth measures utilized by analysts to this day. Tom took over writing the McClellan newsletters several years ago and I have followed and admired his work for a number of years myself. Bottom line is you'd be hard pressed to find a family anywhere in the world that knows more about breadth analysis than the McClellans. Tom shared two studies with me that he had done within the last few years. These were related to the breadth work here at Quantifiable Edges that I'd been discussing.

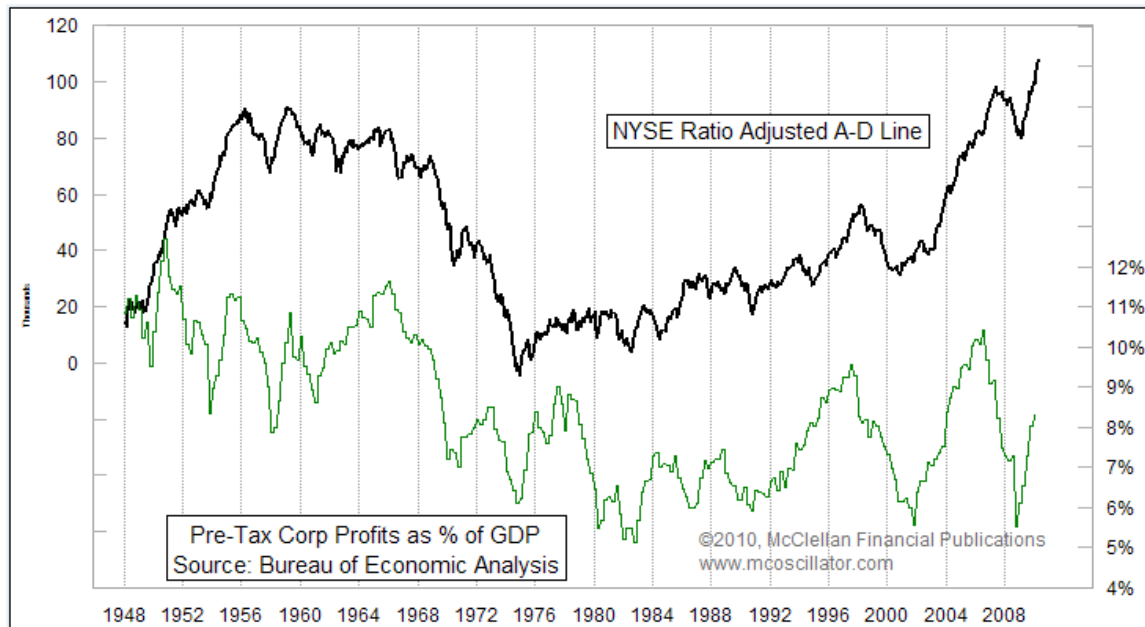
The 1<sup>st</sup> study Tom shared with me looked at market risk when the A/D line was making new highs. In Tom's study he took any time the Advance/Decline line made a 3-year high and then looked forward 3 months to see what the max drawdown was in the SPX. The study had not been updated for a few years. Additionally, we did not manage to make a 3-year high in the A/D line last month. We DID make a 2 ½ year high though. So I re-ran the study using Tradestation data (which should be very similar) and used a requirement of a 2 ½ year high instead of 3 years.

*Note: A full year typically contains about 252 trading days. For purposes of this test I rounded that down to 250 and multiplied by 2.5 to get 625 trading days. To estimate 3 months I used a 63-day period. Also note that the flat spots on the chart are times when the high A/D condition is not met.*



As you can see above, since 1970 there has only been one instance that saw a larger drawdown over the following 3 months than we've already seen this past month. Other corrections were generally capped at between an 8% - 10% decline. This doesn't mean we can't drop precipitously from here. The market has demonstrated several times in the past few years that it is completely capable of breaking records. It does show that we've reached an area where risk has pretty much maxed out in the past under similar conditions – at least temporarily. And as Tom put it, the study “is good enough to illustrate the philosophical point that strong breadth is a good thing.”

Tom also shared a 2<sup>nd</sup> Advance/Decline study with me that showed the A/D Line was a good predictor of corporate profits. Improving corporate profits generally mean an improving economy.



From Tom:

*A couple of points worth noting: This is not a predictive relationship. It merely shows that both stock market performance and corporate profits are dependent on something else, i.e. liquidity. And it is a coincident relationship, although it does not seem that way because of the lag in the reporting of profits. The point here is that if you say that you are going to wait until you see profits improve before you decide to jump back into the market, then you are going to miss the move. Profits as a % of GDP look the best at the end of the bull market, not at the beginning. So watching profits to determine what stock prices are going to do is backwards. Prices are going to tell you the important information before the accountants can, and it is the behavior of the broad list of issues that has the most important information about what the economy is going to do.*

*Also, the A-D Line has zoomed up to a new all-time high, while the corporate profits line is still just getting back to the middle of the range for recent years. This is not unusual. The A-D Line is unbounded, whereas corporate profits have a natural range that they will stay in. When things get bad, the Fed works to boost liquidity. When things get too good in terms of profits, the Fed responds and Congress also thinks of new ways to skim off more of those profits for purposes that it likes. So the correlation is not about levels, but about directions and slopes.*

If you'd like to see a bit more on this study you may find additional comments from Tom at:

[http://www.mcoscillator.com/learning\\_center/weekly\\_chart/ad\\_line\\_has\\_the\\_story\\_on\\_corporate\\_profits/](http://www.mcoscillator.com/learning_center/weekly_chart/ad_line_has_the_story_on_corporate_profits/)

A few other quick intermediate-term observations to note tonight. First the Nasdaq/SPX Relative Strength indicator has flipped again showing the Nasdaq is leading. This has generally been a bullish indication for the market.

Second, intermediate-term traders will no doubt be watching for a Follow Through Day in the coming days. I'd encourage you to review the [Quantifiable Edges posts associated with follow-through days](#) before one actually occurs.

So my outlook remains neutral. I am at the ready to turn bullish though should we see additional follow-through or other confirmation of upside.

### **Catapult and Capitulative Breadth Statistics**

*(Catapult Presentation Part 1) - (Catapult Presentation Part 2)*

#### ***Open Catapult Triggers***

*MON - 1/3 position @ \$64.73 limit ( filled @ \$62.60)*

*MON - 1/3 position @ \$62.25 limit (filled @ \$60.74)*

*MON - 1/3 position @ \$55.54 limit (filled @ \$54.79)*

*EXC - 1/3 position @ \$40.59 limit (filled @ \$40.11)*

*EXC - 1/3 @ \$39.31 limit*

*CSCO - 1/3 @ \$23.31 limit*

*MSFT - 1/3 @ \$27.11 limit*

*QCOM - 1/3 @ \$35.59 limit*

*MSFT - 1/3 position @ \$26.84 limit*

*ORCL - 1/3 position @ \$22.16 limit*

*DELL - 1/3 position @ \$13.35 limit*

*MSFT - final 1/3 @ \$26.27*

*EXC - final 1/3 @ \$38.06 limit (no fill)*

*GILD - 1/3 @ \$34.82 limit (no fill)*

*New*

*JNJ - 1/3 position @ \$58.30 limit*

#### ***Catapult for ETF's Trades***

*none*

***Broad Market Large Cap CBI - 14 (MON-3, EXC-3, CSCO, MSFT-3, QCOM, DELL, GILD, JNJ)***

### **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.*

JNJ – buy 1/3 @ \$58.30 limit From Catapult section above.

### **Active Trades Table**

<b>Symbol</b>	<b>Entry Date</b>	<b>Entry Price</b>	<b>Current Price</b>	<b>% Gain/Loss</b>	<b>Stop</b>	<b>Notes</b>
MON(1/3)	4/29/2010	\$62.60	\$50.87	-18.74%		Catapult
MON(1/3)	5/5/2010	\$60.74	\$50.87	-16.25%		Catapult
MON(1/3)	5/14/2010	\$54.79	\$50.87	-7.15%		Catapult
SPY(1/4)	5/19/2010	\$111.76	\$109.37	-2.14%		Aggregator
SPY(1/4)	5/21/2010	\$105.91	\$109.37	3.27%		Aggregator
EXC(1/3)	5/20/2010	\$40.11	\$38.60	-3.76%		Catapult
EXC(1/3)	5/21/2010	\$38.50	\$38.60	0.26%		Catapult
CSCO(1/3)	5/21/2010	\$22.67	\$23.16	2.16%		Catapult
MSFT(1/3)	5/21/2010	\$26.63	\$25.80	-3.12%		Catapult
QCOM(1/3)	5/21/2010	\$35.10	\$35.56	1.31%		Catapult
MSFT(1/3)	5/24/2010	\$26.84	\$25.80	-3.87%		Catapult
DELL(1/3)	5/25/2010	\$13.05	\$13.33	2.15%		Catapult
MSFT(1/3)	5/25/2010	\$25.65	\$25.80	0.58%		Catapult

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