

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 13, 2010

Volume 3 Issue 132

Market Overview



Tonight's Research Points

- Very low SPY volume while closing at a 10-day high and under the 200ma has had consistent short-term bearish implications.
- Very weak breadth on an up day has been a bad omen for the next day over the last decade.
- The sharp drop in volatility is likely to lead to a big move.
- With the SPX short-term overbought and above the 200ma, the “big move” has been consistently down over the last 20 years.
- 5 higher closes coming off a 50-day low and under the 200ma has led to choppy short-term but consistently bullish intermediate-term (20-25 days) results.
- The Aggregator System changed to short.
- The NDX Aggressive Trend Timer remained flat.

Short-term Outlook – updated 7/13

The Bottom Line

Short-term indications couldn't get much more bearish than what we are seeing. This is just short-term, though as the intermediate-term continues to pile up bullish studies. I'm now interested in the short side, but not for more than a few days at this point.

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				
July 13, 2010	SPY high close 10 low vol 20	1-2 days	Bearish	-1.80%
July 13, 2010	3/10 Offset HV<0.25, RSI2>90, C<200	1-2 days	Bearish	-2.50%
July 13, 2010	Up Issue % < 40%. SPX closes higher	1 day	Bearish	-1.70%
July 12, 2010	Low range low vol overbought<200	1-4 days	Bearish	-3.20%
July 9, 2010	VXO 15% under 10ma	1-8 days	Bearish	-3.30%
July 9, 2010	3 up Low Range From 50-low	1-4 days	Bullish	2.50%
July 7, 2010	Low HV, no SPX highs	1-8 days	Bearish	-3.30%
July 7, 2010	McClellan Oscillator Bottom Divergence	1-4 days	Bullish	
July 6, 2010	inside day nr3 under 200ma	1-3 days	Bearish	
Active - Long Term				
July 13, 2010	5 higher close from a 50-day low	int term	Bullish	
July 7, 2010	McClellan Oscillator Bottom Divergence	int term	Bullish	
July 5, 2010	5 down under 200 and 50 low	1-20 days	Bullish	

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

The Evidence

A quiet day on Wall St. led to small gains in most major indices. The SPX and Nasdaq closed up 0.1% and the Dow 0.2%. The Russell 2000, though, was *down* 1.2%. Breadth sided with the Russell as the NYSE Up Issues % came in at just 35% while the Up Volume % was 44%. Total volume declined again to the lowest level in now what appears to be all of 2010.

There is a lot to go over tonight. Most of today's action suggests short-term bearish implications. There was one study with intermediate-term bullish ones, though. With a lot to discuss and no desire to pull an all-nighter on a Monday, I'll keep the prose short and let the studies do most of the talking. Monday's action contained problems with regards to volume, breadth, and price action. I'll show studies related to each.

In the 2/23/10 subscriber letter I showed what happens when the SPY closes at a 10-day high on the lowest volume in 20 days. Tonight I also added the 200ma as a filter.

SPY posts highest close in 10 days on lowest volume in 20 days.
Buy in 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
5	-14,242.93	13	6	7	46.15	965.13	-2,861.96	0.34	0.29	-1,095.61
4	-10,281.31	14	8	6	57.14	947.76	-2,977.23	0.32	0.42	-734.38
3	-15,319.34	15	5	10	33.33	497.47	-1,780.67	0.28	0.14	-1,021.29
2	-15,154.74	15	3	12	20.00	713.53	-1,441.28	0.50	0.12	-1,010.32
1	-6,633.73	17	8	9	47.06	925.05	-1,559.34	0.59	0.53	-390.22

100% of instances closed below their entry price at some point in the next 4 days.

Instances are on the low side but the stats are overwhelmingly bearish with much of the market damage occurring almost immediately. I also ran this on the SPX with NYSE volume and results were equally bearish but instances were quite a bit lower. Hence the reason I used SPY instead.

This next study is from the 10/24/2008 blog. It examines results following days where the Up Issue % was less than 40% and the SPX closed higher.

NYSE Up Issue % < 40%. SPX closes higher.
Buy SPX on close. Sell X days later. \$100k/trade. 1999 - 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	-19,814.45	28	11	17	39.29	2,571.03	-2,829.16	0.91	0.59	-707.66
4	-22,557.82	29	9	20	31.03	2,767.86	-2,373.43	1.17	0.52	-777.86
3	-27,263.99	30	8	22	26.67	2,236.36	-2,052.49	1.09	0.40	-908.80
2	-27,801.58	30	14	16	46.67	1,464.10	-3,018.68	0.49	0.42	-926.72
1	-26,676.37	30	8	22	26.67	1,528.38	-1,768.34	0.86	0.31	-889.21

26 of 30 instances (87%) closed below the entry price at some point in the next 3 days.

Again we see some very bearish figures with the damage almost immediate.

Along with the weak volume and breadth we have now seen a sharp contraction in volatility over the last few days. I use a tool which is [shown on the website](#) that compares the 3-day historical volatility to the previous 10 days. Research on this

indicator may be found in [the July 13, 2009 blog post](#). The basic idea here is that when there is a quick contraction in volatility that often is followed by a sharp move. The indicator does not provide any directional clues, but when you combine it with other indicators you can sometimes get powerful bullish or bearish implications. In the 2/22/10 Letter I showed the below study.

SPX 3/10 Historical Offset Volatility < 0.25. SPX 2-day RSI > 90. Close < 200ma. 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	-21,556.67	18	8	10	44.44	1,114.98	-3,047.65	0.37	0.29	-1,197.59
4	-22,178.89	18	5	13	27.78	1,192.56	-2,164.75	0.55	0.21	-1,232.16
3	-23,058.97	18	5	13	27.78	962.94	-2,144.13	0.45	0.17	-1,281.05
2	-25,168.36	18	2	16	11.11	1,415.62	-1,749.97	0.81	0.10	-1,398.24
1	-17,437.21	19	5	14	26.32	940.82	-1,581.52	0.59	0.21	-917.75

Implications here seem to be extremely bearish, though again we are seeing this short-term bearish inclination last only a very short time. Below I list all the instances since 1989 using a 2-day exit.

SPX 3/10 Historical Offset Volatility < 0.25. SPX 2-day RSI > 90. Close < 200ma.
Buy on close. Sell X days later. \$100k/trade. 1989 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
05/03/90	Buy	\$335.57	1.48%	\$1,639.00
05/07/90	Sell	\$340.53		(\$122.18)
11/05/90	Buy	\$314.59	(2.73%)	\$53.89
11/07/90	Sell	\$306.01		(\$2,789.60)
09/16/98	Buy	\$1,045.50	(2.43%)	\$0.00
09/18/98	Sell	\$1,020.10		(\$3,196.75)
10/20/98	Buy	\$1,063.95	1.37%	\$1,534.50
10/22/98	Sell	\$1,078.50		(\$544.05)
12/28/00	Buy	\$1,334.19	(3.82%)	\$437.34
01/02/01	Sell	\$1,283.27		(\$4,302.36)
01/18/01	Buy	\$1,347.97	(0.38%)	\$486.92
01/22/01	Sell	\$1,342.90		(\$1,045.62)
03/07/01	Buy	\$1,261.89	(2.26%)	\$364.19
03/09/01	Sell	\$1,233.42		(\$2,644.13)
08/02/01	Buy	\$1,220.75	(1.66%)	\$0.00
08/06/01	Sell	\$1,200.48		(\$1,895.40)
12/19/01	Buy	\$1,149.56	(0.41%)	\$159.96
12/21/01	Sell	\$1,144.89		(\$828.18)
12/28/01	Buy	\$1,161.02	(0.55%)	\$12.04
01/02/02	Sell	\$1,154.67		(\$2,131.94)
10/21/02	Buy	\$899.72	(0.40%)	\$0.00
10/23/02	Sell	\$896.14		(\$2,867.13)
11/06/02	Buy	\$923.76	(3.14%)	\$3.24
11/08/02	Sell	\$894.74		(\$3,466.80)
03/20/03	Buy	\$875.84	(1.33%)	\$2,286.84
03/24/03	Sell	\$864.23		(\$1,575.48)
08/02/04	Buy	\$1,106.62	(0.72%)	\$0.00
08/04/04	Sell	\$1,098.63		(\$1,279.80)
02/13/08	Buy	\$1,367.20	(1.26%)	\$70.08
02/15/08	Sell	\$1,349.98		(\$2,122.11)
04/07/08	Buy	\$1,372.53	(1.31%)	\$0.00
04/09/08	Sell	\$1,354.49		(\$1,624.32)
04/25/08	Buy	\$1,397.85	(0.49%)	\$358.55
04/29/08	Sell	\$1,390.95		(\$791.65)
11/28/08	Buy	\$896.24	(5.29%)	\$0.00
12/02/08	Sell	\$848.81		(\$8,941.05)

When I did this tonight I realized the last 14 in a row have led to a down close 2 days later. I then re-ran the test only to show these instances, which stretched back to 1999.

SPX 3/10 Historical Offset Volatility < 0.25. SPX 2-day RSI > 90. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1999 - 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	-27,649.33	14	4	10	28.57	706.79	-3,047.65	0.23	0.09	-1,974.95
4	-23,349.49	14	3	11	21.43	1,004.61	-2,396.67	0.42	0.11	-1,667.82
3	-21,336.53	14	3	11	21.43	757.49	-2,146.27	0.35	0.10	-1,524.04
2	-22,866.73	14	0	14	0.00	0.00	-1,633.34	0.00	0.00	-1,633.34
1	-16,154.50	14	2	12	14.29	1,256.79	-1,555.67	0.81	0.13	-1,153.89

Not only does every instance close lower on day 2, but the run-up / drawdown stats strongly favor the bulls as well. Since 1999 the average runup over the next 2 days was only 0.3%. Meanwhile the average 2-day max drawdown was over 2.5%. That means potential reward was nearly 8 times the size of potential risk. Furthermore, as can be seen in the list of trades above the MAX runup (just under 2.3%) was actually less than the AVERAGE drawdown (just over 2.5%).

So the 3/10 Offset HV is suggesting a big move is coming. And price, volume and breadth are suggesting that move will be down (short-term).

The studies aren't all bearish, though. Monday marked the 5th higher close in a row. In the 11/28/08 Subscriber Letter I showed that this kind of persistence coming off a low has almost always led to further upside over the intermediate-term. I've updated that study below.

After closing at a 50-day low, SPX then makes 5 consecutive higher closes. Close < 200ma.
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
25	40,237.44	15	13	2	86.67	3,182.67	-568.65	5.60	36.38	2,682.50
24	40,003.67	15	14	1	93.33	2,906.91	-693.00	4.19	58.73	2,666.91
23	40,708.96	15	14	1	93.33	2,994.76	-1,217.70	2.46	34.43	2,713.93
20	25,307.77	15	11	4	73.33	2,838.72	-1,479.53	1.92	5.28	1,687.18
15	13,182.85	15	9	6	60.00	1,861.74	-595.47	3.13	4.69	878.86
10	-8,214.63	16	8	8	50.00	1,586.21	-2,613.04	0.61	0.61	-513.41
9	-12,770.97	16	8	8	50.00	1,419.53	-3,015.90	0.47	0.47	-798.19
8	-9,938.99	16	8	8	50.00	1,491.82	-2,734.19	0.55	0.55	-621.19
7	-10,049.38	16	8	8	50.00	1,544.51	-2,800.68	0.55	0.55	-628.09
6	-5,040.99	16	10	6	62.50	1,362.69	-3,111.31	0.44	0.73	-315.06
5	-5,504.10	16	9	7	56.25	1,407.27	-2,595.64	0.54	0.70	-344.01
4	-3,483.45	16	9	7	56.25	1,381.05	-2,273.27	0.61	0.78	-217.72
3	2,543.29	16	12	4	75.00	1,024.13	-2,436.56	0.42	1.26	158.96
2	-5,275.58	16	9	7	56.25	967.67	-1,997.80	0.48	0.62	-329.72
1	-5,604.17	16	11	5	68.75	573.68	-2,382.94	0.24	0.53	-350.26

Short-term results were very choppy. But you can see that once you get out a month or so the results strongly favor the bulls.

For those that want to take a closer look, I have listed all instances with a 23 day exit in the table below.

After closing at a 50-day low, SPX then makes 5 consecutive higher closes.
Close < 200ma. Buy on close. Sell 23 days later. \$100k/trade. 1960 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
07/03/62	Buy	\$56.49	2.23%	\$3,079.80
08/06/62	Sell	\$57.75		(\$566.40)
03/22/66	Buy	\$89.46	2.93%	\$3,306.32
04/25/66	Sell	\$92.08		(\$759.56)
12/01/71	Buy	\$95.54	6.86%	\$6,976.82
01/04/72	Sell	\$102.09		\$0.00
09/20/74	Buy	\$70.14	1.27%	\$4,788.00
10/23/74	Sell	\$71.03		(\$11,200.50)
04/14/77	Buy	\$101.00	(1.22%)	\$39.60
05/17/77	Sell	\$99.77		(\$3,851.10)
11/09/77	Buy	\$92.98	0.62%	\$3,988.25
12/13/77	Sell	\$93.56		(\$215.00)
03/13/78	Buy	\$88.94	4.46%	\$4,900.64
04/14/78	Sell	\$92.91		(\$977.88)
07/13/81	Buy	\$129.63	2.99%	\$4,271.34
08/13/81	Sell	\$133.50		(\$2,829.57)
10/02/81	Buy	\$119.36	4.51%	\$5,557.68
11/04/81	Sell	\$124.74		(\$2,142.72)
10/16/92	Buy	\$411.72	2.70%	\$2,845.92
11/18/92	Sell	\$422.85		(\$258.94)
12/15/94	Buy	\$455.35	2.55%	\$3,302.52
01/19/95	Sell	\$466.95		\$0.00
12/28/00	Buy	\$1,334.19	2.94%	\$3,639.32
02/01/01	Sell	\$1,373.45		(\$4,408.18)
03/18/03	Buy	\$866.45	2.95%	\$4,420.60
04/21/03	Sell	\$892.01		(\$2,618.55)
08/02/04	Buy	\$1,106.62	1.06%	\$1,124.10
09/02/04	Sell	\$1,118.31		(\$4,131.00)
11/28/08	Buy	\$896.24	3.97%	\$4,272.39
01/02/09	Sell	\$931.80		(\$8,941.05)

It's interesting that we see positive representation from every decade here.

There is a very large amount of short-term bearish evidence. Studies based on price, breadth, volume, and sentiment are all active and suggesting lower prices. Should the market ignore all these indications and continue to power higher, that could be a very bullish sign for the intermediate-term.

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



With all the short-term bearish studies now appearing the green Aggregator line flipped down below 0 tonight. This indicates the net expectation from the Active Studies over the next few days is for downside. Meanwhile the black Differential line shows the SPX has outperformed expectations over the last few days. So we have negative expectations and a market that is overbought versus recent expectations. This configuration has historically provided a downside edge. Based on this the Aggregator System turned short at the close.

Based on the current studies the green Aggregator line is set to remain negative tomorrow. Of course strong bullish evidence could change that outlook. Meanwhile the Differential pivot will be 1,072.51 tomorrow. This means it would take an SPX close at or below this level in order for the black Differential line to turn positive.

I am looking to take advantage of this apparent short-side edge and have suggested trade ideas in the Trade Idea section below. Traders should keep in mind that shorting is substantially more risky when you are near the initiation of a potential new rally. As with a counter-trend trade, risk management is important.

Intermediate-term Outlook (2 weeks – 2 months)– updated 7/12 - neutral

Last week I examined the large divergence that was forming in the McClellan Oscillator. The studies found that such a large divergence greatly increased the chances of an

intermediate-term bottom being put in place should the market bounce. The market has bounced and that bottom now remains a possibility.

It was pointed out to me that IBD declared Wednesday to be a Follow-Through-Day. Since it was only the 2nd day off the bottom this seemed odd to me. I've done an [extensive series quantifying Follow-Through-Days](#). IBD's rules have been fluid over time and sometimes nonsensical based on the evidence. From all appearances they have done very little actual research on their own indicator, and have never shared any verifiable results.

One basic guideline IBD has suggested with Follow-Through-Days is that they should occur between the 4th and 10th day of the beginning of a rally. I examined FTD's after the 10th day in the [February 29, 2008 blog post](#). At that time I found that FTD's after day 10 are NOT less reliable as IBD claims. In fact, the small sample was much *more* reliable.

But what of FTD's that occur prior to Day 4?

Using the [original basic assumptions](#) from the January 14, 2008 study I adjusted the requirement from 4 days (standard) to 2 days (Wednesday's "FTD"). Below is a quick comparison since 1970. Again, refer to the original basic assumptions for definitions of success and failure of an FTD.

4th Day of Rally Is Earliest Possible FTD – 38 winners and 35 losers.
2nd Day of Rally Is Earliest Possible FTD – 39 winners and 43 losers.

So it appears that allowing FTD's on day two did identify one additional rally. I looked to see when this additional "success" took place. It was July of 1973. The total rally only lasted 3 weeks. The reason it was "successful" if you entered on the FTD on the 2nd day off the bottom was that the "success" target of a move of twice the size of the distance from the bottom to the FTD was more easily achieved. This "successful" July rally never even went on to break the swing highs of May. Not exactly the kind of winner most traders would be disappointed to miss out on. And while it met the test definition, when looking at a chart it likely isn't a rally that most traders would even consider successful. Also note that shortening the requirement to 2 days from 4 days triggers 8 more losers.

I don't agree with many of IBD's teachings on FTD's, but in my eyes this particular rule (waiting until day 4) is a very good one. I personally wouldn't ignore it and am a bit surprised that they did.

So at this point the market has made a bounce with a sizable McClellan Oscillator divergence in place. It's certainly possibly that the market is on its way to a sizable rally and perhaps new highs. I'll want to see a bit more evidence before declaring that, though. Short-term the market appears nearly ready for a pullback. If the bulls can power through this short-term inclination, or if the pullback is able to hold above recent lows, then that could indicate probable success. I'm alert but non-committal at this point.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

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 ¼ index position @ \$108.00 limit. Based on Aggregator/short-term outlook above.

SPY – short ¼ index position @ \$108.05 limit ON CLOSE. With the 3/10 Offset HV so low any move could be strong. Therefore I'll wait until the end of the day before looking to short into a move higher.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY	6/30/2010	\$103.92	\$108.00	3.93%		<i>sold @ \$108 limit</i>

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