

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 15, 2010

Volume 3 Issue 134

Market Overview



Tonight's Research Points

- A down close but a 2-day RSI > 85 suggests more downside over the next few days.
- SPX inside day in the upper end of its range has short-term bearish implications.
- The Aggregator System remained short.
- The NDX Aggressive Trend Timer remained flat.

Short-term Outlook – updated 7/15

The Bottom Line

Pretty much the same as last night...*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 still 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 15, 2010	SPY down but RSI(2) > 85	1-3 days	Bearish	-3.00%
July 14, 2010	Follow Through Day	1-6 days	Bullish	
July 14, 2010	75% Up Issue twice in 3 days	1-9 days	Bullish	3.30%
July 14, 2010	1% Gap No Fill 10-high < 200	1-5 days	Bearish	-3.70%
July 14, 2010	SPX Up VIX Up	1-4 days	Bearish	-3.10%
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 7, 2010	Low HV, no SPX highs	1-8 days	Bearish	-3.30%
July 6, 2010	inside day nr3 under 200ma	1-3 days	Bearish	
Active - Long Term				
July 14, 2010	Follow Through Day	int term	Bullish	
July 14, 2010	75% Up Issue twice in 3 days	1-20 days	Bullish	
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	
Dropped Tonight				
July 13, 2010	3/10 Offset HV < 0.25, RSI2 > 90, C < 200	1-2 days	Bearish	-2.50%
July 13, 2010	SPY high close 10 low vol 20	1-2 days	Bearish	-1.80%

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

The Evidence

A pretty tame day in the market on Wednesday. That's not unusual following a day with lots of action like Monday. Just as quiet consolidations are often followed by sharp moves, strong 1-day moves are often followed by quiet consolidations. Anyway after a bit of back and forth the market ended about where it ended the day before. The SPX fell 0.17 points. The Nasdaq was up 0.35% while the Russell 2000 closed down 0.38%. Breadth was a little weak with the NYSE Up Issues % coming in at 44% and the Up Volume % at 40%. Total volume remained below average and declined from yesterday's levels.

The primary questions asked by most of the studies in the Quantifinder today was "What happens when the market is very short-term overbought in a long-term downtrend and it gently begins to consolidate or pull back?"

One study with interesting results examined inside days near the upper end of the short-term range. It was published in the 11/4/08 Subscriber Letter and I have updated the results below.

SPX closes in top 20% of 10-day range. Today is an inside day. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1983 - 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	-22,368.79	40	19	21	47.50	1,445.90	-2,373.38	0.61	0.55	-559.22
4	-33,107.31	40	19	21	47.50	1,073.75	-2,548.03	0.42	0.38	-827.68
3	-46,107.68	40	13	27	32.50	953.42	-2,166.75	0.44	0.21	-1,152.69
2	-37,332.74	40	12	28	30.00	866.48	-1,704.66	0.51	0.22	-933.32
1	-4,385.97	40	21	19	52.50	851.25	-1,171.70	0.73	0.80	-109.65

37 of 40 instances (92.5%) closed below the entry price at some point in the next week.

It appears to suggest a decent downside edge over the next few days. I'm not terribly enthused tonight though because while the SPX posted an inside day, the SPY did not. The only reason SPX qualified is that gaps are not accurately represented in the index numbers. Therefore, I have elected not to include this study in the Aggregator.

With the market so overbought and the "pullback" today so weak I thought I'd examine other similar scenarios. Despite the pullback, the RSI(2) closed over 98. A reading that high on a down day has never happened before. I lowered the requirement all the way to 85 in order to get a little larger sampling.

SPY closes down on the day but the 2-day RSI > 85. 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
5	-21,306.78	7	1	6	14.29	2,144.90	-3,908.61	0.55	0.09	-3,043.83
4	-18,584.82	7	1	6	14.29	2,047.00	-3,438.64	0.60	0.10	-2,654.97
3	-16,311.59	7	0	7	0.00	0.00	-2,330.23	0.00	0.00	-2,330.23
2	-13,438.22	7	1	6	14.29	418.30	-2,309.42	0.18	0.03	-1,919.75
1	-5,653.42	7	2	5	28.57	489.62	-1,326.53	0.37	0.15	-807.63

To qualify for the study the market first needs to be very overbought and then second it needs to pull back extremely gently. The 2-day RSI is such a sensitive indicator that any decent pullback – even from a very overbought condition – would likely see it move well below 85. To get a better idea of risk/reward I've listed below all 7 instances assuming a 3-day exit.

SPY closes down on the day but the 2-day RSI > 85.
Buy on close. Sell 3 days later. \$100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
06/06/94	Buy	\$46.22	(0.39%)	\$129.78
06/09/94	Sell	\$46.04		(\$951.72)
11/07/00	Buy	\$143.75	(4.95%)	\$152.90
11/10/00	Sell	\$136.63		(\$5,017.90)
05/22/01	Buy	\$131.48	(2.57%)	\$0.00
05/25/01	Sell	\$128.10		(\$2,720.80)
07/03/01	Buy	\$124.10	(3.55%)	\$0.00
07/09/01	Sell	\$119.70		(\$4,065.25)
11/07/01	Buy	\$112.25	(0.20%)	\$1,628.70
11/12/01	Sell	\$112.03		(\$2,002.50)
12/06/01	Buy	\$117.34	(2.72%)	\$0.00
12/11/01	Sell	\$114.15		(\$2,930.88)
01/05/09	Buy	\$92.85	(1.95%)	\$1,723.20
01/08/09	Sell	\$91.04		(\$3,424.86)

The average run-up is over 3% while the average drawdown is about 0.5%. Additionally, 5 of the 7 instances saw max run-ups of less than 0.2% over the 3-day period.

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



The Active List is still dominated by bearish studies and this is reflected in the green Aggregator line. 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 through Friday before turning back to bullish. Of course strong bullish evidence could change that outlook. Meanwhile the Differential pivot will be 1,077.75 tomorrow. This means it would take an SPX close at or below this level in order for the black Differential line to turn positive.

A flat day today did pretty much nothing to change the outlook. There is still a strong amount of bearish short-term evidence. So a pullback should occur. The time frame appears quite narrow though. If the pullback doesn't happen by Friday's close the Aggregator would turn back to bullish unless additional compelling bearish evidence emerged.

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.

With no fill Wednesday, I'll try a similar approach on Thursday...

SPY – short 1/4 index position @ \$110.10 limit ON OPEN. If not filled on open, order will be canceled. I will then switch order to a "\$110.10 short on close".) Based on Aggregator/short-term outlook above.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	7/13/2010	\$109.15	\$109.65	-0.46%		
SPY(1/4)(s)	7/14/2010	\$109.66	\$109.65	0.01%		

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