

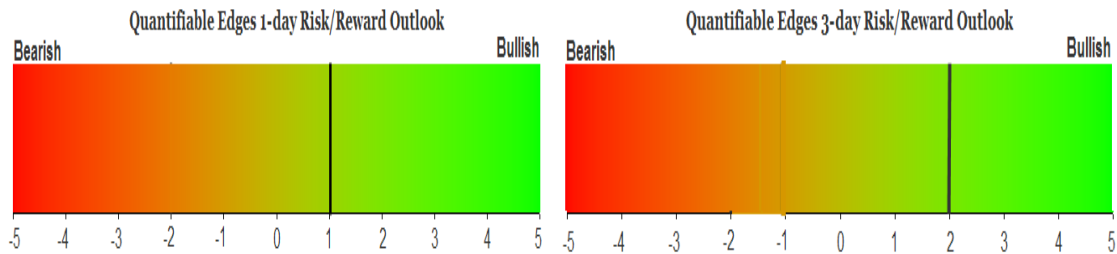
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 30, 2010

Volume 3 Issue 145

## Market Overview



## Tonight's Research Points

- The upside edge from the 3-day pullback is further enhanced by the low 3/10 Offset HV.
- The Aggregator System turned long.
- The NDX Aggressive Trend Timer remained long.

## Short-term Outlook

### The Bottom Line

After 3 down days it now appears we have a bit of an upside edge. I'm going to take it slow but begin to scale in long on further weakness.

*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>				
July 30, 2010	3 days down. 3/10 HV < 0.25	1-3 days	Bullish	2.00%
July 28, 2010	Higher hi, higher low streak, dn close	1-4 days	Bullish	1.60%
<b>Active - Long Term</b>				
July 26, 2010	Nasdaq/S&P RS favors Nasdaq	int term	Bullish	
July 20, 2010	Down 1 week after FTD	int term	Bearish	
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	
<b>Dropped Tonight</b>				
July 27, 2010	3 up 2 lower vol SPX > 200ma	1-3 days	Bearish	-1.20%

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

### *The Evidence*

The market pulled back a bit more on Thursday, making it 3 in a row. The SPX finished down 0.4%, the Nasdaq lost 0.6% and the Russell 2000 almost broke even with a 0.1% loss. Breadth was mixed as the NYSE Up Issues % came in at 51% while the Up Volume % was 46%. Total volume was the highest in a week as the market had some fairly large intraday swings.

There were two mildly interesting studies in the Quantifinder tonight that become more interesting when they trigger at the same time. One of the studies looked at 3-day pullbacks and the other showed a low reading has occurred in out 3/10 Offset HV indicator.

As a brief review the 3/10 Offset HV compares the current 3-day historical volatility to the historical volatility of the 10 days prior to these three. When very low readings occur that means there has been a sharp contraction in volatility. This often leads to a volatility expansion. It isn't often useful in determining direction. It does suggest that a large move could occur, though. The 0.25 level is one I tend to use. Historically it has reached 0.25 or lower about 9% of the time. The 3 days following such low readings have seen the 3-day HV expand 5.5 times over the next 3 days.

When the 3/10 Offset HV numbers are this low that suggests the 3-day pullback has been quite tame. So let's take a look and see how the market has reacted following 3-day pullbacks with low readings vs. those without low readings. First I'll show times when the 3/10 Offset HV is above 0.25.

SPX pulls back for exactly 3 days in a row and the HV Offset 3/10 indicator > 0.25.  
Buy on close. Sell X days later. \$100k/trade. 2000 - 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	32,508.42	89	53	36	59.55	2,889.30	-3,350.68	0.86	1.27	365.26
9	47,849.26	93	56	37	60.22	2,787.22	-2,925.27	0.95	1.44	514.51
8	39,907.38	95	57	37	60.00	2,660.78	-3,020.46	0.88	1.36	420.08
7	29,438.53	98	54	44	55.10	2,657.78	-2,592.76	1.03	1.26	300.39
6	22,140.30	101	57	44	56.44	2,303.56	-2,480.96	0.93	1.20	219.21
5	26,642.74	110	57	53	51.82	2,482.26	-2,166.90	1.15	1.23	242.21
4	27,021.73	118	68	50	57.63	1,948.58	-2,109.64	0.92	1.26	229.00
3	25,327.13	118	68	50	57.63	1,694.89	-1,798.51	0.94	1.28	214.64
2	25,623.52	118	71	47	60.17	1,405.26	-1,577.66	0.89	1.35	217.15
1	30,815.45	118	74	44	62.71	1,055.57	-1,074.92	0.98	1.65	261.15

81% of instances closed above the entry price at some point in the next week.

As we knew from the older studies there is a mild upside bias after a 3-day pullback. It appears over the last 10+ years that the edge has really only lasted 1-day. Returns after the 1<sup>st</sup> day are fairly flat.

Now let's look at times like now where the 3/10 Offset HV is very low.

SPX pulls back for exactly 3 days in a row and the HV Offset 3/10 indicator < 0.25.  
Buy on close. Sell X days later. \$100k/trade. 2000 - present.

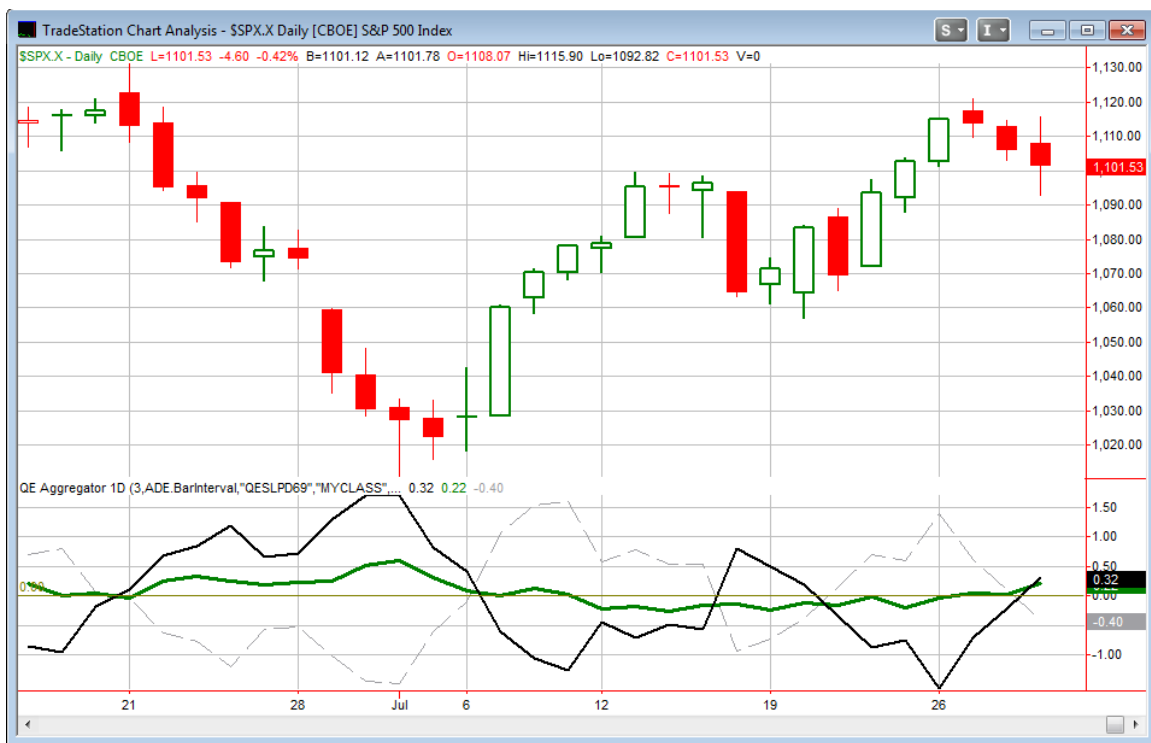
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	28,223.86	25	17	8	68.00	2,802.10	-2,426.47	1.15	2.45	1,128.95
9	25,559.50	25	16	9	64.00	2,663.18	-1,894.60	1.41	2.50	1,022.38
8	21,164.52	25	15	10	60.00	2,877.32	-2,199.53	1.31	1.96	846.58
7	10,913.95	25	14	11	56.00	2,621.90	-2,344.79	1.12	1.42	436.56
6	10,175.57	25	14	11	56.00	2,747.34	-2,571.57	1.07	1.36	407.02
5	12,925.15	25	15	10	60.00	2,518.28	-2,484.90	1.01	1.52	517.01
4	7,758.07	25	15	10	60.00	2,128.62	-2,417.12	0.88	1.32	310.32
3	16,984.72	25	13	12	52.00	2,429.73	-1,216.82	2.00	2.16	679.39
2	13,416.67	25	13	12	52.00	2,027.83	-1,078.76	1.88	2.04	536.67
1	7,655.75	25	15	10	60.00	1,184.70	-1,011.47	1.17	1.76	306.23

22 of 25 instances (88%) closed above the entry price at some point in the next week.

These numbers appear to be quite a bit better. Both immediately and after a couple of weeks. The reliability of some kind of bounce improves nicely as well. Now it isn't exactly one of the strongest studies we've ever seen but it does suggest a decent upside bias over the next few days.

Something else to consider is the fact that we are now at the end of the month. The 1<sup>st</sup> day of the month has historically had a positive bias. This is especially true when the previous month finishes with the last 2 days lower. (See [2009-10-01 QE Subscriber Letter.pdf](#).) When [looking at this post from last year](#) you'll note that August is one of the few months that has not carried an upside bias. I don't know how the numbers would look if we went into August with the last two days of July being down. If it happens I'll run the numbers tomorrow but I suspect the number of instances will be quite low.

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



With the Active Studies list now void of bearish studies the green Aggregator line has moved well above zero. The positive Aggregator line value indicates the net expectation from the Active Studies over the next few days is for upside. Meanwhile the black Differential line is now back above zero, indicating the SPX has underperformed

expectations over the last few days. So we have positive expectations and a market that is already oversold versus recent expectations. Historically this combination has provided an upside edge. Due to this the Aggregator System turned long at the close.

With the current studies the green Aggregator line is set up to remain positive tomorrow. Of course with the low number of active studies some bearish evidence could change this. Meanwhile the Differential pivot will be 1,111.68 tomorrow. This means it would take a close at or above this number in order to turn the Differential line negative. That would be about a 1% rally from today's close.

I'm going to look to start scaling in tomorrow on further weakness. I'm not going to get too aggressive just yet. While we have nothing but bullish studies short-term, they aren't terribly strong, and with the 3/10 HV so low, a move against me could be a big one. I've detailed entry criteria in the trade ideas section below.

### ***An edge for ORB traders?***

I don't always daytrade, but I will sometimes when the 3/10 Offset HV is very low. I've found because large moves are common it can provide a nice opportunity to trade opening range breakouts. Last year I published some research on this for subscribers. I've provided a link below. (It can also be found on the "Downloads" page of the website at any time.)

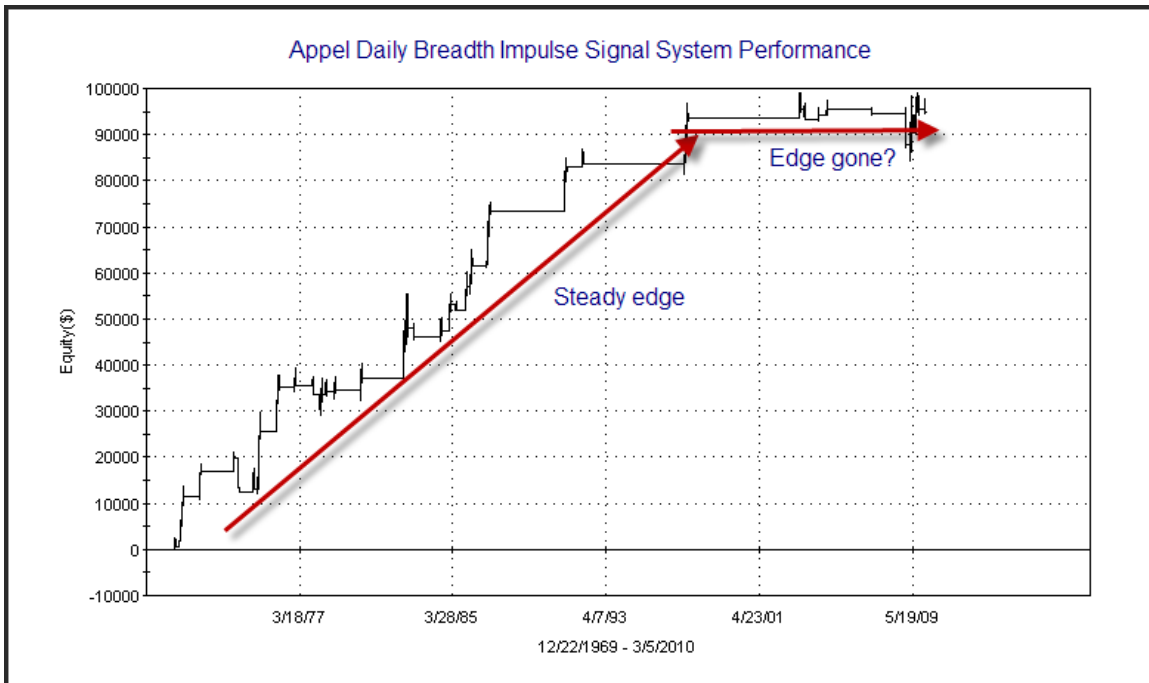
## [Quantifiable Edges ORBs Study.pdf](#)

### ***Intermediate-term Outlook (2 weeks – 2 months)– updated 7/26 – somewhat bullish***

Two new studies with possible positive intermediate-term implications triggered on Friday. One was an Appel Daily Breadth thrust signal and the other was a flip in the Nasdaq/S&P 500 Relative Strength Indicator.

I last discussed the Appel Daily Breadth Impulse Signal in the 3/8/10 Subscriber Letter. Here is an excerpt:

*Another interesting breadth achievement from Friday that was identified by the Quantifinder was the triggering of Gerald Appel's Daily Breadth Impulse Signal from his book "Technical Analysis – Power Tools for Active Investors". The signal is activated when the 10ema of the Up Issue % hits a certain point and is removed when it drops below a certain point. I am not giving specifics because it is not my copyrighted work. You see can details on pages 142 – 145 of his book. From 1970 – 2003 this indicator was a pretty good buy signal as these breadth thrusts often led to significant rallies. In recent years it has faltered a bit. Below is a long-term performance graph.*



This is the 9<sup>th</sup> signal since 2005. Below is a listing of how all the recent ones worked out.

Appel Daily Breadth Impulse Signal System Performance				
Date/Time	Signal	Price	% Profit	Run-up DrawDown
03/21/07	Daily Breadth	\$1,435.04	(1.24%)	\$265.65
03/28/07	Sell	\$1,417.23		(\$1,446.93)
01/02/09	Daily Breadth	\$931.80	(6.60%)	\$1,289.35
01/12/09	Sell	\$870.26		(\$7,220.36)
03/18/09	Daily Breadth	\$794.35	(0.86%)	\$4,825.00
03/30/09	Sell	\$787.53		(\$3,518.75)
04/02/09	Daily Breadth	\$834.38	5.94%	\$11,399.01
05/13/09	Sell	\$883.92		(\$2,362.15)
06/01/09	Daily Breadth	\$942.87	(2.03%)	\$1,416.16
06/15/09	Sell	\$923.72		(\$2,461.32)
07/16/09	Daily Breadth	\$940.74	4.14%	\$8,189.56
08/17/09	Sell	\$979.73		(\$645.54)
09/10/09	Daily Breadth	\$1,044.14	0.64%	\$3,420.95
09/24/09	Sell	\$1,050.78		(\$868.30)
12/24/09	Daily Breadth	\$1,126.48	(0.89%)	\$2,109.36
01/21/10	Sell	\$1,116.48		(\$1,026.96)
03/05/10	Daily Breadth	\$1,138.70	n/a	\$0.00
open	n/a	\$1,138.70		\$0.00

Certainly this is not as strongly suggestive as it once was. The question now is whether it is providing any edge at all. Rather than put much faith in it I'll just continue to monitor it for the time being.

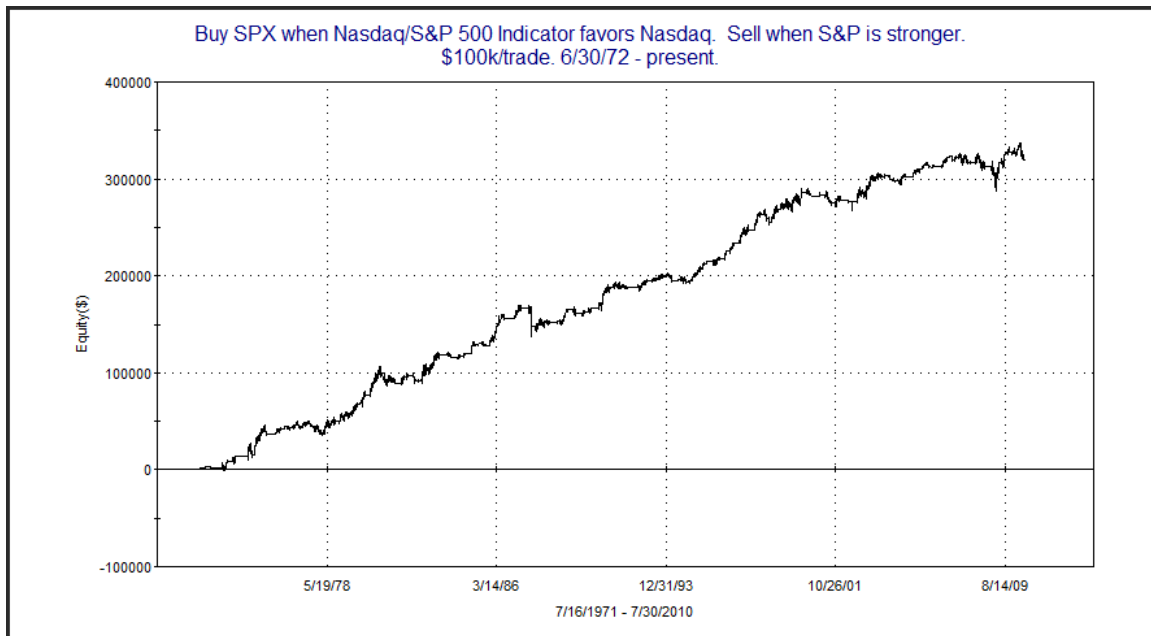
Since I wrote this there have been 2 signals. The 1<sup>st</sup> was from 3/5/10 to 4/19/10 and it posted a gain of 5.17%. The 2<sup>nd</sup> signal lasted from 6/15 – 6/22 and it posted a loss of 1.79%. As I did in March I'll just continue to monitor this signal rather than give it substantial weight in my intermediate-term bias.

The Nasdaq/S&P 500 Relative Strength indicator is found on the charts page. I wrote about that indicator in detail on the blog last year. Links are below:

<http://quantifiableedges.blogspot.com/2009/05/simple-powerful-timing-indicator.html>

<http://quantifiableedges.blogspot.com/2009/06/tweaking-nasdaq-leadlag-model.html>

The bottom line with this indicator is that the market has historically performed substantially better when the Nasdaq has led the S&P 500. Below is an equity curve of a simple strategy that uses the indicator:



As you can see the indicator has provided a nice edge on a fairly consistent basis. But since last October the indicator has not worked so well. Below is a list of all signals over this recent time period.

Nasdaq / S&P 500 RS triggers. 10/16/2009 - present.				
Date/Time	Signal	Price	% Profit	Run-up DrawDown
10/23/09	Buy	\$1,079.60	(4.02%)	\$1,117.80
10/30/09	Sell	\$1,036.19		(\$4,238.44)
12/04/09	Buy	\$1,105.98	(2.90%)	\$4,002.30
01/29/10	Sell	\$1,073.87		(\$3,095.10)
02/12/10	Buy	\$1,075.51	3.29%	\$13,274.68
05/07/10	Sell	\$1,110.88		(\$894.24)
05/14/10	Buy	\$1,135.68	(4.23%)	\$1,142.24
05/21/10	Sell	\$1,087.69		(\$7,020.64)
05/28/10	Buy	\$1,089.41	0.20%	\$1,479.66
06/11/10	Sell	\$1,091.60		(\$4,298.84)
06/18/10	Buy	\$1,117.51	(3.65%)	\$1,221.08
06/25/10	Sell	\$1,076.76		(\$4,416.18)

While I don't think a relatively short period like this should raise big alarms, I do think it is worth noting that the indicator has been out of sync lately.

Part of what I believe has made the indicator effective over time is the fact that it has done a decent job of measuring risk appetite. Since the Nasdaq has traditionally been more risky than the SPX when the Nasdaq is leading then that means investors are more willing to accept risk. In recent times though, financials, which make up a large part of the SPX, have been viewed as one of the riskiest sectors. Over the last few months there has been a lot of focus on bank problems in Greece, Spain, and Portugal among others. So perhaps in recent times risk acceptance was occurring when the SPX was leading and not the Nasdaq.

So if technology is viewed as riskier than financials again this indicator may again become effective.

Friday's signal occurred the same day that stress tests of European banks came back with favorable results. Perhaps this could signal a return to normalcy for this indicator and an upside edge for the market.

## **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 – buy ¼ index position @ \$110.29 LIMIT ON CLOSE. With an upside edge I certainly *could* look to enter early in the day. I'm not setting it up that way because the 3/10 Offset HV has me concerned about a strong selloff should the market fail to bounce. Personally I may look to go long on weakness in the morning or to buy an Opening Range Breakout if the first half hour or so is tight and we get an upside breakout. Tough to lay out exact details in a subscriber letter though, so the trade idea tonight will just look to enter on a down close.*

## **Current Open Trade Ideas**

*None.*

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