

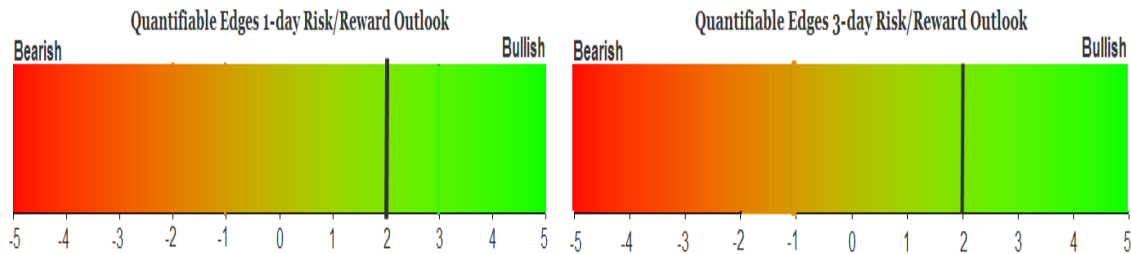
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 9, 2010

Volume 3 Issue 151

Market Overview



Tonight's Research Points

- 2 Unfilled down gaps in a row have historically provided an upside edge over the following few days.
- The extremely low VIX:VXV ratio is suggesting a bit of a downside edge.
- Tuesday's Fed Day carries a bullish edge.
- The Aggregator System turned long.
- The NDX Aggressive Trend Timer remained flat.

Short-term Outlook

The Bottom Line

Friday's action turned the Aggregator long and it appears there is an upside edge over the next few days.

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				
August 9, 2010	VIX:VXV < 0.85		Bearish	
August 9, 2010	2 Unfilled Down Gaps	1-5 days	Bullish	2.46%
August 5, 2010	SPX 10-high on NYSE 10 low vol	1-5 days	Bearish	-2.10%
August 3, 2010	50-day breakout on lower vol	1-5 days	Bullish	1.80%
Active - Long Term				
August 3, 2010	50 high 90% volume	1-25 days	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	
Dropped Tonight				
August 6, 2010	SPY unfilled gap from 50 high	1-2 days	Bearish	-1.00%

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

The Evidence

Jobs disappointed Friday morning but it was the bears who were disappointed Friday afternoon. After a big drop to start the day and further selling around 11am EST, the market put together a rally in the last couple of hours that wiped out most of the early damage. While still down the close came near the highs of the day. The SPX finished down 0.4%, the Nasdaq dropped 0.2% and the Russell 2000 lost 0.7%. Breadth remained negative as the NYSE Up Issues % came in at 46% and the Up Volume % was just 34%. Total volume rose over the prior day for the 1st time in a week.

The Quantifinder identified a few studies tonight that examined SPY inclinations following 2 consecutive unfilled down gaps. Historically this has led to a bounce over the next several days. I've updated those studies from the 11/23/09 Subscriber Letter below. This first one just looks at the unfilled gap pattern. I originally looked at it going all the way back to 1993. Upon closer examination this weekend I found that the edge has been more prominent since 1998. Therefore I'm showing results back to that date below.

SPY posts an unfilled downside gap today and yesterday. Buy on close. Sell X days later. \$100k/trade. 1998 - 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	33,112.09	30	23	7	76.67	1,860.83	-1,383.85	1.34	4.42	1,103.74
4	18,934.52	30	17	13	56.67	2,207.13	-1,429.74	1.54	2.02	631.15
3	15,947.66	30	17	13	56.67	1,767.47	-1,084.56	1.63	2.13	531.59
2	10,027.63	31	14	17	45.16	1,925.52	-995.86	1.93	1.59	323.47
1	9,559.50	33	20	13	60.61	938.96	-709.21	1.32	2.04	289.68

90% of instances posted at least 1 close above the entry price during the next week.

These are very consistent results, especially for a test with so few parameters. Technical analysts have long believed that gaps have a tendency to act as a price magnet. This would seem to partially validate those claims.

In November I also filtered by times the SPY closed above its open price on day 2. That occurred again today so I've rerun those results below.

SPY posts an unfilled downside gap today and yesterday. Today it closed above the open.
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	3,659.01	8	6	2	75.00	1,598.74	-2,966.70	0.54	1.62	457.38
4	4,070.42	8	5	3	62.50	2,122.41	-2,180.54	0.97	1.62	508.80
3	6,573.00	8	5	3	62.50	2,224.37	-1,516.29	1.47	2.44	821.63
2	7,997.63	8	7	1	87.50	1,357.96	-1,508.10	0.90	6.30	999.70
1	6,853.21	9	8	1	88.89	904.40	-381.99	2.37	18.94	761.47

Every instance close above the entry price
on either day 1 or day 2.

In the few cases that this has occurred the bounce has been almost immediate.

Out of curiosity I also decided to look at 2 unfilled up gaps today.

SPY posts 2 consecutive unfilled up gaps.
Buy on close. Sell X days later. \$100k/trade. 1998 - 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	-24,011.35	49	22	27	44.90	1,086.88	-1,774.91	0.61	0.50	-490.03
4	-20,518.38	49	23	26	46.94	1,014.78	-1,686.86	0.60	0.53	-418.74
3	-783.04	49	28	21	57.14	795.02	-1,097.32	0.72	0.97	-15.98
2	3,863.50	49	31	17	63.27	751.15	-1,142.48	0.66	1.20	78.85
1	-245.09	53	28	25	52.83	551.81	-627.83	0.88	0.98	-4.62

It does appear downside is favored here, but the edge is not nearly as pronounced as the upside edge provided by 2 unfilled down gaps. I suspect this pattern could provide a substantial edge if factors like trend and market position were taken into account.

So price action is suggesting the market is likely to go up over the next few days. But complacency may be a problem. One indicator suggesting this is the VIX:VXV Ratio. The VIX estimates 30-day volatility expectations while the VXV measures 3-month implied volatility. When the VIX is higher than the VXV that means expectations are that volatility will decrease over the next few months. When the VIX is lower than the VXV then volatility is expected to increase over the next few months. When the ratio

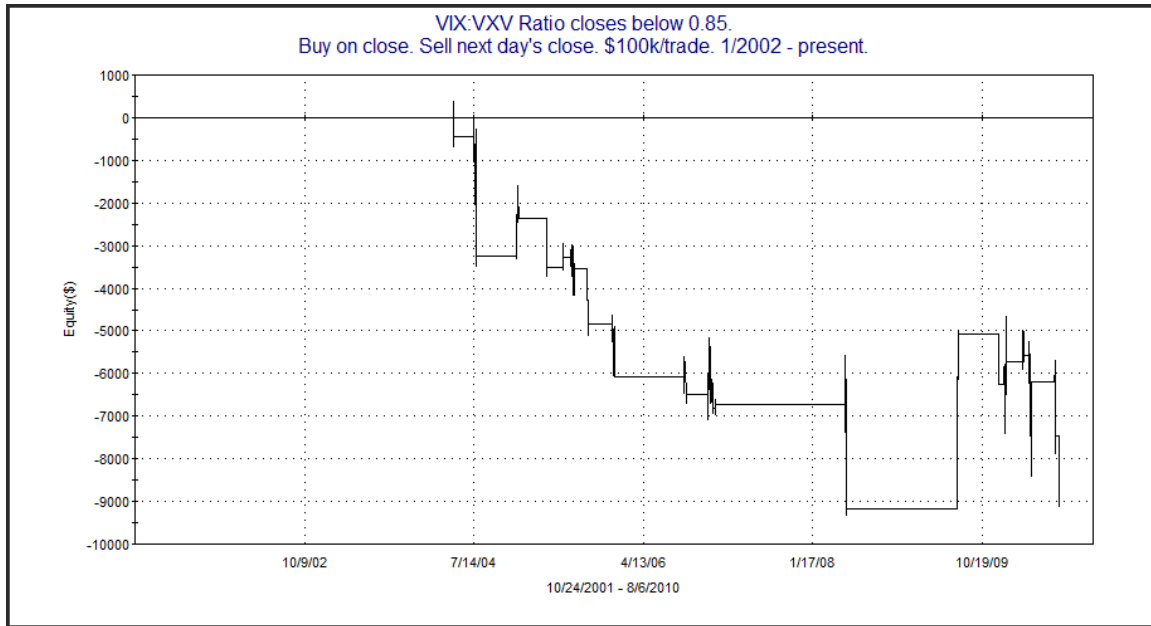
between the two hits an extreme level there is often a reversion that takes place. The ratio on Friday came in at 0.83, which is very low. Perhaps “too” low. When this happens a reversion often takes place, which would commonly see the VIX rise. A rise in the VIX often occurs in conjunction with a drop in the market, so a low VIX:VXV could spell trouble for the market.

Below is a study that shows SPX returns on days following a VIX:VXV Ratio below 0.85.

VIX:VXV Ratio closes below 0.85. Buy on close. Sell next day's close. \$100k/trade. 1/2002 - present.			
TradeStation Performance Summary			Collapse 
All Trades			
Total Net Profit	(\$7,841.46)	Profit Factor	0.66
Gross Profit	\$15,307.80	Gross Loss	(\$23,149.26)
Total Number of Trades	73	Percent Profitable	47.95%
Winning Trades	35	Losing Trades	38
Even Trades	0		
Avg. Trade Net Profit	(\$107.42)	Ratio Avg. Win:Avg. Loss	0.72
Avg. Winning Trade	\$437.37	Avg. Losing Trade	(\$609.19)
Largest Winning Trade	\$2,952.40	Largest Losing Trade	(\$1,602.28)

We see here that while the “% profitable” is fairly close to even down days were quite a bit bigger than up days. Complacency can create shocks and exaggerated moves down. It rarely will lead to outsized moves higher. So the edge here lies not in the winning %, but in the risk:reward. Complacency and a low VIX:VXV suggest increased risk. (Note that while the VXV was only introduced in 2007, the CBOE calculated it back several more years. I was therefore able to run this test back to 2002 using that data.)

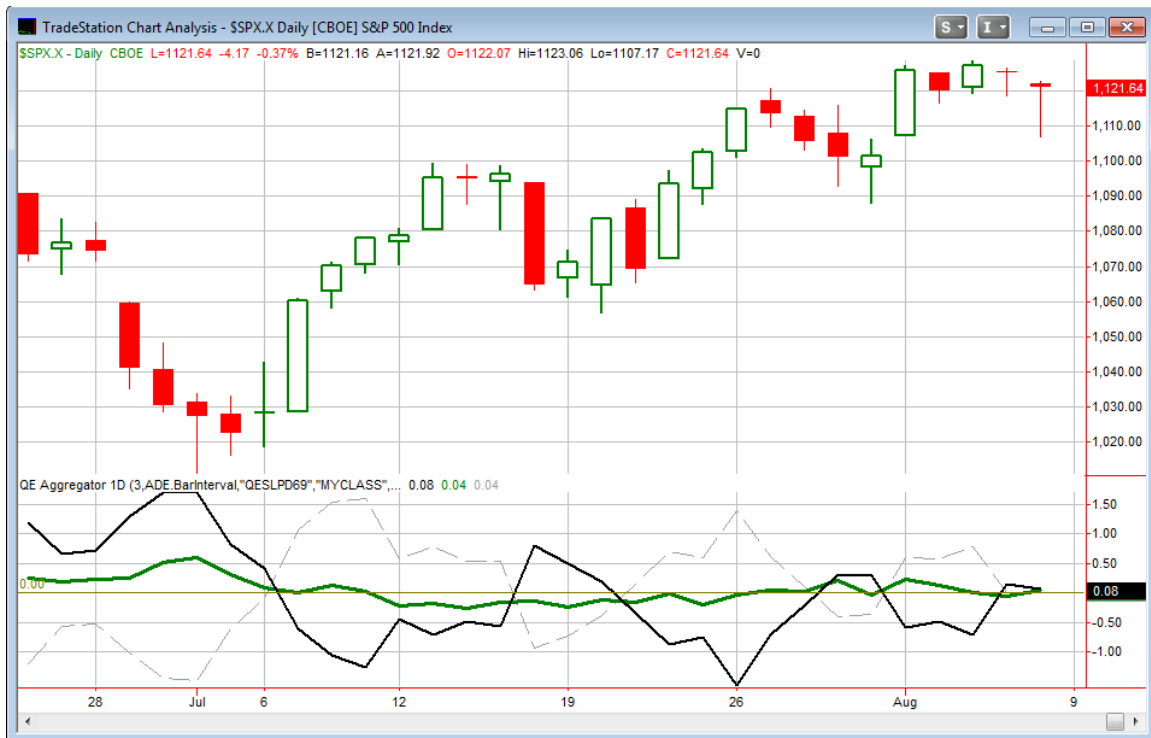
Below is a chart showing performance over time.



Other than July of 2009 the downside edge has been fairly consistent.

Another consideration for traders in the next few days is the fact that Tuesday is a Fed Day. The market has exhibited some strong tendencies on and around Fed Days. In fact the edges have been so pronounced that it inspired me to write *The Quantifiable Edges Guide to Fed Days*. Many of the edges depend on market action as it will unfold over the next few days. One of the strongest tendencies is that Fed Days themselves have been extremely bullish over the years. Also, the greatest upside tendencies have taken place from the close of trading the day before the Fed Day up until the announcement around 2:15. Once the announcement is out it has been a bit of a crapshoot.

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



The “2 unfilled gaps down” study has helped to propel the green Aggregator line back above 0. The positive value indicates the net expectation from the Active Studies over the next few days is for some upside. Meanwhile the black Differential line is also above zero, indicating the SPX has slightly underperformed expectations over the last few days. So we have mildly positive expectations and a market that is a little oversold versus recent expectations. And while the positive readings aren’t very large, historically this combination has provided an upside edge. Due to this the Aggregator System turned long at the close.

Currently the green Aggregator line is set up to remain positive tomorrow. Of course new bearish studies could change this. Meanwhile the Differential pivot will be 1,131.65 tomorrow. This means it would take an SPX close at or above this number to turn the black Differential line negative.

It appears a bit of an upside edge is emerging and I’ll be looking to take advantage of it over the next few days.

Intermediate-term Outlook (2 weeks – 2 months)– updated 8/9 – bullish

Monday’s SPX breakout on strong breadth led to a few studies with intermediate-term implications that appear in the August 3rd Letter Monday night. They both looked at times the market hit new 50-day highs on extremely strong breadth. The first one simply looked at any 50-day high on a 90% or greater NYSE Up Volume %.

SPX closes at a 50-day high while the NYSE Up Volume % close > 90%. Buy on close. Sell X days later. \$100k/trade. 1970 - 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
21	66,250.56	16	13	3	81.25	5,314.80	-947.29	5.61	24.31	4,140.66
20	59,416.79	17	13	4	76.47	5,105.66	-1,739.19	2.94	9.54	3,495.11
19	56,188.99	17	14	3	82.35	4,568.72	-2,591.04	1.76	8.23	3,305.23
18	52,597.01	17	13	4	76.47	4,768.23	-2,347.49	2.03	6.60	3,093.94
17	45,628.34	17	13	4	76.47	4,442.24	-3,030.20	1.47	4.76	2,684.02
16	43,642.00	17	12	5	70.59	4,744.13	-2,657.51	1.79	4.28	2,567.18
15	45,653.48	17	13	4	76.47	4,391.20	-2,858.02	1.54	4.99	2,685.50
14	35,151.48	18	13	5	72.22	4,142.55	-3,740.34	1.11	2.88	1,952.86
13	30,920.05	18	13	5	72.22	3,773.18	-3,626.26	1.04	2.71	1,717.78
12	33,165.24	18	11	7	61.11	4,500.07	-2,333.65	1.93	3.03	1,842.51
11	37,504.81	18	11	7	61.11	4,264.55	-1,343.60	3.17	4.99	2,083.60
10	35,501.76	18	12	6	66.67	3,824.66	-1,732.36	2.21	4.42	1,972.32
9	25,265.04	18	11	6	61.11	3,476.45	-2,162.66	1.61	2.95	1,403.61
8	24,873.22	18	12	6	66.67	3,305.37	-2,465.20	1.34	2.68	1,381.85
7	24,220.47	18	12	6	66.67	3,197.44	-2,358.14	1.36	2.71	1,345.58
6	25,043.14	18	12	6	66.67	2,797.62	-1,421.39	1.97	3.94	1,391.29
5	29,139.19	19	15	4	78.95	2,331.05	-1,456.62	1.60	6.00	1,533.64
4	23,823.24	19	16	3	84.21	1,935.10	-2,379.47	0.81	4.34	1,253.85
3	20,616.55	19	14	5	73.68	1,778.35	-856.06	2.08	5.82	1,085.08
2	20,893.52	19	17	2	89.47	1,261.72	-277.87	4.54	38.60	1,099.66
1	13,553.71	20	14	6	70.00	1,119.17	-352.45	3.18	7.41	677.69

These results suggested bullish tendencies both in the short-term and the intermediate-term.

I also examined the implications of fresh breakouts to new highs versus a repeated new high. Fresh breakouts typically provide a better edge and I found that was true in this case as well. This 2nd study from the August 3rd letter demonstrated this.

SPX closes at a 50-day high after not having done so for at least 10 days.
NYSE Up Volume % > 90%. Buy SPX on close. Sell X days later. \$100k/trade. 1970 - 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	50,143.03	10	9	1	90.00	5,867.85	-2,667.60	2.20	19.80	5,014.30
20	45,876.72	10	7	3	70.00	7,144.22	-1,377.60	5.19	12.10	4,587.67
15	38,685.53	10	7	3	70.00	6,262.94	-1,718.35	3.64	8.50	3,868.55
10	35,095.45	10	8	2	80.00	4,657.74	-1,083.25	4.30	17.20	3,509.55
9	29,807.00	10	7	2	70.00	4,616.82	-1,255.38	3.68	12.87	2,980.70
8	26,436.14	10	8	2	80.00	3,968.24	-2,654.88	1.49	5.98	2,643.61
7	26,064.35	10	8	2	80.00	3,950.95	-2,771.63	1.43	5.70	2,606.44
6	21,595.12	10	8	2	80.00	3,382.30	-2,731.65	1.24	4.95	2,159.51
5	24,817.77	10	8	2	80.00	3,549.12	-1,787.58	1.99	7.94	2,481.78
4	17,452.07	10	8	2	80.00	2,867.70	-2,744.75	1.04	4.18	1,745.21
3	21,710.82	10	9	1	90.00	2,432.15	-178.50	13.63	122.63	2,171.08
2	17,810.14	10	10	0	100.00	1,781.01	0.00	100.00	100.00	1,781.01
1	12,193.10	10	9	1	90.00	1,362.43	-68.80	19.80	178.23	1,219.31

Follow through so far has been weak. Wednesday (day 2) is the only day that the market closed above Monday at this point. But down days have been muted and with the short-term outlook now appearing positive we could get another leg up here soon.

Overall there are still a good number of intermediate-term studies in effect suggesting upside. Meanwhile, very little is appearing that would favor the bears. I'm still feeling more comfortable buying the dips than I am shorting the rallies.

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 @ \$112.39 limit. I'll take a small position based on the Aggregator and the short-term outlook above.

IJR – buy @ \$57.50 limit. Based on system 90609. This is a nice little system to try and jump into a trend and ride it for a while. IJR has lagged the SPX lately as it still hasn't broken above its July or June highs. Still, with my outlook bullish both short and intermediate-term and 90609 lining up nicely here risk/reward appears to be well in my favor.

Fed Day SPY Trade Ideas

I mentioned above that my findings indicated Fed Days have carried an upside edge for a long time and that the edge primarily occurred between the close on the day before the Fed Day and about 2pm on the Fed Day. In addition to that the book also showed that Fed Day risk/reward was greatly affected by the previous day's action. Specifically, where the SPY closed in relation to its daily range. Overall it found that the worse the close, the bigger the upside edge the next day. The two trade ideas below are based on this.

SPY – buy ¼ index position on close if SPY closes below the top 25% of its daily range.

SPY – buy another ¼ index position if the SPY closes in the bottom 25% of its daily range.

If either or both of these Fed Day trade ideas fill I will look to exit them at 2pm on Tuesday before the announcement is made.

Current Open Trade Ideas

None

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