

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 30, 2010

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Market Overview



Tonight's Research Points

- Friday's reversal bar gives us a chance at a rally, though the record hasn't been very good over the last few years.
- AAI Investor Survey is hitting levels that usually lead to a rally.
- The Aggregator System switched back to flat.
- The NDX Aggressive Trend Timer flipped to short.

Short-term Outlook

The Bottom Line

The market bounce came as expected on Friday, but it quickly put the Differential into negative territory. Short-term evidence from Friday is weak, so I'm going to give things a day or so and see what other clues emerge before taking any new exposure. I'll also look to reduce current long exposure.

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 27, 2010	Bounce immediately fails	1-4 days	Bullish	2.65%
August 26, 2010	SPY gap dn 10-low reverse up	1-3 days	Bearish	-3.70%
August 25, 2010	SPX down 1%. Decliners 2x advancers	1-9 days	Bullish	3.00%
August 24, 2010	3 lower closes into Turnaround Tuesday	1-9 days	Bullish	3.70%
August 24, 2010	HV low SPX no highs	1-8 days	Bearish	-3.20%
Active - Long Term				
August 30, 2010	AAII Survery very bearish	1-30 days	Bullish	
August 16, 2010	1 (borderline) Hindenburg Omen Day	int term	Bearish	
August 3, 2010	50 high 90% volume	1-25 days	Bullish	
July 20, 2010	Down 1 week after FTD	int term	Bearish	
July 7, 2010	McClellan Oscillator Bottom Divergence	int term	Bullish	

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

The Evidence

Friday was another wild day. This time it ended in favor of the bulls. The SPX and Nasdaq each rose 1.7% while the Russell gained 2.8%. Breadth was very strong as the NYSE Up Issue % came in at 85% and the Up Volume % was 91%. Total volume rose from Thursday’s level and was a little above average.

Surprisingly little appeared in the Quantifinder after Friday’s action. One study that did appear looked at “reversal bars” like the one seen on Friday. This study was actually [one of the first published on the blog in January of 2008](#). I last looked at it in detail in the 9/18/08 Subscriber Letter. Tonight I’ve updated it again.

SPX makes a 20-day intraday low and then closes up at least 1% on increased volume. Buy on close. Sell X days later. \$100k/trade. 1978 - 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	31,828.49	29	16	13	55.17	3,851.27	-2,291.68	1.68	2.07	1,097.53
9	22,189.83	30	14	16	46.67	4,277.02	-2,355.53	1.82	1.59	739.66
8	11,939.22	30	16	14	53.33	3,653.49	-3,322.62	1.10	1.26	397.97
7	10,253.17	30	14	16	46.67	3,743.32	-2,634.58	1.42	1.24	341.77
6	5,878.80	31	18	13	58.06	2,953.29	-3,636.96	0.81	1.12	189.64
5	862.26	32	18	14	56.25	2,815.39	-3,558.19	0.79	1.02	26.95
4	6,931.44	32	18	14	56.25	2,880.80	-3,208.78	0.90	1.15	216.61
3	19,294.80	32	16	16	50.00	2,840.51	-1,634.59	1.74	1.74	602.96
2	3,589.76	34	15	19	44.12	1,962.35	-1,360.29	1.44	1.14	105.58
1	9,688.45	34	18	16	52.94	1,910.01	-1,543.23	1.24	1.39	284.95

17 of 34 instances (50%) managed to go at least 2 weeks without violating the low of the trigger day.

Overall the statistics seem to favor the bulls – but not greatly. Back in 2008 these stats appeared quite a bit more favorable. To see why, I ran the stats just over this recent period. Those results are below.

SPX makes a 20-day intraday low and then closes up at least 1% on increased volume.
Buy on close. Sell X days later. \$100k/trade. 2008 - 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	-13,150.96	5	0	5	0.00	0.00	-2,630.19	0.00	0.00	-2,630.19
9	-14,975.95	6	0	6	0.00	0.00	-2,495.99	0.00	0.00	-2,495.99
8	-14,904.73	6	2	4	33.33	2,251.38	-4,851.87	0.46	0.23	-2,484.12
7	-12,245.19	6	2	4	33.33	2,588.74	-4,355.67	0.59	0.30	-2,040.87
6	-8,922.68	7	4	3	57.14	2,514.49	-6,326.87	0.40	0.53	-1,274.67
5	-15,542.14	8	5	3	62.50	1,538.02	-7,744.08	0.20	0.33	-1,942.77
4	-6,741.73	8	4	4	50.00	3,933.36	-5,618.79	0.70	0.70	-842.72
3	5,143.46	8	4	4	50.00	3,975.37	-2,689.50	1.48	1.48	642.93
2	-7,827.27	9	2	7	22.22	3,580.10	-2,141.07	1.67	0.48	-869.70
1	780.86	9	5	4	55.56	2,480.57	-2,905.50	0.85	1.07	86.76

As you can see the recent results have been awful. I don't have a neat explanation as to why. I suspect a large part of the reason is that the 2008-09 bear market was so vicious it simply overran these attempted reversals.

When I run stats on setups I typically only use the first instance so as not to skew the results unfairly bullish in a test like this. (See [this blog post for more details.](#)) This appears to be one of those unusual cases where the results got skewed a quite a bit more bearish than they really are thanks to the way the test was run. For instance, while the 11/13/2008 reversal bar was a miserable failure, the 11/20/08 bar just 5 trading days later marked the low for the next few months.

As I noted in the 1st table above, 50% of the time these reversal bars have marked bottoms that lasted at least 2 weeks. And there have been a few other recent instances that marked short-term bottoms including 1/23/08 and 1/21/09. So it seems there is a decent chance that Friday could mark at least a temporary bottom. Still, the effectiveness of these bars and the ability of the market to rally strongly following their appearance has been weak over the last 2 ½ years. I don't think it is worthy or including in the Active Studies List, but I do think it is notable nonetheless.

I did look at the reversal bar a few other ways as well, including requiring an outside day, looking at gaps up to start the day, and a few others. The results were generally pretty close to this original study with the performance better up until 2008.

So Friday's action doesn't seem to give us a reliable indication to trade with. Often times we get indications not on the day of the bottom but in the days that follow. Generally we'd like to see continued follow through with strong breadth and volume to provide positive indications. In any case, I'm sure the next several days will provide plenty of clues.

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



Without anything new and substantial the green Aggregator remained a bit above 0. The positive value indicates the net expectation from the Active Studies over the next few days is for upside. Meanwhile Friday's rally dropped the black Differential line below 0. This means the SPX has outperformed expectations over the last few days. So we have positive expectations but a market that is already overbought versus recent expectations. This is considered a neutral configuration. Due to this the Aggregator System turned back to flat at the close.

Currently the green Aggregator line is set up to remain positive tomorrow. This could change depending on what studies emerge. Meanwhile the Differential pivot will be 1,056.25 tomorrow. This means the SPX would need to close a little over 8 points lower in order to flip the black Differential line back to positive.

The studies are suggesting there should be some more in this bounce. The Differential line is saying there is now some extra risk in trying to hold on for further gains. I'm going to scale back a bit but not completely exit my longs.

Intermediate-term Outlook (2 weeks – 2 months)– updated 8/30 – neutral to bullish

One indicator I thought it was worth taking a closer look at this weekend was the [AAII Investor Sentiment survey](#). In general the survey is viewed by technicians as a contrary indicator when it reaches extremes.

This past week the number of bears rose to 49.5% and the bulls dropped to 20.7% so it is now at fairly extreme levels. The last time the Bull-Bear Spread was this low was in early July as the July rally was just beginning. Prior to that it was the first week of November of '09 just as that rally was kicking off, and the time before that was early March of '09 just before that rally began.

I looked at the data a number of different ways this weekend. (For those interested you may get all the data using the AAI link I provided above. Just scroll down and you'll find a link to a historical spreadsheet on the right hand side of the page.) Below is a sample of the kind of results I saw when conducting some studies.

AAII Investor Survey Bull-Bear Spread crosses below -25%. Buy SPX on close. Sell X days later. \$100k/trade. 7/87 - 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	All: Max Losing Trade	All: Max Winning Trade
50	37,460.19	18	12	6	66.67	6,830.14	-7,416.91	0.92	1.84	2,081.12	-16,443.76	20,975.06
45	48,998.82	19	15	4	78.95	6,372.73	-11,648.05	0.55	2.05	2,578.89	-27,020.80	18,085.65
40	63,192.00	20	16	4	80.00	6,566.10	-10,466.40	0.63	2.51	3,159.60	-27,533.60	18,300.41
35	78,304.76	22	17	4	77.27	6,723.64	-8,999.29	0.75	3.18	3,559.31	-23,596.80	17,152.87
30	80,709.06	21	17	4	80.95	7,128.92	-10,120.63	0.70	2.99	3,843.29	-27,275.20	24,058.32
25	44,567.69	24	18	6	75.00	5,124.79	-7,946.43	0.64	1.93	1,856.99	-24,209.60	15,441.36
20	32,088.11	27	17	10	62.96	5,230.95	-5,683.81	0.92	1.56	1,188.45	-27,130.40	17,878.08
15	20,894.96	27	16	11	59.26	4,143.71	-4,127.67	1.00	1.46	773.89	-10,781.60	16,802.28
10	15,122.51	28	17	11	60.71	3,920.26	-4,683.82	0.84	1.29	540.09	-12,337.92	16,319.16
5	33,080.64	28	16	12	57.14	3,689.49	-2,162.60	1.71	2.27	1,181.45	-4,845.44	18,981.60

So what we see here is that an extremely pessimistic outlook from investors has been followed by a rise in the market on pretty consistent basis. Six weeks later the market has been higher 81% of the time and the average gain was over 7%. The problem is that the failures have been very, very large. Using the same 6-week time frame the average loss was 10% and the max loss was 27%. The max loss occurred in September/October of 2008. August of 1990 also saw a sharp decline in the spread to levels similar to current levels. That was followed by further selling that maxed out around a 12% decline

between then and October. Other instances that were followed by large selloffs included July of 2002 with a 12% decline and February 2009 with a 14% decline.

So it appears the AAI Investment Survey is suggesting there is a good chance of a rally emerging over the next several weeks. But if the market can't manage to rally then the probable alternative is substantial selloff.

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.

None tonight.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
IJR	8/9/2010	\$57.50	\$54.56	-5.11%		<i>sold on close</i>
SPY(1/4)	8/12/2010	\$107.65	\$106.86	-0.73%		
CMCSA	8/24/2010	\$17.29	\$17.25	-0.23%		System 80402
UTX	8/25/2010	\$65.14	\$66.57	2.20%		<i>sold on close</i>
SPY(1/4)	8/12/2010	\$105.23	\$106.86	1.55%		<i>sell @ \$106.86 limit</i>
NOV	8/27/2010	\$36.75	\$37.97	3.32%		<i>sold on close</i>

IJR, UTX, and NOV all triggered exits at the close according to their respective system rules.

I am looking to exit 1 lot of the SPY. I will hold the other lot for now and see how this bounce develops.

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