

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 3, 2010

Volume 3 Issue 170

Market Overview



Tonight's Research Points

- 3 days up in a downtrend carries potential bearish implications. This tendency is strengthened by Thursday's low range and the fact it is not emerging from a 50-day low.
- Back to back "strong up" days also have bearish implications – especially with a declining volume pattern.
- The Aggregator System remained short.
- The NDX Aggressive Trend Timer changed to flat.

Short-term Outlook

The Bottom Line

The short-term bearish evidence continues to pile up. I'm looking to get more aggressively short to take advantage of a move down.

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				
September 3, 2010	Up 0.75% on lower vol 2 days < 200ma	1-5 days	Bearish	-3.90%
September 3, 2010	Up 3, low range, no 50-low, < 200ma	1-2 days	Bearish	-1.80%
September 2, 2010	1st day of month up 2.5%	1-6 days	Bearish	-3.35%
September 2, 2010	10-high, strong breadth, low vol, <200	1-7 days	Bearish	-2.40%
September 2, 2010	SPY gap up, trend up, < 200	1-5 days	Bearish	-4.00%
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				
September 2, 2010	2 90% Up Vol days in 1 week	1-20 days	Bullish	
September 1, 2010	August down > 4%	1 month	Bearish	
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	
Dropped Tonight				
August 25, 2010	SPX down 1%. Decliners 2x advance	1-9 days	Bullish	3.00%

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

The Evidence

The market gapped up again to open trading on Thursday. After that it was a slow grind sideways to slightly higher for most of the day. Strong buying came in during the last half hour and the final numbers ended strongly positive. The SPX gained 0.9%, the Nasdaq was up 1.1% and the Russell 2000 rallied 1.2%. Breadth was strongly positive as the NYSE Up Issues % came in at 69% and the Up Volume % was 83%. Total NYSE Volume declined for the 2nd day in a row and was below average.

There were numerous studies that appeared in the Quantifinder tonight. They were all either neutral or bearish. A common theme among them was that multiple up days while under the 200ma led to a downside edge. This edge was improved when such things as range, volume, the strength of the last 2 days, and the position of the market prior to the upmove were considered. Below I'll highlight some of the more compelling studies.

This first study was from the 7/9/10 Subscriber Letter. It looked at narrow range days that occurred in a short-term upmove. It also took market position into consideration.

SPX closes higher for at least the 3rd day in a row. It is NOT coming off a 50-day low.
 Today's range is the smallest of the last 7 days. Close < 200ma.
 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
5	-32,149.63	31	15	16	48.39	961.46	-2,910.72	0.33	0.31	-1,037.08
4	-25,794.86	31	14	17	45.16	755.69	-2,139.68	0.35	0.29	-832.09
3	-29,562.25	31	10	21	32.26	1,035.44	-1,900.79	0.54	0.26	-953.62
2	-31,298.26	32	9	23	28.13	902.05	-1,713.77	0.53	0.21	-978.07
1	-9,669.75	33	15	18	45.45	796.97	-1,201.35	0.66	0.55	-293.02

The stats here are very compelling. Not included in the above table is that 90% of instances closed below the entry price at some point in the next week.

But although the range on Thursday wasn't large, the price action was still strong by a few measures. For one the market opened near its lows and closed near its highs. Also, the percent change was fairly sizable. Below are some studies that look at both of these factors.

When a market opens near its low and closes near its high it is considered a sign of strength. On a classic candle chart it is seen as a white candle with very small or no wicks. Not only did we see this formation occur in the SPY on Thursday, but we also saw it Wednesday. So what happens after you get back to back days that are so strong that they manage to open in the bottom 10% of the day's range and close in the top 10%? Looking back to the inception of the SPY I only found 5 other instances. I've listed them all below along with their next-day returns.

SPY opens in bottom 10% of daily range and closes in top 10% of daily range for the 2nd day in a row. Buy on close. Sell next day close. \$100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
06/19/95	Buy	\$54.58	(0.24%)	\$73.28
06/20/95	Sell	\$54.45		(\$329.76)
02/01/96	Buy	\$63.92	(0.42%)	\$172.04
02/02/96	Sell	\$63.65		(\$656.88)
06/18/02	Buy	\$104.97	(2.33%)	\$0.00
06/19/02	Sell	\$102.52		(\$2,598.96)
11/21/02	Buy	\$94.09	(0.71%)	\$191.16
11/22/02	Sell	\$93.42		(\$870.84)
11/28/08	Buy	\$90.09	(8.86%)	\$0.00
12/01/08	Sell	\$82.11		(\$9,135.30)

The most obvious observation is that all 5 instances declined the next day. But what really stands out to me is the “Run-up” column. If you look there you will note that none of the 5 instances managed an intraday gain of even 0.2%. Meanwhile they all suffered intraday drawdowns of at least 0.3%, and 4 of the 5 were greater than 0.6%.

The Quantifinder identified a study that looked at back to back strong price moves by measuring the percent change rather than the candle pattern. This study was last seen in the 3/27/09 blog. In the blog I showed stats going back as far as 1980. Upon further examination tonight I found that the downside edge has been more pronounced over the last decade. Below are updated results back to 2000.

SPX closes up over 0.75% two days in a row and close < 200ma.
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
5	-24,139.27	55	26	29	47.27	2,150.88	-2,760.77	0.78	0.70	-438.90
4	-49,596.43	57	25	32	43.86	1,492.34	-2,715.78	0.55	0.43	-870.11
3	-19,380.67	61	28	33	45.90	1,860.30	-2,165.73	0.86	0.73	-317.72
2	-25,572.62	63	29	34	46.03	1,610.91	-2,126.15	0.76	0.65	-405.91
1	-26,802.01	70	27	43	38.57	1,058.05	-1,287.66	0.82	0.52	-382.89

87% of instances posted a close below the entry price at some point in the next week.

More compelling evidence here. As I mentioned earlier, though, then decline in volume over the last 2 days is also something that a few studies from the Quantifinder picked up on. Rather than re-run some of those studies, I decided to see what would happen if I also included a declining volume filter in the above study. These results are below.

SPX closes up over 0.75% two days in a row and close < 200ma. NYSE volume declines both days. 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
5	-19,005.27	11	1	10	9.09	3,827.88	-2,283.32	1.68	0.17	-1,727.75
4	-15,233.86	11	3	8	27.27	1,445.01	-2,446.11	0.59	0.22	-1,384.90
3	-3,840.72	11	4	7	36.36	1,417.69	-1,358.78	1.04	0.60	-349.16
2	-9,176.10	11	7	4	63.64	874.46	-3,824.32	0.23	0.40	-834.19
1	-7,702.97	11	6	5	54.55	999.00	-2,739.40	0.36	0.44	-700.27
All 11 instances closed below the entry price at some point in the next week.										

It seems as though nearly everything about the current setup is suggesting a strong short-term downside edge. This was seen both last night and tonight. And in addition to all these bearish studies emerging we also had 1 of the 2 short-term bullish studies reach its target price so that it is being removed from the Active Studies List tonight.

One wildcard will be the employment report to be issued around 8:30am Friday. That has the potential to spike the market higher despite all the bearish studies emerging. Should that happen I would take the opportunity to short more aggressively into a gap up. Details on how I am looking to trade this are in the trade ideas section. Below are a few studies from the blog that looked at gaps up when the market is already near a short-term high or has risen the last few days:

<http://quantifiableedges.blogspot.com/2009/04/large-gaps-after-market-has-already.html>

<http://quantifiableedges.blogspot.com/2009/04/gaps-up-from-10-day-highs.html>

<http://quantifiableedges.blogspot.com/2010/06/large-gap-up-from-high-level.html>

You'll note they all suggest a downside edge from open to close on the day of the gap. I also noticed Scott Andrews of Master the Gap posted research along these lines in his video tonight. His results were confirming of mine. Below is a link to that:

http://www.masterthegap.com/public/Gap_Trading_Video_Small_and_mixed_gaps_after_a_large_unfilled_up_gap_plus_research_on_fading_gaps_that_follow_a_close_that_is_35_higher_than_the_close_of_2_days_prior.cfm

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



With bearish studies now dominating the green Aggregator line is further below 0 than it has been in quite a while. The negative value indicates the net expectation from the Active Studies over the next few days is for downside. Meanwhile the black Differential line is also stretched far below 0. This means the SPX has strongly outperformed expectations over the last few days. So we have negative expectations and a market that is overbought versus recent expectations. Historically, this has provided a downside edge. The condition is represented by both lines closing below 0. Due to this the Aggregator System remained short.

Currently the green Aggregator line is set up to remain negative tomorrow. It would be difficult but possible for enough bullish studies to appear tomorrow to change this. Meanwhile the Differential pivot will be 1,049.83 tomorrow. It would take a close at or below this level to flip the black Differential line positive. That's nearly a 4% drop from Thursday's close. This all suggests a move down will last multiple days and that the short signal is likely persist over the weekend.

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 a 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.

SPY – short 1/4 index position @ \$109.50 LIMIT. Based on the short-term outlook and the Aggregator. I'm looking to up my exposure with more bearish studies emerging.

SPY – short 1/4 index position @ \$110.25 LIMIT ON OPEN – I will view a gap up as a gift and will look to get more aggressively positioned in this case. Should this order not fill on the open, it will be cancelled.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	9/2/2010	\$109.47	\$109.47	0.00%		shorted on close

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