

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 7, 2010

Volume 3 Issue 171

Market Overview



Tonight's Research Points

- Breadth has been so strong the past few days that it is moving past “overbought and likely to pull back” into “overbought with such a strong breadth thrust that it is likely to continue to power higher”.
- The extremely low VXO reading is suggesting 1) a pullback is probable, and 2) it could be sharp.
- Three consecutive unfilled up gaps in the SPY has been a rarity. The few times it has occurred the market has pulled back within 2 days.
- The Aggregator System remained short.
- The NDX Aggressive Trend Timer changed to long.

Short-term Outlook

The Bottom Line

Some short-term bullish evidence is now emerging. Still the overwhelming majority of evidence is suggesting a pullback in 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				
September 7, 2010	3 Unfilled Up Gaps in SPY	1-3 days	Bearish	-1.40%
September 7, 2010	VXO < 15% below 10ma	1-5 days	Bearish	-3.80%
September 7, 2010	SPX up 3 days, NYSE Up Vol % > 90%	1-7 days	Bullish	2.90%
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%
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 24, 2010	3 lower closes into Turnaround Tuesday	1-9 days	Bullish	3.70%

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

The Evidence

Another gap up was inspired by the employment report and the market managed to even add a bit to the gains by the close. All the indices finished strongly higher. The SPX gained 1.3%, the Nasdaq gained 1.5%, and the Russell 2000 finished up 1.8%. Breadth was again extremely strong as the NYSE Up Issues % came in at 77% and the NYSE Up Volume % was 91%. Total NYSE volume declined for the 3rd day in a row. The Nasdaq volume declined for the 2nd day in a row.

There were a good amount of studies to examine this weekend as the action over the last few days has been interesting.

Wednesday and Thursday in the letter we saw some studies that considered breadth and concluded the move was likely overdone and should pull back. Friday we saw the market power ahead despite those potentially bearish influences. And breadth was again slanted very positive on Friday. When markets power through overbought conditions it is often a bullish sign – both short and intermediate-term. We saw several past breadth-related studies appear in the Quantifinder this weekend that suggested this. Below is one of the more compelling studies, which was last published in the 3/8/10 Subscriber Letter.

SPX closes higher for at least the 3rd day in a row and the 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
20	77,947.96	28	18	10	64.29	5,510.96	-2,124.93	2.59	4.67	2,783.86
19	71,310.57	28	19	9	67.86	4,923.15	-2,469.91	1.99	4.21	2,546.81
18	72,774.47	28	21	7	75.00	4,505.75	-3,120.89	1.44	4.33	2,599.09
17	71,367.50	29	22	7	75.86	4,302.88	-3,327.98	1.29	4.06	2,460.95
16	70,103.22	29	20	9	68.97	4,649.17	-2,542.24	1.83	4.06	2,417.35
15	70,455.24	30	21	9	70.00	4,447.76	-2,549.74	1.74	4.07	2,348.51
14	64,180.02	30	22	8	73.33	3,951.06	-2,842.92	1.39	3.82	2,139.33
13	55,669.31	31	22	9	70.97	3,600.89	-2,616.69	1.38	3.36	1,795.78
12	42,087.90	31	21	10	67.74	3,146.70	-2,399.27	1.31	2.75	1,357.67
11	41,920.52	31	19	12	61.29	3,171.77	-1,528.60	2.07	3.29	1,352.27
10	48,801.69	31	22	9	70.97	3,032.10	-1,989.38	1.52	3.73	1,574.25
9	39,862.58	31	21	9	67.74	2,870.25	-2,268.08	1.27	2.95	1,285.89
8	33,237.97	31	22	9	70.97	2,601.87	-2,667.03	0.98	2.38	1,072.19
7	37,907.56	31	20	11	64.52	2,950.61	-1,918.61	1.54	2.80	1,222.82
6	29,712.66	31	18	13	58.06	2,731.18	-1,496.05	1.83	2.53	958.47
5	26,982.67	31	21	10	67.74	2,249.16	-2,024.96	1.11	2.33	870.41
4	23,147.78	31	20	11	64.52	1,999.22	-1,530.61	1.31	2.37	746.70
3	11,435.26	31	19	11	61.29	1,593.95	-1,713.62	0.93	1.61	368.88
2	11,872.50	31	24	7	77.42	1,026.13	-1,822.09	0.56	1.93	382.98
1	11,885.30	32	18	14	56.25	940.05	-359.69	2.61	3.36	371.42

As you can see the results start off quite positive and remain that way for some time. I also looked at more recent results to see if the edge might have begun to wane in recent years.

SPX closes higher for at least the 3rd day in a row and the NYSE Up Volume % > 90%.
Buy SPX on close. Sell X days later. \$100k/trade. 10/20/87 - 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
20	34,484.47	13	9	4	69.23	4,881.40	-2,362.03	2.07	4.65	2,652.65
19	27,550.65	13	10	3	76.92	3,709.76	-3,182.31	1.17	3.89	2,119.28
18	30,432.59	13	11	2	84.62	3,462.96	-3,829.97	0.90	4.97	2,340.97
17	32,573.46	13	10	3	76.92	4,065.12	-2,692.58	1.51	5.03	2,505.65
16	31,634.15	13	11	2	84.62	3,594.07	-3,950.33	0.91	5.00	2,433.40
15	33,201.11	14	11	3	78.57	3,694.09	-2,477.95	1.49	5.47	2,371.51
14	33,690.68	14	13	1	92.86	2,775.12	-2,385.90	1.16	15.12	2,406.48
13	26,476.09	15	12	3	80.00	2,558.62	-1,409.13	1.82	7.26	1,765.07
12	21,658.53	15	12	3	80.00	2,230.40	-1,702.08	1.31	5.24	1,443.90
11	20,229.34	15	9	6	60.00	2,667.17	-629.20	4.24	6.36	1,348.62
10	23,562.34	15	11	4	73.33	2,730.13	-1,617.29	1.69	4.64	1,570.82
9	23,929.43	15	12	3	80.00	2,289.96	-1,183.36	1.94	7.74	1,595.30
8	19,910.11	15	12	3	80.00	2,169.33	-2,040.61	1.06	4.25	1,327.34
7	22,994.60	15	11	4	73.33	2,500.60	-1,128.00	2.22	6.10	1,532.97
6	16,670.79	15	10	5	66.67	2,253.17	-1,172.19	1.92	3.84	1,111.39
5	14,725.30	15	12	3	80.00	1,815.75	-2,354.56	0.77	3.08	981.69
4	12,426.06	15	11	4	73.33	1,641.49	-1,407.58	1.17	3.21	828.40
3	3,353.16	15	10	5	66.67	1,380.01	-2,089.39	0.66	1.32	223.54
2	3,457.89	15	14	1	93.33	818.75	-8,004.64	0.10	1.43	230.53
1	8,479.23	15	9	6	60.00	961.74	-29.41	32.70	49.05	565.28

My concern about a possible weakening of the edge proved needless. Results have actually been even better over the recent past.

Another similar strong-breadth study with bullish implications was from the 7/14/10 Subscriber Letter. I have copied that study below (results not updated).

NYSE Up Issues % > 75% in 2 of the last 3 days and makes a 10-day intraday high. 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
20	107,484.86	36	27	9	75.00	5,166.10	-3,555.54	1.45	4.36	2,985.69
15	92,949.90	37	27	10	72.97	4,246.02	-2,169.27	1.96	5.28	2,512.16
10	71,424.42	39	30	9	76.92	3,341.47	-3,202.19	1.04	3.48	1,831.40
9	71,150.64	39	28	11	71.79	3,481.40	-2,393.52	1.45	3.70	1,824.38
8	59,700.36	39	29	10	74.36	2,916.50	-2,487.81	1.17	3.40	1,530.78
7	54,559.48	39	28	11	71.79	2,891.16	-2,399.37	1.20	3.07	1,398.96
6	47,615.27	40	30	10	75.00	2,408.70	-2,464.58	0.98	2.93	1,190.38
5	41,881.89	41	29	12	70.73	2,156.61	-1,721.65	1.25	3.03	1,021.51
4	33,006.29	43	26	17	60.47	2,019.98	-1,147.83	1.76	2.69	767.59
3	27,801.06	44	28	16	63.64	1,729.99	-1,289.92	1.34	2.35	631.84
2	15,797.54	50	31	19	62.00	1,219.09	-1,157.60	1.05	1.72	315.95
1	11,269.24	54	32	20	59.26	773.69	-674.45	1.15	1.84	208.69

93% of instances closed above the entry price at some point in the next week. In two weeks it was 98%.

This serves as confirmation of the results of the previous study.

But not all the news was good. While some studies were suggesting the move over the last few days was so strong that it was likely to continue, others suggested upside risk was elevated and the chances of a pullback were high.

One example looked at the VXO compared to its 10ma. When the VXO gets stretched strongly to the downside it may imply complacency on the part of traders. This complacency increases risk. Not only do pullbacks become common, but those pullbacks seem to catch traders by surprise and they quickly panic out of new purchases, effectively increasing volatility on the down move. The below study from the 7/9/10 Subscriber Letter demonstrates this.

VXO crosses more than 15% below its 10ma on a closing basis. SPX <= 200ma. Buy on close. Sell X days later. \$100k/trade. 1987 - 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	-36,848.75	27	11	16	40.74	1,942.97	-3,638.84	0.53	0.37	-1,364.77
4	-31,286.35	28	10	18	35.71	1,519.80	-2,582.46	0.59	0.33	-1,117.37
3	-36,262.75	31	11	20	35.48	1,497.30	-2,636.65	0.57	0.31	-1,169.77
2	-24,674.99	31	15	16	48.39	1,311.22	-2,771.45	0.47	0.44	-795.97
1	-138.93	31	15	16	48.39	1,033.48	-977.57	1.06	0.99	-4.48

Note the size of the average loss, both on its own and in relation to the average win. Once you get out 2 days you can see the losses have been substantial.

I also noted over the last 3 days that we've seen 3 unfilled up gaps in a row for SPY. This could suggest a good portion of the buying over the last few days was done by shorts who were forced to cover as prices began to get away from them. I decided to quantify the affect of 3 unfilled up gaps.

SPY leaves an unfilled up gap for the 3rd day in a row. 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	-4,316.82	9	5	4	55.56	883.11	-2,183.10	0.40	0.51	-479.65
4	-4,692.04	9	4	5	44.44	682.88	-1,484.71	0.46	0.37	-521.34
3	-6,963.81	9	1	8	11.11	643.71	-950.94	0.68	0.08	-773.76
2	-5,108.76	9	3	6	33.33	106.31	-904.61	0.12	0.06	-567.64
1	-2,654.95	9	1	8	11.11	87.00	-342.74	0.25	0.03	-294.99

**All 9 instances closed below the entry price
on either day 1 or day 2.**

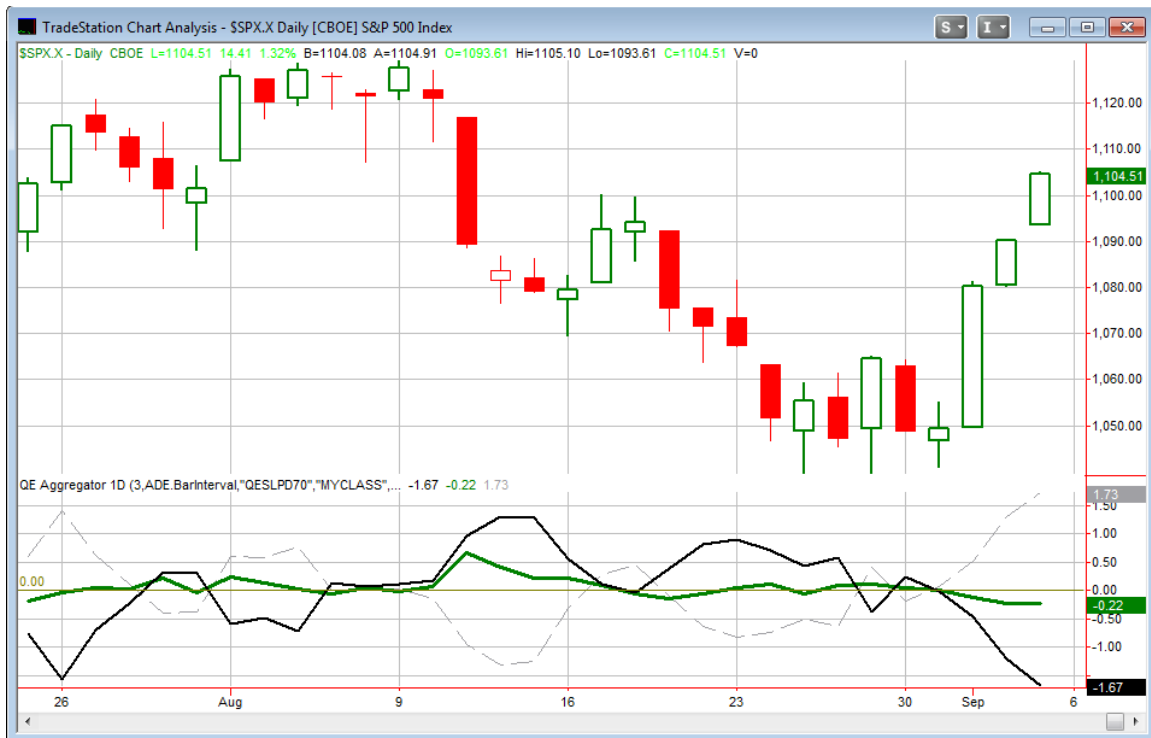
The number of instances has been quite low. On average we've only seen this occur about once every 2 years. In every case there has been a move lower in the next day or two. Statistics strongly favor the downside. I also listed below all 9 instances for anyone that would like to examine them further.

SPY leaves an unfilled up gap for the 3rd day in a row.
Buy on close. Sell next days close. \$100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
01/31/94	Buy	\$48.22	(0.52%)	\$0.00
02/01/94	Sell	\$47.97		(\$642.63)
04/06/95	Buy	\$50.75	(0.08%)	\$236.40
04/07/95	Sell	\$50.71		(\$551.60)
05/14/96	Buy	\$66.77	(0.12%)	\$808.38
05/15/96	Sell	\$66.69		(\$179.64)
09/16/96	Buy	\$68.80	(0.23%)	\$261.54
09/17/96	Sell	\$68.64		(\$828.21)
12/01/97	Buy	\$98.09	(0.60%)	\$0.00
12/02/97	Sell	\$97.50		(\$1,559.07)
10/29/99	Buy	\$137.00	(1.05%)	\$0.00
11/01/99	Sell	\$135.56		(\$1,049.76)
11/05/99	Buy	\$137.88	0.09%	\$362.50
11/08/99	Sell	\$138.00		(\$819.25)
07/02/01	Buy	\$124.13	(0.02%)	\$0.00
07/03/01	Sell	\$124.10		(\$869.40)
06/15/07	Buy	\$153.07	(0.12%)	\$208.96
06/18/07	Sell	\$152.89		(\$267.73)

You can see that 4 of the 9 instances never saw any upside at all the next day as they posted unfilled gaps down. The pullbacks, while reliable, weren't terribly large. (Of course the VXO study suggests a pullback could be.)

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



Despite the strong breadth now suggesting upside the bearish studies continue to dominate and the green Aggregator line remains strongly below zero. 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 now stretched very 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 for enough bullish studies to appear tomorrow to change this. Meanwhile the Differential pivot will be 1,079.31 tomorrow. It would take an SPX close at or below this level to flip the black Differential line positive. That's about a 2.25% drop from Friday's close.

I'm fairly heavily short at this point. My entry prices aren't too far away. With the studies mixed tonight I'm going to give it a day or two to see how it plays out and what edges emerge before committing more capital.

Intermediate-term Outlook (2 weeks – 2 months)– updated 9/7 – slightly bullish

There's quite a bit active right now on the intermediate-term active studies list. There is pull from both sides and I'm not seeing overwhelming evidence in either direction.

The most compelling studies for the bears are the Hindenburg Omen from the August 16th letter and the [September seasonality study](#). There is also the study that noted the weak performance after the Follow Through Day in July. That is still on the board because by the study's definition the FTD has neither succeeded nor failed at this point. Still, I'm not sure the trading action from that week is having a great influence on current action so I'm discounting that one heavily at this point.

The bulls have seen some studies (including the 1st one tonight) that have suggested strong A/D Breadth and/or A/D Volume Breadth are paving the way for further upside. Additionally, the [AAII Investor Sentiment Survey study](#) is also suggesting an intermediate-term upside edge.

So we have a bit of push and pull going on here. Overall I'm leaning towards the bullish side. I think we've seen enough evidence of buying interest that the April highs are more likely to be broken over the next few months than the July lows are. I'm inclined to play the long side slightly more aggressive than the short side 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.

None tonight – I'm going to give it a day before considering putting the last portion of my short SPY trade on. Nothing appeared on the systems triggers page tonight, which was a bit surprising considering how strong the move was over the last few days. I'm going to hold off here before adding any new exposure.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	9/2/2010	\$109.47	\$110.89	-1.30%		Aggregator
SPY(1/4)(s)	9/3/2010	\$110.54	\$110.89	-0.32%		shorted on open
SPY(1/4)(s)	9/3/2010	\$110.54	\$110.89	-0.32%		shorted on open

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