

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 6, 2010

Volume 3 Issue 234

## Market Overview



## Tonight's Research Points

- Weak volume rallies like the last 3 days favor a pullback.
- The sharp movement in the VIX suggests a continuation of the move up.
- The SPY breakout would have been short-term bullish if it came with an unfilled upside gap. As is it appears more neutral.
- The Aggregator System is short.
- The NDX Aggressive Trend Timer is flat.

## Short-term Outlook

### The Bottom Line

The Aggregator is again short. I am looking to take a quick stab at the short side, but will likely be moving to the long side quickly if the market does pull back.

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>             |                                      |           |         |              |
| December 6, 2010          | VIX 10% up to 10% dn in 1 week       | 1-5 days  | Bullish | 1.60%        |
| December 6, 2010          | Low Volume Rally > 200ma             | 1 day     | Bearish |              |
| December 2, 2010          | 10-day price & up vol% high. Low vol | 1-3 days  | Bearish | -1.10%       |
| <b>Active - Long Term</b> |                                      |           |         |              |
| December 6, 2010          | SPY 3 lower volume up days           | 1-19 days | Bearish |              |
| December 2, 2010          | 2 90% Up Volume % days in 5 days     | 1-16 days | Bullish |              |
| November 22, 2010         | High number of POMO Days recently    | int term  | Bullish |              |
| November 15, 2010         | QQQQ 5 lower lows and large drop     | 1-20 days | Bullish |              |
| November 15, 2010         | SPX down 1% SOX Up                   | 1-20 days | Bullish |              |
| November 5, 2010          | Very strong breadth & 50-day high    | 1-30 days | Bullish |              |
| October 25, 2010          | SPX Golden Cross                     | int term  | Bullish |              |
| September 20, 2010        | Nas/SPX RS favors Nasdaq             | int term  | Bullish |              |
| <b>Dropped Tonight</b>    |                                      |           |         |              |
| December 2, 2010          | 5-day low to 10-day high             | 1-2 days  | Bearish | -1.30%       |

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

### *The Evidence*

Friday the market gapped down at the open. It then traded in a fairly tight range in negative territory for most of the day. In the last hour it broke that range and ran higher. The major indices all closed higher and at or near new highs for the year. On the day the SPX gained 0.3%, the Nasdaq was up 0.5% and the Russell 2000 gained 0.7%. Breadth was positive as the NYSE Up Issues % came in at 60% and the Up Volume % was 70%. Total volume declined for the 3<sup>rd</sup> day in a row.

There has been a strong rally the first 3 days of the month, but with participation seemingly starting to wane most of the short-term studies that appeared on Friday night suggested bearish implications. The most common theme had to do with volume declining as prices have risen. Below are a couple of studies that examined this. The first one from the 3/3/10 Subscriber Letter looks at the SPX and the NYSE volume. It also considers the fact that Friday's gain was the smallest of the upmove. This is another possible sign of waning enthusiasm.

| SPX advances for at least the 3rd day in a row. Volume falls both today and yesterday. Today's rise is the smallest of the upmove. Close > 200ma.<br>Buy on close. Sell X days later. \$100k/trade. 6/1/97 - 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   | -13,116.91      | 31                | 12                  | 19                 | 38.71             | 1,368.21               | -1,554.50             | 0.88                | 0.56              | -423.13        |
| 4   | -7,565.58       | 31                | 11                  | 20                 | 35.48             | 1,672.06               | -1,297.91             | 1.29                | 0.71              | -244.05        |
| 3   | -2,860.77       | 31                | 15                  | 16                 | 48.39             | 1,275.55               | -1,374.63             | 0.93                | 0.87              | -92.28         |
| 2   | -3,638.15       | 31                | 12                  | 19                 | 38.71             | 995.58                 | -820.27               | 1.21                | 0.77              | -117.36        |
| 1   | -4,025.06       | 32                | 14                  | 18                 | 43.75             | 582.81                 | -676.91               | 0.86                | 0.67              | -125.78        |

**84% of instances closed below the entry price at some point in the next 4 days.**

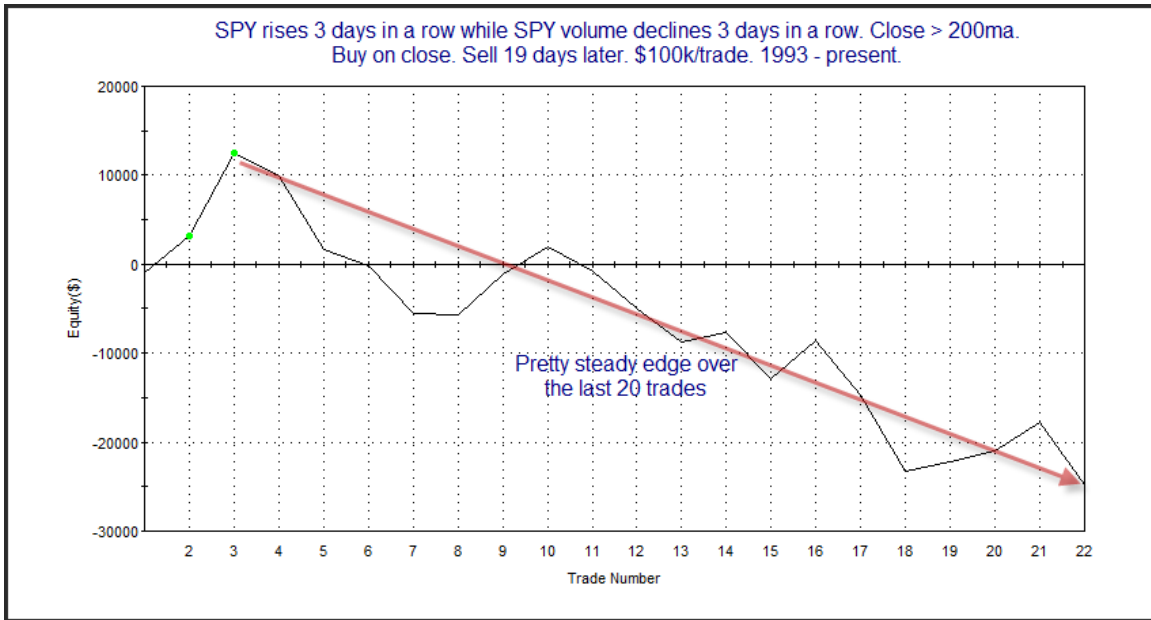
Results are not as strong as they once appeared. Since the 2009 bottom there have been a few instances that have gotten run over to the upside. Still, it's worth keeping an eye and considering for the future.

This next one from the 4/13/10 Letter looks at SPY rallies on declining volume. I've found SPY volume can often be useful to monitor. In this case I'm looking for 3 consecutive lower volume up days. I also included a long-term trend filter.

SPY rises 3 days in a row while SPY volume declines 3 days in a row. Close > 200ma.  
But 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 |
|--------|-----------------|-------------------|---------------------|--------------------|-------------------|------------------------|-----------------------|---------------------|-------------------|----------------|
| 20     | -13,591.42      | 22                | 10                  | 12                 | 45.45             | 3,457.10               | -4,013.54             | 0.86                | 0.72              | -617.79        |
| 19     | -24,814.61      | 22                | 9                   | 13                 | 40.91             | 3,548.03               | -4,365.15             | 0.81                | 0.56              | -1,127.94      |
| 18     | -18,008.73      | 23                | 9                   | 14                 | 39.13             | 3,709.85               | -3,671.24             | 1.01                | 0.65              | -782.99        |
| 17     | -19,393.75      | 23                | 10                  | 13                 | 43.48             | 2,935.89               | -3,750.20             | 0.78                | 0.60              | -843.21        |
| 16     | -16,404.61      | 23                | 10                  | 13                 | 43.48             | 3,029.93               | -3,592.61             | 0.84                | 0.65              | -713.24        |
| 15     | -20,612.98      | 23                | 11                  | 12                 | 47.83             | 2,652.04               | -4,148.79             | 0.64                | 0.59              | -896.22        |
| 14     | -14,867.62      | 24                | 10                  | 14                 | 41.67             | 2,899.30               | -3,132.90             | 0.93                | 0.66              | -619.48        |
| 13     | -13,766.33      | 24                | 11                  | 13                 | 45.83             | 2,383.22               | -3,075.52             | 0.77                | 0.66              | -573.60        |
| 12     | -10,254.63      | 24                | 12                  | 12                 | 50.00             | 1,990.27               | -2,844.83             | 0.70                | 0.70              | -427.28        |
| 11     | -8,558.57       | 24                | 12                  | 12                 | 50.00             | 1,991.79               | -2,705.00             | 0.74                | 0.74              | -356.61        |
| 10     | -10,074.83      | 24                | 14                  | 10                 | 58.33             | 2,012.23               | -3,824.60             | 0.53                | 0.74              | -419.78        |
| 9      | -10,590.11      | 24                | 13                  | 11                 | 54.17             | 1,878.19               | -3,182.42             | 0.59                | 0.70              | -441.25        |
| 8      | -8,707.48       | 24                | 13                  | 11                 | 54.17             | 1,662.72               | -2,756.63             | 0.60                | 0.71              | -362.81        |
| 7      | -5,094.77       | 25                | 15                  | 10                 | 60.00             | 1,544.36               | -2,826.01             | 0.55                | 0.82              | -203.79        |
| 6      | -7,406.16       | 25                | 14                  | 11                 | 56.00             | 1,452.84               | -2,522.36             | 0.58                | 0.73              | -296.25        |
| 5      | -16,997.72      | 25                | 15                  | 10                 | 60.00             | 1,010.01               | -3,214.79             | 0.31                | 0.47              | -679.91        |
| 4      | -7,296.20       | 26                | 14                  | 11                 | 53.85             | 1,054.58               | -2,005.48             | 0.53                | 0.67              | -280.62        |
| 3      | -6,182.87       | 26                | 13                  | 13                 | 50.00             | 914.40                 | -1,390.00             | 0.66                | 0.66              | -237.80        |
| 2      | -915.00         | 26                | 14                  | 12                 | 53.85             | 854.86                 | -1,073.59             | 0.80                | 0.93              | -35.19         |
| 1      | -2,828.16       | 28                | 14                  | 14                 | 50.00             | 574.44                 | -776.45               | 0.74                | 0.74              | -101.01        |

The % profitable is pretty much a 50/50 proposition. Risk/reward seems to favor the bears though as losses have consistently and sizably outsized gains. Combined with the 1<sup>st</sup> study it appears the price/volume action over the last few days is suggesting a mild short-term downside edge. I also find it interesting that this somewhat simple setup seems to have intermediate-term implications. Below is the equity curve using a 19-day hold.



It seems to have stair-stepped its way lower on a fairly consistent basis over the years. This is unusually attractive for bears when considering the study filters out any trades below the 200ma.

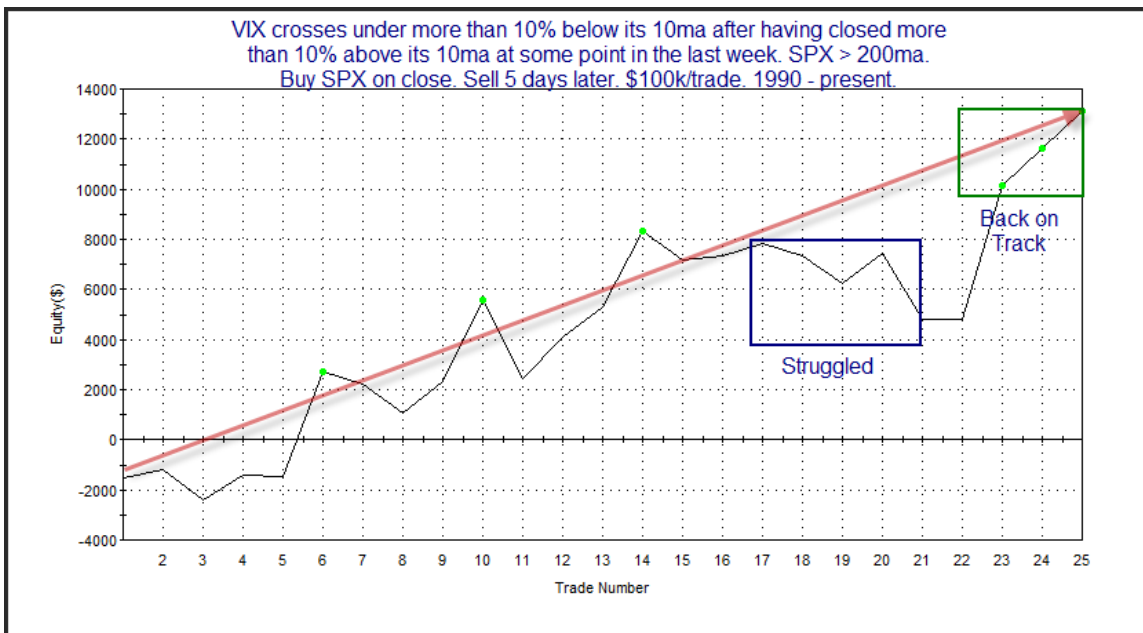
The news wasn't all bad though. I found it interesting that the VIX, which was strongly short-term overbought just a few days ago, is now short-term oversold. Tuesday it closed almost 15% above its 10ma. Friday it closed over 11% below it. Sometimes a downside stretch can suggest a downside edge. In the 11/9/09 Letter I looked at other times the VIX went from more than 10% above to more than 10% below its 10ma within a week. That study is updated below.

VIX crosses under more than 10% below its 10ma after having closed more than 10% above its 10ma at some point in the last week. SPX > 200ma.  
Buy SPX on close. Sell X days later. \$100k/trade. 1990 - 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     | 21,932.43       | 24                | 15                  | 9                  | 62.50             | 2,584.24               | -1,870.13             | 1.38                | 2.30              | 913.85         |
| 9      | 21,289.15       | 24                | 13                  | 11                 | 54.17             | 2,482.80               | -998.84               | 2.49                | 2.94              | 887.05         |
| 8      | 20,144.93       | 24                | 16                  | 8                  | 66.67             | 2,062.39               | -1,606.67             | 1.28                | 2.57              | 839.37         |
| 7      | 16,383.88       | 25                | 15                  | 10                 | 60.00             | 2,149.99               | -1,586.60             | 1.36                | 2.03              | 655.36         |
| 6      | 15,527.07       | 25                | 13                  | 12                 | 52.00             | 2,159.83               | -1,045.89             | 2.07                | 2.24              | 621.08         |
| 5      | 13,125.65       | 25                | 14                  | 11                 | 56.00             | 1,868.88               | -1,185.33             | 1.58                | 2.01              | 525.03         |
| 4      | 8,175.98        | 25                | 15                  | 10                 | 60.00             | 1,447.88               | -1,354.22             | 1.07                | 1.60              | 327.04         |
| 3      | 5,529.79        | 26                | 15                  | 11                 | 57.69             | 1,022.20               | -891.20               | 1.15                | 1.56              | 212.68         |
| 2      | 4,386.02        | 26                | 12                  | 14                 | 46.15             | 1,102.05               | -631.33               | 1.75                | 1.50              | 168.69         |
| 1      | 6,093.29        | 26                | 13                  | 13                 | 50.00             | 915.96                 | -447.24               | 2.05                | 2.05              | 234.36         |

22 of 26 instances (85%) closed above the entry price at some point in the next 4 days.

In this case the downside VIX stretch doesn't have negative implications. It even appears a bit bullish. This would make sense when considering the market condition that would have accompanied this setup. For the VIX to move like this the SPX would normally be experiencing a strong rebound from a sharp decline. And it is happening during a long-term uptrend. So a continuation of the strong up thrust isn't terribly surprising. Below is an equity curve using a 5-day exit strategy to see how the edge has played out over time.



As you can see results have been a bit choppy but have generally favored the bull case. There was a brief period where the setup struggled to register gains but over the last 3-4 trades it seems to have gotten back to its long-term uptrend line.

Several of the indices managed to make new highs for the year. These included the Russell 2000, the S&P Midcap 400, and the Nasdaq Composite. And while the S&P 500 index just missed, the SPY actually did make a new intraday high. In the 9/21/10 Letter I broke down SPY 50-day high breakouts based on gaps. Below is an excerpt (studies not updated):

*Still, I thought it would be worthwhile to examine 50-day high breakouts that were accompanied by an unfilled gap vs. those that weren't. First let's look at instances where SPY broke out and posted an unfilled gap.*

| SPY closes at a 50-day high after not having done so for at least 10 days. Today it leaves an unfilled gap up. 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   | 32,878.39       | 34                | 24                  | 10                 | 70.59             | 1,837.09               | -1,121.18             | 1.64                | 3.93              | 967.01         |
| 4   | 23,712.11       | 34                | 25                  | 9                  | 73.53             | 1,416.13               | -1,299.00             | 1.09                | 3.03              | 697.42         |
| 3   | 20,311.52       | 34                | 25                  | 9                  | 73.53             | 1,253.06               | -1,223.89             | 1.02                | 2.84              | 597.40         |
| 2   | 12,915.59       | 34                | 23                  | 11                 | 67.65             | 929.03                 | -768.37               | 1.21                | 2.53              | 379.87         |
| 1   | 4,983.07        | 34                | 24                  | 10                 | 70.59             | 549.85                 | -821.33               | 0.67                | 1.61              | 146.56         |

**30 of 34 instances (88%) posted a close above the entry price at some point in the next 4 days.**

*Results here are strong. Technicians will often use the term "breakaway gap" in cases like this. The idea is that the new high causes excitement and the gap leaves a good amount of people stuck short. When it doesn't immediately fill, it leads these shorts to chase and helps to propel the market even higher.*

*Now let's look at instances where the 50-day high breakout was not accompanied by an unfilled gap. Interestingly, the number of instances was nearly the same.*

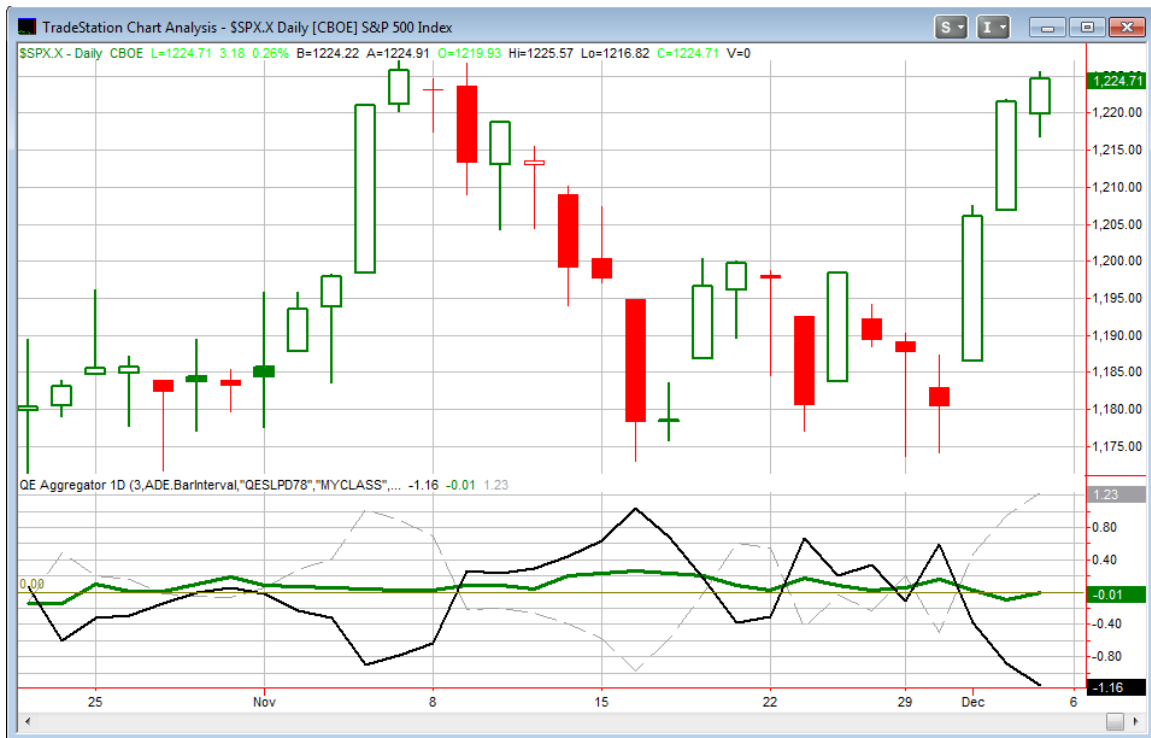
SPY closes at a 50-day high after not having done so for at least 10 days. No unfilled gap today. Buy on close. Sell X days later. \$100k/trade. 1993 - present.

| 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 |
|--------|-----------------|-------------------|---------------------|--------------------|-------------------|------------------------|-----------------------|---------------------|-------------------|----------------|
| 10     | -15,890.08      | 35                | 15                  | 20                 | 42.86             | 1,258.86               | -1,738.65             | 0.72                | 0.54              | -454.00        |
| 9      | -9,118.75       | 35                | 15                  | 20                 | 42.86             | 1,469.62               | -1,558.16             | 0.94                | 0.71              | -260.54        |
| 8      | -4,726.50       | 35                | 17                  | 18                 | 48.57             | 1,204.38               | -1,400.05             | 0.86                | 0.81              | -135.04        |
| 7      | -3,439.05       | 35                | 17                  | 18                 | 48.57             | 899.15                 | -1,040.26             | 0.86                | 0.82              | -98.26         |
| 6      | 2,163.49        | 35                | 21                  | 14                 | 60.00             | 1,021.47               | -1,377.67             | 0.74                | 1.11              | 61.81          |
| 5      | 888.97          | 35                | 20                  | 15                 | 57.14             | 1,059.69               | -1,353.65             | 0.78                | 1.04              | 25.40          |
| 4      | -2,701.06       | 35                | 17                  | 18                 | 48.57             | 1,120.86               | -1,208.65             | 0.93                | 0.88              | -77.17         |
| 3      | 1,957.36        | 35                | 18                  | 17                 | 51.43             | 1,140.05               | -1,091.97             | 1.04                | 1.11              | 55.92          |
| 2      | -1,497.59       | 36                | 18                  | 18                 | 50.00             | 700.55                 | -783.75               | 0.89                | 0.89              | -41.60         |
| 1      | 501.03          | 36                | 19                  | 16                 | 52.78             | 486.74                 | -546.69               | 0.89                | 1.06              | 13.92          |

*As you can see these moves to new highs that don't start with an unfilled gap are much less reliable.*

Friday's breakout action in the SPY is fairly neutral based on this study. Should the SPX manage to break out on Monday we may see some additional clues depending on how that breakout transpires.

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



This weekend's mix of studies kept the green Aggregator line slightly below 0. A negative value indicates the net expectation from the Active Studies over the next few days is for a move lower. Meanwhile the 3-day rally has caused the black Differential line to drop farther below 0 than it has been for a long time. The negative value means the SPX has outperformed expectations over the last few days. This strongly overbought condition could be worked off with a pullback or a consolidation over the next few days. So we have negative expectations and an overbought market. Historically this configuration has provided a downside edge. It can be seen on the chart whenever the Aggregator and Differential lines are both below 0. Due to this the Aggregator System remained short at the close.

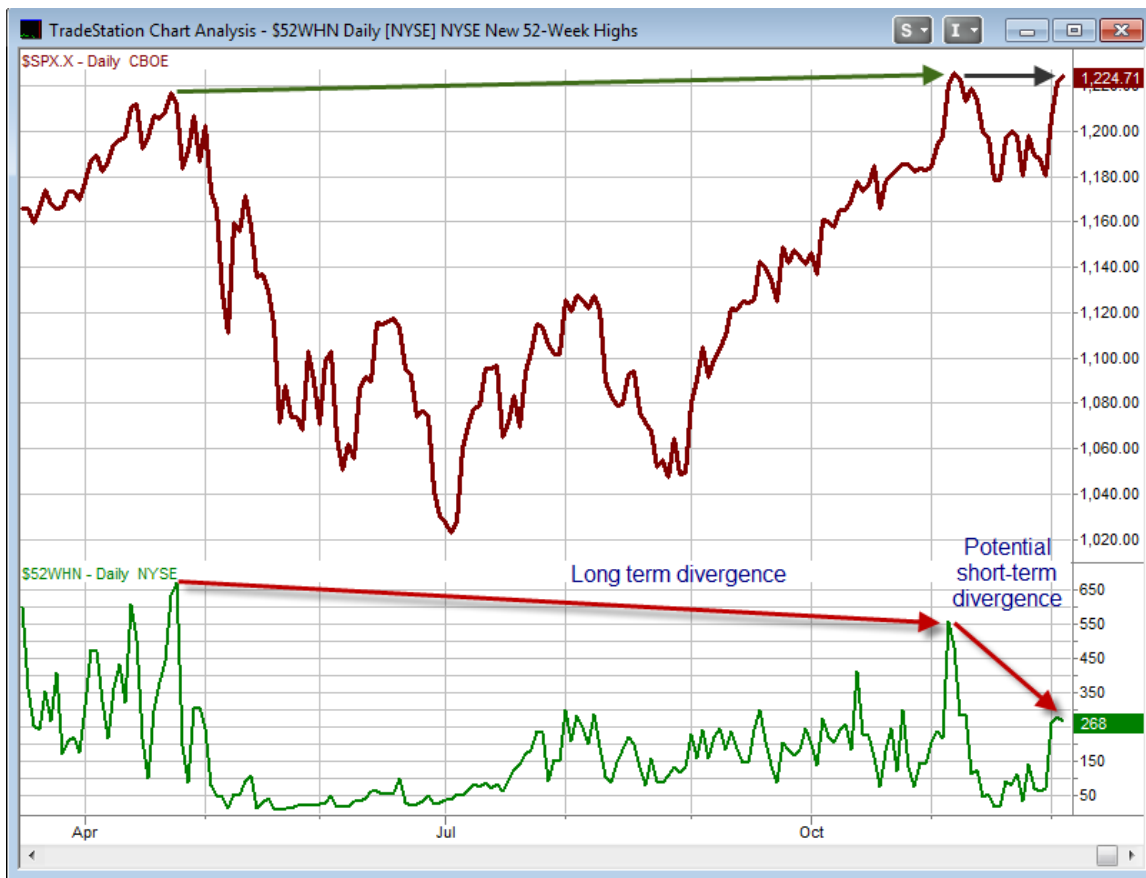
The green Aggregator line is set up to turn slightly positive tomorrow, but with so few studies active it will really be dependent on Monday's action. Meanwhile the Differential Pivot will be 1,208.68. This means the SPX would need to drop 1.3% in order for the Differential line to cross back above 0. Should this happen the Aggregator could flip back to a long signal. Otherwise it will be neutral or short depending on Monday's studies.

I've been a bit slow to embrace this Aggregator short signal, but if we get an opportunity near tomorrow's open I'll take a speculative short position that I will likely exit at the close should it go my way. If we get another up day Monday then I'll defer to the emerging studies to determine whether I'll hold another day. Once the

pullback/consolidation is completed I still expect to see more gains over the next few weeks. I'll continue to trade the long side aggressively. But more about that in the intermediate-term outlook below.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 12/6 – bullish***

The SPY study from the short-term section above (12/6) is the first study we've seen in a while with bearish intermediate-term implications. I'll be on the lookout for additional evidence that the rally could be in danger of serious correction. One concern I've brought up a few times recently is the divergence in the number of stocks making 52-week highs as opposed to other recent peaks. Below is a chart that demonstrates what I am talking about. The top line is the SPX and the bottom indicator is the NYSE 52-week highs.

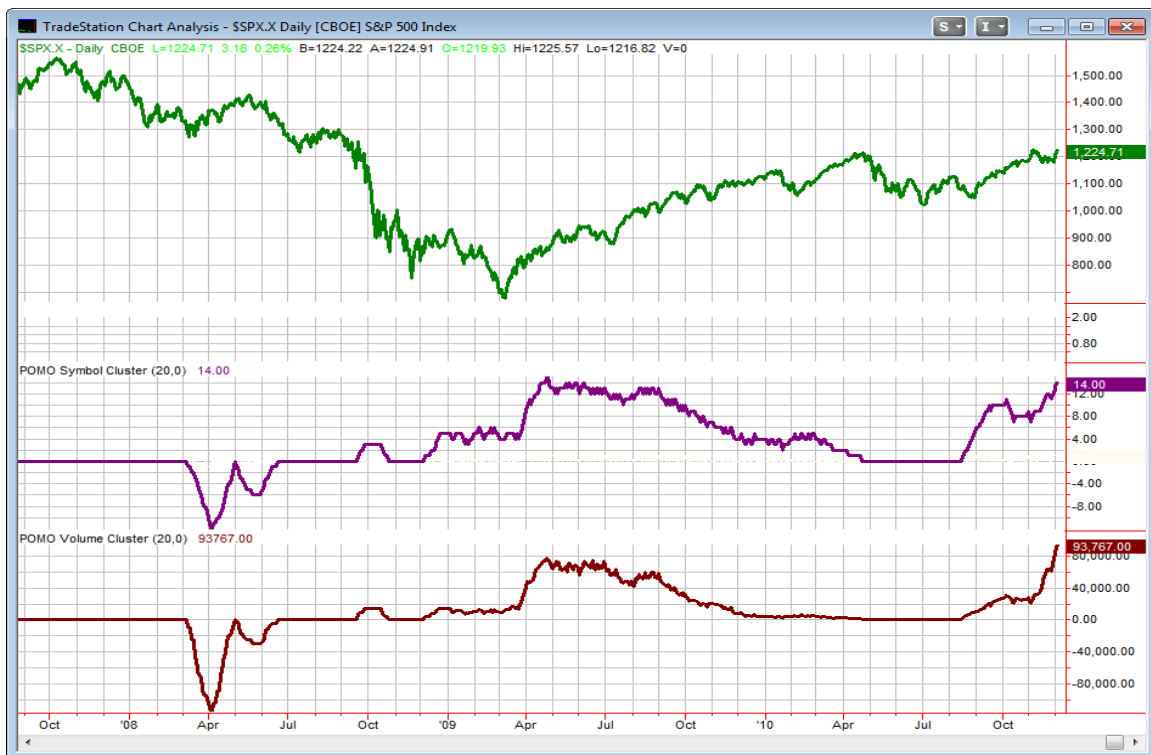


When the SPX made a new high in November we saw a divergence in the new highs versus April levels. To this point that divergence has persisted and appears to be worsening. Though the SPX is extremely close to a new high, the number of stocks making new highs is about half of what we saw last month.

I did a fair amount of research on broadening and narrowing rallies last winter. I found that divergences like this can persist for some time before the market actually suffers a substantial pullback. What was more interesting was that without such a divergence it was highly unlikely that a serious market correction would take place. So as long as we continue to see this divergence the market may be susceptible to a decline, but if the number of new highs expands and the divergence is eliminated, then that would be a strong positive for the market. I'll likely conduct further research this week should the magnitude of the divergence remain so large and the SPX actually make it to new highs.

A bullish indicator I've been showing the last few weeks is the POMO activity. Below is a refresher from last week.

*POMO stands for Permanent Open Market Operations and it is how the Fed goes into the open market to buy securities. The net effect of this buying is an influx of cash into the system. It appears a portion of that cash makes its way to the stock market and works as a bullish influence. A "POMO Day" is simply a day where these operations take place... The chart below (shows a couple of POMO indicators). The top pane is the S&P 500. The middle pane is the rolling number of days in the last 20 that have been POMO days. The bottom pane is the total amount of money infused into the system over the previous 20 days.*



As you can see monetary POMO stimulus over the last 20 days has now spiked to an all-time high – far exceeding even the levels reached in the summer of 2009. I suspect this will act as a strong bullish force on the market.

In addition to POMO there are still several other intermediate-term studies on the active list with bullish implications. They include studies related to breadth, price patterns, leadership (relative strength), and momentum. We are also about to enter some seasonally strong periods. I'll be discussing them in more detail in the next few weeks. For those that might want a preview I've posted links to some old blog posts below. Bottom line is that I'll continue to favor the long side and trade extra selectively from the short side.

<http://quantifiableedges.blogspot.com/2009/12/most-wonderful-tiiiiime-of-yearrrrrr.html>

<http://quantifiableedges.blogspot.com/2009/12/twill-be-3-nights-before-christmas.html>

### **Catapult and Capitulative Breadth Statistics**

*Catapult & CBI Presentation Link*

***Open Catapult Triggers***

*GOOG – @ \$603.29*

*GOOG –@ \$595.47*

*GOOG –@ \$583.72*

***Catapult for ETF's Trades***

*None*

***Broad Market Large Cap CBI – 3 (GOOG-3)***

### **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 @ \$122.89 LIMIT. If not filled in first 30 minutes of trading, cancel order. This is based on the short-term outlook and the Aggregator above. Since the Aggregator could very well flip to neutral or short at the end of the day I am not interested in taking an entry beyond early morning. Should this position be filled and close the day profitably, I will most likely look to take profits and will send out an intraday update to subscribers if this is the case.*

### **Current Open Trade Ideas**

| Symbol    | Entry Date | Entry Price | Current Price | % Gain/Loss | Stop | Notes    |
|-----------|------------|-------------|---------------|-------------|------|----------|
| GOOG(1/3) | 11/15/2010 | \$603.00    | \$573.00      | -4.98%      |      | Catapult |
| GOOG(1/3) | 11/16/2010 | \$593.39    | \$573.00      | -3.44%      |      | Catapult |
| GOOG(1/3) | 11/17/2010 | \$583.72    | \$573.00      | -1.84%      |      | Catapult |

GOOG has been an especially difficult and trying Catapult trade. It is rare to see one last this long, especially when the market is an uptrend. It is also rare to see a stock rally for 3 days and not trigger an exit. GOOG has done just that. It shouldn't take much of a move on Monday to trigger an exit. Certainly a close of near \$578 or higher would do it. The standard exit would be Tuesday's open should it trigger, but I may send out an intraday update as I often do to alert subscribers if GOOG reaches its exit target.

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