

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

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December 16, 2010

Volume 3 Issue 242

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## Market Overview



## Tonight's Research Points

- SPX had its first down day after a persistent move up. Similar occurrences have typically been followed by more upside.
- A 2<sup>nd</sup> Hindenburg Omen signal fired on Wednesday.
- We are now entering a strong seasonal period for the Russell 2000.
- The Aggregator System is long.
- The NDX Aggressive Trend Timer is long.

## *Short-term Outlook*

### *The Bottom Line*

Expectations remain strong and the market is no longer overbought. I started building a long position and will look to add to it if we go lower tomorrow.

**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 16, 2010	1 day drop after 5 up days. Close > 200ma	1-10 days	Bullish	2.20%
December 15, 2010	100-day high on Fed Day	1-6 days	Bullish	1.70%
December 15, 2010	50-day SAV is > 0.7	short-term	Bullish	
December 15, 2010	Gap up reverse down, but still pos twice	1-5 days	Bullish	2.20%
December 15, 2010	<b>SPY 10 days &gt; 5ma &amp; 10-day high</b>	<b>1-3 days</b>	<b>Bearish</b>	
December 15, 2010	<b>Up Vol % and Up Iss% &lt; 45%. SPX up.</b>	<b>1-4 days</b>	<b>Bearish</b>	<b>-1.80%</b>
December 15, 2010	<b>SPX 50-day high. VIX up.</b>	<b>1-2 days</b>	<b>Bearish</b>	<b>-0.80%</b>
December 14, 2010	Unfilled gap. 20-high. Close < open > 200	1-4 days	Bullish	1.40%
December 13, 2010	SPX strong December op-ex week	1-5 days	Bullish	2.00%
December 13, 2010	3/10 Offset HV < 0.3 4 days. Uptrend.	1-4 days	Bullish	1.00%
<b>Active - Long Term</b>				
December 16, 2010	<b>2 Hindenburg Signals</b>	<b>1-50 days</b>	<b>Bearish</b>	
December 9, 2010	<b>SPX &amp; TNX 50-day highs</b>	<b>1-50 days</b>	<b>Bearish</b>	
December 6, 2010	<b>SPY 3 lower volume up days</b>	<b>1-19 days</b>	<b>Bearish</b>	
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 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 9, 2010	Base breakout to 50-day high	1-5 days	Bullish	1.70%

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

**The Evidence**

For the first time in a long time the major indices all closed the day lower. The SPX dropped 0.5% while the Nasdaq and Russell 2000 each fell 0.4%. Breadth was solidly negative. The NYSE Up Issues % came in at 34%, which is the lowest level since November, and the Up Volume % was 25%. Total volume rose for the 2<sup>nd</sup> day in a row.

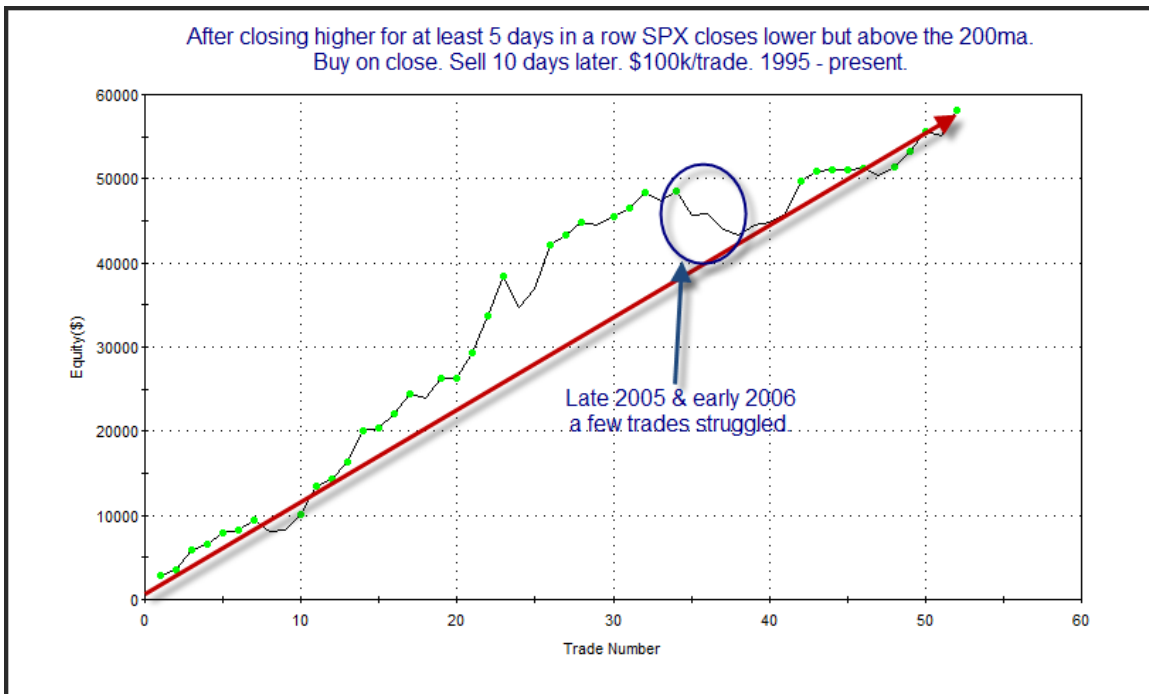
The Quantifinder came up with a few studies that showed little edge under current circumstances. One that was appealing was from the 11/9/10 Subscriber Letter. I've updated it below.

After closing higher for at least 5 days in a row SPX closes lower but above the 200ma.  
Buy on close. Sell X days later. \$100k/trade. 1995 - 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	58,147.58	52	42	10	80.77	1,709.37	-1,364.60	1.25	5.26	1,118.22
9	58,887.59	57	47	10	82.46	1,623.84	-1,743.29	0.93	4.38	1,033.12
8	50,953.53	58	40	18	68.97	1,866.54	-1,317.11	1.42	3.15	878.51
7	39,631.19	59	40	19	67.80	1,619.03	-1,322.63	1.22	2.58	671.72
6	38,059.19	61	41	20	67.21	1,537.67	-1,249.26	1.23	2.52	623.92
5	29,944.56	61	40	21	65.57	1,269.62	-992.39	1.28	2.44	490.89
4	27,780.81	61	38	23	62.30	1,245.43	-849.81	1.47	2.42	455.42
3	12,823.25	61	36	25	59.02	1,014.18	-947.49	1.07	1.54	210.22
2	7,263.06	61	36	25	59.02	847.05	-929.23	0.91	1.31	119.07
1	3,614.22	61	36	24	59.02	530.38	-644.98	0.82	1.23	59.25

53 of 61 instances (87%) closed above the entry price at some point in the next week.

It's not the highest percentage play over the first few days, but once you look out 9-10 days it appears very consistent. I believe the reason for this is based on an idea I've demonstrated a number of times before: persistent moves higher rarely end abruptly. You are more likely to see either a continuation of the move or at least some chop before a substantial decline. Below is an equity curve using a 10-day exit.



Aside from the brief drawdown I've circled above performance has been quite steady. I've included this study on the Active List.

The Hindenburg Omen triggered today for the 2<sup>nd</sup> day in a row. I included a section in last night's Letter about the Hindenburg Omen. Two triggers has not been much more powerful of a signal than just one. If we get to three that could raise a warning flag. A link to last night's subscriber letter is below in case you missed it or want to go back and review it.

[2010-12-15 QE Subscriber Letter.pdf](#)

Also, a reminder that we are now entering a very strong seasonal period for the Russell 2000. In Sunday's Letter I discussed the fact that the Russell tends to do extremely well once you get past Dec. 15<sup>th</sup> or op-ex Thursday. I have copied that research below.

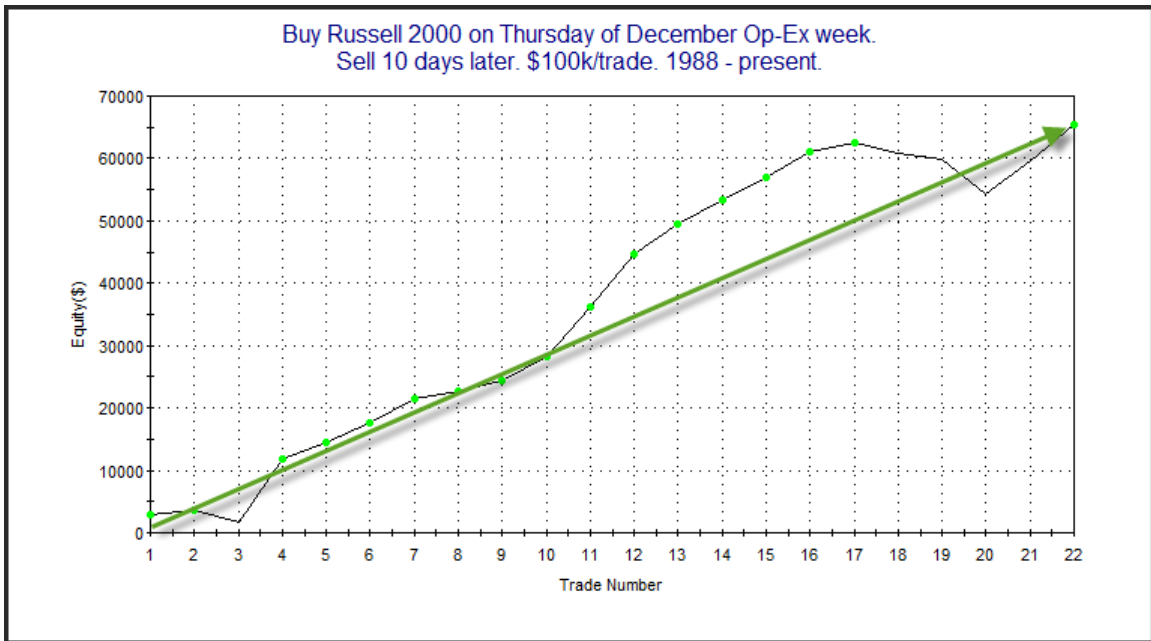
*In 2008 I discussed the January Effect, which is a tendency that I believe was first published in the Stock Trader's Almanac. It suggests that from mid-December through January smallcap stocks tend to outperform largecaps. My research in 2008 looked back to 1988 and used the Russell 2000 versus the SPX. I found that the bulk of this tendency was realized in the end of December and the 1<sup>st</sup> day of January. I measured from the 15<sup>th</sup> of December (or the 1<sup>st</sup> trading day afterwards if the 15<sup>th</sup> was a weekend) through the 1<sup>st</sup> trading day in January. In 2008 and 2009 this edge played out quite strongly with the Russell outperforming by 4.4% and 3.3%. So the edge certainly has not waned in recent years. Since 1988 we have now seen the Russell outperform 17 of 22 years, or 77% of the time. But not only have there been substantially more winning years, but the average win has doubled the average loss. The average winning year saw the Russell outperform by 2.07% while the average losing year saw the SPX outperform by 1.03%. There have been gross gains of 35.25% in the 17 winning years and gross losses of 5.15% in the 5 losing years. So gains have outsized losses by nearly 7 to 1. And the only losing year to post a loss of greater than 1% was 1991 when the SPX outperformed the Russell by 2.82%. In all the Russell has outperformed the SPX over the last 22 years by an average of 1.4% during this 2+ week period.*

*I also found last year that unlike the SPX, the Russell has not had stellar performance during December op-ex. It seems the SPX tends to outperform during op-ex week right*

up until op-ex Friday when the Russell takes over. So I also ran a study that looked at buying the Russell on op-ex Thursday and holding for up to 2 weeks. This was shown in the 12/14/09 Letter and I have updated it below.

Buy Russell 2000 on Thursday of December Op-Ex week. Sell X days later. \$100k/trade. 1988 - 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 Intraday Drawdown	All: Max Winning Trade
10	65,503.03	22	18	4	81.82	4,199.42	-2,521.64	1.67	7.49	2,977.41	-5,643.30	-11,982.22	10,279.71
9	58,580.15	22	18	4	81.82	3,695.63	-1,985.28	1.86	8.38	2,662.73	-5,973.50	-10,741.42	9,009.63
8	50,304.64	22	18	4	81.82	3,052.97	-1,162.20	2.63	11.82	2,286.57	-2,948.40	-7,005.55	7,115.85
7	38,375.37	22	17	5	77.27	2,547.72	-987.18	2.58	8.77	1,744.34	-1,809.60	-7,569.21	7,790.58
6	28,887.83	22	16	6	72.73	2,192.97	-1,033.28	2.12	5.66	1,313.08	-2,720.64	-5,687.21	6,599.88
5	20,673.82	22	15	7	68.18	1,910.34	-1,140.18	1.68	3.59	939.72	-3,194.64	-4,782.15	4,892.25
4	13,968.20	22	14	8	63.64	1,810.74	-1,422.77	1.27	2.23	634.92	-3,892.32	-4,812.89	4,413.75
3	11,347.09	22	13	9	59.09	1,736.07	-1,246.88	1.39	2.01	515.78	-2,650.68	-4,633.69	3,814.20
2	7,188.42	22	13	9	59.09	1,351.69	-1,153.72	1.17	1.69	326.75	-2,810.39	-5,454.66	3,495.70
1	8,656.48	22	12	10	54.55	943.60	-266.68	3.54	4.25	393.48	-816.48	-2,405.68	2,299.70

Stats are very very strong. I included some additional columns on the right showing max loss, max intraday drawdown, and max gain. These show that while the stats have been overwhelmingly bullish, the trade has not been without risk. Below is an equity curve using the 10-day exit strategy.

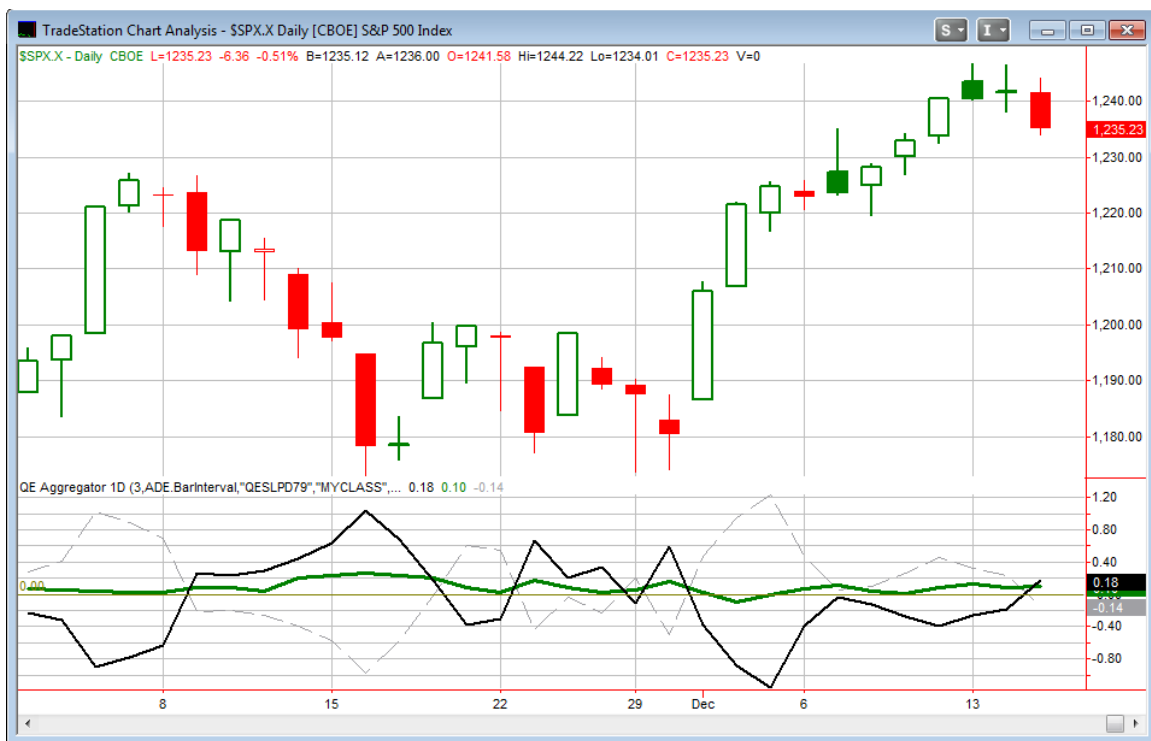


2005, 2006, and 2007 the Russell saw declines occur over this period before getting back on track the last 2 years.

*Bottom line from a seasonality standpoint is that there should be some strong winds at the markets' back through the end of the year. Once we get past Thursday I will consider using IWM (the Russell 2000 etf) instead of SPY for my long index trades to take advantage of the probable Russell outperformance.*

It's interesting to note that the early-week underperformance has played out according to form. The Russell has closed lower and underperformed the SPX on Monday, Tuesday, and Wednesday of this week. If form holds that should reverse soon and the Russell should take the lead for the rest of the year.

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



The Aggregator configuration turned outright bullish tonight. The green Aggregator line remains above 0 as it has for a while now. The positive value indicates the net expectation from the Active Studies over the next few days is for a move higher. The black Differential line tonight also produced a positive reading. The positive value means the SPX has underperformed expectations over the last few days. So we have positive

expectations and an oversold market. Historically this configuration has indicated an upside edge. It can be seen on the Aggregator chart whenever both lines are above 0. Due to this the Aggregator System turned long at the close.

The green Aggregator line is set up to remain positive again tomorrow. This is unlikely to change but it could if strong bearish evidence emerges. Meanwhile the Differential Pivot will be 1,243.15. The SPX would need to close at or above this level in order for the Differential line to turn back negative. This equates to a little over a 0.6% gain. So unless the SPX posts a nice gain tomorrow it's likely the long Aggregator signal will remain in place.

I started to scale in to an index position Wednesday afternoon. I will look to add more exposure Thursday on further weakness. Rather than using SPY as I typically do, I will be looking to trade IWM to take advantage of the positive Russell seasonality discussed above.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 12/13 – bullish***

Please refer to the 12/13 Subscriber Letter for the detailed intermediate-term outlook. Link below.

[2010-12-13 QE Subscriber Letter.pdf](#)

## **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.*

*IWM – buy 1/4 index position @ \$77.07 LIMIT ON CLOSE. This is based on the short-term outlook above. The hardest decision for me tonight was whether to take an Aggressive stance and look for an entry at the open or whether to wait until the close to scale in to the 2<sup>nd</sup> part of my index position. Ultimately I chose to wait for the close. Hopefully I don't miss out by playing it too conservatively.*

## **Current Open Trade Ideas**

*None.*

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