

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 28, 2010

Volume 3 Issue 249

Market Overview



Tonight's Research Points

- SPX up and VIX up on a Monday suggests a 1-day downside edge.
- The Aggregator System is long.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

The SPX barely moved off of its overbought reading Monday. In doing so it managed to trigger a long signal for the Aggregator System at the close. I'm mildly bullish and looking to buy into weakness on Tuesday.

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				
December 28, 2010	VIX up. SPX up & 50-high, twice.	1 day	Bearish	
December 27, 2010	1 day drop after 5 up days. Close > 200ma	1-10 days	Bullish	2.20%
December 23, 2010	2 Unfilled up gaps & 50-day high.	1-3 days	Bullish	1.00%
December 22, 2010	Twas 3 Nights Before Christmas	1-5 days	Bullish	1.90%
Active - Long Term				
December 16, 2010	2 Hindenburg Signals	1-50 days	Bearish	
December 9, 2010	SPX & TNX 50-day highs	1-50 days	Bearish	
December 6, 2010	SPY 3 lower volume up days	1-19 days	Bearish	
November 22, 2010	High number of POMO Days recently	int term	Bullish	
October 25, 2010	SPX Golden Cross	int term	Bullish	
September 20, 2010	Nas/SPX RS favors Nasdaq	int term	Bullish	
Dropped Tonight				
December 22, 2010	VIX up. SPX up & 50-high, twice.	1-3 days	Bearish	-1.50%

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

The Evidence

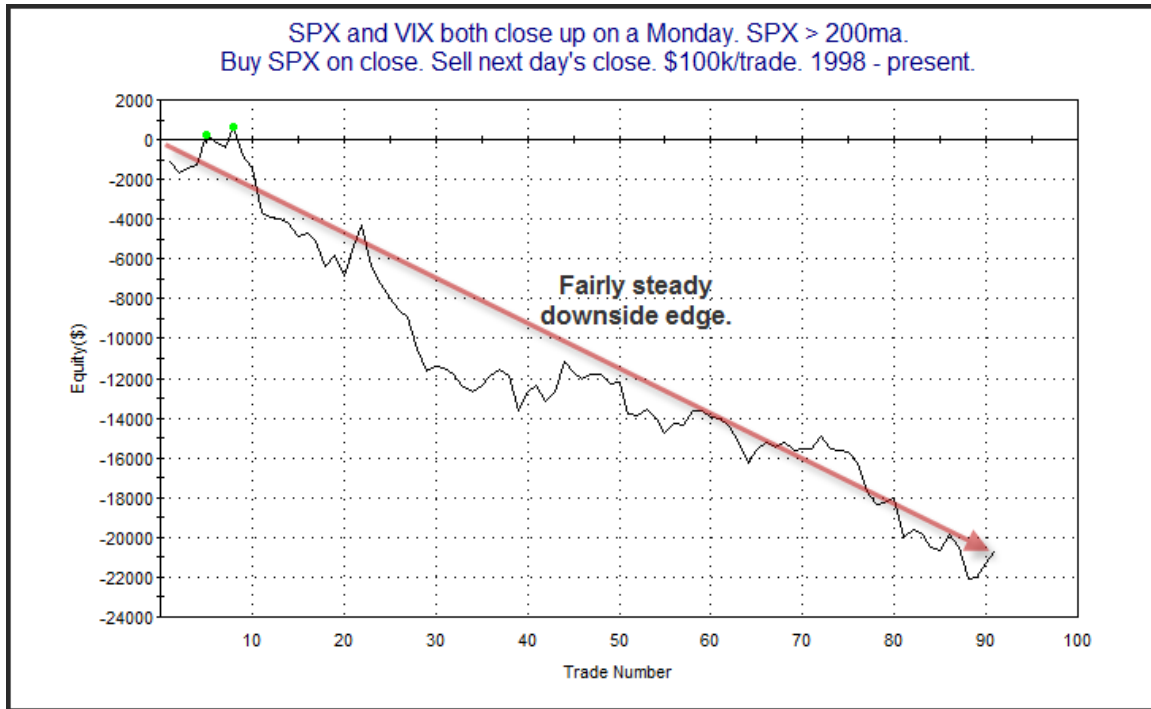
Monday's trading was a lot like we saw last week. It was marked with low volume and a fairly tight range. We will likely continue to see these types of conditions throughout the rest of this holiday week. The major indices finished mostly higher. The SPX and Nasdaq finished up 0.1% and the Russell 2000 was up 0.4%. Breadth was mildly positive as the NYSE Up Issues % came in at 56% and the Up Volume % was also 56%. Total volume was the lightest we've seen in a long time.

Of note on Monday was that the SPX and VIX both closed higher. This also happened last Monday. Below is an excerpt from the December 21, 2010 Subscriber Letter with updated tables.

(This study) looked at other times the VIX and SPX both closed higher on a Monday. This is more frequent on Mondays since there is a mild tendency for the VIX to rise on Mondays.

SPX and VIX both close up on a Monday. SPX > 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1998 - 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	-2,013.09	88	45	43	51.14	1,476.08	-1,591.55	0.93	0.97	-22.88
4	-8,878.86	91	43	48	47.25	1,304.85	-1,353.90	0.96	0.86	-97.57
3	-13,929.13	91	42	49	46.15	1,066.60	-1,198.50	0.89	0.76	-153.07
2	-18,501.74	91	39	52	42.86	764.83	-929.42	0.82	0.62	-203.32
1	-20,672.14	91	36	55	39.56	481.52	-691.03	0.70	0.46	-227.17

This appears to suggest a 1-day edge. Below is the equity curve so you can see how it has played out over time.



For a bearish study above the 200ma the edge shown here has been pretty consistent. I've included this among the active studies.

There were again several studies tonight related to low volume. As I did last week, I chose to ignore these again tonight. Traders are free to disagree with me and incorporate low volume studies in their analysis, but I have found when the low volume is due to holidays, and not disinterest, the effects are typically less reliable.

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



Despite tonight's mildly bearish study, the green Aggregator line managed to close solidly positive. The positive value indicates the net expectation from the Active Studies over the next few days is for a move higher. Meanwhile the black Differential line closed just barely above 0. The positive value means the SPX has underperformed expectations over the last few days. (Although in this case it has almost exactly matched expectations.) So net expectations are for more upside and the SPX is no longer overbought. Historically this configuration has provided an upside edge. It can be seen on the 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 stay positive again tomorrow. This could change if strong bearish evidence emerges. Meanwhile the Differential Pivot will be 1,261.03. This is about 3 1/2 points above Monday's close. So the SPX will again be considered "underperforming" unless it can manage a least a gain of this size on Tuesday. A down close or a mildly positive one would see the Differential line remain positive. An SPX gain that puts it above the Differential pivot would put the Aggregator System into profit-taking mode on Tuesday.

While the Aggregator System barely triggered a long signal the close, the SPY trade idea from last night just missed filling. With the Aggregator System just barely triggering I don't plan on getting too aggressive. If a favorable entry presents itself tomorrow I will look to take advantage of that. Details on my approach can be found in the Trade Ideas

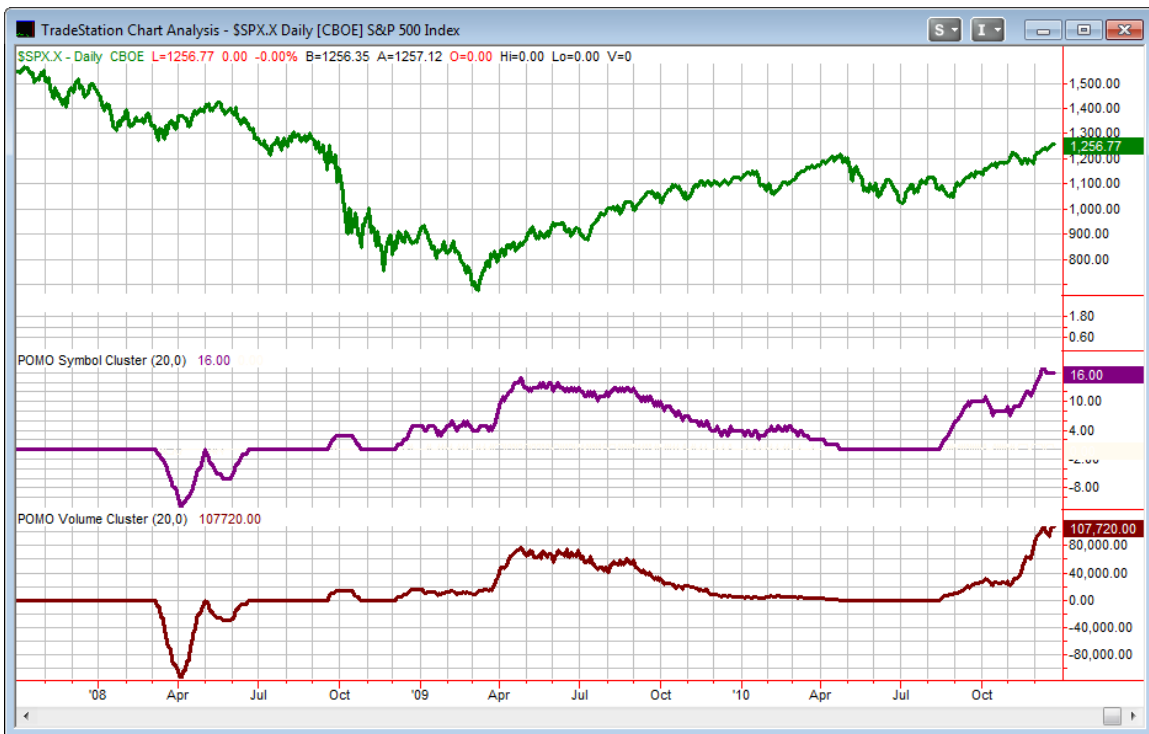
section below. I should also note that several of the numbered systems triggered tonight and I have chosen one of those setups to track below as well.

Intermediate-term Outlook (2 weeks – 2 months)– updated 12/27 – slightly bullish

Intermediate-term indications are becoming more mixed, but the market is continuing to grind higher.

I've been updating the POMO chart each week in the Letter. For those who may not recall below is a brief refresher on POMO. Beneath that I have updated our POMO indicator chart.

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.



20-day POMO volume hit a new high again at the end of this week and the number of days remains extremely high. I expect this will continue to act as a bullish influence on the market.

Over the last several weeks I have also been noting the divergence in the number of 52-week highs while the market indices are making new highs. I've mentioned that divergences like this are not great timing tools but they do raise a yellow flag. This week I thought I'd take a more detailed look at why I've been saying that.

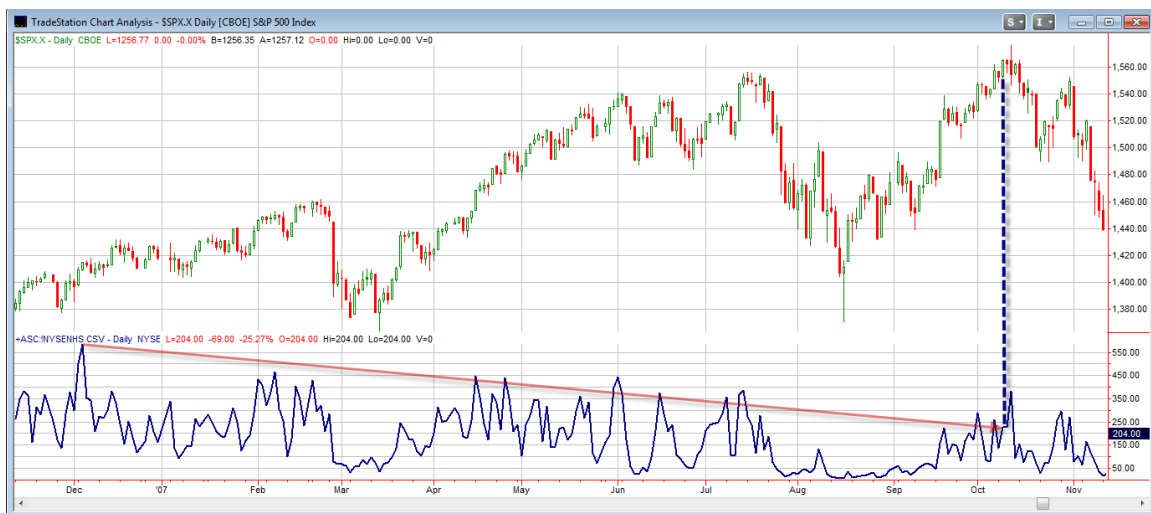
You may read some articles over the next few weeks or months that will claim such a divergence will inevitably lead to a large market decline. "Proof" might even be offered by showing you times where the market has tanked after such divergences have taken place.

I ran some studies examining other times there were divergences of similar magnitude to the current one. I laid out the parameters as follows:

- 1) The SPX must make a high today that is at least 3% higher than the last time the number of NYSE New Highs made a 200-day high.
- 2) The number of NYSE New Highs today must be less than 40% of the previous NYSE New Highs number. It won't look back for more than a year.

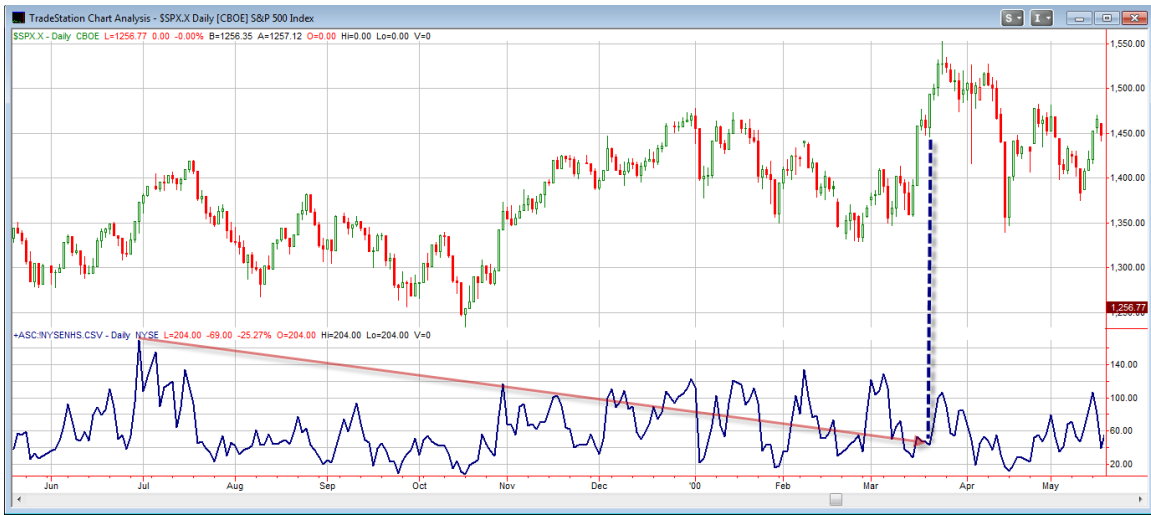
This setup would have triggered on Wednesday. Let's first look at some that bearish prognosticators could point to as "proof".

Here is the 2007 instance:



This almost exactly called the 2007 top.

Here is an instance from 2000:



Again we see another big market top occur within a few days of such a significant divergence.

But what if we look at all the results in a results table? This table goes back to 1970.

QE NHs lag on rally: daysin	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
100	42,098.95	25	13	12	52.00	9,843.85	-7,155.93	1.38	1.49	1,683.96
90	16,672.65	26	13	13	50.00	8,553.26	-7,270.75	1.18	1.18	641.26
80	26,350.72	26	15	11	57.69	6,432.79	-6,376.46	1.01	1.38	1,013.49
70	24,643.25	27	15	12	55.56	6,716.09	-6,341.51	1.06	1.32	912.71
60	32,266.23	28	16	12	57.14	5,544.12	-4,703.31	1.18	1.57	1,152.37
50	35,717.49	31	17	14	54.84	5,704.29	-4,375.38	1.30	1.58	1,152.18
40	41,638.42	35	19	16	54.29	5,087.74	-3,439.29	1.48	1.76	1,189.67
30	1,076.55	38	23	15	60.53	3,160.66	-4,774.58	0.66	1.02	28.33
20	9,460.70	46	28	18	60.87	2,951.98	-4,066.38	0.73	1.13	205.67
10	4,309.88	55	31	24	56.36	1,760.57	-2,094.50	0.84	1.09	78.36

There's a fair amount of overlap as you move out from 10 to 100 days, but you are generally looking at a 50-50 proposition and very slight net gains. No edge is suggested. Below is a list of recent instances going back to 1983. This assumes the 50-day exit.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
10/10/83	Buy	\$172.64	(6.16%)	\$138.96
12/20/83	Sell	\$162.00		(\$6,971.16)
11/11/85	Buy	\$197.28	3.53%	\$8,748.74
01/23/86	Sell	\$204.25		(\$202.40)
05/28/86	Buy	\$246.63	(3.89%)	\$2,656.80
08/07/86	Sell	\$237.03		(\$5,961.60)
08/27/86	Buy	\$253.30	(2.94%)	\$327.02
11/06/86	Sell	\$245.86		(\$9,936.68)
12/03/86	Buy	\$253.85	10.18%	\$11,165.13
02/13/87	Sell	\$279.69		(\$4,943.94)
06/16/87	Buy	\$304.76	9.78%	\$10,863.36
08/26/87	Sell	\$334.57		(\$731.44)
10/09/89	Buy	\$359.80	(4.82%)	\$174.51
12/19/89	Sell	\$342.45		(\$9,052.36)
01/03/90	Buy	\$358.76	(5.77%)	\$0.00
03/15/90	Sell	\$338.07		(\$10,822.54)
05/29/90	Buy	\$360.64	(6.18%)	\$2,531.78
08/08/90	Sell	\$338.35		(\$7,875.11)
11/27/92	Buy	\$430.15	3.53%	\$4,614.48
02/09/93	Sell	\$445.33		(\$760.96)
12/29/93	Buy	\$470.58	(1.42%)	\$2,601.24
03/10/94	Sell	\$463.90		(\$2,736.92)
09/21/95	Buy	\$582.99	4.11%	\$4,394.70
12/01/95	Sell	\$606.98		(\$1,956.24)
09/20/96	Buy	\$687.01	10.12%	\$10,890.95
12/02/96	Sell	\$756.53		(\$870.00)
05/15/97	Buy	\$841.88	11.23%	\$12,244.86
07/28/97	Sell	\$936.45		(\$1,825.46)
02/03/98	Buy	\$1,005.99	10.16%	\$12,474.00
04/16/98	Sell	\$1,108.17		(\$649.44)
04/22/98	Buy	\$1,130.50	1.41%	\$1,589.28
07/02/98	Sell	\$1,146.45		(\$4,937.68)
07/02/98	Buy	\$1,146.45	(10.18%)	\$3,839.31
09/14/98	Sell	\$1,029.70		(\$17,961.15)
02/24/99	Buy	\$1,253.41	6.27%	\$9,342.54
05/06/99	Sell	\$1,332.05		(\$2,953.02)
03/21/00	Buy	\$1,493.82	(3.01%)	\$3,897.30
06/01/00	Sell	\$1,448.80		(\$10,191.72)
12/14/05	Buy	\$1,272.74	0.62%	\$1,936.74
02/28/06	Sell	\$1,280.66		(\$2,106.00)
03/14/06	Buy	\$1,297.48	(3.00%)	\$2,249.94
05/24/06	Sell	\$1,258.57		(\$4,014.78)
05/15/07	Buy	\$1,501.19	(1.23%)	\$3,610.86
07/26/07	Sell	\$1,482.66		(\$2,368.74)
10/09/07	Buy	\$1,565.15	(7.17%)	\$689.22
12/19/07	Sell	\$1,452.99		(\$10,020.15)

You can see much of the rally during the late 90s occurred on narrowing breadth. Divergences such as the one we are seeing can last for close to 2 years before becoming a problem. Bottom line is that it's not encouraging to see new highs contracting, and if it doesn't correct itself it may eventually lead to a market correction, but it is a poor timing tool and not a sign of impending doom.

Another plus for the bulls is that the trend is obviously up. Momentum is positive as we hit a new closing high again on Wednesday.

The SPX/Nasdaq Relative Strength Weekly indicator as shown on the charts page is still favoring the Nasdaq. Since 1971 the SPX has made close to 100% of its gains when the Nasdaq has been leading. The Nasdaq lead continues to shrink though and it is just barely outpacing the SPX at this point.

Bond rates are still a concern. The December 9th study that looked at other instances where SPX and TNX (10-yr rates) both hit new highs suggests bearish implications out over 2 months.

Intermediate-term studies lately have begun to turn bearish. We have one more week of strong seasonality and then the market will no longer have that wind at its back.

Of course the final arbiter is price. Until price starts to roll over it is highly unlikely I will turn outright bearish. For now I'll lean slightly to the bull side. I'm certainly open to trading both sides of the market here, though.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

Open Catapult Triggers

AXP – 1/3 @ \$42.50 limit (not filled)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 1 (AXP)

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.

INTC – buy @ \$20.84 LIMIT. Based on system 80402.

SPY – buy @ \$125.64 LIMIT ON CLOSE. Based on short-term outlook above. I'll again be looking to buy into a pullback tomorrow. I considered using a straight limit order with this one, but ultimately decided to play it more conservatively since it just barely triggered. Those subscribers who are adept at day trading could consider buying into intraday weakness if a reversal pattern to the upside appears.

Current Open Trade Ideas

None.

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