

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 29, 2010

Volume 3 Issue 250

Market Overview



Tonight's Research Points

- The recent inclination of the market to close strong suggests an overbought condition that has typically been followed by a pullback
- The Aggregator System is long.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

It appears there still may be a net upside edge. It isn't a terribly strong one though. I plan on giving it another day before putting more capital at risk.

Summary of Recent Active Studies (see <http://QuantifiableEdges.blogspot.com> or Letters from listed dates for details)

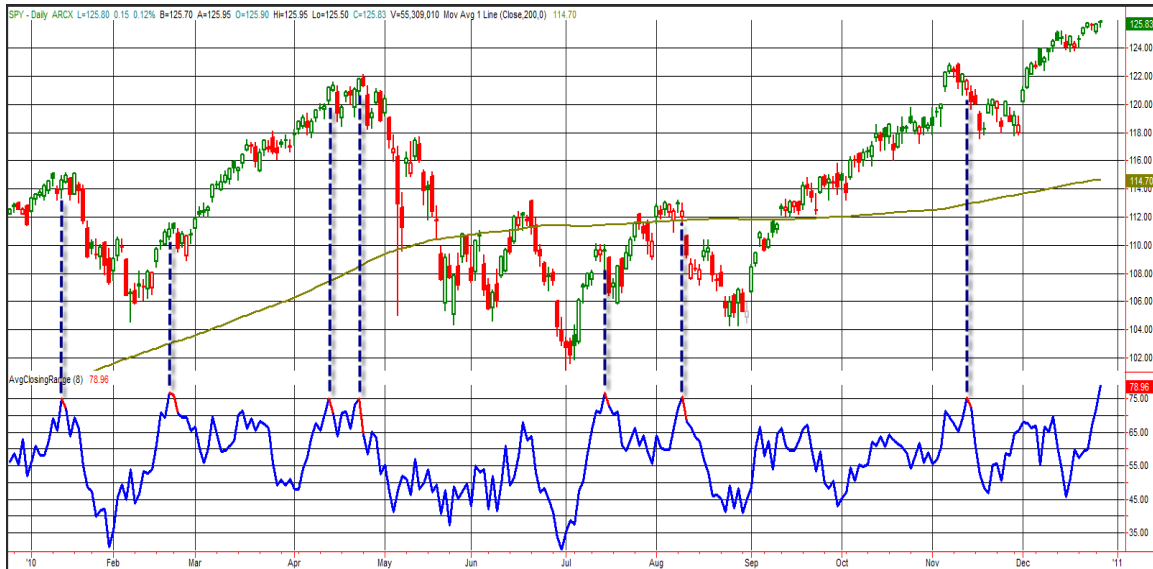
Study Date	Description	Time span	Bias	Avg Max Move
Active				
December 29, 2010	8-day Avg Closing Rng>75. SPX>200ma	1-2 days	Bearish	-1.50%
December 27, 2010	1 day drop after 5 up days.Close>200ma	1-10 days	Bullish	2.20%
December 22, 2010	Twas 3 Nights Before Christmas	1-5 days	Bullish	1.90%
Active - 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 28, 2010	VIX up. SPX up & 50-high, twice.	1 day	Bearish	
December 23, 2010	2 Unfilled up gaps & 50-day high.	1-3 days	Bullish	1.00%

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

The Evidence

Tuesday's market action was like so many other recent days. It was marked by light volume and a fairly narrow range. We saw another close near the upper end of the range and modest gains for most of the major indices. The SPX finished up 0.1% while the NASDAQ fell 0.2% and the Russell 2000 fell 0.4%. Breadth was mixed as the NYSE Up Issue % came in at 48% and the Up Volume % was 54%. Total volume rose slightly from Monday's level but was still holiday light.

Interesting about recent market action is its propensity to close in the upper end of its range. After a bout of weak closes from December 13th through the 15th, the SPY has managed to close relatively well each of the last eight days. This includes the two days that SPY closed down. Over the last eight days it has now closed on average in the 78th percentile of its daily range. The indicator on the bottom of the chart below shows the eight day average closing range. This is now the eighth time this indicator has moved above 75 in 2010. As you can see, previous instances have quickly been followed by pullbacks.



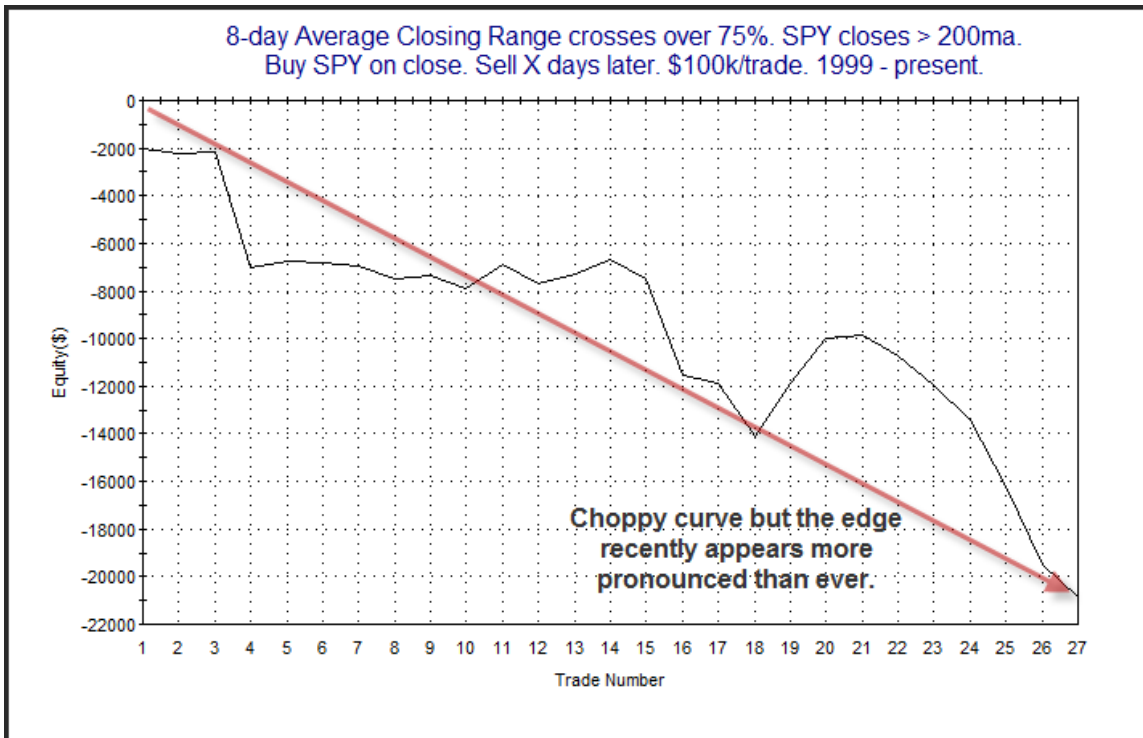
I ran a study to see how such high readings have fared over the long haul. I found that very few instances occurred when the market was below its 200 day moving average. In total those instances showed no strong inclination. Below are the results of those times when the market was locked in an uptrend.

8-day Average Closing Range crosses over 75%. SPY closes > 200ma.
Buy SPY on close. Sell X days later. \$100k/trade. 1999 - 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	-24,260.82	24	10	14	41.67	896.60	-2,373.34	0.38	0.27	-1,010.87
4	-20,335.11	24	9	15	37.50	1,013.86	-1,963.99	0.52	0.31	-847.30
3	-18,243.07	25	9	16	36.00	862.56	-1,625.38	0.53	0.30	-729.72
2	-20,829.50	27	9	18	33.33	747.70	-1,531.05	0.49	0.24	-771.46
1	-10,229.62	27	10	17	37.04	323.79	-792.21	0.41	0.24	-378.87

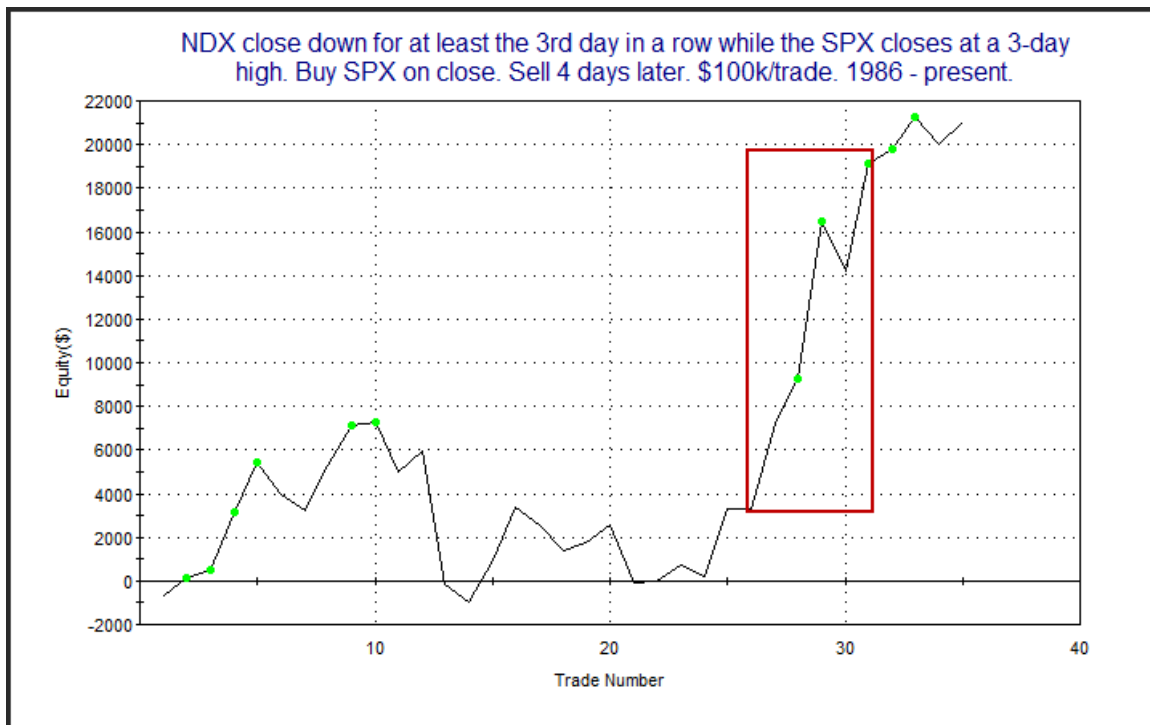
23 of 27 instances (85%) posted a close below the entry price on either day 1 or day 2.

The stats here suggest a strong downside inclination. To get a better idea of how the edge has played out over time, I have also included an equity curve below.



Results have been a bit choppy over time but the slope in general has always been down and over the last six trades the downside inclination appears stronger than ever. I've decided this study is worthy of inclusion on the Active List.

There were a few studies tonight appeared in the Quantifinder, but I did not find any of them compelling. The bearish ones included some low volume SPY studies. As I've been discussing recently I'm not inclined to include low volume studies in this holiday trading environment. There was also a study that examined recent SPX strength versus recent NDX weakness. I last examined this study in the October 4th Letter and did not find it worthy of inclusion at that time. I came to the same conclusion again tonight. Below is the equity curve for that study. It was the primary reason I decided to exclude it.



As you can see nearly all of the gains came in a very short time span. Regardless of whether I ran this out over a 2, 3, 4, or 5-day time frame the equity curve appeared unappealing. I will continue to monitor this study as it has performed well recently.

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



Both the green Aggregator line and the black Differential line closed so close to zero tonight that their positive values were nearly indistinguishable. Despite tonight's bearish study, the green Aggregator line still managed to close positive. The positive value indicates the net expectation from the Active Studies over the next few days is for a mild move higher. Meanwhile the black Differential line also 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 again almost exactly matched expectations.) So net expectations are for more upside and the SPX is not 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 remained long at the close.

The position of green Aggregator line tomorrow will be highly dependent upon what studies emerge. Without any new studies appearing it would barely squeak out a positive reading. Meanwhile the Differential Pivot will be 1,259.66. This is about 1 point above Tuesday's close. So the SPX will again be considered "underperforming" unless it can manage a least a gain of this size on Wednesday. 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 Wednesday.

So the Aggregator System remains long, but it is about as weak of a signal as you could possibly get. Having failed to trigger an entry on either of the last two days, I'm not inclined to chase one at this point. Should the market actually managed to pull back

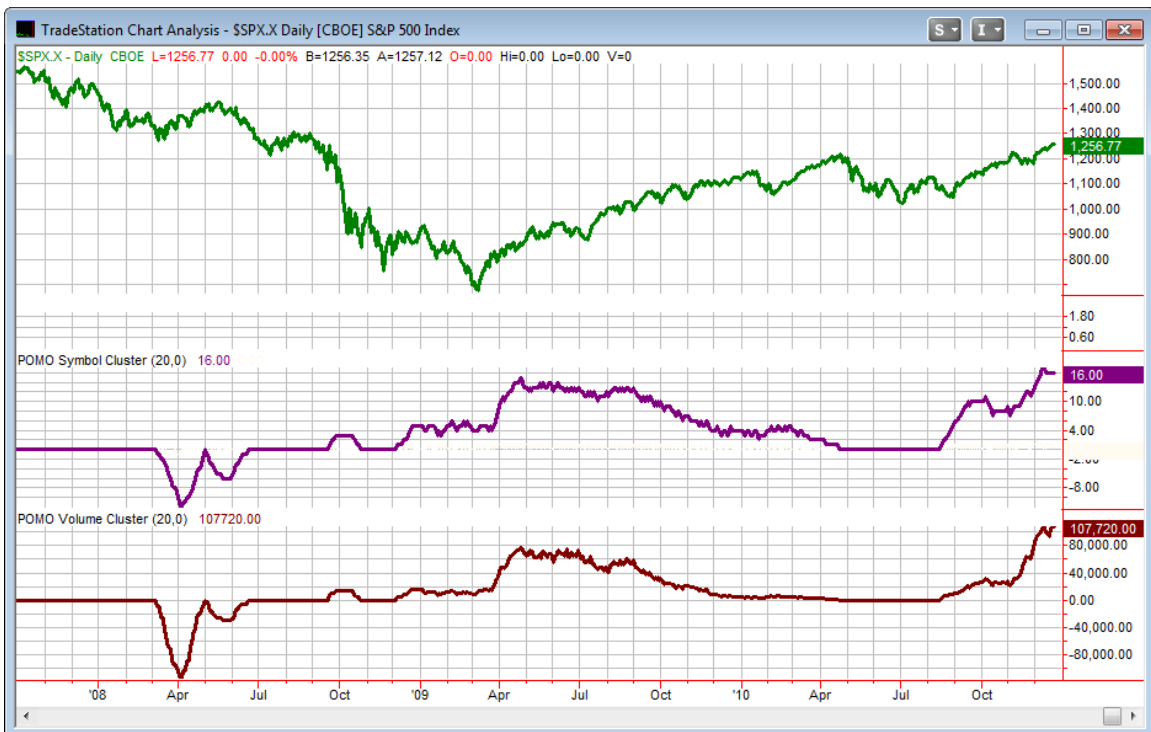
tomorrow there's a good chance I would look to begin building a SPY position on Thursday. Several numbered systems did trigger again tonight but I'm not looking to take on more exposure at this level. More aggressive traders certainly could.

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.

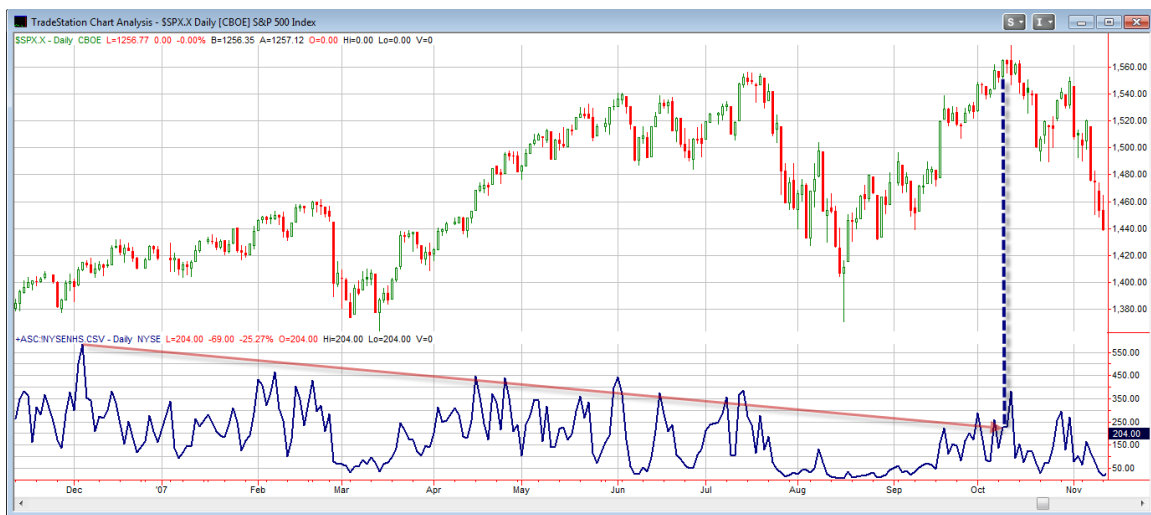
You may read some articles over the next few weeks or months that will claim such a divergence will inevitably lead to a large market decline. "Proof" might even be offered by showing you times where the market has tanked after such divergences have taken place.

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.

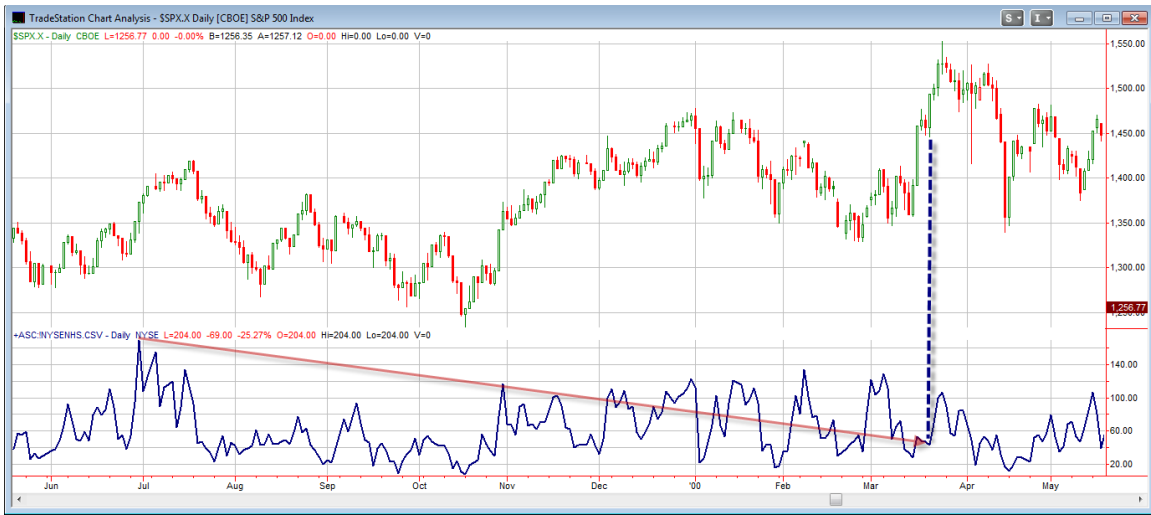
This setup would have triggered on Wednesday. Let's first look at some that bearish prognosticators could point to as "proof".

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.

None tonight.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
INTC	12/28/2010	\$20.81	\$20.88	0.34%		sell on close > \$21.09

INTC was bought at the open and was based on system 80402 as discussed in last night's Letter.

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