

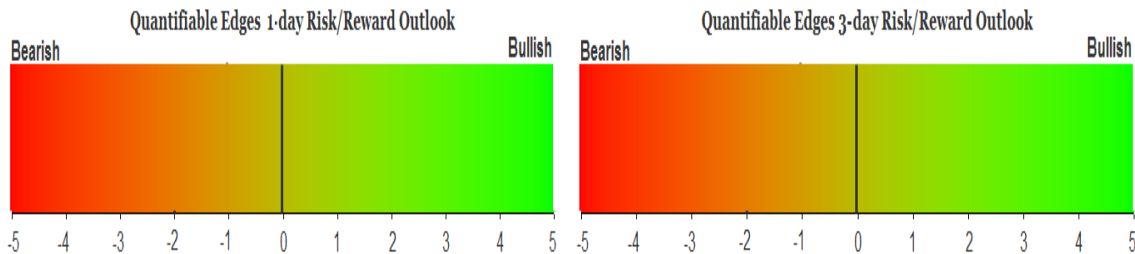
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 30, 2010

Volume 3 Issue 251

Market Overview



Tonight's Research Points

- Multiple SPY price pattern studies suggest bullish implications.
- The VIX:VXV ratio is flashing a bearish warning.
- The Aggregator System is flat.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

The market is slightly overbought, but the evidence tonight is suggesting more short-term upside.

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 30, 2010	VIX:VXV < 0.85 and SPX 50-day high	1-2 days	Bearish	
December 30, 2010	SPY 20-high unfilled gap poor close	1-3 days	Bullish	
December 30, 2010	2 Days of gap, reverse but positive close	1-5 days	Bullish	
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%
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	Twas 3 Nights Before Christmas	1-5 days	Bullish	1.90%

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

The Evidence

Wednesday was another low volume, narrow-range, dull trading day. The only difference from other recent days was that the market closed near its lows rather than its highs. When it was over the SPX, NASDAQ, and Russell 2000 were all up about 0.1%. Breadth was moderately positive as the NYSE Up Issues % closed at 60% and the Up Volume % was 58%. Volume was again extremely light and came in lower than Tuesday.

The pattern of the last 2 days is a rare and interesting one that we last saw just a couple of weeks ago. Both days had a gap higher, a move up above the previous day's high, and then a reversal that led the SPY to close below its open but still in positive territory. I looked at this 2-day setup in the 12/15/10 subscriber letter using a long-term trend filter. I have updated that study below.

SPY gaps up, makes a higher high and then closes below the open but still positive on the day and above the 200ma. It also did this yesterday. 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	22,776.62	13	13	0	100.00	1,752.05	0.00	100.00	100.00	1,752.05
4	16,813.06	13	11	2	84.62	1,607.54	-434.94	3.70	20.33	1,293.31
3	14,213.77	13	9	4	69.23	1,655.63	-171.73	9.64	21.69	1,093.37
2	12,109.47	13	11	2	84.62	1,250.95	-825.51	1.52	8.33	931.50
1	8,910.30	15	13	2	86.67	776.03	-589.07	1.32	8.56	594.02

Only 13 instances but the results are overwhelmingly positive. Below are all 13 instances listed using a 5-day exit strategy.

SPY gaps up, makes a higher high and then closes below the open but still positive on the day and above the 200ma. It also did this yesterday.
Buy on close. Sell X days later. \$100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
04/19/96	Buy	\$64.54	1.39%	\$1,967.23
04/26/96	Sell	\$65.44		\$0.00
11/28/97	Buy	\$95.63	3.46%	\$3,521.65
12/05/97	Sell	\$98.94		\$0.00
11/05/99	Buy	\$137.88	1.36%	\$1,522.50
11/12/99	Sell	\$139.75		(\$1,305.00)
12/10/99	Buy	\$141.88	0.57%	\$1,006.72
12/17/99	Sell	\$142.69		(\$1,302.40)
12/17/99	Buy	\$142.69	2.52%	\$2,863.00
12/27/99	Sell	\$146.28		(\$1,120.00)
07/13/00	Buy	\$149.78	0.57%	\$1,467.40
07/20/00	Sell	\$150.63		(\$1,020.51)
05/24/04	Buy	\$110.27	2.21%	\$2,500.56
06/01/04	Sell	\$112.71		(\$607.02)
11/02/04	Buy	\$113.55	2.93%	\$3,599.20
11/09/04	Sell	\$116.88		\$0.00
01/26/05	Buy	\$117.23	1.74%	\$2,013.08
02/02/05	Sell	\$119.27		(\$528.86)
01/25/06	Buy	\$126.66	1.37%	\$1,696.35
02/01/06	Sell	\$128.39		\$0.00
03/30/07	Buy	\$142.00	1.72%	\$1,971.20
04/09/07	Sell	\$144.44		(\$781.44)
03/03/10	Buy	\$112.30	2.38%	\$2,652.20
03/10/10	Sell	\$114.97		(\$240.30)
12/14/10	Buy	\$124.67	0.58%	\$641.60
12/21/10	Sell	\$125.39		(\$737.84)

The average runup was 2.1% while the MAX drawdown was 1.3% and the average drawdown was 0.6%.

Not only has the setup consistently been followed by gains risk/reward has strongly favored the bulls.

The fact that the opening gap never filled helped bring about some interesting studies as well. The below studies are from the December 14th Subscriber Letter.

I ran a test of performance following unfilled upside gaps that make a 20-day high. Below I've broken out the results by times the SPY closed above the open versus times where it closed below the open.

First let's look at those times where the finish was relatively strong (results not updated):

SPY posts a 20-day intraday high & a low above yesterday's close. It then closes ABOVE the open and above the 200ma. 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	5,660.93	111	57	52	51.35	1,083.08	-1,078.35	1.00	1.10	51.00
4	7,684.00	121	67	53	55.37	1,001.35	-1,120.87	0.89	1.13	63.50
3	1,501.68	132	75	56	56.82	728.72	-949.15	0.77	1.03	11.38
2	-3,487.55	139	71	67	51.08	589.35	-676.59	0.87	0.92	-25.09
1	3,663.97	148	76	71	51.35	449.06	-429.08	1.05	1.12	24.76

There doesn't appear to be any edge in either direction here. Now let's examine times like the present where SPY closed below the open. (Results updated.)

SPY posts a 20-day intraday high & a low > yesterday's close. It then closes < the open but >200ma. 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	13,478.71	25	14	11	56.00	1,688.14	-923.21	1.83	2.33	539.15
4	14,093.62	25	17	8	68.00	1,202.81	-794.26	1.51	3.22	563.74
3	17,173.43	27	19	7	70.37	1,159.51	-693.89	1.67	4.54	636.05
2	11,856.77	28	17	11	60.71	1,065.88	-569.38	1.87	2.89	423.46
1	4,738.02	29	18	11	62.07	548.00	-465.99	1.18	1.92	163.38

25 of 29 instances (86%) closed above the entry price at some point in the next 3 days.

These results are substantially better than earlier where the finish was good. Rather than worrying about the weak finish bulls should be excited by it.

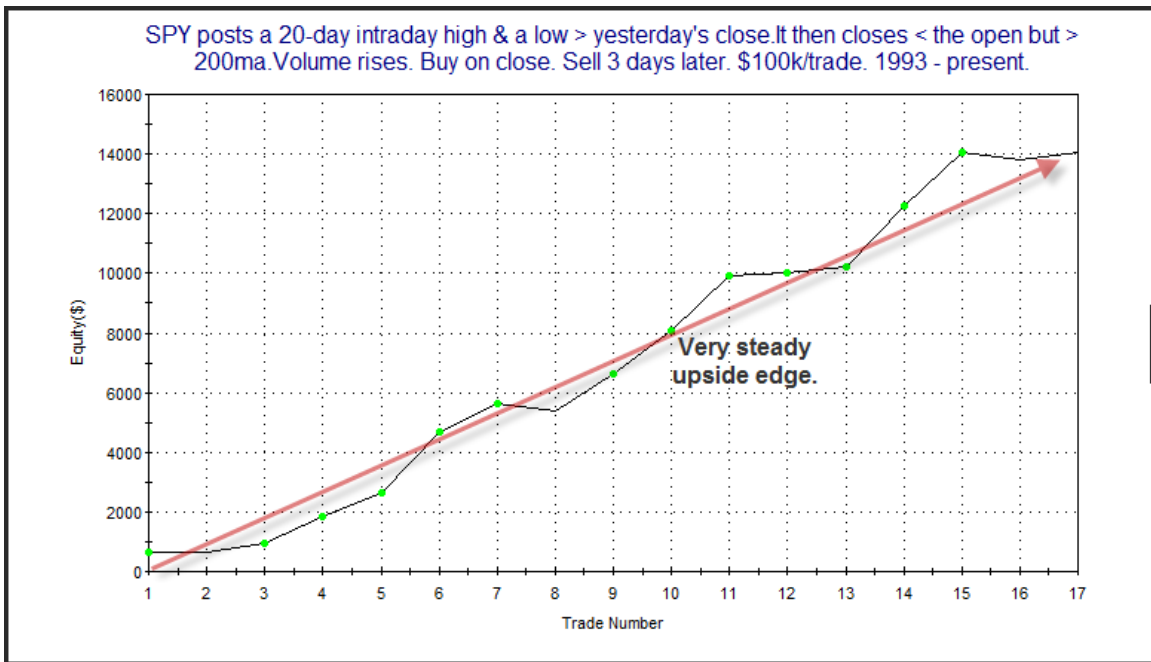
I also added another filter to see what a rise in volume might mean. (Results here are updated as well.)

SPY posts a 20-day intraday high & a low > yesterday's close. It then closes < the open but > 200ma. Volume rises. 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
12	22,197.34	15	12	3	80.00	2,344.58	-1,979.19	1.18	4.74	1,479.82
11	26,404.93	16	14	2	87.50	2,163.97	-1,945.29	1.11	7.79	1,650.31
10	22,594.00	16	10	6	62.50	2,842.59	-971.98	2.92	4.87	1,412.13
9	18,060.30	16	12	4	75.00	1,887.06	-1,146.11	1.65	4.94	1,128.77
8	16,996.06	16	11	4	68.75	1,978.32	-1,191.36	1.66	4.57	1,062.25
7	15,929.11	16	10	6	62.50	2,141.26	-913.91	2.34	3.90	995.57
6	15,872.68	16	11	5	68.75	1,953.73	-1,123.67	1.74	3.83	992.04
5	10,494.09	16	8	8	50.00	1,822.81	-511.05	3.57	3.57	655.88
4	13,609.00	16	12	4	75.00	1,249.26	-345.53	3.62	10.85	850.56
3	14,036.09	17	14	2	82.35	1,038.00	-247.98	4.19	29.30	825.65
2	9,447.71	18	12	6	66.67	1,009.49	-444.35	2.27	4.54	524.87
1	7,101.44	18	14	4	77.78	595.21	-307.88	1.93	6.77	394.52

17 of 18 instances (94%) closed above the entry price at some point in the next 3 days.

Results here appear solid all around and the edge even plays out a little longer than the 3-4 days of the previous study. To get an idea of how the edge has looked over time I have created an equity curve using a 3-day exit below.



Equity curves don't often get much straighter than this. Though instances are a little low I feel this study is well worth inclusion on the Active List.

Not only did the SPY close below its open, it also closed near the very bottom of its daily range. In the past I've looked at unfilled up gaps in SPY that closed at the bottom of the range. I have updated those results below.

SPY closes in the bottom 10% of the day's range but still higher than yesterday's close. 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	10,297.50	20	13	7	65.00	1,409.40	-1,146.38	1.23	2.28	514.88
4	12,965.19	21	16	5	76.19	1,156.89	-1,109.01	1.04	3.34	617.39
3	17,067.46	21	16	4	76.19	1,141.64	-299.68	3.81	15.24	812.74
2	13,195.50	21	15	6	71.43	1,032.15	-381.11	2.71	6.77	628.36
1	8,907.36	22	17	5	77.27	672.42	-504.75	1.33	4.53	404.88

All 22 instances posted a close above the entry price at some point in the next four days.

Even though the number of instances is a little low, the results are strongly suggestive of an upside edge. The profit factor and winning % are both very compelling.

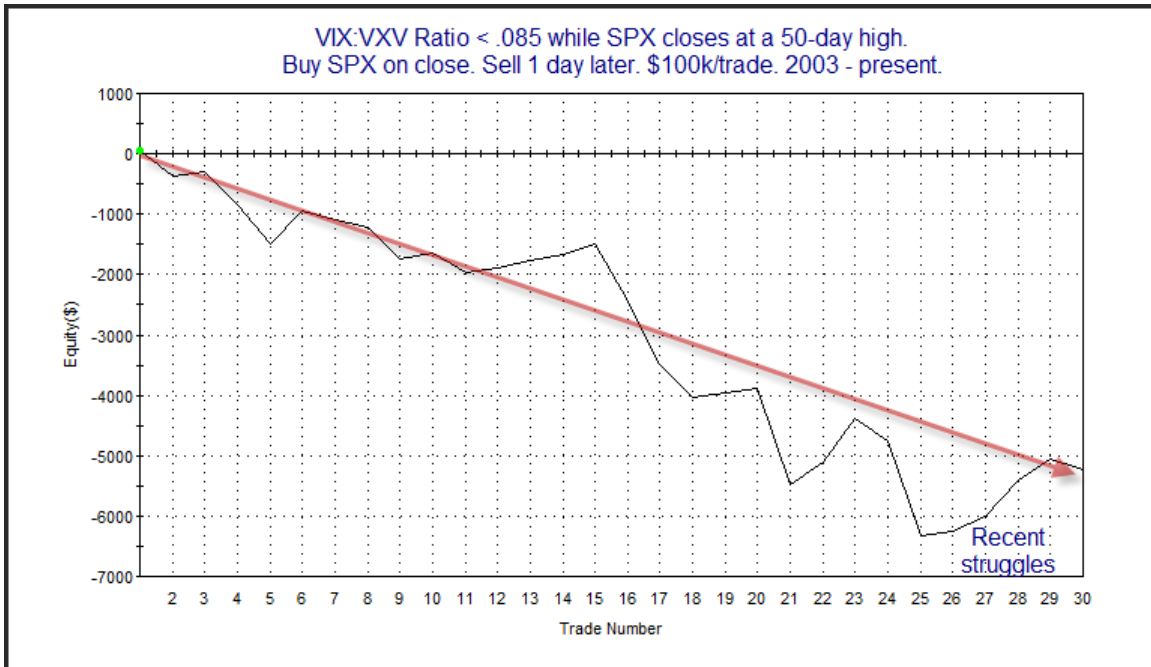
The bottom line is that while late day selloffs like Wednesday's appear ugly on chart they often set up the market nicely for gains over the next few days.

But while the price pattern suggested positive implications, the low VIX: VXV ratio with the SPX at a new high suggests caution is warranted. I've shown the below study a number of times recently. The last time was in the December 23rd Subscriber Letter just a few days ago. I have updated it once again tonight.

VIX:VXV Ratio < .085 while SPX closes at a 50-day high.
Buy SPX on close. Sell X days later. \$100k/trade. 2003 - 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	-3,703.79	17	10	7	58.82	600.47	-1,386.92	0.43	0.62	-217.87
4	-4,723.75	18	8	10	44.44	542.37	-906.27	0.60	0.48	-262.43
3	-4,117.14	20	11	9	55.00	447.21	-1,004.04	0.45	0.54	-205.86
2	-4,491.75	22	8	14	36.36	544.17	-631.80	0.86	0.49	-204.17
1	-5,221.59	30	16	14	53.33	236.31	-643.04	0.37	0.42	-174.05

The numbers aren't overwhelming but they do seem to suggest caution. Most of the downside edge is exhausted in the first day or two. Below is an equity curve using a one-day exit strategy.



As you can see the edge hasn't played out as well recently. It doesn't appear time to give up on it just yet though.

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



The bullish studies tonight provided a nice little boost to the green Aggregator line. It closed squarely above zero. 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 slipped barely below 0. The negative value means the SPX has outperformed expectations over the last few days. (Although in this case it has again almost exactly matched expectations.) So net expectations are for more upside but the SPX is now slightly overbought. This is considered a neutral configuration. It can be seen on the chart whenever both lines are on opposite sides of 0. Due to this the Aggregator System turned flat at the close.

The green Aggregator line tomorrow is set up to remain above 0. Of course this could change should strong bearish evidence emerge. Meanwhile the Differential Pivot will be 1,261.94. This is about 2 points above Wednesday's close. So the SPX will need to rise at least this much in order to maintain its "outperforming" status. A down close or a mildly positive one would see the Differential line turn positive. This would likely trigger another long signal from the Aggregator System.

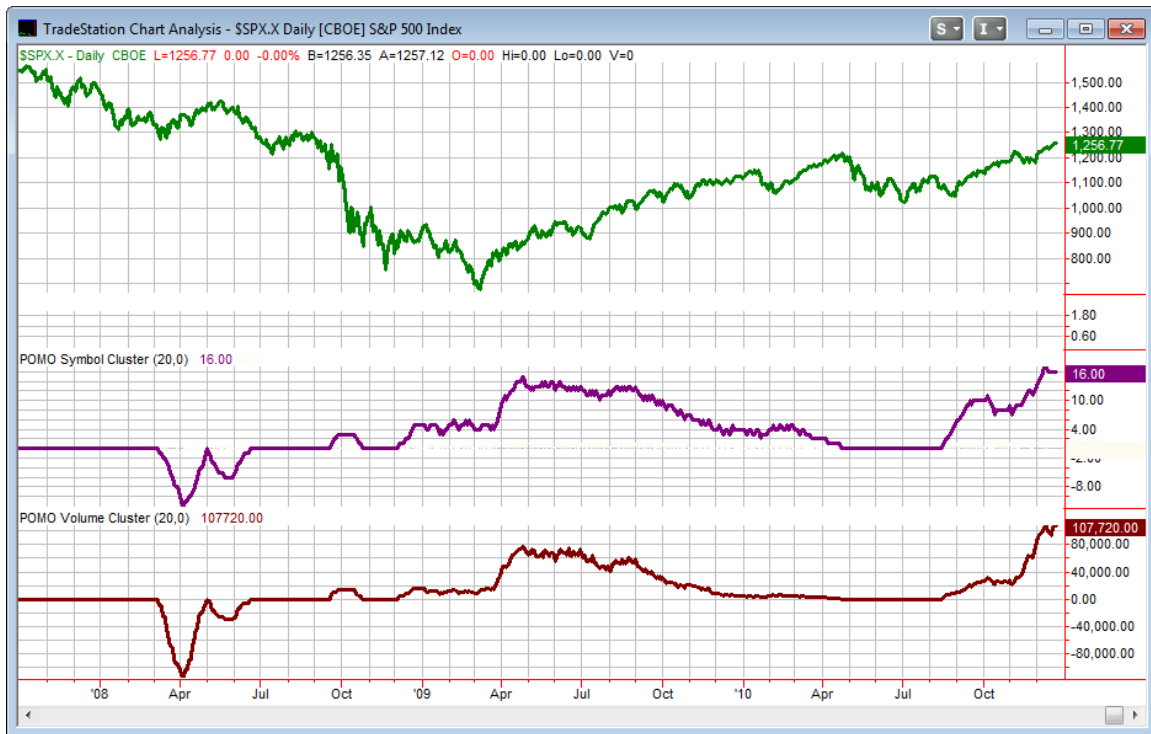
So the Aggregator System is back to flat but the patterns are suggesting the market may have a bit more upside in it over the next few days. Should we get a pullback tomorrow I will likely begin looking to the long side again.

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.

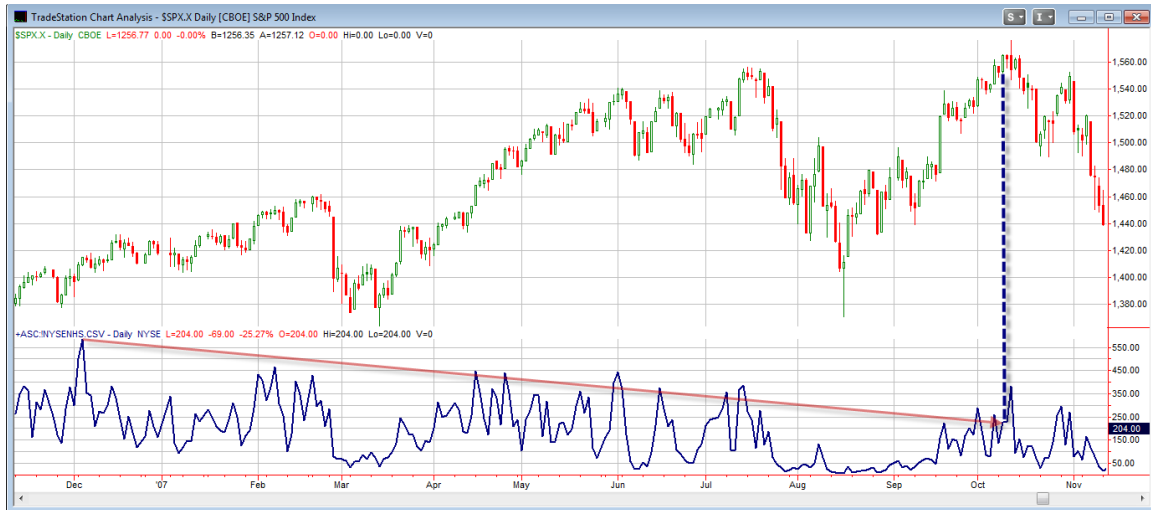
You may read some articles over the next few weeks or months that will claim such a divergence will inevitably lead to a large market decline. "Proof" might even be offered by showing you times where the market has tanked after such divergences have taken place.

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. Aggressive traders could look for a SPY entry near tomorrow's close. I'll wait to evaluate Thursday's action and likely attempt an entry Friday morning.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
INTC	11/28/2010	\$20.81	\$20.94	0.62%		sell on close>\$21.05

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