

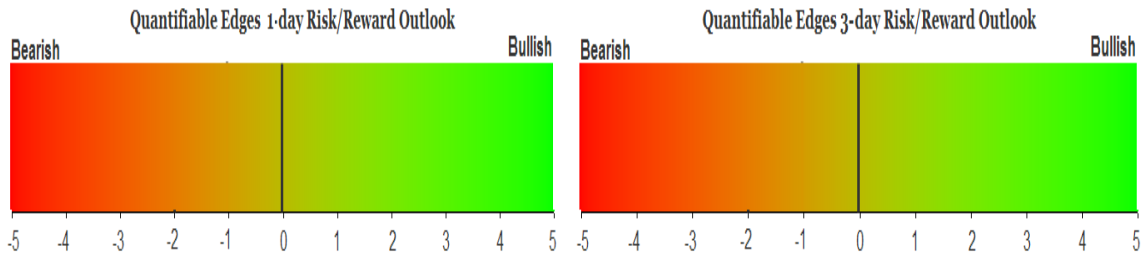
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 16, 2011

Volume 4 Issue 32

Market Overview



Tonight's Research Points

- SPY gapping down 5 days in a row suggests a strong upside edge.
- Unfilled gaps from 50-day highs are often followed by more selling.
- When the unfilled gap down is accompanied by an open and close in the upper end of the range implications appear even more bearish.
- The Aggregator System is flat.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

Evidence is shifting towards the short-term bullish case. But with the market overbought it is not time for entry.

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				
February 16, 2011	SPY 5 gaps lower	1-3 days	Bullish	2.50%
February 16, 2011	Unfilled gap from 10 high. Opn&cls high	1-3 days	Bearish	-1.70%
February 15, 2011	SPY 10 days > 5ma & 10-day high	1-2 days	Bearish	-1.20%
February 15, 2011	20-day high on 20-day low vol.	1-2 days	Bearish	-1.10%
Active - Long Term				
January 21, 2011	SPY 1st close < 10ma in over 25 days	1-20 days	Bullish	
January 19, 2011	SPX 20-day high. Vol 20-day high.	int term	Bullish	
December 9, 2010	SPX & TNX 50-day highs	1-50 days	Bearish	
November 22, 2010	High number of POMO Days recently	int term	Bullish	
October 25, 2010	SPX Golden Cross	int term	Bullish	
Dropped Tonight				
February 14, 2011	SPY 8-day avg closing range > 75	1-2 days	Bearish	-1.50%
February 15, 2011	SPX up VIX up on Monday	1 day	Bearish	

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

The Evidence

The market underwent a quiet day of trading on Tuesday. After gapping down it established it's high and low in the 1st hour of trading and the chopped around in that range the rest of the day. In the end the SPX lost 0.3%, the Nasdaq was down 0.5% and the Russell 2000 dropped 0.7%. Breadth was moderately negative. The NYSE Up Issues % came in at 40% and the Up Volume % was 42%. Total volume rose from Monday's extremely low levels.

The Quantifinder identified a mix of studies Tuesday afternoon. This first one was last shown in the 8/17/10 Letter. The excerpt below is from that letter. (Stats are updated.)

(Today) was the 5th day in a row that the market gapped down to start the day. Pre-market trading is dominated by the pros. Retail traders typically don't trade until the official open at 9:30am EST. I've heard in the past that big institutions that want to buy will sometimes try and push futures lower in the morning when there isn't as much liquidity. They do this with the intention of buying at the open (at cheaper prices) when liquidity comes into the market. Of course news and trading of foreign markets overnight will also have much to do with the open. In any event, 5 gaps down in a row is fairly rare. It raises the question, "Does a consistently cheap open provide an edge going forward?" Let's take a look:

SPY gaps lower at the open for exactly the 5th day in a row.
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	62,276.75	21	13	8	61.90	5,600.12	-1,315.61	4.26	6.92	2,965.56
4	53,798.74	21	12	9	57.14	5,042.93	-746.27	6.76	9.01	2,561.84
3	51,427.53	21	15	6	71.43	3,725.70	-743.00	5.01	12.54	2,448.93
2	44,528.70	21	15	6	71.43	3,342.93	-935.87	3.57	8.93	2,120.41
1	26,235.07	21	14	7	66.67	2,286.75	-825.63	2.77	5.54	1,249.29

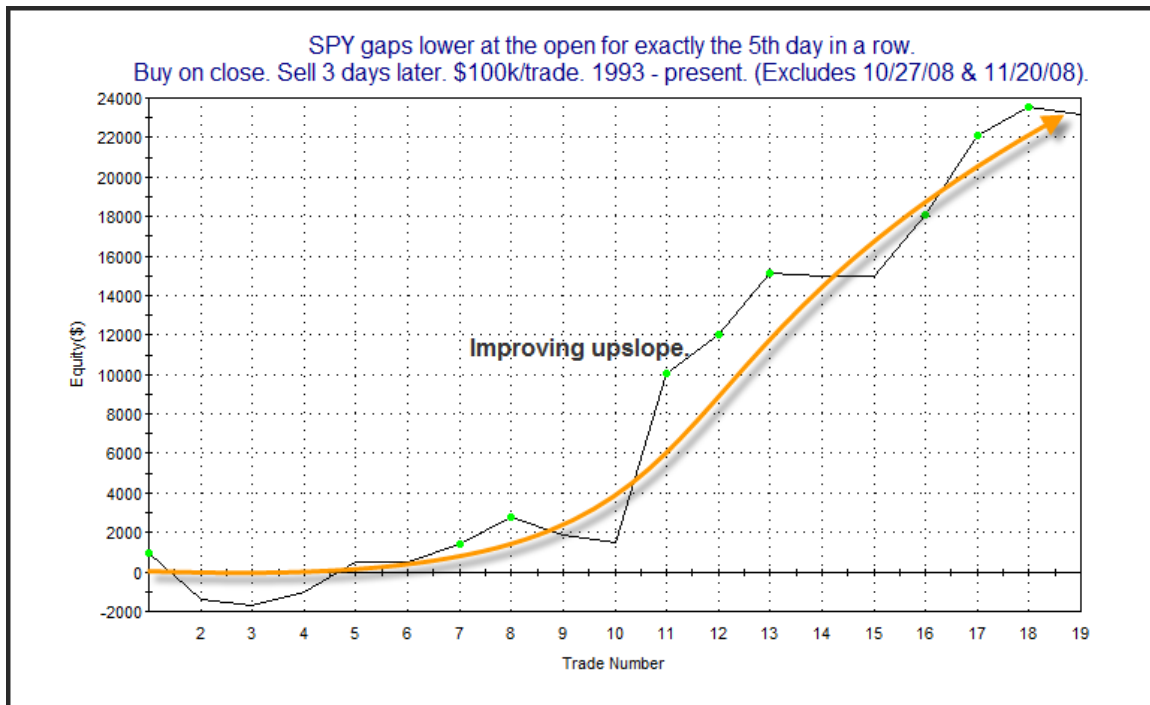
90% of instances posted a close above the entry price at some point in the next 3 days, and 95% at some point in the next week. The one instance that failed to post a close above the entry in the next week was 6/24/2002.

These results appear quite compelling. I dug a little deeper tonight and examined the individual instances. I found that there were 2 large outliers. They occurred on 10/27/08 and 11/20/08. The gains over the next 5 days for those 2 instances were 15.7% and 19.4%. Outliers like this don't mean the study is any less reliable, but you are often better off generating estimates without such large outliers. I don't think anyone believes the market is capable of gaining 15% - 20% in the next week. So I ran the study again below and excluded those 2 instances.

SPY gaps lower at the open for exactly the 5th day in a row.
Buy on close. Sell X days later. \$100k/trade. 1993 - present. (Excludes 10/27/08 & 11/20/08).

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	27,205.19	19	11	8	57.89	3,430.00	-1,315.61	2.61	3.58	1,431.85
4	20,544.66	19	10	9	52.63	2,726.11	-746.27	3.65	4.06	1,081.30
3	23,190.43	19	13	6	68.42	2,126.80	-743.00	2.86	6.20	1,220.55
2	20,961.37	19	13	6	68.42	2,044.35	-935.87	2.18	4.73	1,103.23
1	9,158.61	19	12	7	63.16	1,244.84	-825.63	1.51	2.58	482.03

Results are a bit tamer but strongly positive nonetheless. Below is an equity curve using a 3-day exit criteria.



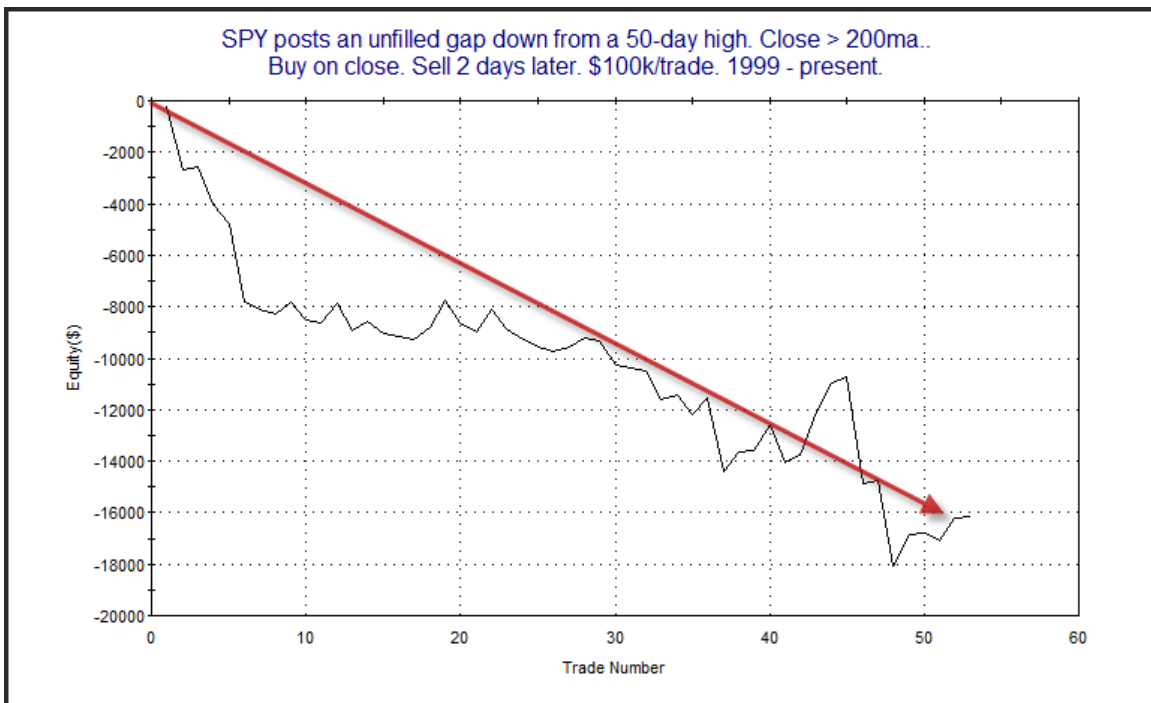
This equity curve doesn't give me any pause. One thing that struck me as odd about the current setup is that despite gapping down 5 days in a row, the SPY actually closed higher than it did 5 days ago. I checked to see how many other times this occurred. There were only 2 other instances. One saw a move higher and the other was followed by a pullback. The instance that saw the short-term rise outweighed the instance that was followed by a drop. Not that I would try and draw any conclusions from just 2 instances, but they provide no evidence suggesting the current setup is inferior to the broad sample. I've included this study on the Active List.

Some other things to consider about the gap down on Tuesday morning are that 1) it went unfilled and 2) it followed a 50-day closing high. Historically, this combination has often been followed by further selling. Below is a study from the 11/9/10 Subscriber Letter that exemplifies this. Stats are updated.

SPY posts an unfilled gap down from a 50-day high. Close > 200ma..
Buy 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	-15,649.28	47	21	26	44.68	1,041.43	-1,443.05	0.72	0.58	-332.96
4	-8,082.54	47	24	23	51.06	827.14	-1,214.51	0.68	0.71	-171.97
3	-10,256.19	48	22	26	45.83	501.20	-818.56	0.61	0.52	-213.67
2	-16,129.38	53	23	30	43.40	558.73	-966.00	0.58	0.44	-304.33
1	-8,441.65	53	24	29	45.28	575.70	-767.54	0.75	0.62	-159.28

Implications appear to be short-term bearish. To get a better idea of how the edge has played out over time I produced an equity curve using a 2-day exit strategy.



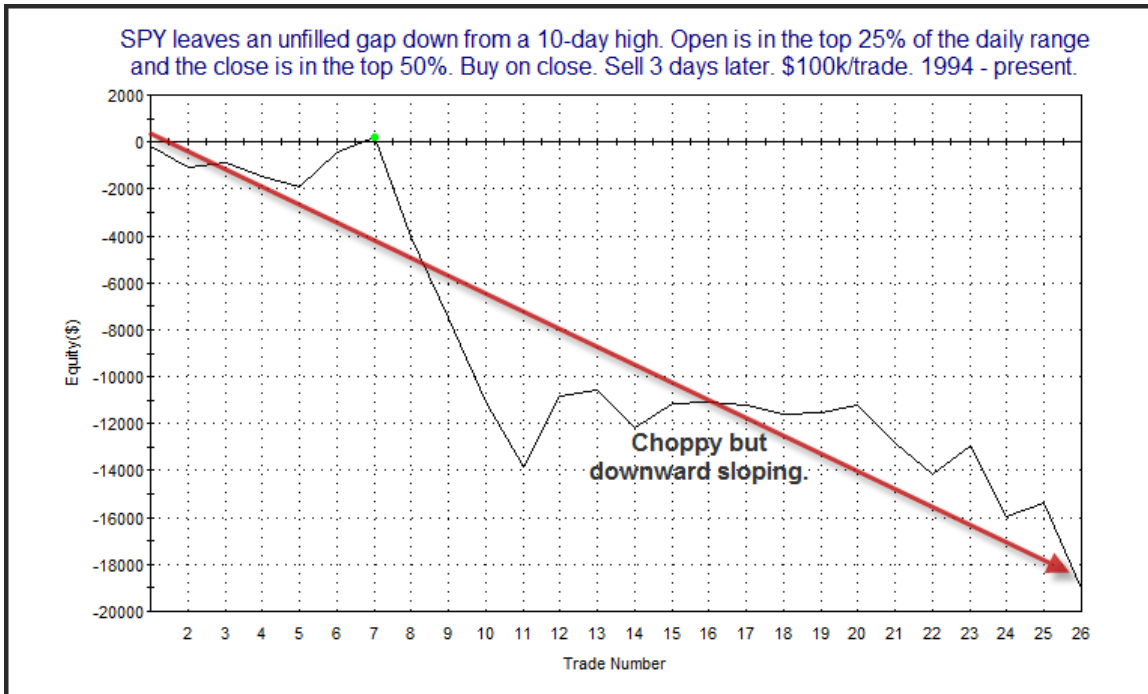
Not the smoothest curve but the fact that it is downward sloping has persisted for a long time.

Also interesting about Tuesday's unfilled down-gap was that it opened and closed near the top of the daily range. This triggered a study from the 1/21/10 letter which I have updated below.

SPY leaves an unfilled gap down from a 10-day high. Open is in the top 25% of the daily range and the close is in the top 50%. Buy on close. Sell X days later. \$100k/trade. 1994 - 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	-16,747.93	26	11	15	42.31	892.17	-1,770.79	0.50	0.37	-644.15
4	-14,165.52	26	11	15	42.31	1,057.32	-1,719.73	0.61	0.45	-544.83
3	-19,027.17	26	11	15	42.31	802.80	-1,857.20	0.43	0.32	-731.81
2	-13,697.56	26	12	14	46.15	798.41	-1,662.75	0.48	0.41	-526.83
1	-10,026.43	26	10	16	38.46	596.85	-999.69	0.60	0.37	-385.63

When the open and close are in the upper part of the range as described above, inclinations appear to be quite bearish. Below is an equity curve using a 3-day exit strategy.



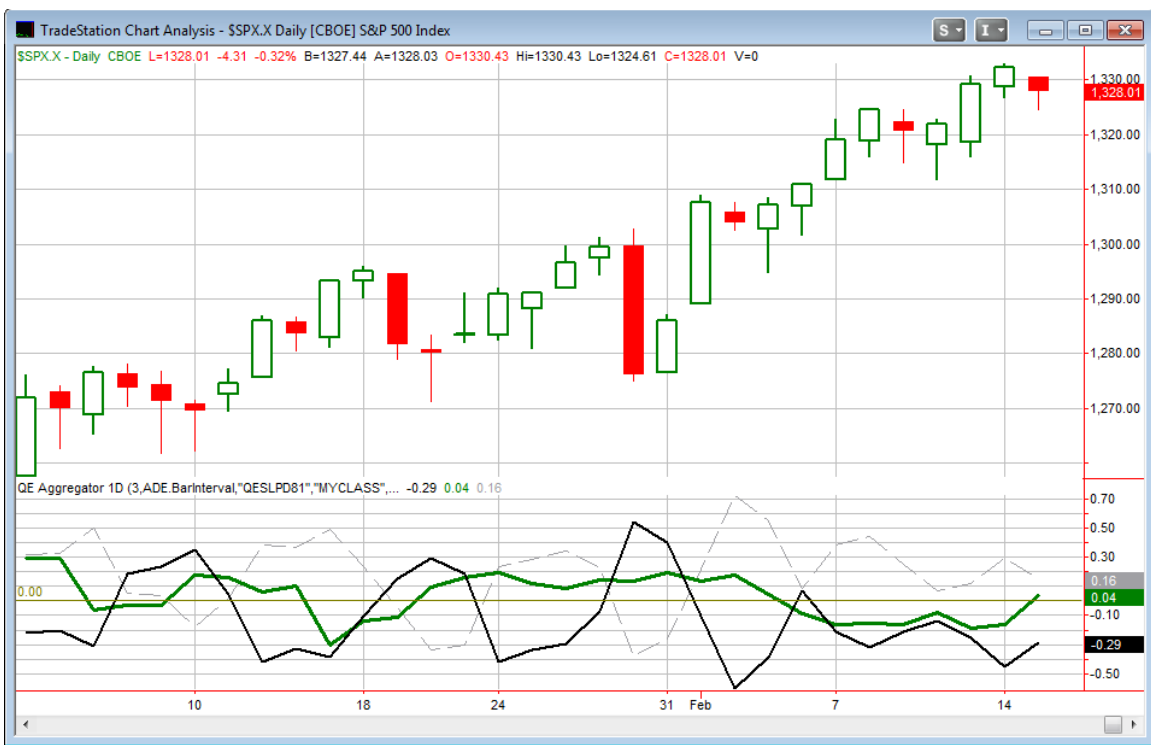
It's not exactly smooth, but good enough. Of course this study only required a 10-day high. What if we instead used a 50-day high like in the previous study?

SPY leaves an unfilled gap down from a 50-day high. Open is in the top 25% of the daily range and the close is in the top 50%. Buy on close. Sell X days later. \$100k/trade. 1994 - 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	-4,247.63	13	6	7	46.15	1,039.74	-1,498.01	0.69	0.59	-326.74
4	-4,788.13	13	6	7	46.15	1,020.05	-1,558.35	0.65	0.56	-368.32
3	-11,001.42	13	6	7	46.15	474.37	-1,978.23	0.24	0.21	-846.26
2	-11,137.77	13	5	8	38.46	530.99	-1,724.09	0.31	0.19	-856.75
1	-8,453.16	13	3	10	23.08	376.70	-958.33	0.39	0.12	-650.24

Instances are low here but there is nothing indicating an intermediate-term high would void the bearish implications.

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



The “5 Gaps Down” study tonight turned the tide and pushed the green Aggregator line above 0. The positive value means the net expectation from the Active Studies List is for upside over the next few days. Meanwhile the black Differential line is still below 0. Readings below 0 mean the SPX has outperformed expectations over the last few days. So net expectations are for upside but the SPX has outperformed recent expectations.

This is considered a neutral configuration. A neutral configuration is evident on the chart whenever both lines are on opposite sides of zero. Due to this the Aggregator System turned flat at the close.

Based on the current active studies the green Aggregator line is set to remain above 0 on Wednesday. This could change if bearish evidence emerges. Meanwhile the Differential Pivot will be at 1,323.34. This is about 0.35% below Tuesday's close. For the Differential Line to move above zero it would require the SPX to drop at least this much.

I've moved out of the SPY short position I had held for the last few days and am short now. This was the 1st Aggregator signal that wasn't profitable since November. The fact that it lost doesn't bother me. I'm happy the winning streak was broken with a small loss rather than a big one. When I swing trade indices I rarely use stops, but I always feel it is important to maintain an open mind. When the evidence swings like it did today, that is my signal to get out. It doesn't matter where my entry price was and whether I'm profitable or unprofitable. It matters that I listen to the market and exit the trade when there no longer appears to be a substantial edge. So I'm flat now and keeping my eyes open for the next substantial edge.

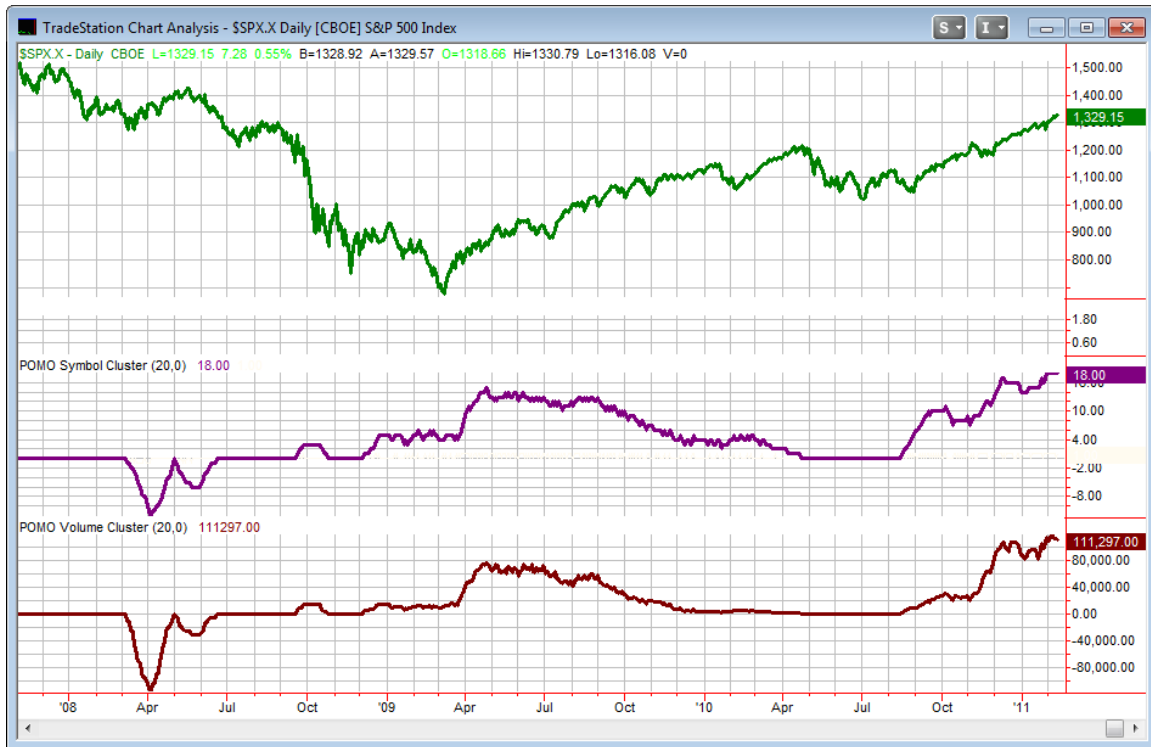
Intermediate-term Outlook (2 weeks – 2 months)– updated 2/14 - bullish

The market continues to make new highs. There can be no doubt we are in an intermediate-term uptrend. And while evidence is mixed, most signs continue to point up.

I've been updating the POMO chart most weekends 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. Information on acquiring the data and constructing the chart can be found in the January 3rd POMO presentation linked below. (Not available for trial users.)

<http://www.quantifiableedges.com/members/pomo.php>



POMO levels remain at or near all-time highs. This has almost certainly provided a strong boost to the market. On Thursday the Fed released its tentative operations schedule for the next month. A link to the schedule is below. After eyeballing it, it appears that POMO activity will be extremely strong. Operations are schedule for almost every day, and most days look to have a substantial amount of buying. This should continue to put a nice wind at the market's back.

http://www.newyorkfed.org/markets/tot_operation_schedule.html

Bulls still have POMO, trend, and momentum on their side, while the bears hopes continue to hinge on bond action. Short-term evidence is suggesting a pullback, but there is little suggesting that a pullback would mark the end of the uptrend. I'll continue to side with the bulls. From my standpoint this means I'll trade the long side more aggressively and the short side more conservatively.

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.

No new trade ideas tonight.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	2/7/2011	\$131.97	\$133.01	-0.79%		covered on close
SPY(1/4)(s)	2/8/2011	\$132.57	\$133.01	-0.33%		covered on close

Both lots were covered at the close as indicated in the intraday update sent to gold subscribers around 3:30 EST.

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