

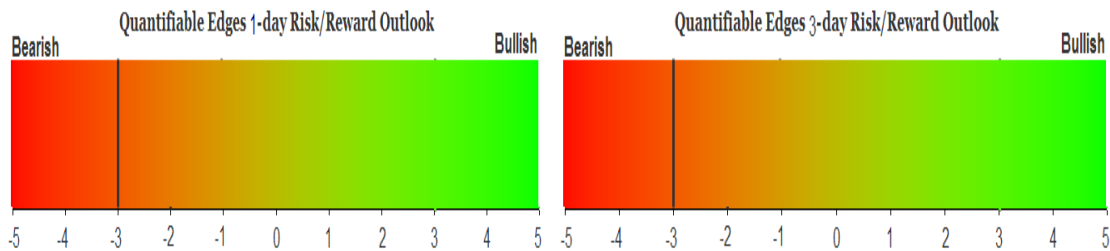
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 22, 2011

Volume 4 Issue 35

Market Overview



Tonight's Research Points

- A strong op-ex week has often been followed by a pullback the next week.
- The move up is overdone and in need of a pullback, but there is some evidence suggesting it has been so persistent that it may just continue higher without pause.
- The Aggregator System is short.
- The NDX Aggressive Trend Timer is long.

Short-term Outlook

The Bottom Line

Same as Thursday. Bearish inclinations continued to be ignored and the market trudged higher. Still, the action is again suggesting a historical downside edge. I am looking to take advantage of it with a conservatively-sized short position.

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 22, 2011	SPX up 1%-2% Op-Ex week	1-5 days	Bearish	-1.40%
February 18, 2011	Upper end of range prior to op-ex	1-4 days	Bearish	
Active - Long Term				
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 18, 2011	Friday Before Pres Day	1 day	Bearish	
February 17, 2011	SPY 10 days > 5ma & 10-day high	1-2 days	Bearish	-1.20%
February 17, 2011	SPX 50 high VIX up midweek	1-2 days	Bearish	-0.80%
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%
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	

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

The Evidence

As has been the pattern lately, morning weakness was quickly overcome and the market finished the day near its highs. Friday was a little different though since it took a sharp rally in the last half-hour to move from the lower end of the day's range into the upper end. When it was over the SPX had gained 0.2%, and the NASDAQ and Russell 2000 were both up 0.1%. Breadth was mixed as the NYSE Up Issues % came in at 56% and the Up Volume % was 49%. Total NYSE volume rose, in large part thanks to options expiration.

Perhaps it's due to the constant Fed liquidity pumping, or perhaps it's just the trading environment we are in, but the upside persistence has been quite remarkable. Bearish inclinations suggested by volume analysis, seasonality, overbought price readings, and sentiment have all been run over in the last 1-2 weeks. I continue to keep an open mind and look for evidence suggesting either bullish or bearish short-term inclinations. As has been the case most nights recently, bearish studies again seem to be dominating.

The Quantifinder identified a few studies on Friday that have not come up recently. Both were associated with the fact that Friday was options expiration. The 1st was from the 10/18/10 Letter. In that letter I examined volume on op-ex Fridays that occurred in conjunction with an up close. I was looking at op-ex Fridays that rose on the highest volume in a month. The finding was that they were typically followed by a pullback. After doing this I ran the same parameters over the same time period except I instead required volume was NOT the highest of the last 20 days. Results here showed a sharp contrast as they not only suggested the inclination was no longer bearish, but that it could in fact be bullish.

I re-examined these findings this weekend in more detail. What I found was that the bullish inclinations that seemed apparent really only played out in the nineties. Since 1999 it appeared that there was no substantial directional edge provided by the setup. The results table showing the '99 – present period below demonstrates this.

SPX rises on op-ex Friday. NYSE volume is NOT the highest of the last 20 days. SPX > 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	-1,894.14	27	13	14	48.15	1,222.93	-1,270.88	0.96	0.89	-70.15
4	1,452.59	27	13	14	48.15	1,391.86	-1,188.69	1.17	1.09	53.80
3	4,934.72	27	14	13	51.85	1,242.73	-958.73	1.30	1.40	182.77
2	3,015.11	27	15	12	55.56	1,036.60	-1,044.49	0.99	1.24	111.67
1	891.72	27	11	16	40.74	840.24	-521.93	1.61	1.11	33.03

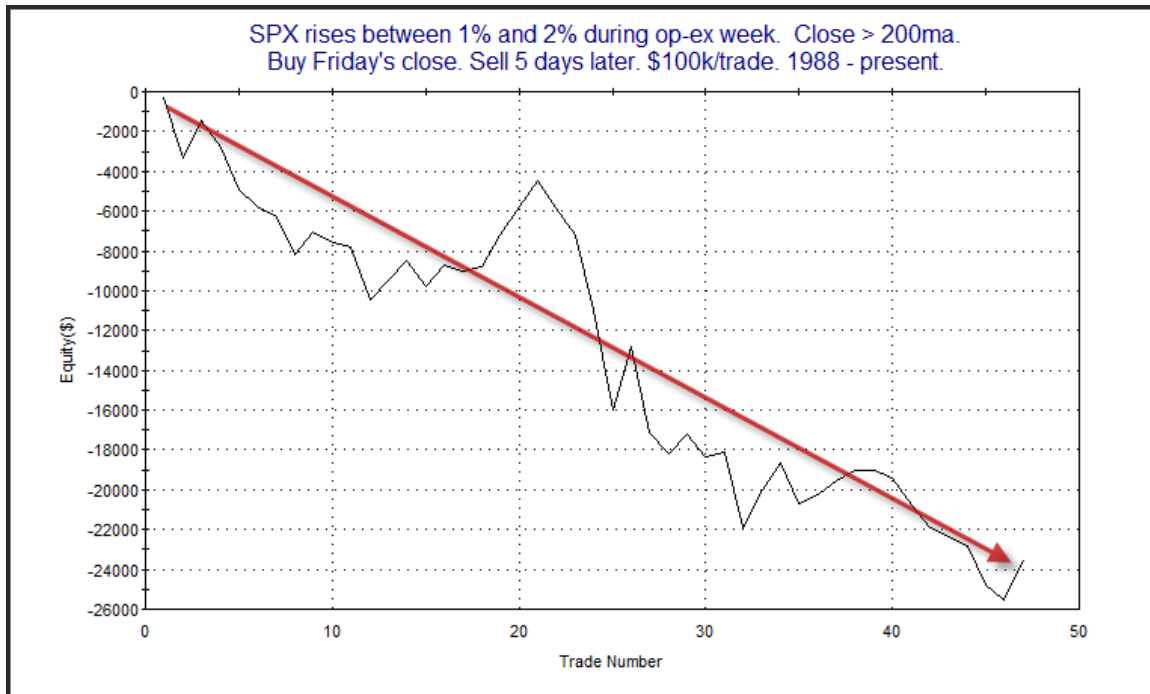
Based on this I view the “light” volume on Friday to be neutral.

In the 7/20/09 Subscriber Letter I examined results the week after op-ex based on how op-ex week performed. The basic finding was that the stronger op-ex week performed, the more significant the tendency to revert back down appeared. In that letter I broke out performance by op-ex week return. Below I decided to take a closer look at instances where the market rose between 1%-2% as is did this past week. I also decided to include a long-term trend filter.

SPX rises between 1% and 2% during op-ex week. Close > 200ma.
Buy Friday's close. 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
5	-23,487.89	47	18	29	38.30	1,216.22	-1,564.82	0.78	0.48	-499.74
4	-17,154.57	47	16	31	34.04	1,072.15	-1,106.74	0.97	0.50	-364.99
3	-4,189.22	47	23	24	48.94	807.66	-948.55	0.85	0.82	-89.13
2	-5,691.78	47	24	23	51.06	574.65	-847.10	0.68	0.71	-121.10
1	-2,358.16	47	18	29	38.30	599.35	-453.33	1.32	0.82	-50.17

Despite the fact that the market has been in a long term uptrend, it appears the historical tendency has still favored a pullback. To confirm this tendency I took a look at the equity curve using a 5-day exit strategy.



There was definitely a big bump for a few trades in the middle of the chart, but that was quickly righted. Overall the equity curve appears suitable enough to confirm the bearish edge suggested by the stats table.

The persistence of the recent move has been quite astounding and really it is a bit difficult to interpret. Let me show you a few studies to illustrate what I mean and then I'll discuss a little further after I show them all.

The market has managed to close above its 5ma now for 14 days in a row, a rather unusual bout of strength. The test below looks back to 1982 and examines what happens when this has occurred in conjunction with a 10-day closing high. This setup would have triggered on Friday.

SPX close above 5ma for at least 14 days in a row and today is the highest close of the last 10 days. Buy on close. Sell X days later. \$100k/trade. 1982 - 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	25,244.11	20	13	7	65.00	2,221.39	-519.13	4.28	7.95	1,262.21
9	29,018.72	20	16	4	80.00	2,013.98	-801.24	2.51	10.05	1,450.94
8	26,317.82	20	17	3	85.00	1,701.74	-870.58	1.95	11.08	1,315.89
7	15,588.61	22	14	8	63.64	1,848.06	-1,285.53	1.44	2.52	708.57
6	11,808.10	22	12	10	54.55	1,892.24	-1,089.88	1.74	2.08	536.73
5	10,790.28	25	18	7	72.00	1,308.16	-1,822.37	0.72	1.85	431.61
4	10,437.84	28	16	12	57.14	1,264.82	-816.61	1.55	2.07	372.78
3	5,677.12	32	17	15	53.13	1,084.26	-850.35	1.28	1.45	177.41
2	2,791.92	38	20	18	52.63	816.00	-751.56	1.09	1.21	73.47
1	2,752.45	59	30	29	50.85	614.09	-540.35	1.14	1.18	46.65

50 of 59 instances (85%) closed above the entry price at some point in the next 5 days.

While there doesn't appear to be much of a directional edge over the first 1-3 days, once you get out a little further, there seems to have been strong upside tendencies. Eight days out the market has been trading higher 85% of the time and the average move has been a 1.3% gain. But let's take a look at when these setups occurred. The table below lists all occurrences using an 8-day exit strategy.

SPX closes above 5ma for at least 14 days in a row and today is the highest close of the last 10 days. Buy on close. Sell 8 days later. \$100k/trade. 1982 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
09/02/82	Buy	\$120.27	3.33%	\$3,789.36
09/15/82	Sell	\$124.28		(\$573.39)
01/28/85	Buy	\$177.39	2.50%	\$2,572.91
02/07/85	Sell	\$181.82		(\$456.03)
11/21/85	Buy	\$201.41	1.40%	\$1,393.76
12/04/85	Sell	\$204.22		(\$659.68)
02/13/86	Buy	\$217.39	3.05%	\$3,629.40
02/26/86	Sell	\$224.03		(\$78.20)
02/27/86	Buy	\$226.77	2.17%	\$2,213.20
03/11/86	Sell	\$231.69		(\$2,024.00)
01/22/87	Buy	\$273.90	0.76%	\$2,573.25
02/03/87	Sell	\$275.98		(\$2,255.70)
06/22/87	Buy	\$309.64	(1.30%)	\$202.86
07/02/87	Sell	\$305.62		(\$2,289.42)
05/21/90	Buy	\$358.00	1.44%	\$1,540.08
06/01/90	Sell	\$363.15		(\$1,026.72)
02/04/91	Buy	\$348.34	4.56%	\$6,371.40
02/14/91	Sell	\$364.21		(\$327.18)
05/10/95	Buy	\$524.36	(0.14%)	\$896.80
05/22/95	Sell	\$523.65		(\$1,385.10)
09/19/95	Buy	\$584.20	0.04%	\$583.11
09/29/95	Sell	\$584.41		(\$1,627.92)
12/13/95	Buy	\$621.69	(1.19%)	\$190.40
12/26/95	Sell	\$614.30		(\$2,662.40)
02/05/96	Buy	\$641.43	1.54%	\$3,534.00
02/15/96	Sell	\$651.34		(\$271.25)
11/19/96	Buy	\$742.16	1.94%	\$2,674.64
12/02/96	Sell	\$756.53		(\$235.84)
01/22/97	Buy	\$786.22	0.06%	\$1,073.15
02/03/97	Sell	\$786.70		(\$3,107.69)
02/18/98	Buy	\$1,032.05	1.52%	\$2,105.28
03/02/98	Sell	\$1,047.72		(\$898.56)
03/25/98	Buy	\$1,102.00	1.76%	\$2,699.10
04/06/98	Sell	\$1,121.40		(\$1,078.20)
07/08/98	Buy	\$1,166.38	1.52%	\$2,057.00
07/20/98	Sell	\$1,184.10		(\$1,317.50)
12/31/03	Buy	\$1,111.91	0.84%	\$1,780.00
01/13/04	Sell	\$1,121.22		(\$607.87)
03/17/10	Buy	\$1,166.21	0.60%	\$1,230.80
03/29/10	Sell	\$1,173.22		(\$1,133.05)

Only 2 instances since 1998.

Results are very strong, but what is striking is that there has only been 2 occurrences in the last 12 ½ years. If I loosen the parameters just a bit you'll see a Quantifinder study that has popped up a few times in recent days that I've updated below.

SPX closes above 5ma for at least 10 days in a row and today is the highest close of the last 10 days. Buy on close. Sell X days later. \$100k/trade. 1997 - present.

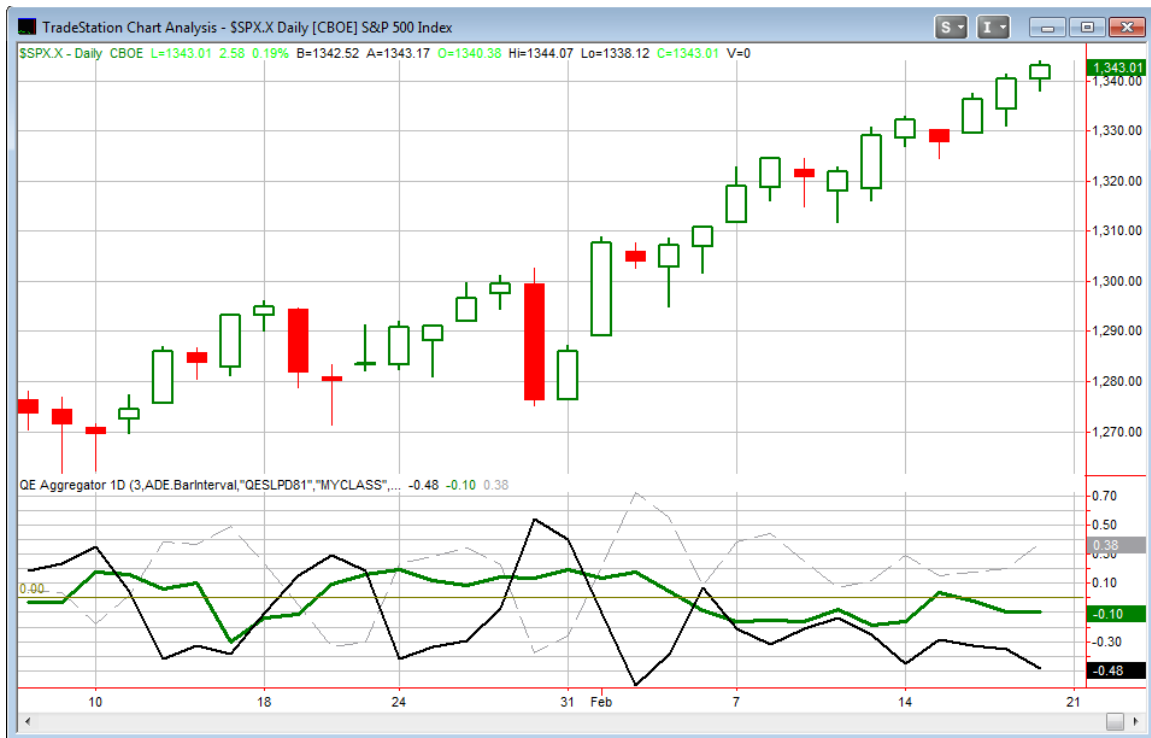
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-10,762.72	32	17	15	53.13	761.87	-1,580.97	0.48	0.55	-336.34
4	-9,514.14	37	17	20	45.95	938.90	-1,273.77	0.74	0.63	-257.14
3	-16,684.43	41	14	27	34.15	676.25	-968.59	0.70	0.36	-406.94
2	-16,998.17	50	24	26	48.00	506.35	-1,121.18	0.45	0.42	-339.96
1	-16,651.56	66	24	42	36.36	417.70	-635.15	0.66	0.38	-252.30

91% of instances posted a close below the entry price at some point in the next 4 days.

This study went back to 1997, so most of the instances in the 1st study are not included here. We know there haven't been many upmoves last 14 days above the 10ma, but there have been a good number that have gone 10 days. Loosening the requirement a little bit would get a good number of instances and would seem to suggest bearish implications.

So should we favor the more recent and less extreme instances? Or are the more extreme, but more distant instances providing the best information? Frankly I am not sure so I am not going to include either among the active studies.

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



The green Aggregator line is still positioned below 0. The negative value means the net expectation from the Active Studies List is for downside over the next few days. Meanwhile the black Differential line is also still negative. Readings below 0 mean the SPX has outperformed expectations over the last few days. So net expectations are for downside and the SPX has outperformed recent expectations. Historically this configuration has suggested a bearish edge. It is evident on the chart whenever both lines are below zero. Due to this the Aggregator System remained short at the close.

Based on the current active studies the green Aggregator line is set to remain below 0 on Tuesday. This could change if bullish evidence emerges. Meanwhile the Differential Pivot will be at 1,334.26. This is about 0.65% below Friday's close. For the Differential Line to move above zero it would require the SPX to drop at least this much.

On Thursday and Friday I scaled in to a ½ size short position. I feel there is a good possibility of a pullback with favorable risk/reward for a short position. At the same time this trade is both counter to the trend and to my intermediate-term outlook. When this happens I tend to trade substantially more conservatively. So I am happy to be short using a reduced size, but I will not look to increase it without very compelling evidence. I will also look to cover my short fairly quickly should the expected pullback develop.

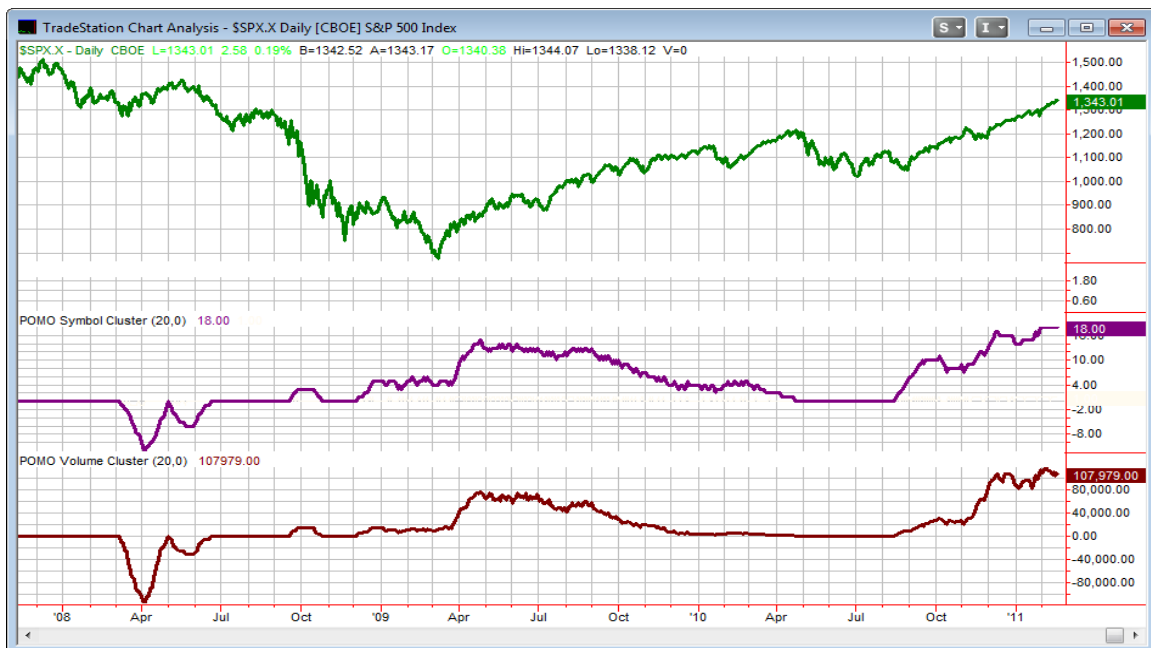
Intermediate-term Outlook (2 weeks – 2 months)– updated 2/22 - bullish

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. POMO activity is expected to remain strong over at least the

next 3 weeks according to the tentative operations schedule. Operations are scheduled 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)	2/17/2011	\$133.85	\$134.53	-0.51%		see below
SPY(1/4)(s)	2/18/2011	\$134.37	\$134.53	-0.12%		see below

I will look to cover both lots of SPY should SPX close at or below the Differential Pivot of 1,334.26.

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