

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 23, 2011

Volume 4 Issue 36

Market Overview



Tonight's Research Points

- Sharp 1-day VIX spikes often lead to an SPX rally the next day.
- Sharp drops from an intermediate-term high on strongly negative breadth also suggest a 1-day upside edge.
- When SPY leaves an unfilled gap down from a 50-day high it is often followed by further selling.
- Moves from a 10 day high to a 10 day low in one day are also often followed by more short-term selling.
- The Aggregator System is flat.
- The NDX Aggressive Trend Timer is long.

Short-term Outlook

The Bottom Line

The bearish inclinations we've been seeing recently played out on Tuesday. It is unclear whether the sharp selloff has already exhausted itself or whether there is further to go. The Aggregator is neutral and I am inclined to stand aside for a day and wait for more clarity.

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 23, 2011	VIX spikes 20% in 1 day	1 day	Bullish	
February 23, 2011	SPX 1% drop from 50hi. Breadth 2:1 neg	1 day	Bullish	
February 23, 2011	SPY Unfilled gap down from 50-day high	1-2 days	Bearish	-1.00%
February 23, 2011	SPX 10-high to 10-low in 1 day	1-3 days	Bearish	-1.40%
Active - Long Term				
February 23, 2011	From 2- hi to 1st 5low in 10 days.	1-11 days	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				
<i>February 22, 2011</i>	<i>SPX up 1%-2% Op-Ex week</i>	<i>1-5 days</i>	<i>Bearish</i>	<i>-1.40%</i>
<i>February 18, 2011</i>	<i>Upper end of range prior to op-ex</i>	<i>1-4 days</i>	<i>Bearish</i>	

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

The Evidence

I'm not sure if it was due to news in Libya or whether Wall St. was reacting to me taking a rare few days off, but the market didn't like it. The major indices gapped lower, tried to bounce in the morning, and then rolled right over and sold off most of the rest of the day. Damage was fairly severe, especially compared to recent action. The SPX dropped 2.1%, the Nasdaq was down 2.7%, and the Russell 2000 lost 2.6%. Breadth was extremely negative. The NYSE Up Issues % came in at just 12% and the Up Volume % was 9%. Total NYSE volume spiked to its highest level since the Egypt scare at the end of January.

Tuesday's selloff was reminiscent of that January Egypt selloff. Several studies that appeared then appeared again today. But while the January selloff triggered a long signal for the Aggregator, Tuesday's failed to do so. And though it may seem like a minor difference, the primary reason the January selloff contained the additional bullish evidence that put it over the top was that it occurred on a Friday. Selloffs that occur just prior to a weekend are more often overreactions. There still is some indication that Tuesday's selloff was an overreaction, but studies are more mixed this time. Quite a bit appeared in the Quantifinder. Below I will review everything I examined tonight that appeared compelling.

This first study last appeared thanks to the Egypt selloff in the 1/31/11 Subscriber Letter. The VIX rose over 26% on Tuesday. Historically 1-day gains of more than 20% have

suggested a market overreaction and led to a quick rebound. This was shown in the study below, which I have updated this evening.

VIX spikes over 20% in one day.
Buy SPX on close. Sell X days later. \$100k/trade. 1990 - 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	21,893.72	33	20	13	60.61	2,837.92	-2,681.91	1.06	1.63	663.45
9	30,821.24	34	25	9	73.53	2,633.68	-3,891.19	0.68	1.88	906.51
8	23,619.26	36	25	11	69.44	2,646.35	-3,867.23	0.68	1.56	656.09
7	34,978.03	36	24	12	66.67	2,780.57	-2,646.31	1.05	2.10	971.61
6	38,506.29	36	23	13	63.89	2,898.71	-2,166.46	1.34	2.37	1,069.62
5	40,149.37	37	25	12	67.57	2,615.90	-2,104.01	1.24	2.59	1,085.12
4	39,252.35	38	26	12	68.42	2,437.40	-2,010.01	1.21	2.63	1,032.96
3	17,813.52	38	26	12	68.42	1,667.64	-2,128.76	0.78	1.70	468.78
2	23,958.27	38	23	15	60.53	1,946.34	-1,387.17	1.40	2.15	630.48
1	37,608.71	39	31	8	79.49	1,414.59	-780.45	1.81	7.02	964.33

92% of instances closed above the entry price at some point in the next 4 days. Only 2 instances occurred following a 50-day high: 11/27/09 and 1/28/11 - both of which marked the closing low for the next several weeks.

While stats strongly suggest a bounce the next day, the upside edge doesn't really follow through beyond that.

Another study that triggered and seemed to support the bulls' case was from the 10/20/10 Subscriber Letter. It looked at sharp declines from a 50 day high on strongly negative breadth. That study is updated below.

SPX closes more than 1% lower. Decliners more than double advancers.
Yesterday closed at a 50-day high. Today closed > 200ma.
Buy on 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	2,241.11	19	12	7	63.16	1,391.83	-2,065.83	0.67	1.15	117.95
4	6,623.95	19	13	6	68.42	1,265.18	-1,637.23	0.77	1.67	348.63
3	8,122.83	19	14	5	73.68	1,002.87	-1,183.46	0.85	2.37	427.52
2	4,373.67	20	13	7	65.00	957.45	-1,153.31	0.83	1.54	218.68
1	6,743.95	20	15	5	75.00	679.00	-688.20	0.99	2.96	337.20

Here again we see a strong inclination for a bounce, but again we are only looking at a 1-day edge. When this combination of a large market drop on strongly negative breadth occurs and the market is not coming off an intermediate-term high the upside implications last 1-2 weeks. It's the fact that we are coming off a 50 day high that puts this setup in doubt.

The studies below are both examples of how strong moves from high levels are often prone to a bit more downside follow-through. This next one was last seen in the 11/9/10 Subscriber Letter. It looks at unfilled gaps down from a 50-day high. (While some data providers are showing that SPY closed its gap on their daily charts that appears to be due to an error. A quick look at an intraday chart will show the gap didn't come close to filling.)

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
10	-13,533.95	41	21	20	51.22	1,317.47	-2,060.05	0.64	0.67	-330.10
9	-17,471.27	41	19	22	46.34	1,299.57	-1,916.50	0.68	0.59	-426.13
8	-15,670.39	42	21	21	50.00	1,049.39	-1,795.59	0.58	0.58	-373.10
7	-14,262.61	43	22	21	51.16	1,024.67	-1,752.63	0.58	0.61	-331.69
6	-14,714.21	45	24	21	53.33	1,076.37	-1,930.81	0.56	0.64	-326.98
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	-15,198.14	54	24	30	44.44	574.25	-966.00	0.59	0.48	-281.45
1	-7,810.81	54	25	29	46.30	577.91	-767.54	0.75	0.65	-144.64

These unfilled gaps from high levels often tend to lead to more selling over the next few days. The edge isn't huge, but it certainly appears worthy of consideration.

The move from a 10-day high to a 10-day low in 1 day is highly unusual, but it also occurred on that Egypt drop and was highlighted in the 1/31/11 subscriber letter. I've again updated that study below.

SPX closes at a 10-day low today after closing at a 10-day high yesterday. 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	-1,653.48	12	6	6	50.00	1,551.35	-1,826.93	0.85	0.85	-137.79
4	-3,695.25	12	5	7	41.67	1,239.99	-1,413.60	0.88	0.63	-307.94
3	-6,039.37	12	4	8	33.33	899.99	-1,204.92	0.75	0.37	-503.28
2	-1,959.73	12	3	9	25.00	1,174.83	-609.36	1.93	0.64	-163.31
1	-1,549.33	12	5	7	41.67	553.10	-616.40	0.90	0.64	-129.11

It's not an overwhelming downside edge, and instances are a little low, but it still seems worthy of consideration and serves as further warning that sharp drops from a high level should not be bought too quickly.

The drop was very sharp, and the market was very high. I decided to look at even more extreme cases and wondered how things have played out in the past with the market has suffered a drop of 2% or immediately following a 200-day high. Looking back to 1960, I found only five other instances. I have listed them all below and shown results using a 10-day exit strategy.

SPX closes over 2% lower after closing at a 200-day high yesterday. Buy on close. Sell X days later. \$100k/trade. 1960 - present.				
Date/Time	Signal	Price	% Profit	Run-up DrawDown
12/01/80	Buy	\$137.21	(5.66%)	\$859.04
12/15/80	Sell	\$129.44		(\$8,655.92)
01/08/86	Buy	\$207.97	(2.15%)	\$681.60
01/22/86	Sell	\$203.49		(\$2,188.80)
06/23/97	Buy	\$878.62	4.57%	\$5,044.32
07/08/97	Sell	\$918.75		\$0.00
11/30/98	Buy	\$1,163.62	(1.93%)	\$2,541.50
12/14/98	Sell	\$1,141.20		(\$2,272.90)
05/14/99	Buy	\$1,337.80	(2.69%)	\$939.80
05/28/99	Sell	\$1,301.82		(\$4,476.26)

There isn't a whole lot you can learn from just five instances, but we do see that the market has been at least capable of further downside over the course of the next couple weeks. The 1980 instance marked a major top. The other 4 went on to see higher prices in the not-too-distant future.

One thing the current market has going for it is that prior to Tuesday's drop it had been locked in a persistent uptrend. I've shown numerous studies in the past that suggest uptrends often become choppy before they ultimately end. It is highly unusual for an uptrend that is showing strong persistence to abruptly top out. The study below demonstrates this concept beautifully. It was last shown in a 10/20/10 subscriber letter.

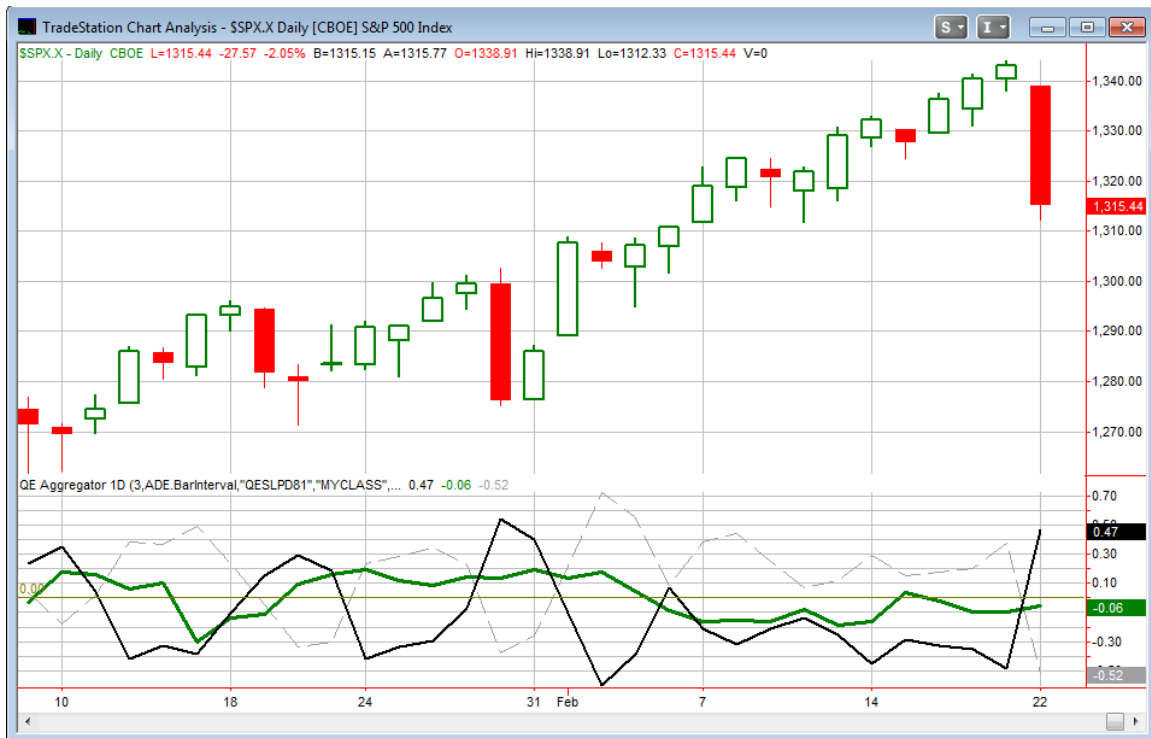
SPY closes at a 5-day low after not having done so for at least 10 days. Yesterday closed at a 20-day high. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1993 - present.

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
12	25,294.08	20	16	4	80.00	1,750.77	-679.55	2.58	10.31	1,264.70
11	27,453.44	20	18	2	90.00	1,583.03	-520.56	3.04	27.37	1,372.67
10	20,796.32	20	16	4	80.00	1,552.84	-1,012.28	1.53	6.14	1,039.82
9	18,736.80	20	17	3	85.00	1,286.96	-1,047.20	1.23	6.96	936.84
8	15,980.77	20	15	5	75.00	1,288.95	-670.69	1.92	5.77	799.04
7	14,713.35	20	15	5	75.00	1,494.19	-1,539.89	0.97	2.91	735.67
6	12,624.03	20	15	5	75.00	1,240.82	-1,197.65	1.04	3.11	631.20
5	12,723.34	20	13	7	65.00	1,472.76	-917.51	1.61	2.98	636.17
4	12,858.27	20	14	6	70.00	1,070.14	-353.94	3.02	7.05	642.91
3	1,114.88	20	13	7	65.00	931.90	-1,571.41	0.59	1.10	55.74
2	-437.38	20	12	8	60.00	957.95	-1,491.60	0.64	0.96	-21.87
1	-1,769.97	20	13	7	65.00	624.67	-1,412.95	0.44	0.82	-88.50

19 of 20 instances (95%) closed above the entry price at some point in the next week.

The first few days are a bit of a crapshoot. While more instances bounced initially, those that didn't got hit pretty hard. Once you get out past the first couple of days though this study is strongly suggestive of an upside edge. 95% of instances posting at least 1 positive close in the next week is impressive. And look at the winning trades column. It rises steadily. When you look out about 2 weeks odds are very strongly suggestive of upside. This study is not in the short-term active list but I have included it in the intermediate-term list. Results were nearly the same if instead of requiring a 20-day high I required the day before close at a 100-day high.

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



With the mix of studies tonight 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 reversed strongly and is now highly positive. Readings above 0 mean the SPX has underperformed expectations over the last few days. So net expectations are for downside but the SPX has underperformed recent expectations. This is considered a neutral configuration. It is evident on the chart whenever both lines are on opposite sides of zero. Due to this the Aggregator System turned from short to flat at the close.

Based on the current active studies the green Aggregator line is set to remain below 0 on Wednesday. This could easily change if bullish evidence emerges. Meanwhile the Differential Pivot will be at 1,338.84. This is nearly 1.8% above Tuesday's close. For the Differential Line to fall back below zero it would require the SPX to rally at least this much.

I should note that the bullish studies are substantially stronger than the bearish ones over a 1-day period. So there does appear to be an upside edge for Wednesday. Probabilities suggest to me that the most likely path for the market would be a 1-day bounce followed by a bit more selling. A long term top appears unlikely and we will probably retest Friday's levels at some point in the next couple of weeks. Two things I'll be watching closely that could provide more clarity are 1) the initial bounce, and 2) market behavior around Friday's high if we get there. Worst case scenario for the bulls tomorrow would

likely be a weak bounce. Further selling could lead to signs of exhaustion and suggest a bullish edge. A strong bounce would likely suggest further upside follow-through. But a weak bounce could mean the market is setting up to suffer another quick leg down.

The short SPY trade ideas from last night's letter were covered at the close as per the instructions in last night's letter. There are no open trade ideas at the present, and without compelling evidence I'm not inclined to start buying yet. Aggressive traders and those who are very short term could look to play individual stocks, ETFs, or indices that appear poised to move higher. They should do so with the understanding that risk is now a bit elevated.

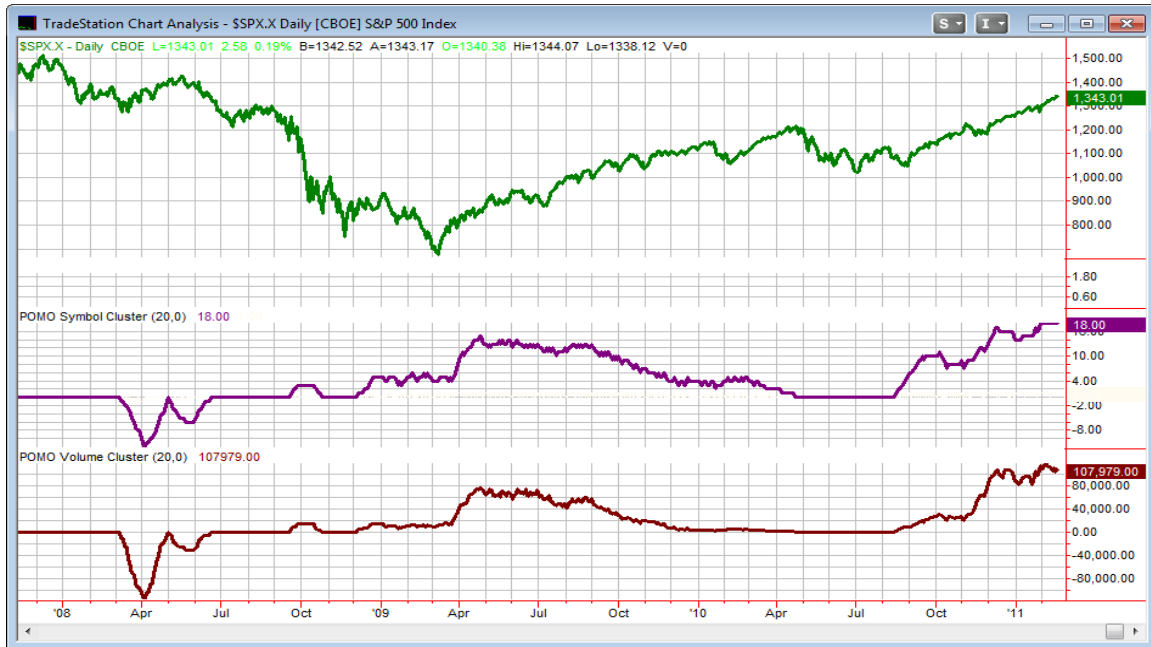
Intermediate-term Outlook (2 weeks – 2 months)– updated 2/22 - bullish

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. Aggressive traders can look at the triggers page. Several stocks and ETFs did trigger 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	\$131.83	1.51%		covered on close
SPY(1/4)(s)	2/18/2011	\$134.37	\$131.83	1.89%		covered on close

Both lots were covered on the close as per last night's letter.

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