

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 02, 2011

Volume 4 Issue 83

Market Overview



Tonight's Research Points

- The 1st day of May has been very strong seasonally, but 1st days don't show an edge when they follow 2 or more up days to finish the month.
- Months that close on a high typically lead to strong move early the next month.
- VIX complacency is suggesting a pullback.
- Momentum as strong as we've been seeing typically begets more buying.
- The rising SPY on declining volume pattern we've seen has typically led to intermediate-term weakness in the past.
- The Aggregator System is flat.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

The market is in one of those modes where strength appears to beget more strength. This is keeping expectations positive despite the overbought readings. The overbought nature of the market has a negative impact on risk/reward and is leaving me wary of establishing new positions.

Summary of Recent Active Studies (see Letters from listed dates for details)

Study Date	Description	Time span	Bias	Avg Max Move
Active				
May 2, 2011	SPX up VIX up on Fri. SPX > 200ma.	1-2 days	Bearish	-1.05%
May 2, 2011	SPY highest close of month on last day	1-5 days	Bullish	2.40%
May 2, 2011	SPX > Upper BB 4 days	1-8 days	Bullish	1.90%
April 28, 2011	100-day high on a Fed Day	1-6 days	Bullish	1.65%
April 27, 2011	Unfilled gap to new 50-day high	1-5 days	Bullish	1.70%
Active - Long Term				
May 2, 2011	SPY up 3 days all lower volume	1-19 days	Bearish	
April 25, 2011	Nas/SPX relative strength favors Nas	int term	Bullish	
April 11, 2011	QQQ 5 lower lows. Today worst day.	1-20 days	Bullish	13.00%
March 22, 2011	3 Days Up Issues % > 70%	int term	Bullish	19.00%
November 22, 2010	High number of POMO Days recently	int term	Bullish	
October 25, 2010	SPX Golden Cross	int term	Bullish	
Dropped Tonight				
April 29, 2011	VIX:VXV < 0.85. SPX at 50-high.	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

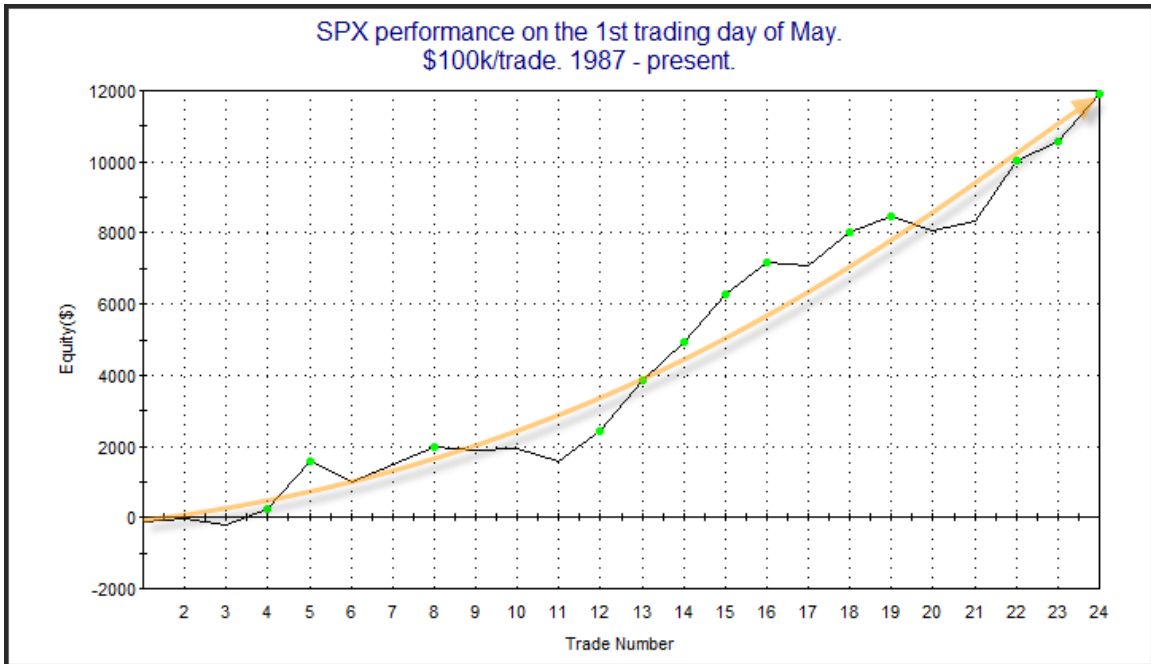
Action was relatively quiet on Friday, but most of the major indices managed gains. The SPX rose 0.2%, the NASDAQ was up a meager 0.04%, and the Russell 2000 gained 0.5%. Breadth was positive as the NYSE Up Issues % came in at 65% and the Up Volume % was 59%. Volume retreated slightly from Thursday's level, but still came in above average.

As I've discussed many times before, the first trading day of the month tends to have a bullish tilt. This phenomenon began to take hold in the late 80s when 401(k) plans gained popularity. Some months have shown stronger tendencies than others, and May has been one of the strongest. This is shown in the study below, which is updated from 5/3/10.

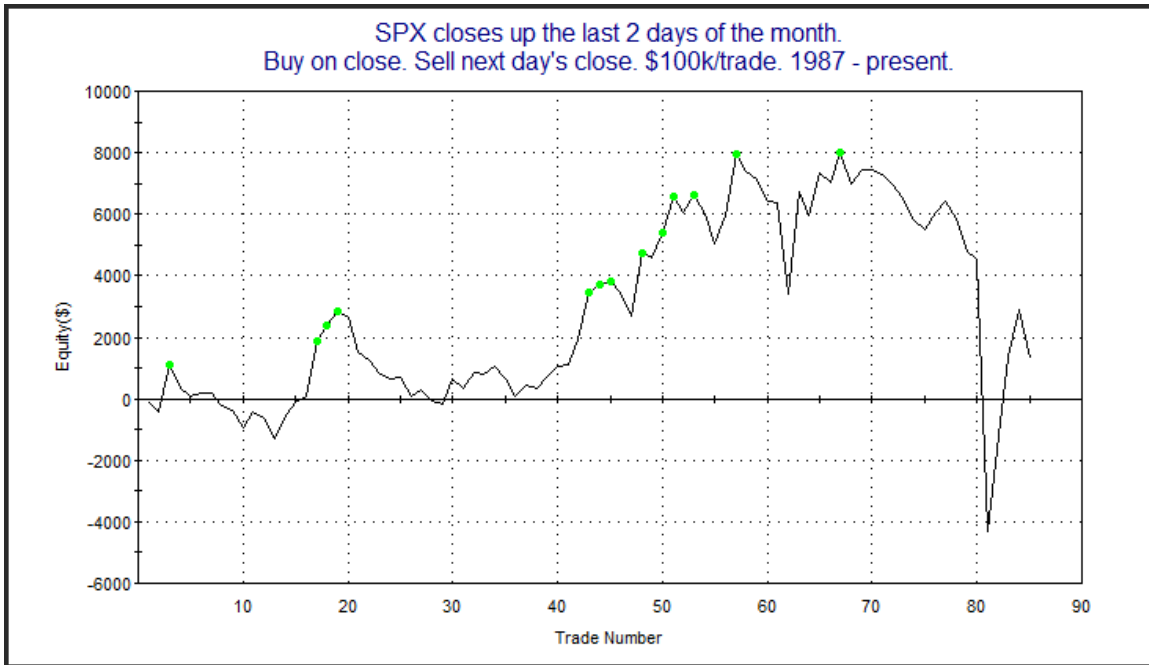
SPX performance on the 1st trading day of May.
\$100k/trade. 1987 - present.

TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	\$11,891.60	Profit Factor	7.71
Gross Profit	\$13,664.40	Gross Loss	(\$1,772.80)
Total Number of Trades	24	Percent Profitable	70.83%
Winning Trades	17	Losing Trades	7
Even Trades	0		
Avg. Trade Net Profit	\$495.48	Ratio Avg. Win:Avg. Loss	3.17
Avg. Winning Trade	\$803.79	Avg. Losing Trade	(\$253.26)
Largest Winning Trade	\$1,710.72	Largest Losing Trade	(\$578.40)

The stats here are all lopsided in favor of the bulls. Not only is the winning percentage strong, but the up days have been very good and the down days haven't been that bad. Below is an equity curve that shows how this edge has played out over time.



The equity curve appears as strong as the results table. But there is one issue that throws up a yellow flag here. That is the fact that the market is already overbought. The study below is from the 3/1/11 Subscriber Letter. It looks at other instances where the month finished with gains on the last two days.



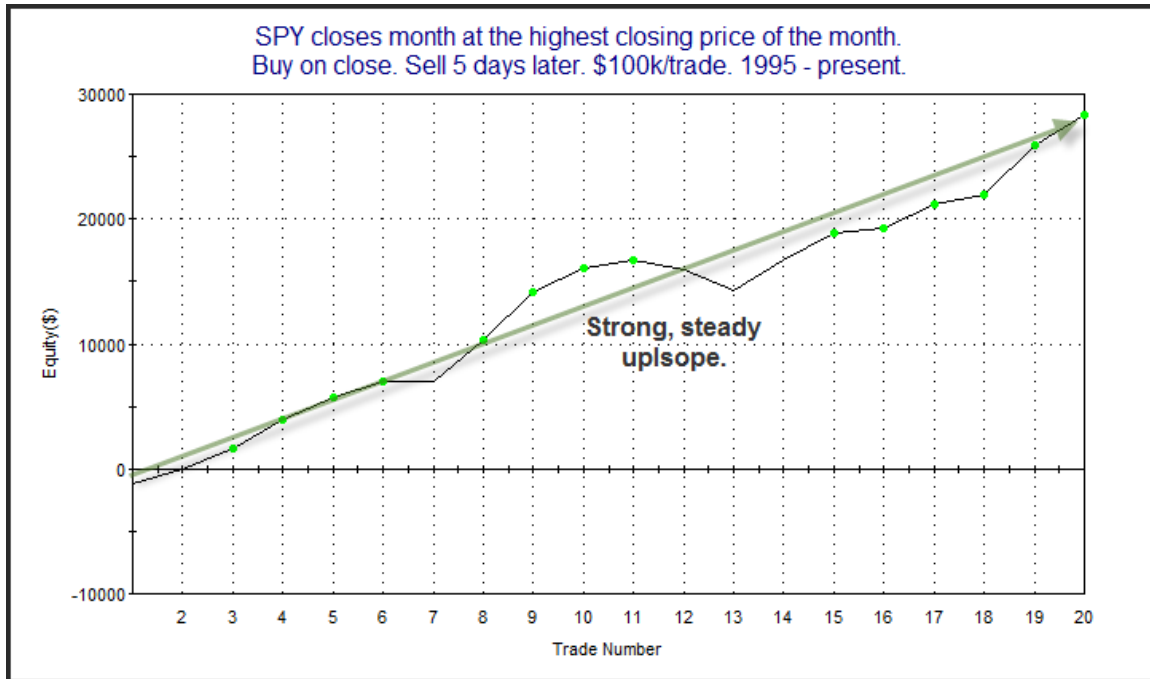
As you can see, under such circumstances the first day of the month has failed to show a bullish tendency. This suggests the “1st day” tendency may be reduced. But even if Monday doesn’t carry the edge it typically does in May, closing the month on a high has often meant good things for the early part of the next month. Below I show all instances since 1995 where the SPY finished a month with the highest closing price of that month.

SPY closes month at the highest closing price of the month.
Buy on close. Sell X days later. \$100k/trade. 1995 - 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	34,573.59	20	17	3	85.00	2,536.05	-2,846.43	0.89	5.05	1,728.68
9	34,612.34	20	16	4	80.00	2,577.23	-1,655.82	1.56	6.23	1,730.62
8	30,061.19	20	17	3	85.00	2,223.93	-2,581.85	0.86	4.88	1,503.06
7	25,973.82	20	15	5	75.00	2,171.94	-1,321.07	1.64	4.93	1,298.69
6	29,741.70	20	16	4	80.00	2,188.46	-1,318.41	1.66	6.64	1,487.09
5	28,275.85	20	16	3	80.00	1,991.64	-1,196.77	1.66	8.88	1,413.79
4	21,151.57	20	14	6	70.00	2,157.42	-1,508.72	1.43	3.34	1,057.58
3	14,389.98	20	13	7	65.00	1,846.02	-1,372.62	1.34	2.50	719.50
2	9,255.31	20	11	9	55.00	1,681.72	-1,027.07	1.64	2.00	462.77
1	5,324.05	20	11	9	55.00	934.16	-550.19	1.70	2.08	266.20

18 of 20 instances (90%) closed above the entry price at some point in the next week. (All 20 within 10 days.)

The numbers are very compelling. Most of the upside edge occurs in week 1, but there is some follow through into week 2. Below is an equity curve showing results using a 5-day holding period.



The steady upslope supports the bullish hypothesis suggested by the stats table.

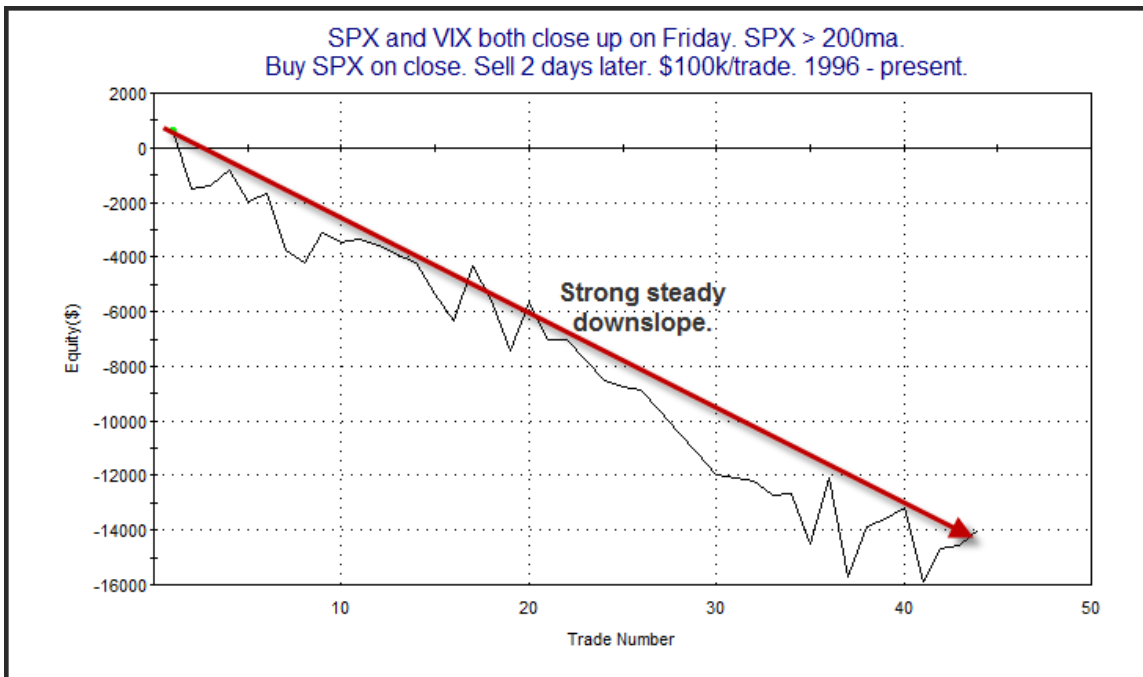
Other than seasonality, two forces suggesting influential behavior are sentiment and momentum. One measure of sentiment I often use is the VIX. Ordinarily when the SPX rises the VIX tends to fall. Of course this isn't always the case, and it wasn't the case on Friday. The study below was last seen in the 1/24/11 Subscriber Letter. It looks at other times where the VIX rose in conjunction with the SPX on a Friday. I've updated the results.

SPX and VIX both close up on Friday. SPX > 200ma.
Buy SPX on close. Sell X days later. \$100k/trade. 1996 - 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	-8,979.42	43	18	25	41.86	1,530.02	-1,460.79	1.05	0.75	-208.82
4	-14,361.38	44	18	26	40.91	1,140.30	-1,341.80	0.85	0.59	-326.40
3	-14,466.12	44	16	28	36.36	1,025.32	-1,102.55	0.93	0.53	-328.78
2	-13,961.25	44	17	27	38.64	800.54	-1,021.13	0.78	0.49	-317.30
1	-10,821.68	44	13	31	29.55	516.35	-565.62	0.91	0.38	-245.95

41 of 44 instances (93%) posted a close below the entry price at some point in the next week.

The statistics seem to strongly suggest a pullback is likely. The consistency is very strong, but the average trade really isn't huge. To see how the edge has played out over time, I have produced below an equity curve using a 2-day exit strategy.



The downslope appears solid, especially considering the 200ma filter.

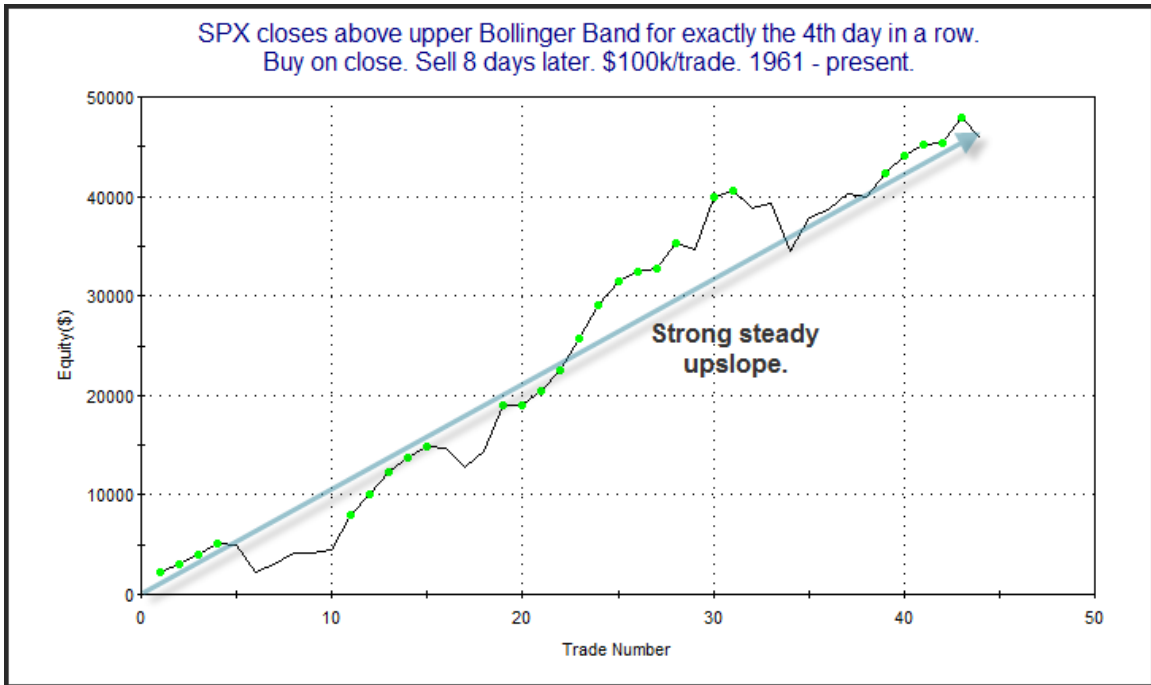
The VIX:VXV ratio is also low and [the study from Thursday night](#) triggered again. I'm not including that one on the active list today since is similar to the one above and I find today's to be more compelling.

The strong upside momentum we are seeing can be viewed a number of different ways. After closing at a pullback low on 4/18, the SPX has now risen 7 of the last 8 days – and the 1 down day only lost less than 0.2%. Additionally, the SPX has now closed above its upper Bollinger Band (using the standard 20-period, 2 standard deviation bands) for 4 days in a row. It’s somewhat unusual to see the market close this far above its mean for 4 days in a row. Such shows of strength have most often begat more short-term strength. This can be seen in the study below.

SPX closes above upper Bollinger Band for exactly the 4th day in a row. Buy on close. Sell X days later. \$100k/trade. 1961 - 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	39,626.79	44	32	11	72.73	1,829.42	-1,719.53	1.06	3.10	900.61
9	45,207.19	44	34	9	77.27	1,780.88	-1,704.76	1.04	3.95	1,027.44
8	45,782.97	44	35	9	79.55	1,727.21	-1,629.91	1.06	4.12	1,040.52
7	36,181.78	44	34	10	77.27	1,508.97	-1,512.31	1.00	3.39	822.31
6	30,183.86	44	32	12	72.73	1,360.25	-1,112.00	1.22	3.26	686.00
5	26,363.89	44	34	10	77.27	1,181.73	-1,381.49	0.86	2.91	599.18
4	26,317.76	44	31	13	70.45	1,116.99	-639.15	1.75	4.17	598.13
3	20,173.21	44	32	12	72.73	844.58	-571.12	1.48	3.94	458.48
2	19,582.88	44	28	16	63.64	913.55	-374.79	2.44	4.27	445.07
1	4,423.61	44	25	18	56.82	460.03	-393.18	1.17	1.63	100.54

41 of 44 instances (93%) posted a close above the entry price at some point in the next week.

The stats seem to strongly support the bull case. Even those instances that didn’t continue higher immediately mostly saw a shallow pullback before hitting new highs at some point in the week. I find the results to be quite compelling from both a consistency and an “avg trade” standpoint. It is especially impressive considering the moves are measured from a point where the market is already substantially overbought. Below is an equity curve that assumes an 8-day exit strategy.



Equity curves don't often get much straighter than this.

There are two bullish studies and one bearish study being added to the Active Studies list tonight.

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



Very little change can be seen tonight with the Aggregator readings. The green Aggregator line remains well 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 is already overbought. This is considered a neutral configuration. A neutral configuration is visible on the chart whenever the green Aggregator and black Differential lines finish on opposite sides of zero. Due to this the Aggregator System remained flat.

The green Aggregator line is again set to close above 0 on Monday. This could change if more bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,358.81. This is about 0.35% below Friday's close. In order for the Differential line to turn positive the SPX would need to close lower by at least this much.

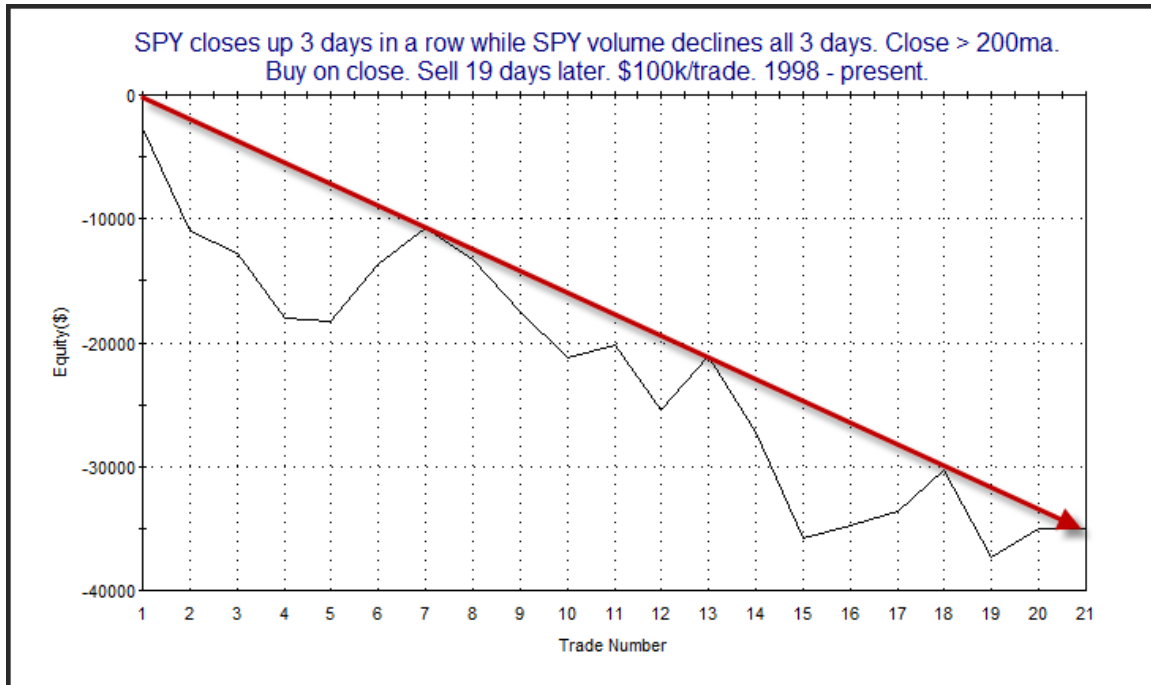
The studies have generated bullish expectations throughout this entire move up as represented by the green Aggregator line. Unfortunately the market has offered nothing in the way of low-risk entry opportunities. This has kept me from adding exposure via my conservative approach. I still think we are going higher, but I'd still rather wait for a better risk/reward setup before adding more long exposure.

Intermediate-term Outlook (2 weeks – 2 months)– updated 5/2 – bullish

The market pushed to new multi-year highs this week for the 1st time since February. And though most indications remain bullish, there was one study that appeared on Friday with possible intermediate-term bearish inclinations. That study looked at the rise in SPY on declining volume each of the last 3 days. It was last seen in the 12/6/10 Subscriber Letter. I have updated the results table below.

SPY closes up 3 days in a row while SPY volume declines all 3 days. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1998 - 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
20	-22,558.69	21	9	12	42.86	2,665.54	-3,879.04	0.69	0.52	-1,074.22
19	-35,044.91	21	9	12	42.86	2,305.93	-4,649.86	0.50	0.37	-1,668.81
18	-28,940.74	22	8	14	36.36	2,737.98	-3,631.76	0.75	0.43	-1,315.49
17	-27,243.43	22	9	13	40.91	2,285.86	-3,678.17	0.62	0.43	-1,238.34
16	-22,301.47	22	10	12	45.45	2,286.36	-3,763.76	0.61	0.51	-1,013.70
15	-27,780.26	22	10	12	45.45	2,121.78	-4,083.17	0.52	0.43	-1,262.74
14	-25,054.18	23	9	14	39.13	2,056.01	-3,111.31	0.66	0.42	-1,089.31
13	-20,210.83	24	12	12	50.00	1,508.80	-3,193.04	0.47	0.47	-842.12
12	-15,982.33	24	12	12	50.00	1,443.72	-2,775.59	0.52	0.52	-665.93
11	-13,402.40	24	12	12	50.00	1,585.78	-2,702.65	0.59	0.59	-558.43
10	-14,720.22	24	14	10	58.33	1,640.42	-3,768.61	0.44	0.61	-613.34
9	-14,787.19	24	13	11	54.17	1,567.45	-3,196.73	0.49	0.58	-616.13
8	-9,081.91	24	14	10	58.33	1,506.67	-3,017.53	0.50	0.70	-378.41
7	-3,062.45	25	16	9	64.00	1,503.71	-3,013.54	0.50	0.89	-122.50
6	-8,125.62	25	14	11	56.00	1,365.52	-2,476.62	0.55	0.70	-325.02
5	-17,916.26	26	14	12	53.85	1,030.28	-2,695.01	0.38	0.45	-689.09
4	-7,609.94	27	15	11	55.56	963.36	-2,005.48	0.48	0.66	-281.85
3	-5,068.15	27	15	12	55.56	820.69	-1,448.21	0.57	0.71	-187.71
2	-633.18	27	14	13	51.85	860.16	-975.03	0.88	0.95	-23.45
1	-2,353.08	29	14	15	48.28	550.12	-670.31	0.82	0.77	-81.14

There doesn't appear to be an overwhelming edge based on the data but it does hint at poor risk/reward for the intermediate-term. Below is an equity curve using a 19-day holding period.

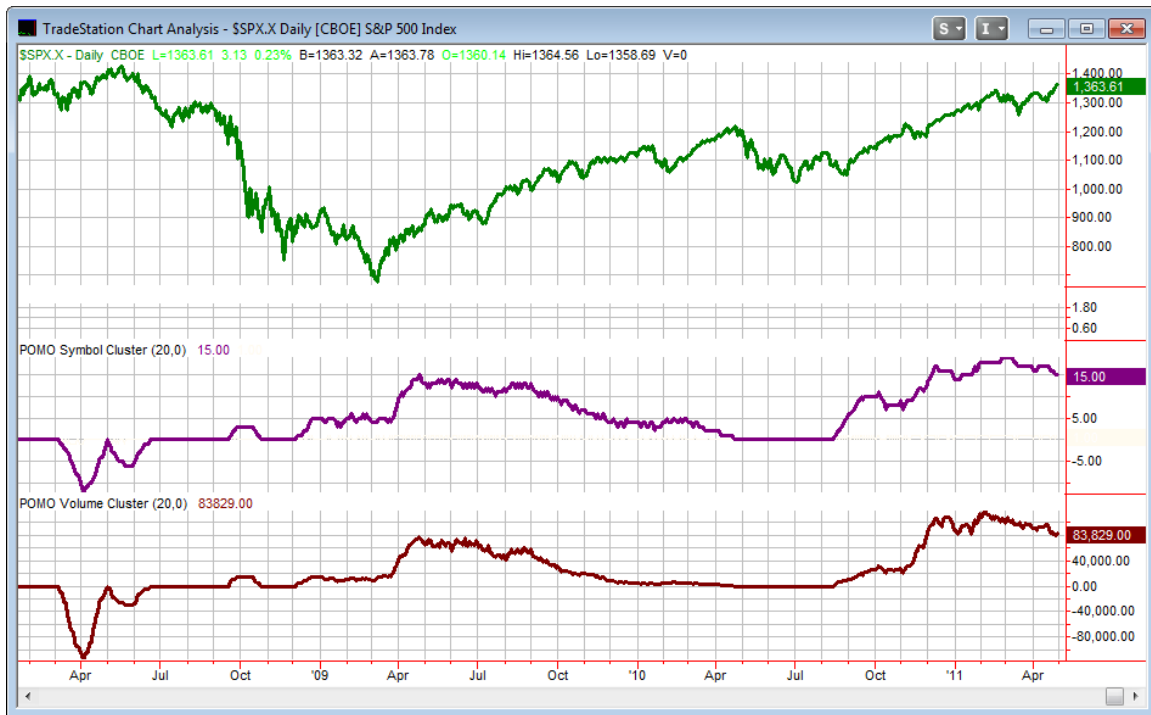


Though choppy, this would seem to support the bearish case. I believe it's worth listing and monitoring this study on the Intermediate-term Active List.

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>



The POMO indicators pulled back a little more this past week. The days indicator is at 15 and the POMO Volume indicator is down near the low end of its recent range. The schedule calls for POMO buying for the next 8 trading days, and then a new schedule to be released on the 8th day. I therefore expect we will see the POMO Days and POMO Volume indicators will get a boost over the next week and a half (and likely longer). I expect POMO to continue to act as a wind at the markets back. The new schedule to be released in a week and a half should be interesting. It will take us through the first 1/3 of June. June is when the QE2 POMO buying is scheduled to end, so we will see if there are any indications of that in the next schedule release.

For those that would like to view the upcoming schedule I have provided a link below.

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

Bullish studies continue to dominate and the market is now making new highs. This is not a situation in which I would become an aggressive short seller. Instead I will look for long opportunities that I can play aggressively, and nibble on the short-side should short-term evidence switch to favor the bears.

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
EPP	4/19/2011	\$48.85	\$50.56	3.50%		System 90609

Being that 90609 uses a trend-following exit technique, EPP is nowhere near an exit at the moment.

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