

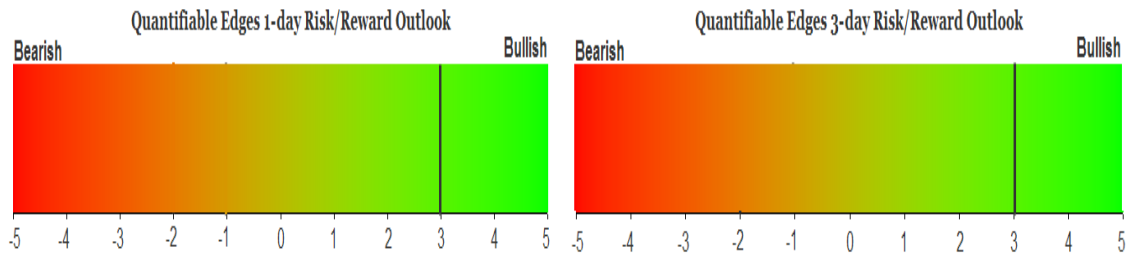
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 12, 2011

Volume 4 Issue 91

Market Overview



Tonight's Research Points

- Unfilled gaps down after unfilled gaps up are often followed by further selling.
- A 1% drop with 2:1 negative breadth suggests an upside edge.
- The Aggregator System is long.
- The NDX Aggressive Trend Timer is long.

Short-term Outlook

The Bottom Line

Strong selling has quickly moved the SPX back into oversold territory. Evidence is still favoring the bulls. Therefore I'm looking to begin building a long position.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
May 12, 2011	SPY unfilled gap up. Unfilled gap down.	1-3 days	Bearish	-1.95%
May 12, 2011	SPX dn 1%. Decliners 2x advancers	1-9 days	Bullish	3.05%
May 11, 2011	SPY unfilled gap up. Up yest. Close < 10hi	1-3 days	Bullish	1.40%
May 11, 2011	SPX dn 4 then Up 3. Close < 7 days ago.	1-10 days	Bullish	3.10%
May 6, 2011	Down 4 days. Today's is the worst.	1-5 days	Bullish	2.10%
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	
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				
May 9, 2011	VIX up. SPX up on Fri.	1-3 days	Bearish	-1.30%
May 2, 2011	SPX > Upper BB 4 days	1-8 days	Bullish	1.90%
May 10, 2011	SPY up 2x but below 3 days ago	1-2 days	Bullish	1.00%

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

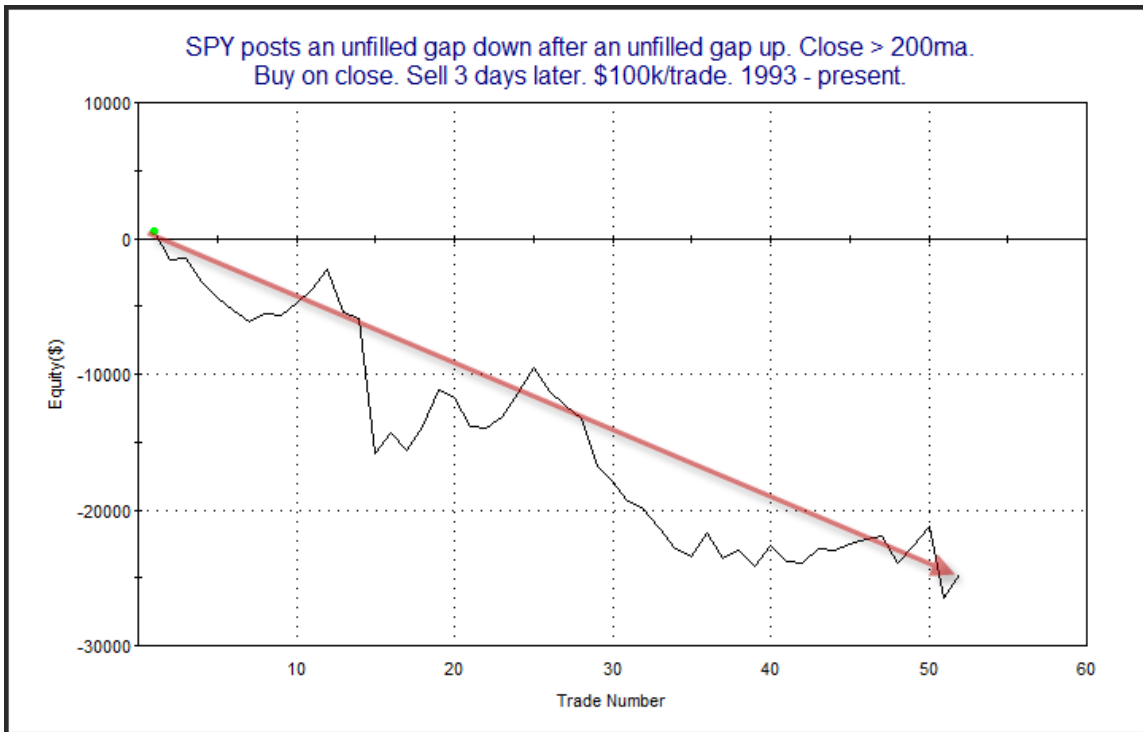
The Evidence

The market gapped down to open the day and bears held control the entire time. A rally in the dollar seemed to negatively impact both commodities and stocks. In the end the major indices all took sizable hits. The SPX lost 1.1%, the Nasdaq closed down 0.9% and the Russell 2000 dropped 1.8%. Breadth was weak as the NYSE Up Issues % came in at 25% and the Up Volume % was just 14%. Total NYSE volume rose to the highest level so far this week.

After leaving an unfilled gap up on Tuesday the SPY left an unfilled gap down Wednesday. Below is a study last seen in the 11/29/10 Letter that looks at similar scenarios during long-term uptrends.

SPY posts an unfilled gap down after an unfilled gap up. 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
5	-13,325.70	50	22	28	44.00	1,527.05	-1,675.74	0.91	0.72	-266.51
4	-8,047.27	51	23	28	45.10	1,355.38	-1,400.75	0.97	0.79	-157.79
3	-24,685.25	52	22	30	42.31	1,161.67	-1,674.74	0.69	0.51	-474.72
2	-20,000.25	53	22	30	41.51	863.05	-1,299.58	0.66	0.49	-377.36
1	-417.59	53	26	26	49.06	661.24	-677.30	0.98	0.98	-7.88

These results would suggest a short-term bearish edge. Using the 3-day exit strategy I ran an equity curve to see how consistent the edge has been.

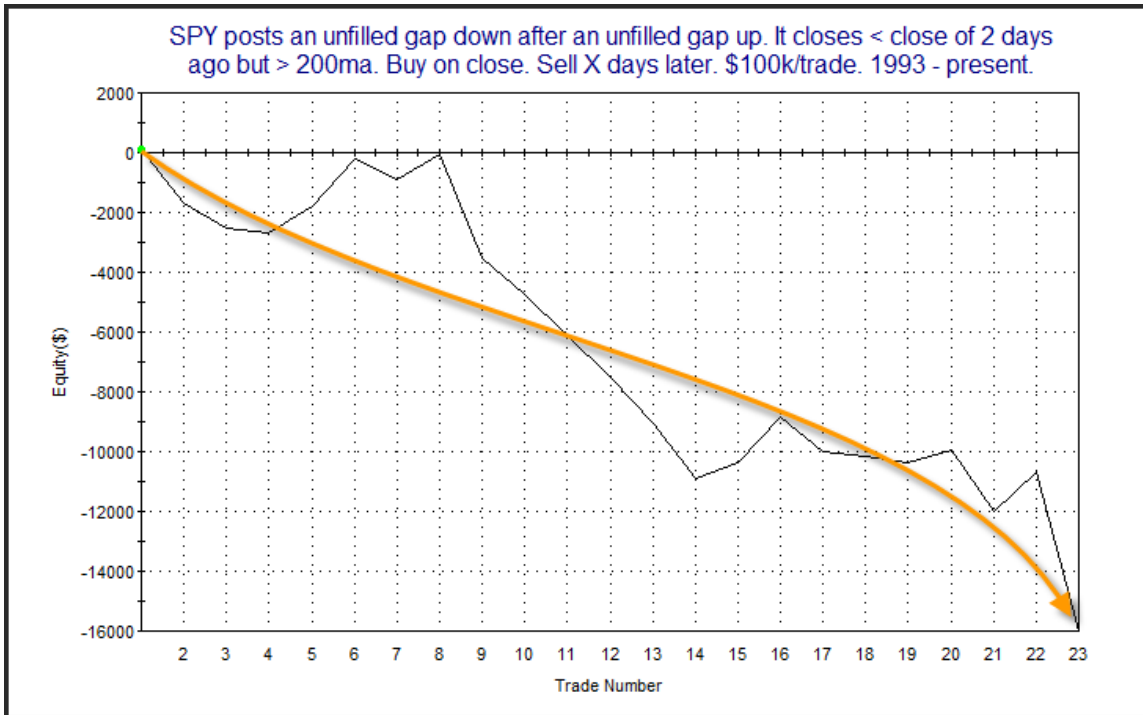


Certainly returns have been choppy, but it's near new lows and the trend down has been in place a very long time. I also wondered whether the fact that the gap down day was more powerful than the gap up day would make any difference. So I filtered the test 1 more time to only include those instances where the SPY closed below the close of 2 days ago (meaning the down day lost more than the up day gained). Those results are below.

SPY posts an unfilled gap down after an unfilled gap up. It closes < close of 2 days ago 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	-4,808.45	22	9	13	40.91	1,389.50	-1,331.84	1.04	0.72	-218.57
4	-2,546.43	22	10	12	45.45	1,251.96	-1,255.51	1.00	0.83	-115.75
3	-15,994.34	23	8	15	34.78	898.89	-1,545.70	0.58	0.31	-695.41
2	-15,493.76	23	7	15	30.43	728.39	-1,372.83	0.53	0.25	-673.64
1	-1,034.42	23	10	12	43.48	555.20	-548.87	1.01	0.84	-44.97

Results here didn't change dramatically. They appear just slightly more bearish than the first set of results. Below is the equity curve using a 3-day exit strategy.



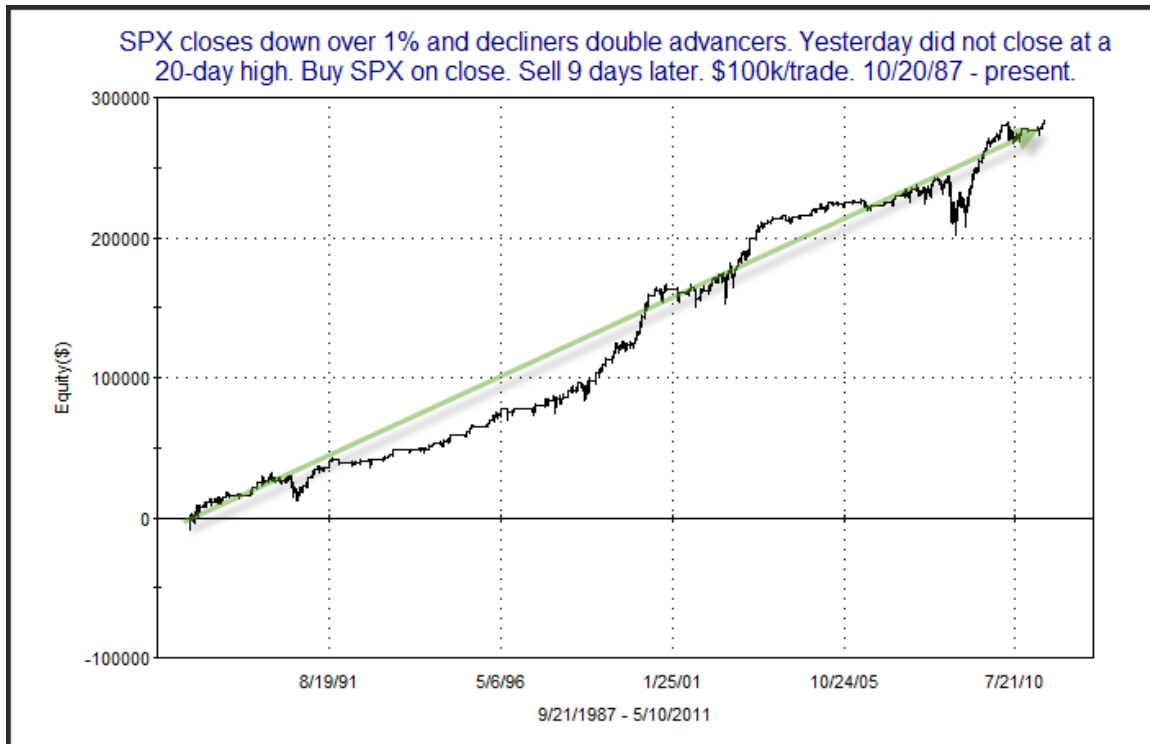
Again the curve appears to confirm the downside edge suggested by the stats table.

There were also some bullish indications from Wednesday. The size and breadth of the selloff was extreme enough that it has been suggestive of a bounce in the past. The study below is one I have shown many times. It was last seen in the 4/19/11 Subscriber Letter. I have updated the results to the present.

SPX closes down over 1% and decliners double advancers. Yesterday did not close at a 20-day high. Buy SPX on close. Sell X days later. \$100k/trade. 10/20/87 - 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	241,510.91	241	157	84	65.15	2,987.50	-2,708.65	1.10	2.06	1,002.12
9	282,502.64	251	175	76	69.72	2,818.00	-2,771.69	1.02	2.34	1,125.51
8	253,324.82	264	175	88	66.29	2,798.69	-2,686.89	1.04	2.07	959.56
7	237,430.22	283	177	106	62.54	2,649.31	-2,183.94	1.21	2.03	838.98
6	215,664.65	298	186	112	62.42	2,532.83	-2,280.74	1.11	1.84	723.71
5	203,899.98	324	197	127	60.80	2,329.10	-2,007.34	1.16	1.80	629.32
4	161,804.64	346	203	143	58.67	2,128.51	-1,890.10	1.13	1.60	467.64
3	167,400.83	380	236	144	62.11	1,817.69	-1,816.48	1.00	1.64	440.53
2	158,362.04	433	247	186	57.04	1,709.49	-1,418.72	1.20	1.60	365.73
1	114,380.41	486	288	198	59.26	1,138.23	-1,077.93	1.06	1.54	235.35

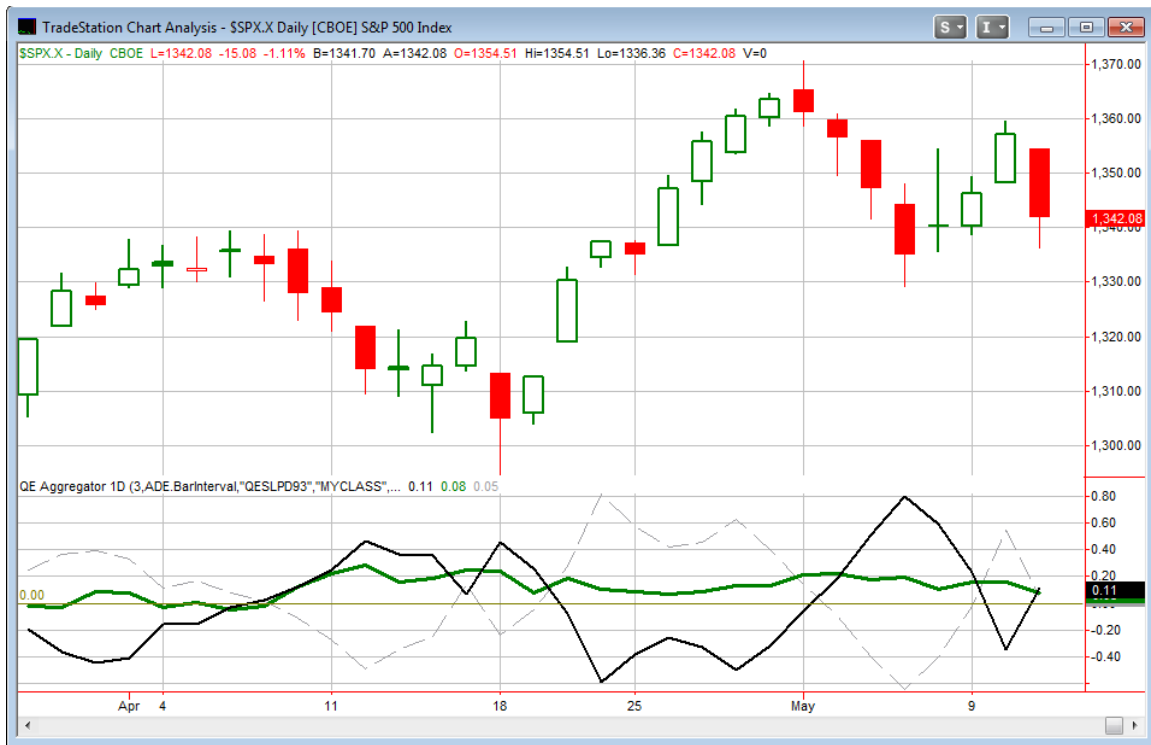
Prior to the Crash of '87, very weak breadth days were often followed by more weakness. This changed after the crash. This is the reason that I only run this test back until just after the crash. As you can see there have been a large number of instances over the last 23 years. The edge appears to be very solid as well. Below is the equity curve using a 9 - day exit.



It's tough to see on the chart but after a shallow drawdown recently the equity curve is again hitting new highs.

Of further note tonight the Fed released its [new schedule for POMO operations](#). Bulls should be pleased as there appears to be no slowdown scheduled between now and June 9th. In fact there are 18 trading days scheduled for POMO buying during that time. Since buying is supposed to end in June, this makes the June schedule release especially interesting. The market may see some turmoil as we approach that date and the end of the stimulus is anticipated.

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



With the new bearish study included expectations are a little more subdued than they've been recently. This is why the green Aggregator line has dipped a little, though it still remains clearly above 0. The positive value means the net expectation from the Active Studies List is for upside over the next few days. Meanwhile, Wednesday's big selloff caused the black Differential Line to pop back above 0. Readings above 0 mean the SPX has underperformed expectations over the last few days. So net expectations are for upside and the SPX is relatively oversold versus recent expectations. Historically this combination has provided an upside edge. It can be seen on the chart whenever both lines close above 0. Due to this the Aggregator System changed from flat to long at the close.

The green Aggregator line is again set to close above 0 on Thursday. This could change if strong bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,352.30. This is about 0.8% above Wednesday's close. So for the black Differential Line to move back above 0 the SPX would need to rally at least this much.

The bullish evidence is a bit weaker than it was. Additionally the gap study is now suggesting a short-term bearish edge. Aside from that I'm not crazy about the fact that the 3-day rally failed just below a new high. There certainly remains the possibility that we are about to begin a new leg down, or that the market may at least test last week's lows. Still, when I weigh all the evidence there certainly appears to be an upside edge at

the moment. As a trader it is my job to take a position when I have a quantifiable edge. But with only one down day and the green Aggregator and black Differential lines only modestly above zero, I intend to begin scaling in slowly. Should more bullish evidence build or should the market become more oversold I will look to step up my exposure in the coming days. You'll see an index trade idea in the Trade Ideas section below.

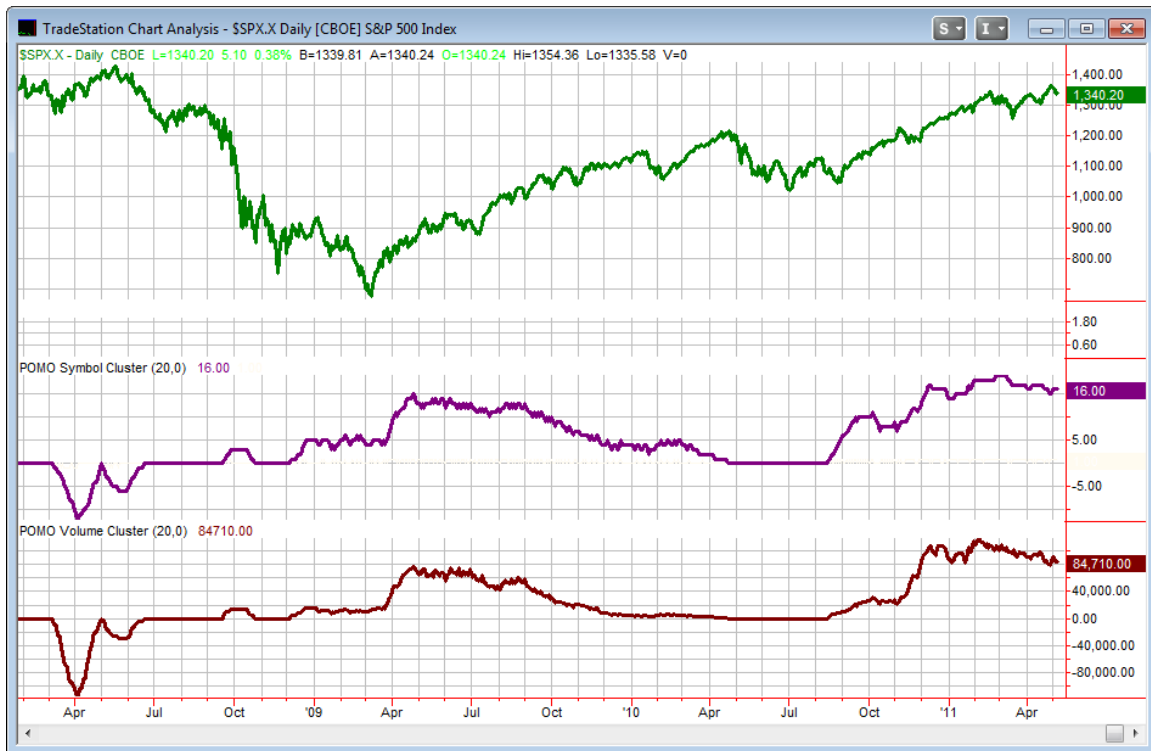
Intermediate-term Outlook (2 weeks – 2 months)– updated 5/9 – bullish

This wasn't a great week for the market. Monday morning marked the high and despite being up on Friday it was still at the low end of the week's range. Overall I am still seeing more positives than negatives and expect the move up isn't over. Still, this upcoming week could provide us with some very valuable insights – especially with regards to liquidity and POMO expectations.

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>



Despite 5 days of buying, the POMO indicators didn't make much headway this past week. The days indicator ticked up from 15 to 16 and the POMO Volume indicator is still near the low end of its recent range. The schedule calls for POMO buying for the next 3 trading days, and then a new schedule to be released on Wednesday.

June is when the QE2 buying is scheduled to end. It hasn't been announced whether that means June 1 or June 30 or somewhere in between. The schedule release on Wednesday could provide some indication of the Fed's intentions. I wouldn't be surprised to see the market get nervous as signs of the end approach. For now POMO activity seems to still be providing a positive influence. But that is not going to last too much longer.

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

Despite the pullback this past week, intermediate-term indications still appear to favor the bulls. At this point there is very little suggesting a top. So I remain intermediate-term bullish. This means I will play long trades more aggressively and short trade 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.

SPY – buy ¼ index position @ \$134.44 limit. Based on short-term outlook above I will begin scaling in to an index position.

Current Open Trade Ideas

None.

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