

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 17, 2011

Volume 4 Issue 94

Market Overview



Tonight's Research Points

- 2-day pullback under current circumstances have often led to more selling the next day.
- The low ADX is hurting the chance of a quick bounce.
- The Aggregator System is long.
- The NDX Aggressive Trend Timer is long.

Short-term Outlook

The Bottom Line

The long Aggregator signal still in place, but Monday's selloff did not increase the odds. I'm still looking to benefit from a bounce, but I'm not overly-enthused about the studies I've seen over the last few days. Therefore, I continue to take a conservative approach.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
May 17, 2011	2 down. 5-low. Today is Monday.	1 day	Bearish	
May 13, 2011	SPY gap down and reverse up.	1-4 days	Bullish	1.90%
May 12, 2011	SPX dn 1%. Decliners 2x advancers	1-9 days	Bullish	3.05%
May 11, 2011	SPX dn 4 then Up 3. Close < 7 days ago.	1-10 days	Bullish	3.10%
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 12, 2011	SPY unfilled gap up. Unfilled gap down.	1-3 days	Bearish	-1.95%

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

The Evidence

Bears controlled the day on Monday as all the major indices sold off. The SPX fell 0.6%, the Nasdaq lost 1.6% and the Russell 2000 dropped 1.5%. Breadth was weak as the NYSE Up Issue % came in at 33% and the Up Volume % was 34%. Total NYSE volume rose a little from Friday's level.

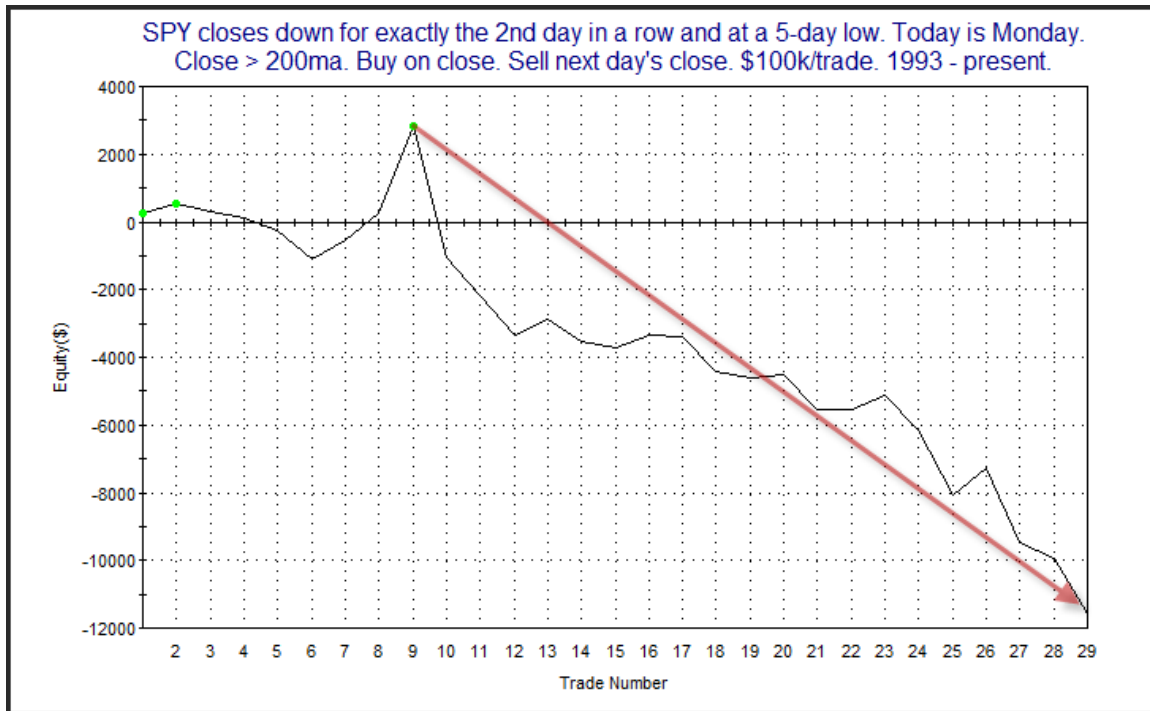
Tuesdays are renowned for short-term trend reversals. I discussed this in the [1/13/09 Blog](#) and I've shown it a number of times since using different filters. I've shown for instance that a 3-day pullback going in to a Tuesday during a long-term uptrend shows a strong chance of a move up over the next few days.

So Monday afternoon I took a look at 2-day drops above the 200ma on a Monday. Results were choppy and unremarkable. I then added one more filter in that the SPY had to close at a 5-day low. I was surprised by the results.

SPY closes down for exactly the 2nd day in a row and at a 5-day low. Today is Monday.
Close > 200ma. Buy on close. Sell next day's close. \$100k/trade. 1993 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	(\$11,598.63)	Profit Factor	0.36
Gross Profit	\$6,570.43	Gross Loss	(\$18,169.06)
Total Number of Trades	29	Percent Profitable	34.48%
Winning Trades	10	Losing Trades	19
Even Trades	0		
Avg. Trade Net Profit	(\$399.95)	Ratio Avg. Win:Avg. Loss	0.69
Avg. Winning Trade	\$657.04	Avg. Losing Trade	(\$956.27)
Largest Winning Trade	\$2,539.68	Largest Losing Trade	(\$3,870.38)

It appears that under these conditions, Tuesdays do NOT provide an upside edge. In fact, there appear to be bearish implications with the setup. Below is an equity curve to see how it has played out over time.



The last 20 instances, since 1998, have been especially negative, with 15 losing Tuesdays versus just 5 winners.

In the past I've discussed how breaks from consolidations are often much less reliable when looking for a reversal than if you hit a new high or low during a trending market. This is because the breakout will often create new excitement in the direction it occurs. Some of that is stops being blown and some of that is from breakout players looking to take advantage of a newly emerging trend.

One way to measure the strength of a trend is with the ADX indicator. It was pointed out to me today by a subscriber that the SPX 14-day ADX was dropping under 12 – which is an extremely low level. (The 14-period reading is the default reading for ADX with most charting packages.)

So using ADX as a measurement of trend strength I created a study that demonstrated low-ADX vs. high-ADX breakdowns, and how the implications were much different. First let's look at situations like the present where the SPX breaks down and ADX is under 20.

SPX closes at a 10-day low for the 1st time in at least 5 days. ADX(14) < 20. Close > 200ma.
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	17,352.23	47	30	17	63.83	1,889.44	-2,313.58	0.82	1.44	369.20
9	22,181.38	49	29	20	59.18	1,878.24	-1,614.38	1.16	1.69	452.68
8	11,972.88	49	28	21	57.14	1,894.06	-1,955.28	0.97	1.29	244.34
7	14,640.31	50	30	20	60.00	1,744.22	-1,884.31	0.93	1.39	292.81
6	17,300.50	52	30	22	57.69	1,815.69	-1,689.55	1.07	1.47	332.70
5	7,401.88	54	29	25	53.70	1,379.10	-1,303.68	1.06	1.23	137.07
4	-8,360.54	54	27	27	50.00	1,274.78	-1,584.43	0.80	0.80	-154.82
3	7,221.59	54	29	25	53.70	1,188.58	-1,089.89	1.09	1.27	133.73
2	6,512.88	54	32	22	59.26	937.93	-1,068.22	0.88	1.28	120.61
1	5,386.10	54	32	22	59.26	693.87	-764.44	0.91	1.32	99.74

As you can see, there is no substantial edge suggested when you are looking at a sharp move out of a consolidation with a low ADX.

Next I ran a 2nd test. This one used all the same parameters except I required the ADX to close above 20 instead of below it. This suggests the market has been moving instead of meandering. Those results are below.

SPX closes at a 10-day low for the 1st time in at least 5 days. ADX(14) > 20. Close > 200ma.
Buy on close. Sell X days later. \$100k/trade. 1995 - present.

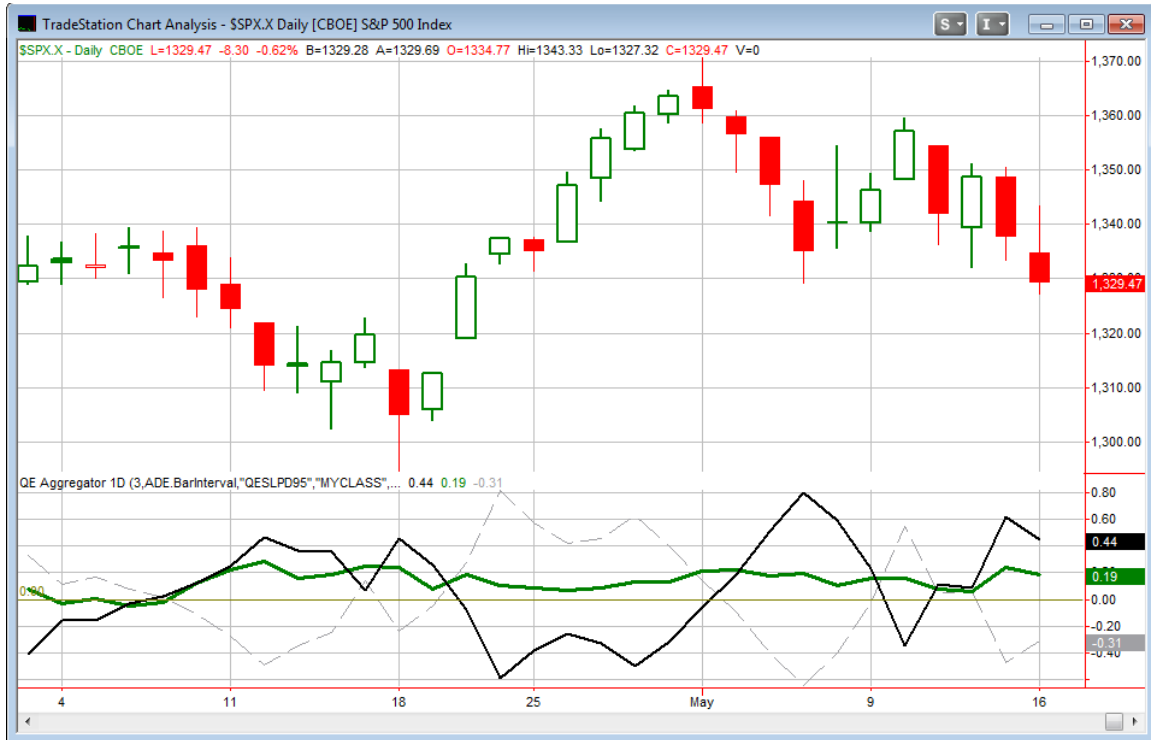
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	87,957.32	59	42	17	71.19	2,803.96	-1,753.47	1.60	3.95	1,490.80
9	81,708.20	59	45	14	76.27	2,384.89	-1,829.42	1.30	4.19	1,384.88
8	74,185.59	60	44	16	73.33	2,296.39	-1,678.47	1.37	3.76	1,236.43
7	60,440.63	62	43	19	69.35	2,203.68	-1,806.18	1.22	2.76	974.85
6	57,037.49	64	41	23	64.06	2,074.16	-1,217.52	1.70	3.04	891.21
5	48,749.03	66	42	24	63.64	1,932.66	-1,350.94	1.43	2.50	738.62
4	57,612.09	66	47	19	71.21	1,801.42	-1,423.93	1.27	3.13	872.91
3	43,790.83	66	47	19	71.21	1,494.72	-1,392.69	1.07	2.65	663.50
2	26,940.95	66	46	20	69.70	1,155.06	-1,309.60	0.88	2.03	408.20
1	10,161.16	66	45	21	68.18	686.06	-986.26	0.70	1.49	153.96

59 of 66 instances (89%) closed above the entry price at some point in the next week. All but 1 (98.5%) did within 2 weeks.

What we see here are vastly more compelling results.

Unfortunately, with the ADX now just under 12, there does not appear to be a substantial upside edge offered by the break lower.

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



With tonight's short-term bearish study the green Aggregator Line dipped a little bit. Still it remains squarely 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 also dipped slightly but remained squarely positive. Readings above 0 mean the SPX has underperformed expectations over the last few days. So net expectations are for upside and the SPX is strongly 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 remained long at the close.

The green Aggregator line is again set to close above 0 on Tuesday. This could change if strong bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,352.35. This is about a 1.7% rise from Monday's close. So for the black Differential Line to

move back below 0 the SPX would need to rally at least this much. At this point it appears the Aggregator is anticipating a multi-day rally.

Astute readers may have noticed that despite the strong Aggregator readings the 1-day Risk/Reward at the top of the letter is 0. In large part due to tonight's study, the 1-day expectations are actually negative.

At this point I expected to be taking a more aggressive approach. But while we've seen the market drop fairly hard the last two days, we have not seen new compelling bullish studies emerge. I am still only ¼ in the index position. The \$133.00 limit on close order for Monday just missed. There is a chance I am playing it too conservatively, but I will only look to increase the position tomorrow if I can get a favorable entry opportunity. That means either a sizable gap down at the open or another down close. Details in the trade ideas section below.

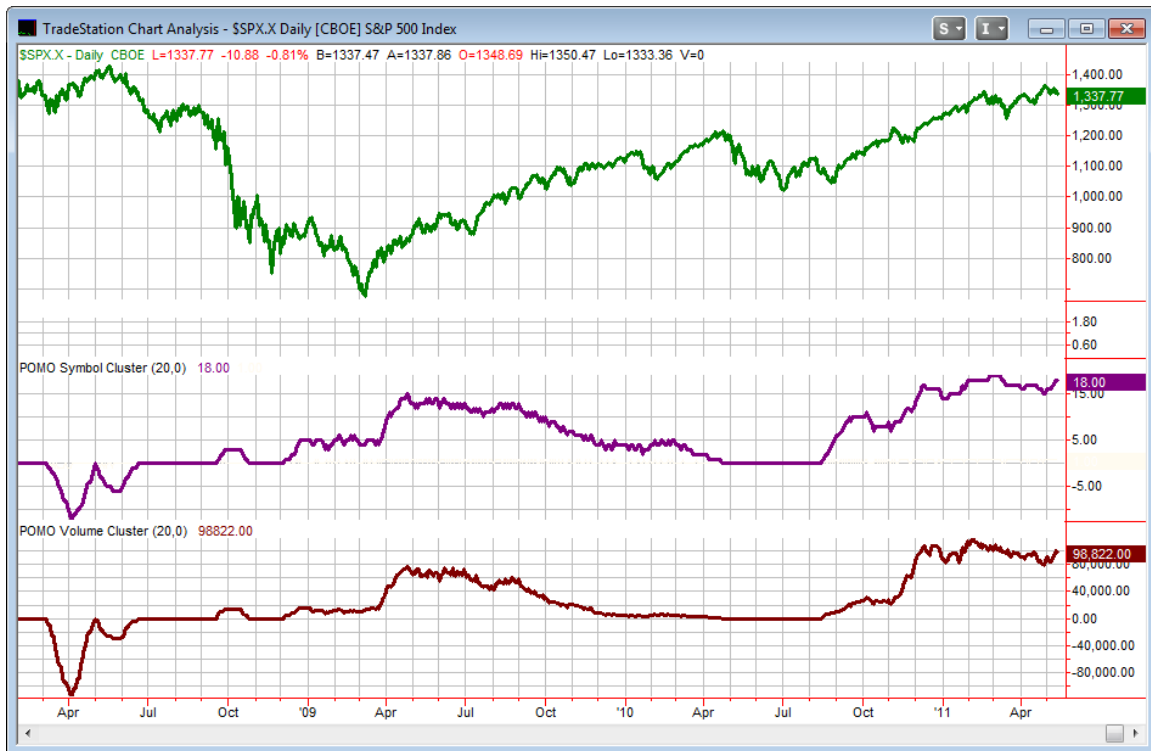
Intermediate-term Outlook (2 weeks – 2 months)– updated 5/16 – moderately bullish

After spending most of the week in positive territory, Friday's action left the market down slightly for the week. Nothing new appeared in the way of intermediate-term studies. The big news was the release of the new POMO schedule which happened on Wednesday afternoon.

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>



Both the POMO Days and POMO Volume indicators rose a bit this past week. This is no surprise since there was sizable buying that occurred every day. The schedule that was released on Wednesday calls for POMO this whole next week. In fact the next day without POMO buying scheduled is May 27th – the day before Memorial Day weekend.

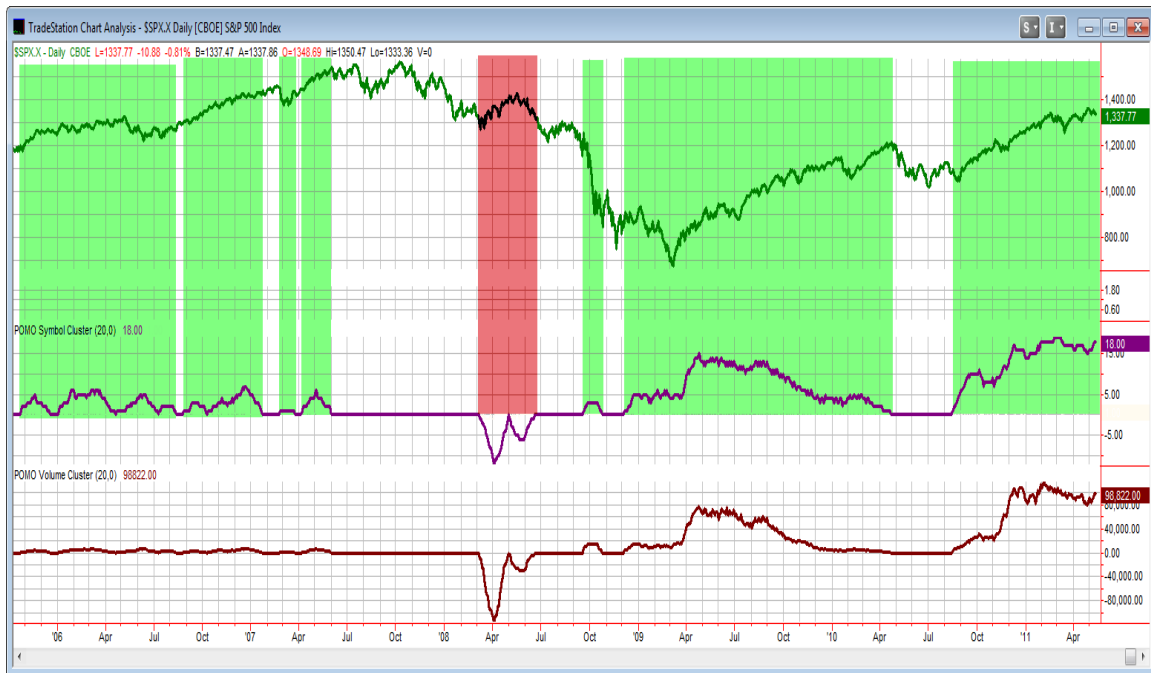
But the new POMO schedule isn't only strong through May. It shows substantial buying also into June. Between May 12th and June 9th there are 18 days of POMO buying scheduled. And though the buying is expected to end in June, it is now clear that it isn't going to happen early in the month. We'll have to wait until the next schedule is released on June 10th to see when the end of QE2 will be.

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

The persistent part of this bull move seems to be over. Since February it has been a choppy struggle to post any new highs. Intermediate-term indications still appear to favor the bulls and new highs still seem more likely than an immediate correction. Still, I'm beginning to feel a bit more cautious. Positive seasonality typically goes out during May and with the end of QE2 looming, reduced liquidity could have a negative impact. The POMO chart below is a long-term version of the one I showed above. The green shaded

areas are times where there was some pumping over the last 20-day period. The pinkish-red shading marks the period where the Fed was selling treasuries instead of buying them. The white areas marked the times where there was no POMO activity over the previous 20 days. POMO buying didn't always seem to take effect immediately, but periods without that buying were generally dismal. The 2 lengthy periods where the POMO indicators were at 0 or below lasted from 6/1/07 through 9/19/08 (SPX lost 18.3%) and from 4/22/10 through 8/17/10 (SPX lost 9.6%).



So it is a bit early to turn bearish, and I still think this rally has some legs, but I'm no longer as gun-ho as I've been. I'll likely begin taking a bit more caution with long trades. Perhaps scaling in slower or managing positions a little tighter. I still favor the long-side over the short-side, but not as clearly.

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 1/4 index position @ \$132.69 LIMIT ON OPEN. Gaps down after the market is already extended down have a tendency to reverse up. The open is often an overreaction and it will frequently scare out weak hands early and then a mean-reversion occurs. In this case I am looking for a gap of at least \$0.50. To confirm my approach here, I also consulted the Master the Gap website, run by Scott Andrews. Both his Gap Guides and his nightly gap video confirm the possible upside edge (intraday) on a gap down. A link to his video is below:

http://www.masterthegap.com/public/Todays_Gap_Wrap_Nominal_gaps_in_mixed_directions_and_zones_on_Friday_2.cfm

SPY – If not filled on open, buy 1/4 index position @ \$133.18 LIMIT ON CLOSE. A close lower would make it 3 in a row. I suspect it will also bring about some more bullish studies. Should this happen I will look to step up the exposure. Note, I will only be looking to enter on the close if I am not filled at the open.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	5/12/2011	\$134.09	\$133.19	-0.67%		Aggregator

I will exit the SPY position on close if SPX closes \geq 1,352.35.

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