

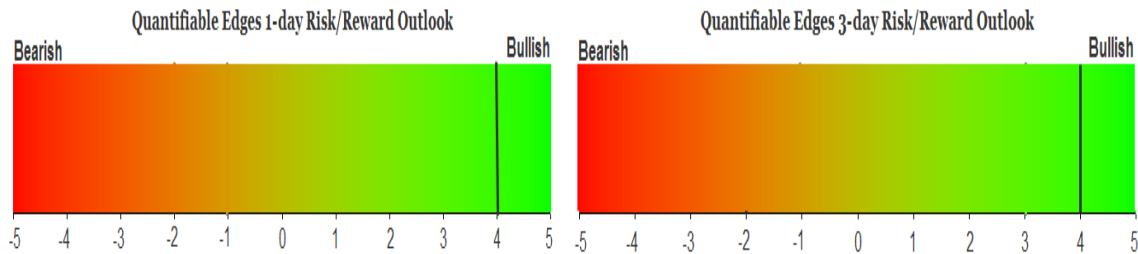
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 18, 2011

Volume 4 Issue 95

Market Overview



Tonight's Research Points

- Characteristics of this 3-day pullback are not suggestive of an edge.
- The SPY gap down and partial reversal from a short-term closing low has historically suggested an upside edge.
- The Aggregator System is long.
- The NDX Aggressive Trend Timer is long.

Short-term Outlook

The Bottom Line

My position size increased on Tuesday. Evidence is still suggesting a bounce. I'm holding my current long in an effort to benefit from that bounce.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
May 18, 2011	SPY gap down and partial reverse up.	1-5 days	Bullish	1.90%
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				
<i>May 17, 2011</i>	<i>2 down. 5-low. Today is Monday.</i>	<i>1 day</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

Tuesday saw lots of wiggling and very little progress in either direction. The indices finished mixed. The SPX fell less than half a point (0.04%), the Nasdaq rose as meekly (0.03%) and the Russell 2000 sold off 0.3%. Breadth was moderately negative as the NYSE Up Issues % came in at 41% and the Up Volume % was 46%. Total NYSE volume rose to the highest level in over a week.

Today was the third day in a row that SPX closed lower. A good number of studies appeared in the Quantifinder tonight related to the 3-day pullbacks. I've looked at these many times and can say with confidence that all 3-day pullbacks are NOT created equal. Some characteristics that would make a 3-day pullback appealing include an extremely low 3/10 Offset HV, and whether the pullback originated from an intermediate-term high. This pullback failed on both counts, making it somewhat suspect to begin with. The 3/10 Offset HV was fairly low, just not extreme enough to qualify as beneficial. So I decided to simply ignore it. Therefore I took a look at 3-day pullbacks that did not immediately follow a 20-day high, and closed above the 200ma.

SPX closes lower for exactly the 3rd day in a row. The pullback did NOT immediately follow a 20-day high. Close > 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	63,733.23	110	64	46	58.18	1,718.01	-1,004.77	1.71	2.38	579.39
4	44,466.84	114	72	42	63.16	1,325.42	-1,213.41	1.09	1.87	390.06
3	47,381.53	114	68	46	59.65	1,379.34	-1,008.99	1.37	2.02	415.63
2	37,861.87	114	71	43	62.28	1,104.70	-943.54	1.17	1.93	332.12
1	19,594.42	114	77	37	67.54	689.88	-906.11	0.76	1.58	171.88

As you can see there appears to be a bit of an upside edge. In the past I've found that the size of the current day's selloff in relation to the other days of the selloff can make a difference. Today's selloff was the smallest of the decline, so I added that as a filter to the above study. The updated results are below.

SPX closes lower for exactly the 3rd day in a row. Today is the **smallest** drop of the decline. The pullback did NOT immediately follow a 20-day high. Close > 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	76.74	25	12	13	48.00	1,064.27	-976.50	1.09	1.01	3.07
4	-758.66	26	16	10	61.54	717.02	-1,223.09	0.59	0.94	-29.18
3	325.90	26	14	12	53.85	727.02	-821.03	0.89	1.03	12.53
2	932.94	26	16	10	61.54	643.06	-935.60	0.69	1.10	35.88
1	185.40	26	15	11	57.69	518.08	-689.62	0.75	1.02	7.13

Amazingly, this seems to have completely wiped away any upside edge. I also decided to see how the results would have looked if today had been the largest drop of the decline instead of the smallest. Those results are below.

SPX closes lower for exactly the 3rd day in a row. Today is the **largest** drop of the decline. The pullback did NOT immediately follow a 20-day high. Close > 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	50,953.66	52	34	18	65.38	2,018.72	-982.38	2.05	3.88	979.88
4	42,071.42	53	37	16	69.81	1,636.29	-1,154.46	1.42	3.28	793.80
3	45,063.47	53	37	16	69.81	1,632.29	-958.19	1.70	3.94	850.25
2	32,070.49	53	36	17	67.92	1,343.01	-957.53	1.40	2.97	605.10
1	15,700.83	53	36	17	67.92	745.37	-654.85	1.14	2.41	296.24

If this were the current setup, it appears the upside edge would be considerable. Unfortunately, the current 3-day pullback doesn't appear to suggest any substantial edge.

Not all was bleak though. The pattern constructed by the SPY over the last 2 days is one that has previously suggested a strong bullish tendency. The below studies were last seen in the 2/25/11 Subscriber Letter. All results have been updated.

Yesterday SPY closed at a 10-day low. Today it gapped down and closed above the open but below yesterday's close. 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	11,514.30	8	7	1	87.50	1,767.60	-858.90	2.06	14.41	1,439.29
4	6,979.10	8	7	1	87.50	1,118.08	-847.44	1.32	9.24	872.39
3	6,331.23	8	7	1	87.50	985.17	-564.96	1.74	12.21	791.40
2	1,444.30	8	6	2	75.00	1,110.74	-2,610.08	0.43	1.28	180.54
1	994.65	9	7	2	77.78	617.73	-1,664.73	0.37	1.30	110.52

All 9 instances posted a close above the entry price at some point in the next week.

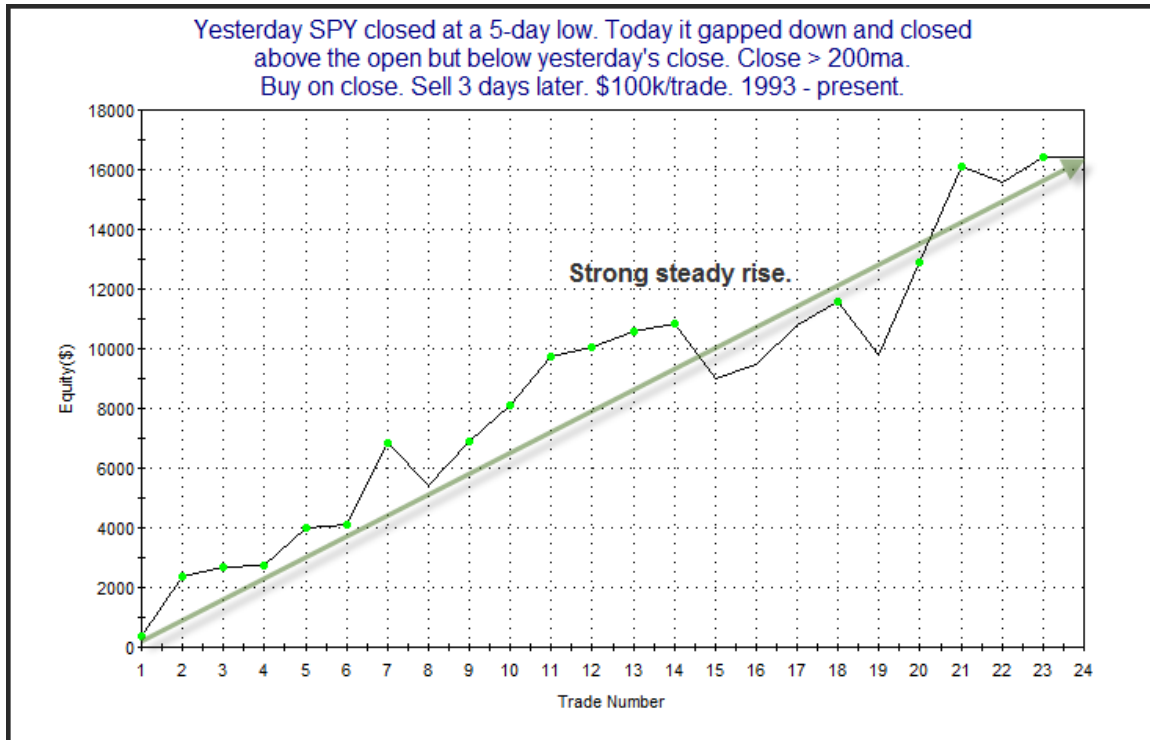
Instances are low, but the results appear very strong nonetheless. One famous loser occurred about a year ago. This setup triggered the day before the May 2010 Flash Crash. That instance registered a loss on all times frames above except for the 5-day period. In February I also showed results with criteria loosened to look at 5-day lows instead of 10-day lows. Since instances were a bit low above I decided to show the results with the loosened criteria once again.

Yesterday SPY closed at a 5-day low. Today it gapped down and closed above the open but below yesterday's close. 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
10	43,716.38	23	18	5	78.26	3,140.02	-2,560.79	1.23	4.41	1,900.71
9	40,528.57	24	20	4	83.33	2,697.21	-3,353.91	0.80	4.02	1,688.69
8	41,227.08	24	18	6	75.00	2,832.58	-1,626.57	1.74	5.22	1,717.80
7	29,563.04	24	18	6	75.00	2,290.73	-1,945.03	1.18	3.53	1,231.79
6	24,382.17	24	15	9	62.50	2,203.51	-963.38	2.29	3.81	1,015.92
5	20,801.92	24	18	6	75.00	1,640.52	-1,454.57	1.13	3.38	866.75
4	16,768.80	24	17	7	70.83	1,541.62	-1,348.39	1.14	2.78	698.70
3	16,415.95	24	20	4	83.33	1,102.38	-1,407.91	0.78	3.91	684.00
2	12,225.97	24	18	6	75.00	1,202.59	-1,570.12	0.77	2.30	509.42
1	5,166.00	26	18	8	69.23	853.80	-1,275.30	0.67	1.51	198.69

23 of 26 instances (88%) posted a close above the entry price at some point in the next week.

These results would seem to confirm the edge suggested by the previous test. Below is an equity curve of this study using a 3-day exit strategy.

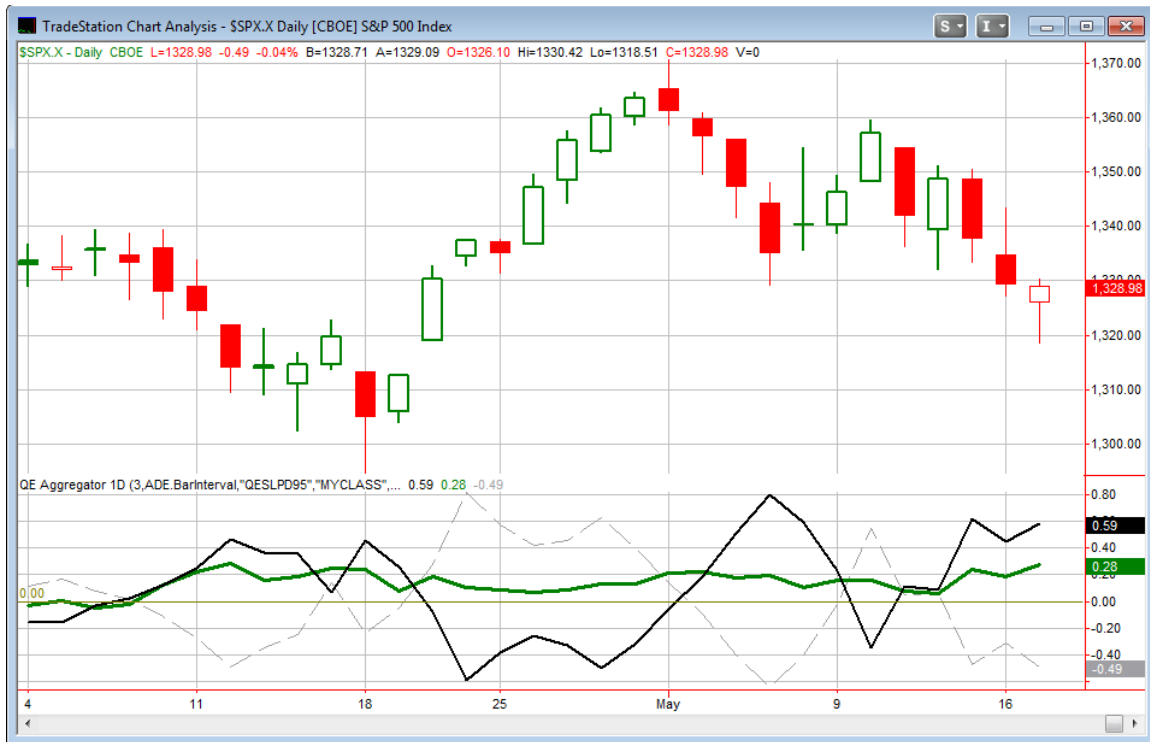


The consistency of the equity curve adds to the appeal of the setup.

Somewhat unusual about Tuesday's action was that while the SPX finished lower the VIX fell 3.8%. The worry people sometimes have when they see this kind of action is that despite the SPX selling off, participants are feeling complacent. I examined this tonight and looked at other times the SPX closed lower while the VIX dropped between 2.5% and 4.5% (and some tighter parameters). I found no compelling evidence. On its own a fall similar to Tuesday's in the VIX while the SPX closes down does not suggest a significant bearish or bullish edge.

Another observation I would make is that there were a large number of stocks and ETFs that triggered tonight on the systems spreadsheet. Many of them triggered 80402, which calls for a bounce in those securities and has been a well-performing system over the years. Typically when there are a high number of securities triggering systems in one direction, it suggests there is a good chance of the market as a whole moving in that direction as well. It isn't nearly as convincing as a large cluster of Catapults (note the CBI is still 0), but it is another hint of a bullish edge.

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



Tonight's bullish SPY pattern study caused the green Aggregator Line to rise a little more. It is now strongly 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 also strongly 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 Wednesday. This could change if strong bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,342.68. This is about a 1% rise from Tuesday's close. So for the black Differential Line to move back below 0 the SPX would need to rally at least this much.

I have a partial long position on already. Tonight's evidence is encouraging, but I'm still not looking to get overly aggressive. The market could still break down further and there doesn't appear to be much fear or capitulative action in this selloff based on VIX action and the 0 CBI reading. I added a 2nd lot of SPY at Tuesday's open. For now I will stick with the 2 lots (1/2 full-size position) and let that ride.

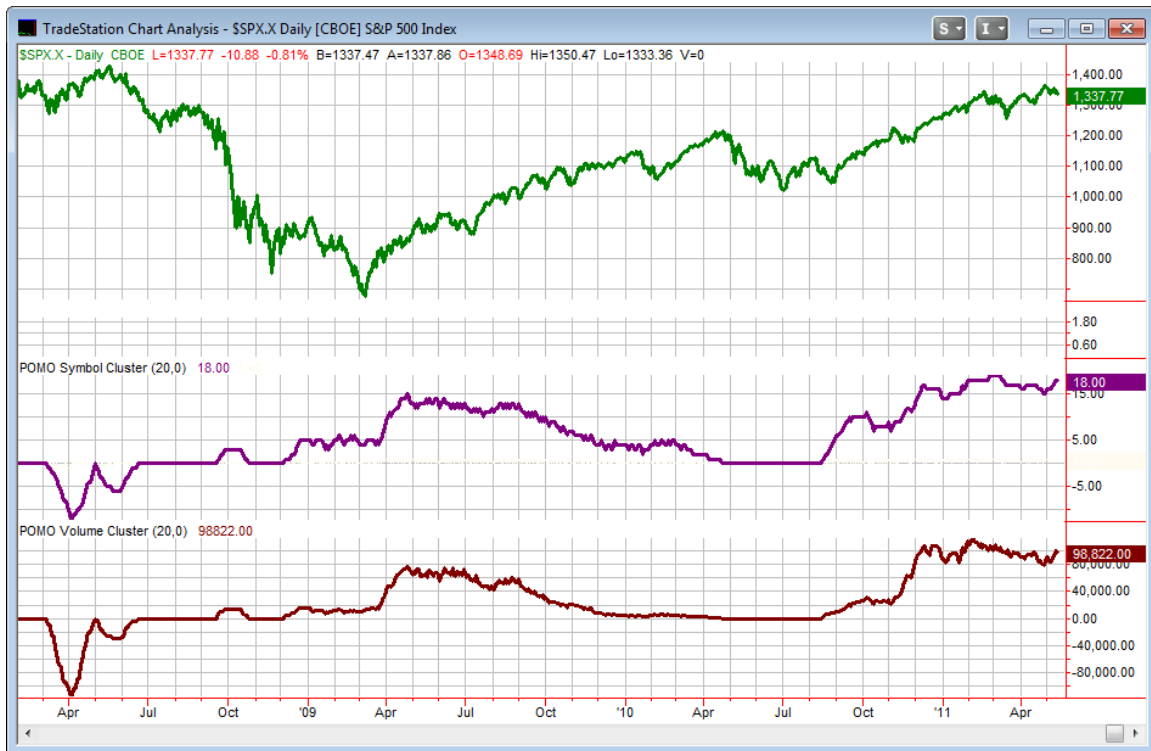
Intermediate-term Outlook (2 weeks – 2 months)– updated 5/16 – moderately bullish

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.

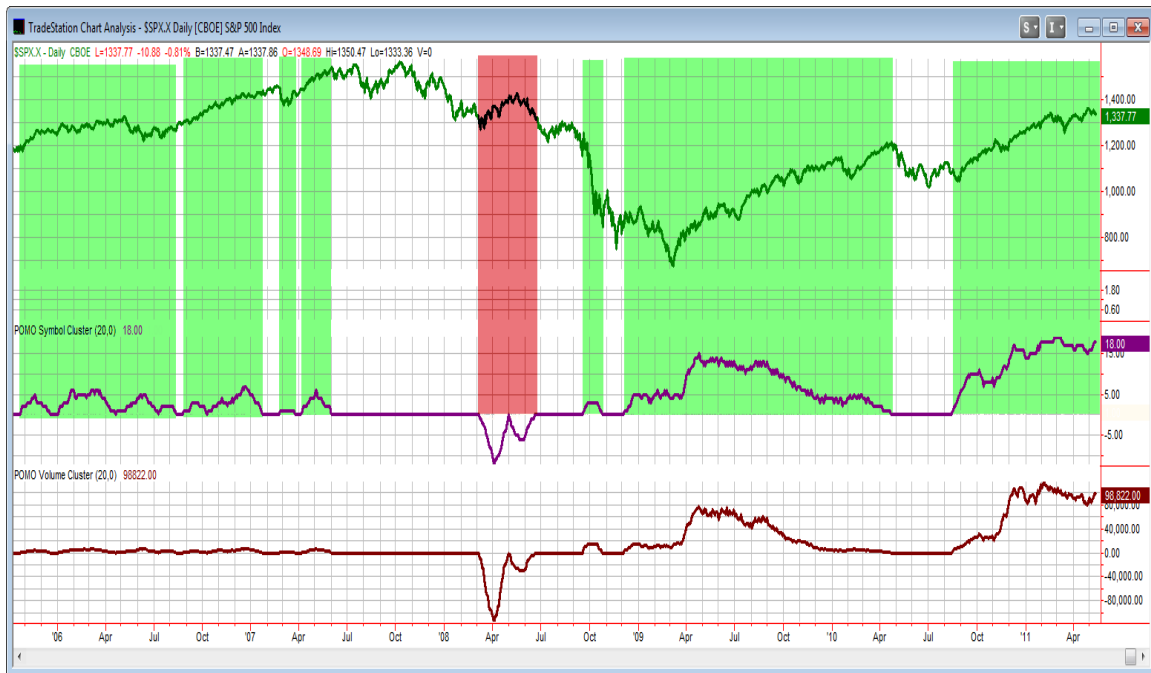
But the new POMO schedule isn't only strong through May. It shows substantial buying also into June. Between May 12th and June 9th there are 18 days of POMO buying scheduled. And though the buying is expected to end in June, it is now clear that it isn't going to happen early in the month. We'll have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

No new trade ideas tonight.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	5/12/2011	\$134.09	\$133.17	-0.69%		Aggregator
SPY(1/4)	5/17/2011	\$132.69	\$133.17	0.36%		bought on open

I will exit 1 SPY lot on close if SPX closes \geq 1,342.68.

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