

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 31, 2011

Volume 4 Issue 103

Market Overview



Tonight's Research Points

- Memorial week / 1st of month seasonality is lending a bullish influence.
- The 3/10 Offset HV is extremely low – warning of a possible big move.
- The Aggregator System is flat.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

Evidence is all pointing to a further rise, but the market is already overbought. I'm not inclined to buy at these levels but will if the market offers a decent pullback.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
May 31, 2011	Memorial Week/1st of mth seasonality	1-4 days	Bullish	2.40%
May 26, 2011	Reversal from 20-day low	1-6 days	Bullish	3.05%
May 24, 2011	SPX dn 1%. Decliners 2x advancers	1-9 days	Bullish	3.05%
May 24, 2011	20-day low & > 200ma. Big drop in 10.	1-7 days	Bullish	2.35%
Active - Long Term				
May 31, 2011	4 Weeks Down. Close > 40ma.	1-10 weeks	Bullish	9.00%
March 22, 2011	3 Days Up Issues % > 70%	8 months	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 25, 2011	Nas/SPX relative strength favors Nas	int term	Bullish	
May 2, 2011	SPY up 3 days all lower volume	1-19 days	Bearish	

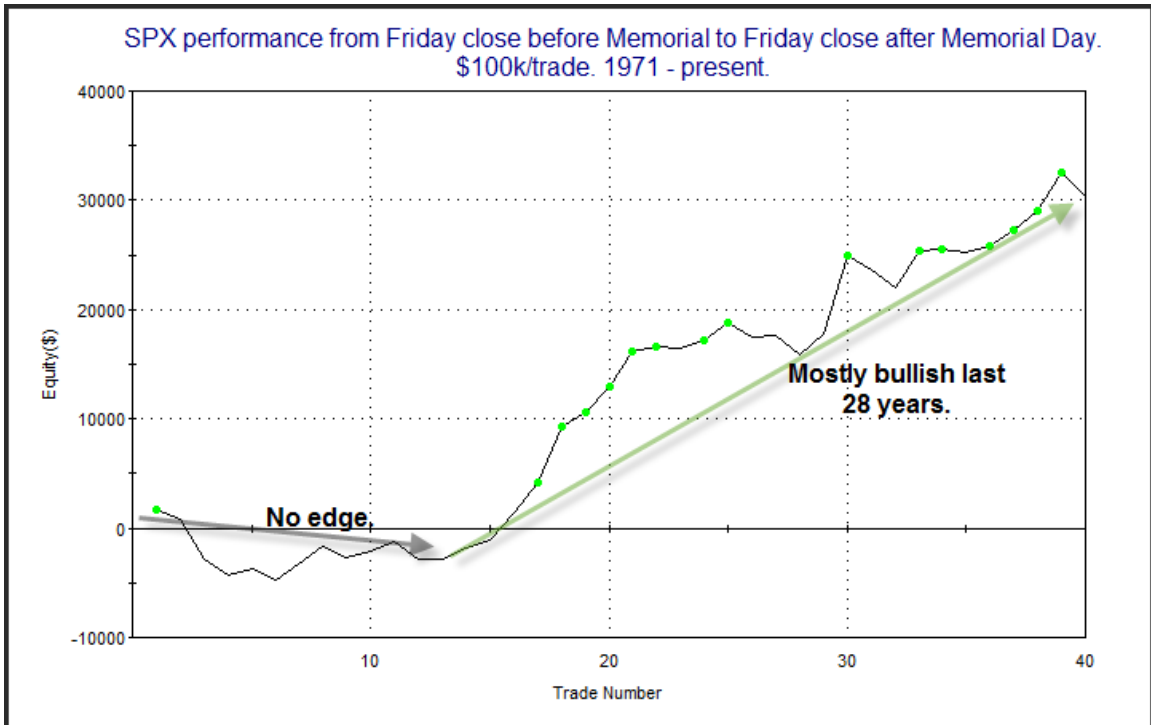
If the avg max move is achieved the study will appear in ***bold italic blue*** and no longer be active.

The Evidence

Friday started out well with a gap up, but not much was accomplished after the open. The range was fairly tight and trading was light ahead of the long weekend. In the end the major indices all finished higher. The SPX gained 0.4%, the Nasdaq was up 0.5%, and the Russell 2000 tacked on 0.65%. Breadth was strongly positive as the NYSE Up Issues % came in at 72% and the Up Volume % was 75%. Total volume was the lowest of the year, but between the inverse split in Citigroup a couple of weeks ago and the fact that we are going in to a long weekend this isn't much of a surprise.

Several volume studies appeared in the Quantifinder on Friday. They looked at things like the SPX rising multiple days and volume coming in very light. When trading above the 200ma none of them are nearly as compelling, and with traders taking off early ahead of the long weekend I am not inclined to give them any weight. As far as I'm concerned the light volume on Friday is a non-issue and won't be factoring it in to my market evaluation.

I mentioned in Thursday night's letter that the week of Memorial Day has frequently seen positive returns for the market. Below is the brief amount of research from that letter.



There was no substantial edge apparent throughout the 70s, but starting in 1983 you'll note a strong bullish tendency. Below are some performance statistics for the '83 – present timeframe.

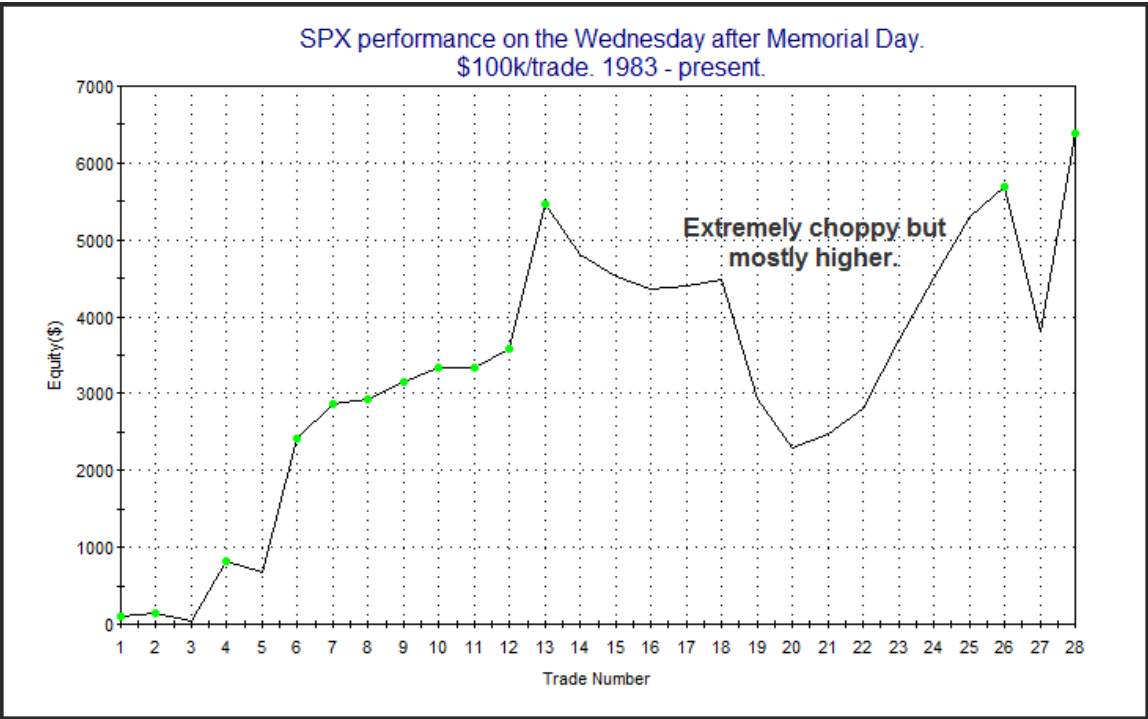
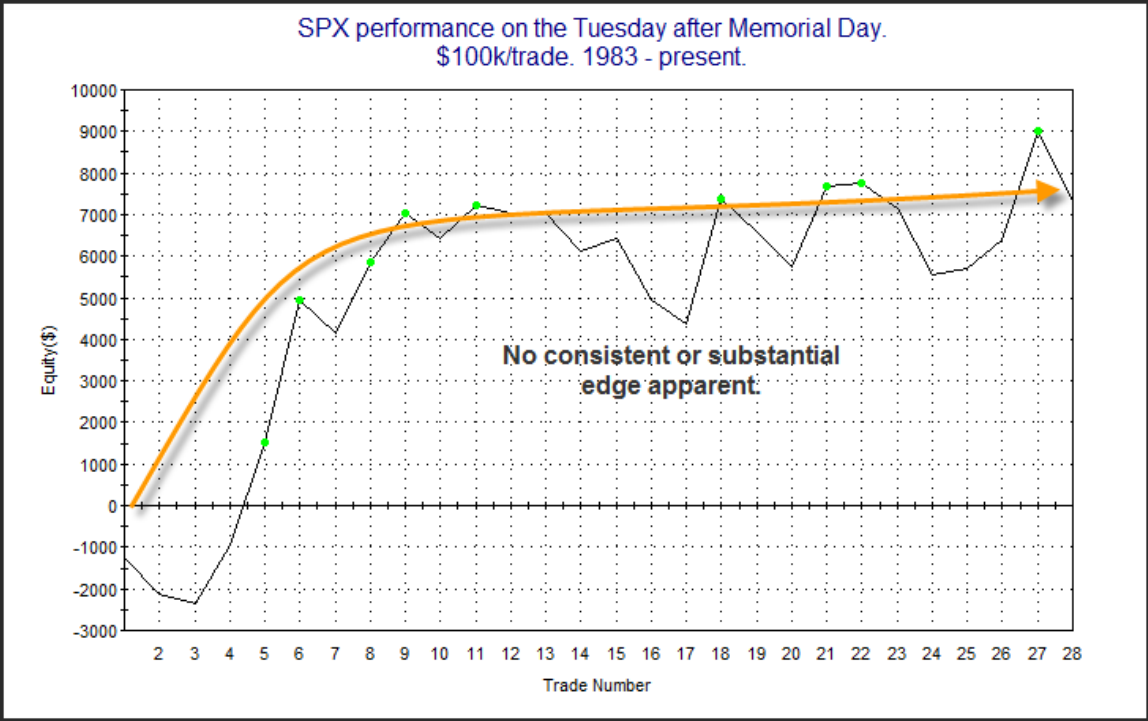
SPX performance from Friday close before Memorial to Friday close after Memorial Day. \$100k/trade. 1983 - present.			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	\$33,155.22	Profit Factor	4.88
Gross Profit	\$41,697.05	Gross Loss	(\$8,541.83)
Total Number of Trades	28	Percent Profitable	71.43%
Winning Trades	20	Losing Trades	8
Even Trades	0		
Avg. Trade Net Profit	\$1,184.11	Ratio Avg. Win:Avg. Loss	1.95
Avg. Winning Trade	\$2,084.85	Avg. Losing Trade	(\$1,067.73)
Largest Winning Trade	\$7,145.28	Largest Losing Trade	(\$2,232.23)

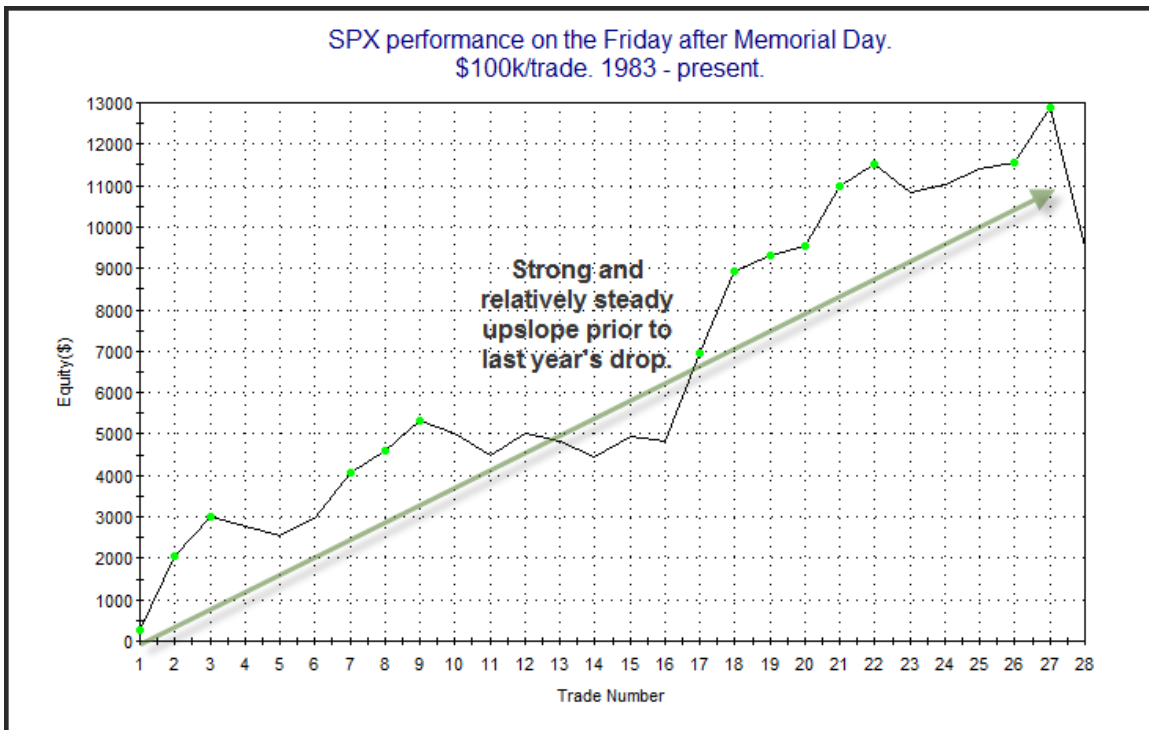
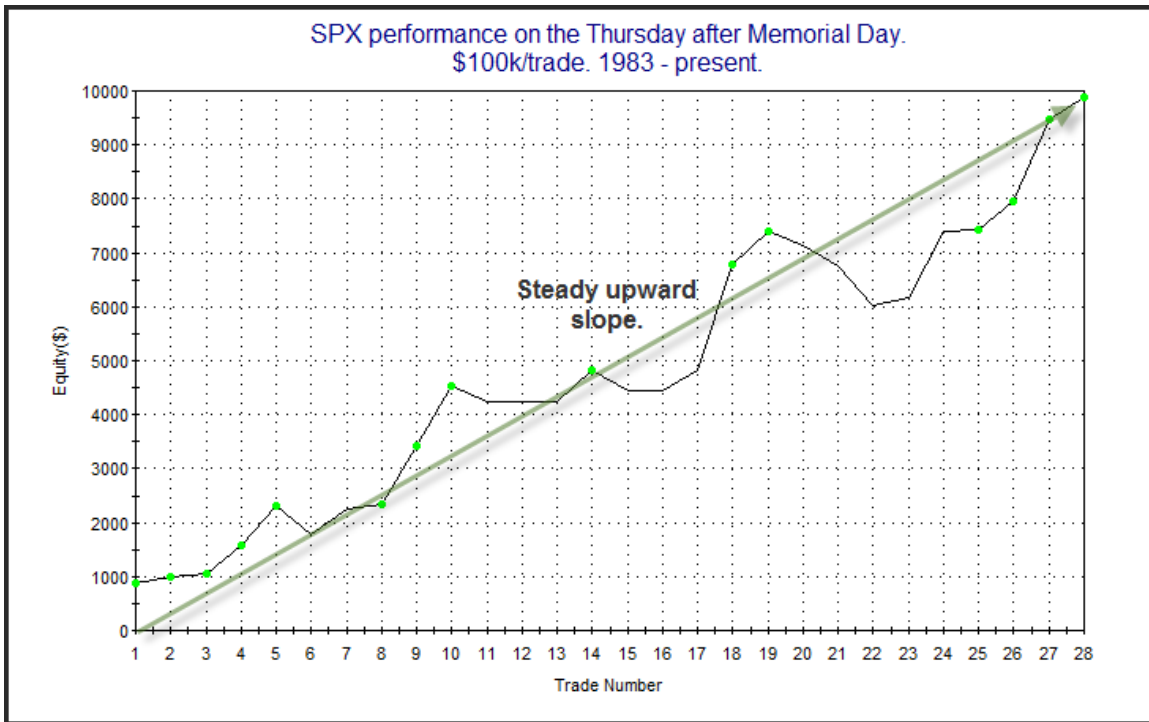
While last year was down the circled stats are all impressive. An average gain of nearly 1.2% for the 4-day period along with a profit factor of 5 is very good.

So tonight let's examine this a bit further. Below I am looking at the same '83 – present time frame and breaking down the returns by the day of the week.

SPX performance on X day of Memorial Day week. \$100k/trade. 1983 - present.										
X Day	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
Fri	9,486.50	28	19	9	67.86	821.91	-681.10	1.21	2.55	338.80
Thurs	9,886.75	28	21	6	75.00	592.72	-426.74	1.39	4.86	353.10
Wed	6,381.58	28	20	8	71.43	589.14	-675.15	0.87	2.18	227.91
Tues	7,301.02	28	13	15	46.43	1,520.61	-831.13	1.83	1.59	260.75

The results table suggests Thursday is the most bullish day while Tuesday has seen the least gains and worst win %. So let's see how the edge has played out over time based on day of the week. The four equity curves below assume ownership on that particular day.





The charts seem to confirm what the results table was suggesting. Thursday appears to have the strongest bullish seasonality. Wednesday and Friday also appear to contain an upside edge. Tuesday has been a bit of a crapshoot.

One reader asked me this weekend whether the combination of Memorial week and the positive seasonality experienced on the 1st day of the month has provided any special results. I took a look, and it has. If the 1st trading day of the month is Tuesday then there was no edge apparent. But since 1977 any time you could buy the close of May 31st and sell the close of June 1st, then June 1 would have been a winner. I have listed all 15 instances in the table below.

SPX performance on June 1 when it falls on the Wed, Thurs, or Fri after Memorial Day. \$100k/trade. 1977 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
05/31/77	Buy	\$96.12	0.84%	\$842.40
06/01/77	Sell	\$96.93		\$0.00
05/31/78	Buy	\$97.24	0.11%	\$719.60
06/01/78	Sell	\$97.35		(\$627.08)
05/31/79	Buy	\$99.08	0.08%	\$615.49
06/01/79	Sell	\$99.16		(\$514.59)
05/31/83	Buy	\$162.38	0.10%	\$750.30
06/01/83	Sell	\$162.55		(\$1,107.00)
05/31/84	Buy	\$150.55	1.79%	\$1,786.16
06/01/84	Sell	\$153.24		\$0.00
05/31/88	Buy	\$262.15	1.73%	\$2,007.87
06/01/88	Sell	\$266.68		(\$19.05)
05/31/89	Buy	\$320.52	0.45%	\$637.55
06/01/89	Sell	\$321.96		(\$158.61)
05/31/90	Buy	\$361.22	0.53%	\$634.80
06/01/90	Sell	\$363.15		(\$5.52)
05/31/94	Buy	\$456.51	0.25%	\$389.82
06/01/94	Sell	\$457.63		(\$551.88)
05/31/95	Buy	\$533.41	0.01%	\$149.60
06/01/95	Sell	\$533.49		(\$628.32)
05/31/00	Buy	\$1,420.65	1.98%	\$1,970.50
06/01/00	Sell	\$1,448.80		(\$3.50)
05/31/01	Buy	\$1,255.84	0.38%	\$750.50
06/01/01	Sell	\$1,260.67		(\$707.84)
05/31/05	Buy	\$1,191.52	0.90%	\$1,171.96
06/01/05	Sell	\$1,202.27		(\$40.67)
05/31/06	Buy	\$1,270.09	1.23%	\$1,218.36
06/01/06	Sell	\$1,285.71		(\$70.20)
05/31/07	Buy	\$1,530.62	0.37%	\$646.10
06/01/07	Sell	\$1,536.34		\$0.00

A couple of thoughts: 1) Between 1962 and 1976 the SPX was only 2-3 under the above conditions. 2) The Memorial week edge didn't kick in until 1983 and the 1st of the month edge began in the late 80s. Therefore, the 5 instances between '77 and '84 may be due

more to chance than to a seasonal influence. In any case, the combination has me giving Wednesday a bit more seasonal weight than I would if I considered either of these edges in isolation.

It's also worth mentioning that the CBI rose again on Friday and now stands at 4. Four is not a significantly high number but it is getting pretty close. In the past readings of 7 have been fairly reliable signals that the market is short-term oversold and likely to bounce. [Readings of 10 or higher have been very reliable](#). Interestingly, even though the market has risen 3 days in a row, there are still several S&P 100 components that are primed to trigger if we see selling in the next few days. So while the CBI is not providing an outright bullish reading at the moment, it is suggesting that selling in the next few days may get reversed pretty quickly. I'll be sure to monitor this indicator carefully in the next several days.

Also notable about current conditions is that the 3/10 Offset Historical Volatility Indicator came in at an extremely low 0.06 on Friday. [I first introduced this indicator in July of 2009](#). It essentially takes a short 3-day measure of Historical Volatility and compares that to the 10-day measure of 3-days ago. Low readings indicate there has been a contraction in volatility. High numbers indicate there has been an expansion. Anything at or below 0.25 is regarded as extremely low. Often after sharp contractions like this we often see a volatility expansion take place. In August of 2009 I published a study that found this condition created a favorable environment for trading Opening Range Breakouts. A link to that study is below:

[Quantifiable Edges ORBs Study.pdf](#)

For anyone who is interested in seeing some techniques for actually trading these ORBs, there is a webinar from October 2010 on the subject on the videos page.

<http://www.quantifiableedges.com/members/videos.php>

It's important to note that the 3/10 Offset HV indicator predicts volatility, not direction. For direction I look to the Aggregator. The Aggregator is currently in a neutral position. This means if the right setup appeared in the morning I'd likely be willing to take a trade

in either direction – but with a more conservative position size than if the Aggregator was in agreement with the breakout.

Of further note, the 3/10 Offset HV Calculation is available as part of the new “QE Indicators/Functions for Tradestation”. Subscribers may download it to include on their own charts. A link to the Indicators page is below, where you may download the User Guide or the Tradestation ELD.

<http://www.quantifiableedges.com/members/qeindicators.php>

I should also note that the indicator is designed not only for charts, but may be applied to Radarscreen as well. By adding it as a column on Radarscreen you can find candidates for trading ORBs on a more regular basis. Amazingly, 41 of the 98 ETFs that are tracked on [my ETF list](#) are currently showing a reading of 0.25 or lower.

From a technical standpoint, the downtrending channel that I have been drawing on the Aggregator chart is becoming more and more obvious. Friday’s rally failed right near the upper channel line. A break of either trendline could become a significant event. I’ll be interested to see whether the market is able to rally through the upper line in the next few days or whether it heads back down towards the lower end of the channel.

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



The green Aggregator Line remained well above 0 again tonight. The positive value means the net expectation from the Active Studies List is for upside over the next few days. This is no surprise since all of the active studies are currently bullish. Meanwhile, the black Differential Line is now solidly below 0. This will often happen after the market has risen for 3 days in a row. Readings below 0 mean the SPX outperformed expectations over the last few days. So net expectations are for upside but the SPX is overbought versus recent expectations. This is considered a neutral configuration. It can be seen on the chart whenever both lines close on opposite sides of 0. Due to this the Aggregator System remained flat 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 1,325.70. This is about 0.4% below Friday's close. So the SPX will only need to fall this much in order to flip the Differential Line back into positive territory.

Overall I think the market has a decent chance of putting in some gains this week. It's a little extended at this point, but if it manages to close down at least the 0.4% needed to flip the Differential line on Tuesday then I'll become a buyer at the close in anticipation of move higher in the Wed-Fri timeframe.

Intermediate-term Outlook (2 weeks – 2 months)– updated 5/31 – very slightly bullish

May has been a difficult month for the market. I’m sure many traders will welcome the end of it arriving on Tuesday. Even with Friday’s gains the SPX experienced its 4th down week in a row. I decided to examine other times the SPX has posted 4 consecutive lower closes but still closed above its 40-week moving average.

SPX closes down for the 4th week in a row, but above its 40-week moving average. Buy on close. Sell X weeks later. \$100k/trade. 1975 - present.										
X	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	83,820.26	12	12	0	100.00	6,985.02	0.00	100.00	100.00	6,985.02
9	76,782.86	12	10	2	83.33	7,805.13	-634.23	12.31	61.53	6,398.57
8	57,176.35	12	9	3	75.00	7,290.42	-2,812.47	2.59	7.78	4,764.70
7	58,368.59	13	10	3	76.92	6,601.69	-2,549.43	2.59	8.63	4,489.89
6	58,698.10	13	8	5	61.54	8,057.78	-1,152.83	6.99	11.18	4,515.24
5	47,674.13	13	9	4	69.23	6,810.07	-3,404.13	2.00	4.50	3,667.24
4	43,252.27	13	9	4	69.23	6,091.52	-2,892.86	2.11	4.74	3,327.10
3	34,340.92	13	11	2	84.62	3,970.81	-4,668.98	0.85	4.68	2,641.61
2	27,496.07	13	10	3	76.92	3,522.23	-2,575.41	1.37	4.56	2,115.08
1	20,160.87	13	11	2	84.62	2,167.33	-1,839.91	1.18	6.48	1,550.84

**The 1 overlapping instance occurred on 7/9/04.
It too closed higher 10 weeks later.**

These results are strongly suggestive of an upside edge over the next several weeks. Below I have listed all 12 non-overlapping instances using a 10-week exit strategy.

SPX closes down for the 4th week in a row, but above its 40-week moving average. Buy on close. Sell X weeks later. \$100k/trade. 1975 - present.

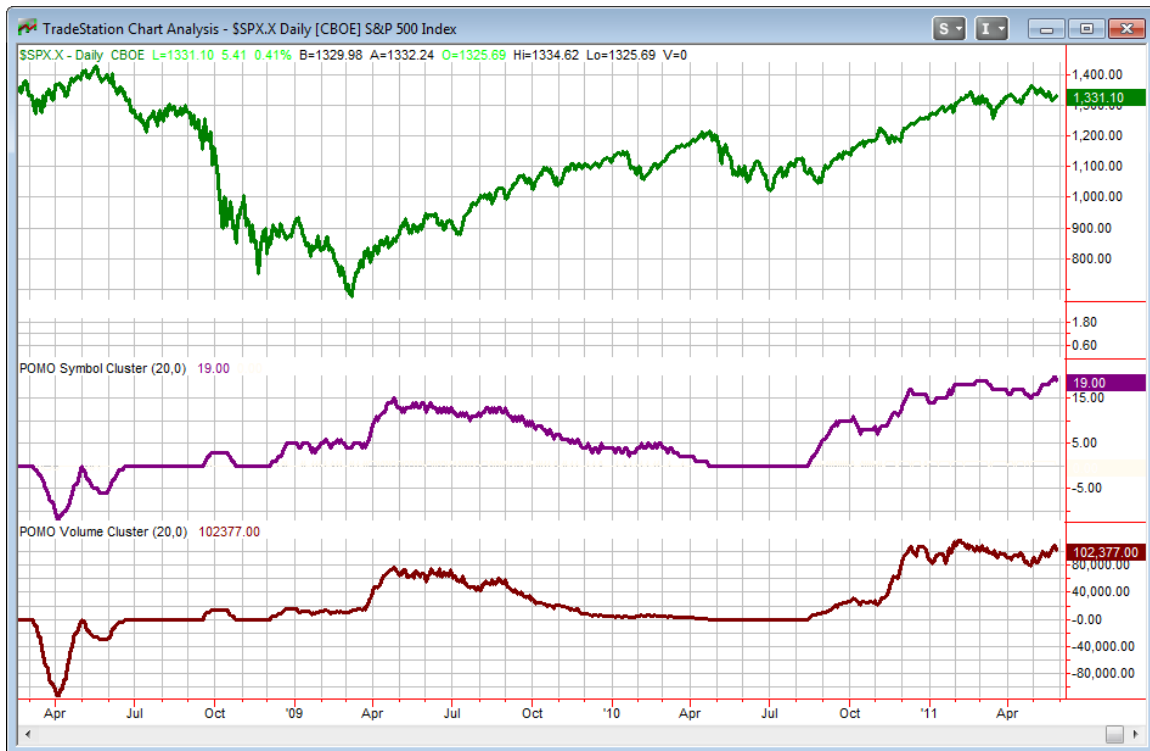
Date/Time	Signal	Price	% Profit	Run-up Drawdown
08/08/75	Buy	\$86.02	3.30%	\$3,997.28
10/17/75	Sell	\$88.86		(\$4,566.66)
06/04/76	Buy	\$99.15	5.14%	\$6,854.40
08/13/76	Sell	\$104.25		(\$524.16)
07/07/78	Buy	\$94.88	9.73%	\$13,868.01
09/15/78	Sell	\$104.11		(\$642.33)
11/04/83	Buy	\$162.44	2.82%	\$4,341.90
01/13/84	Sell	\$167.02		(\$1,131.60)
08/16/85	Buy	\$186.10	0.76%	\$1,793.58
10/25/85	Sell	\$187.52		(\$3,576.42)
08/26/88	Buy	\$259.67	6.41%	\$9,343.95
11/04/88	Sell	\$276.31		(\$1,039.50)
06/26/92	Buy	\$403.44	3.38%	\$5,357.43
09/04/92	Sell	\$417.08		\$0.00
04/04/97	Buy	\$757.90	17.86%	\$17,919.49
06/13/97	Sell	\$893.27		(\$3,191.16)
08/14/98	Buy	\$1,062.74	0.74%	\$4,126.60
10/23/98	Sell	\$1,070.65		(\$13,107.36)
05/21/04	Buy	\$1,093.59	0.74%	\$4,800.25
07/30/04	Sell	\$1,101.72		(\$1,347.71)
07/10/09	Buy	\$879.13	21.52%	\$22,033.87
09/18/09	Sell	\$1,068.30		(\$430.53)
02/05/10	Buy	\$1,066.19	11.81%	\$13,738.89
04/16/10	Sell	\$1,192.13		(\$900.24)

The only real alarming instance was '98 when the market experienced a 13% drop on the way to its 4% gain.

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 Friday being the first non-POMO day in over a month, both the POMO Days and POMO Volume indicators remain extremely elevated. The liquidity pump continues to inject massive amounts of money into the system and to this point such action has acted as a strong positive influence on the market. Three of the four days this upcoming week are schedule to see more buying. The only off day is Thursday.

For those that would like to view the upcoming schedule through June 10th I have provided a link below.

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

Another notable indication on Friday can be seen on the charts page. There we see that the Nasdaq/SPX relative strength indicator is now suggesting the SPX is exhibiting relative strength over the Nasdaq. This is not necessarily a bearish configuration, but rather neutral. Most of the market's gains over the years have come with the Nasdaq leading.

It remains unclear whether the action throughout May is just a mini move lower or whether it is the start of something bigger. The new highs divergence I discussed in last week's intermediate-term outlook suggests a substantial decline is *possible*. The last couple of times the Fed abandoned POMO buying the stock market didn't seem to notice until about a month later. Of course this time may be different. From what I am seeing and reading it appears the end of QE2 is much more highly anticipated than other liquidity campaigns. There is a chance the market might begin to decline in anticipation of the end of these injections rather than feeling the effects post-QE2. On the bullish side, the market does remain in a long-term uptrend. It is trading above both its 50ma (barely) and its 200ma. The 4-week pullback study above provides some bullish evidence. Additionally, the breadth thrust signal given at the end of March has typically led to 8 months of continued gains and it has only been 2 months so far.

There still appears to be more evidence supporting the bullish case than the bearish one, though it continues to weaken. At this point I'm not inclined to aggressively bet against the long-term uptrend. I'm also not inclined to bet big on the long side. For my own trading, I'll continue to prefer long trades to short ones, but I'll likely be playing both sides fairly conservatively until the intermediate-term outlook provides more clarity.

Catapult and Capitulative Breadth Statistics

[*Catapult & CBI Presentation Link*](#)

Open Catapult Triggers

PG – 1/3 position @ \$66.19

MRK – 1/3 position @ 36.38

New

ABT – 1/3 position @ \$

MRK – 1/3 position @ \$

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 4/3(PG, MRK(2), ABT)

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 position at close if SPX closes at 1,325.70 or lower. Based on short-term market outlook above. I’m anticipating an Aggregator long signal would trigger under these circumstances, and with Wednesday showing strong bullish seasonality, I’d rather not wait for Wednesday’s open in case it gaps up.

ABT – buy 1/3 position @ \$51.55 limit – based on Catapult system.

MRK – buy 1/3 position @ \$36.21 limit – based on Catapult system.

If you are new to Catapults I’d encourage you to learn more about them before you consider taking any trade ideas based on them. The place to start would be the Catapult & CBI presentation, which can be found on the videos page. I’ve also linked to it below.

<http://www.quantifiableedges.com/videos/QE20100621.html>

Or for traders that would like to take a detailed look at the trades, you can see all of the ones that were tracked by the subscriber letter on the Trade Idea Results Spreadsheet (downloadable near the bottom of the systems page). One thing that I would note is that while the trades have done very well over the years, they have also been very volatile and there were some sizable losses in individual trades along the way.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
GS(1/3)	5/23/2011	\$133.64	\$138.66	3.76%		<i>sold on close</i>
PG(1/3)	5/27/2011	\$66.04	\$66.20	0.24%		Catapult
MRK(1/3)	5/27/2011	\$36.38	\$36.21	-0.47%		Catapult

Gold subscribers were sent an intraday email around noon on Friday that indicated GS had hit its target and that I would be closing out the trade idea at the close rather than waiting for Tuesday’s open. Typically Catapults are exited the morning after the exit trigger, but with the long weekend and the fact that many foreign markets are open I thought it best to simply take the profits and eliminate the risk.

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