

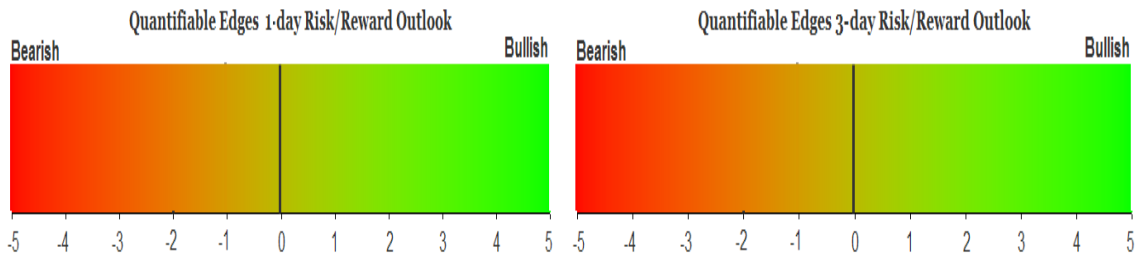
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

June 22, 2011

Volume 4 Issue 119

## Market Overview



## Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Flat	50% Long XIV	Flat	Flat

## Tonight's Research Points

- Fed Days carry a positive edge – though somewhat reduced by Tuesday's strong close.
- The strong breadth on Tuesday's Follow Through Day appears to be a nice positive for both the short and intermediate-term.

## *Short-term Outlook*

### *The Bottom Line*

More upside expected by the studies but the market is already somewhat overbought. I'm mostly sidelined and am awaiting the next substantial edge before putting more capital at risk.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
June 22, 2011	Fed Day	1 day	Bullish	
June 22, 2011	FTD with Up Issues % 1-yr Rank > 95%	1-3 days	Bullish	2.10%
<b>Active - Long Term</b>				
May 31, 2011	FTD with Up Issues % 1-yr Rank > 95%	int term	Bullish	
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	POMO	int term	weakening	
October 25, 2010	SPX Golden Cross	int term	Bullish	
<b>Dropped Tonight</b>				
<b>June 21, 2011</b>	<b>U 3 below 4 ago.</b>	<b>1 day</b>	<b>Bullish</b>	
<b>June 20, 2011</b>	<b>SPX up 2 days, below close 3 days ago</b>	<b>1-3 days</b>	<b>Bullish</b>	<b>1.60%</b>
<b>June 17, 2011</b>	<b>VIX up 6% while SPX up.</b>	<b>1-3 days</b>	<b>Bullish</b>	

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

***The Evidence***

A strong gap up was followed by consistent buying as the market remained strong throughout the day. In the end the SPX finished up 1.3%, the Nasdaq gained 2.2% and the Russell 2000 added on 2.3%. Breadth was also strong as the NYSE Up Issue % came in at 84% and the Up Volume % was 89%. Total NYSE volume rose but still came in a bit lower than normal.

I mentioned last night that despite the extremely low 3/10 Offset HV reading I didn't expect a large move today since tomorrow was a Fed Day and the day before Fed Days the market will often quiet down. Boy was I wrong about that.

The higher volume and the strong gains on the 4<sup>th</sup> day of an attempted rally means Tuesday qualified as a Follow-Through Day (FTD) under the Investors Business Daily rules. I've done extensive research on FTDs and added some to that research tonight. My database of Fed Days goes back to 1982 and this is the first time a FTD has occurred on the day before a Fed Day. There have been 3 instances where an FTD occurred on a Fed Day. Two of them led to failed rallies. They triggered on 9/22/87 and 8/18/98. The third was on 2/7/90 and that went on to stage a successful rally.

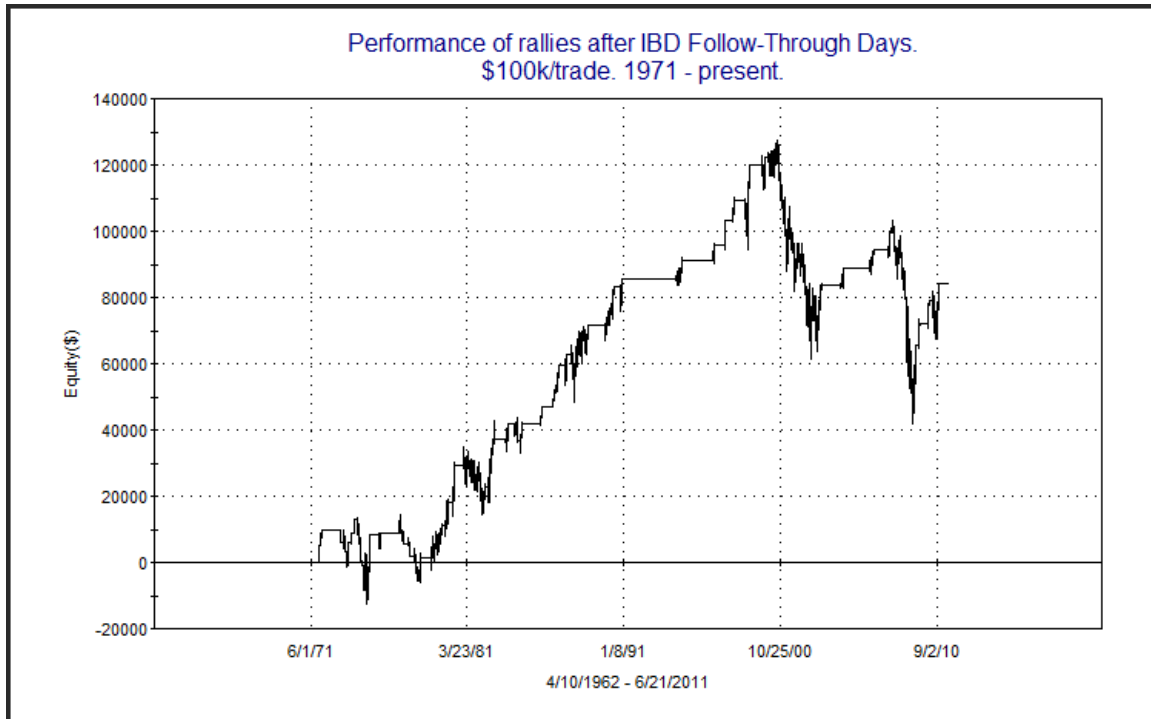
I looked at FTDs in a few new ways tonight. Most striking to me was not the price gains or the volume but the exceptionally strong breadth on Tuesday. I ran several tests that examined how strong breadth on a FTD might affect its chances of success.

Before I show those tests I thought I would point you to the rules of FTDs and some of the assumptions I used in testing them. I basically followed all of the rules as IBD laid them out. Two rules that IBD has never clearly defined are what entails “success” or “failure”. I defined “failure” to be a close below the intraday low of the bottom prior to the FTD. I defined “success” as a move either 1) twice as large as the distance from the low of the potential bottom to the close of the FTD, or 2) a new 52-week high. More detailed explanations of the rules may be found using the link below:

<http://quantifiableedges.blogspot.com/2008/01/ibd-follow-through-days-pt-1-are-they.html>

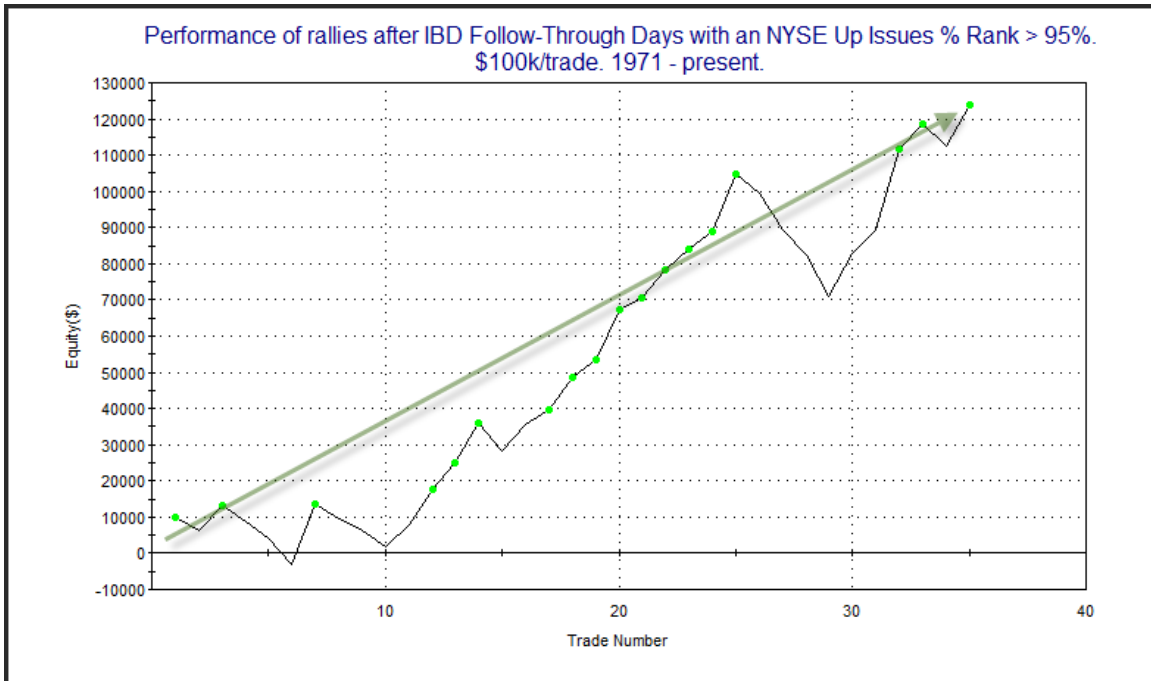
Whether a FTD successfully predicts a rally is not an indication of whether someone trading individual stocks using IBD’s techniques would make money or not. What it does measure is the usefulness of FTDs as a market timing indicator. I believe this is a fair way to test them since IBD claims they are extremely valuable in identifying when downtrends are ending and new uptrends are emerging.

Using the original parameters as described in the post I linked to above there have been 74 FTDs since 1971. Thirty-eight of them (53%) led to successful rallies. This is an interesting stat but it doesn’t tell the whole story. Below is an equity curve that I don’t believe I’ve ever shown before. It shows how someone trading the SPX would have performed using FTDs as a buy trigger and then exiting the trade when the rally either “succeeded” or “failed”.



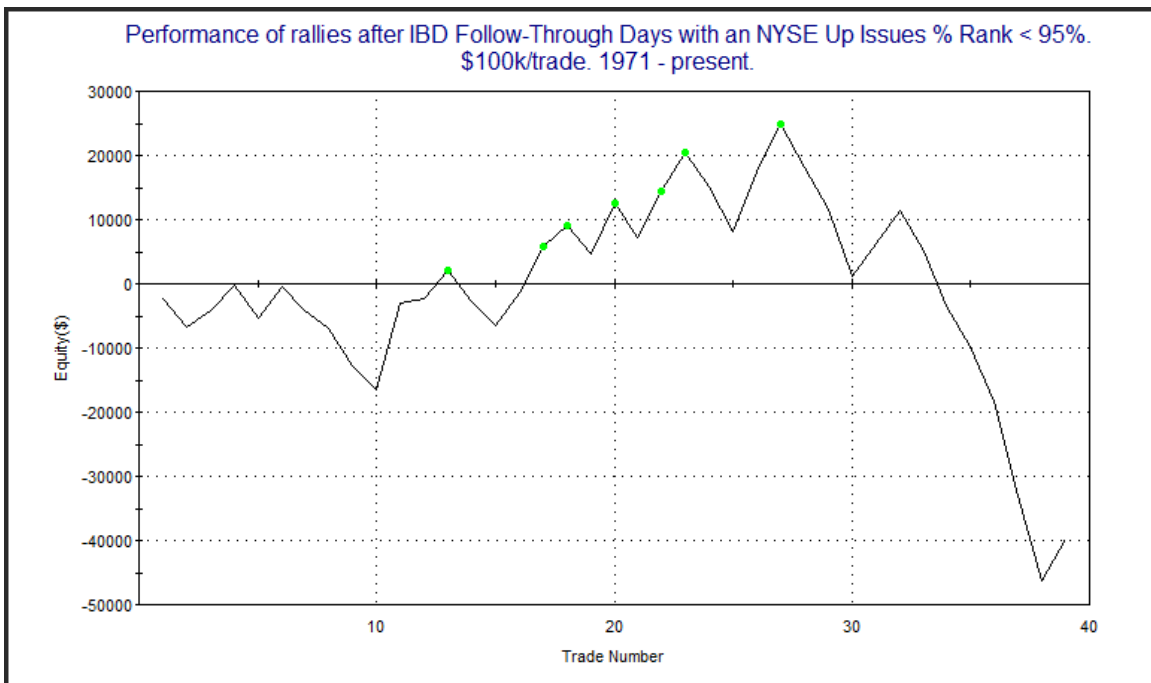
As you can see FTDs worked very well during the long bull market of the 80s and 90s. But in the 70s, and again since 2000, FTDs have struggled as a market timing tool.

As I mentioned earlier breadth was also very strong on Tuesday. When compared to the past year the Up Issues % on the NYSE was higher than 98.4% of all days. I used the Up Issues % Rank to normalize breadth over the long test period, and broke down FTD results based on those times the % Rank was  $> 95\%$  and those times it was  $< 95\%$ . First let's look at times like now where the NYSE Up Issues % Rank was  $> 95\%$ .



In this case 22 of 35 FTDs (63%) have been followed by successful rallies and gains have been fairly steady over the years.

Now let's look at FTDs that came without very strong relative breadth.

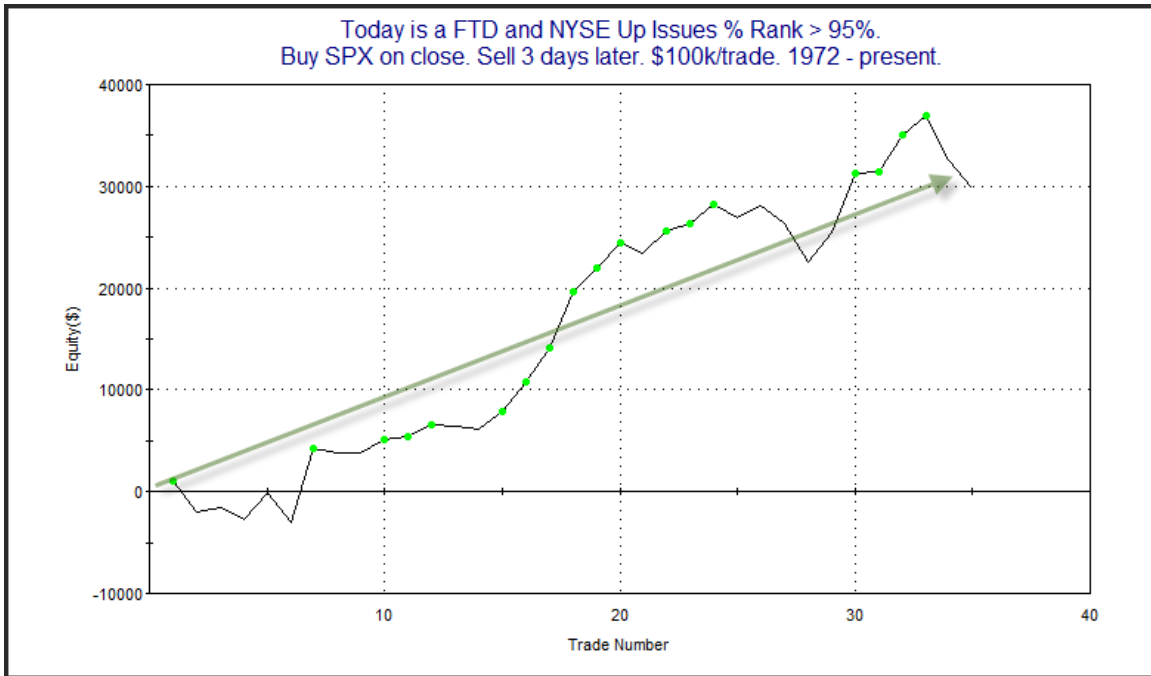


Results here were never strong and they've turned quite negative in recent years. Rather than a 63% success rate as happened with strong breadth, only 44% of instances here succeeded.

So Tuesday's breadth appears to be good news for the intermediate-term prospects of the rally. But in the past I've also [found FTDs can sometimes be predictive of short-term market action](#). Tonight I used the same breadth filter to see possible short-term implications.

Today is a FTD and NYSE Up Issues % Rank > 95%. Buy SPX on close. Sell X days later. \$100k/trade. 1972 - 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	23,786.18	35	22	13	62.86	2,273.02	-2,016.95	1.13	1.91	679.61
4	28,144.04	35	22	13	62.86	2,344.12	-1,802.04	1.30	2.20	804.12
3	29,887.90	35	23	12	65.71	2,303.68	-1,924.72	1.20	2.29	853.94
2	26,009.08	35	24	11	68.57	1,828.58	-1,625.17	1.13	2.45	743.12
1	18,603.01	35	22	13	62.86	1,153.20	-520.57	2.22	3.75	531.51
<b>30 of 35 instances (86%) closed above the FTD close at some point in the next 4 days.</b>										

Results here seem to suggest a solid bullish edge. Below is an equity curve using a 3-day exit strategy.



The steady upward slope seems to confirm the bullish tendency.

I mentioned briefly that the Fed Day tomorrow is another potential positive. I ran several tests today to see whether the strong move just before a Fed Day had any impact on the typical Fed Day edge. Results examining this concept a number of ways remained positive and pretty much in line with typical Fed Days. Of course the bias may be a little weaker since SPY closed in the top quartile of its daily range, as I discussed last night.

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



The green Aggregator Line is still solidly above 0. Readings above 0 mean net expectations from the active list are for upside over the next few days. Meanwhile, the black Differential Line continues to fall further below 0. This means the SPX has outperformed expectations over the last few days. So net expectations are positive but the SPX is already overbought versus recent expectations. This is considered a neutral configuration. Neutral configurations 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 Wednesday. This could change if strong bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,281.06. This is about 1.1% below Tuesday's close. So for the Differential Line to rise back above 0 it would take a strong drop on Wednesday.

Tuesday's positive breadth and the fact that Wednesday is a Fed Day both suggest we could go higher over the next few days. The CBI also dropped back to 0 on Monday and bearish evidence is lacking. Still, with the market overbought, it simply isn't at an entry point that offers great risk/reward. I'm mostly sidelined and don't anticipate changing anything tomorrow.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 6/20 – neutral***

The SPX closed higher this past week. In fact it closed higher on 4 of the 5 days. This sounds impossible since every day but Tuesday seemed disappointing, but it is true. From the 5/2 peak down to the low on Thursday the SPX declined 8.2%.

I conducted extensive research into IBD Follow-Through-Days (FTD) over the last few years. Much of it was published on the blog in 2008. Most of the work I published required an SPX correction of at least 8% before a FTD was looked for. Investors Business Daily followers and other intermediate-term trade will be eagerly awaiting a FTD before looking to aggressively allocate intermediate-term trend following positions to their portfolios.

That research is too vast to explore in detail in the letter, but I would suggest readers that are interested may want check out the links below.

This first one is a summary post with links to different areas of the research.

<http://quantifiableedges.blogspot.com/2008/07/follow-through-days-quantified.html>

This second link will bring up all blog posts with an “IBD Follow Through Day” label. There have been a few since the summary post above was published.

<http://quantifiableedges.blogspot.com/search/label/IBD%20Follow%20Through%20Day>

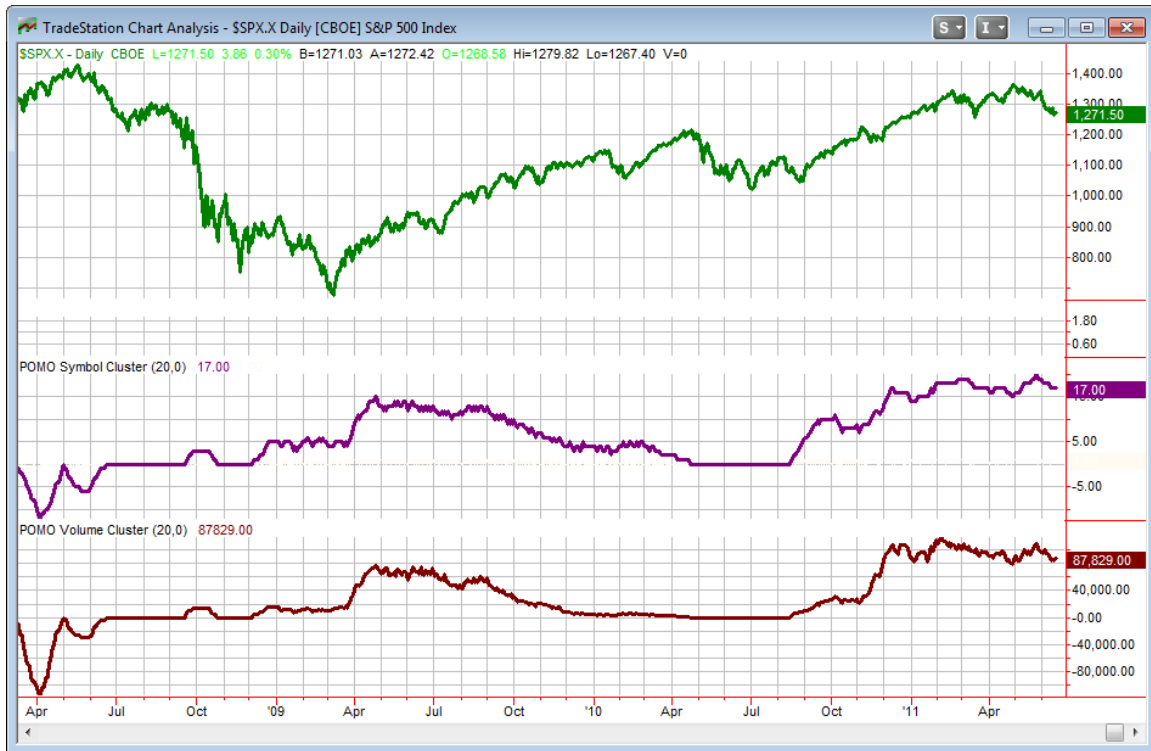
As bounces occur and FTDs are registered I will be sure to alert readers to odds and edges associated with FTDs.

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 3<sup>rd</sup> POMO presentation linked below. (Not available for trial users.)

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



My POMO interpretation remains the same as last week.

*Both the POMO Days and POMO Volume indicators remain at high levels. Still, they are beginning to trend lower. The current schedule calls for steady buying until the end of the month, but after that there will be little in the way of Fed stimulus. Starting July 1 we will see these indicators begin to head back towards the 0 line. There are 2 small days of buying currently scheduled in July which is associated with the reinvestment of principal payments rather than the \$600billion of QE2 money. The past few times POMO stimulus was halted, it took the market about a month after the halt until prices began to decline.*

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

[http://www.newyorkfed.org/markets/tot\\_operation\\_schedule.html](http://www.newyorkfed.org/markets/tot_operation_schedule.html)

Intermediate-term studies are moderately bullish but we are certainly in the midst of a correction. Whether it turns into something worse or whether it straightens itself out

quickly isn't yet clear. I expect we will get a bounce here in the short-term as suggested by the short-term section above. That bounce could carry forward for another few weeks. I don't have great confidence that it will surpass the May highs. My outlook remains neutral for now. This means I will approach both longs and shorts with some caution but am willing to bet either way should short-term evidence suggest an edge.

**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.*

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
LOW(1/3)	6/3/2011	\$23.18	\$23.19	0.04%		<b>sold on open</b>
SPY(1/4)	6/6/2011	\$129.04	\$128.99	-0.04%		<b>sold on open (div adjusted)</b>
LOW(1/3)	6/8/2011	\$22.72	\$23.19	2.07%		<b>sold on open</b>
XIV	6/13/2011	\$170.38	\$167.00	-1.98%		
SPY(1/4)	6/16/2011	\$127.02	\$128.99	1.55%		<b>sold on open (div adjusted)</b>

I felt a little dumb watching the market rally so nicely today after having closed out my index trades at Monday's close and Tuesday's open. Overall the index trades suffered a fairly small loss.

The Catapults fared pretty well, though. Even LOW, which looked somewhat ugly a few days ago, turned into a small gain. It wasn't the most powerful cluster of Catapults ever, but it was impressive considering the weakness of the market bounce through Tuesday's open when the cluster closed out.

I've decided not to exit the XIV just yet for a few reasons. 1) The bullish studies suggesting more upside. 2) The futures term structure has turned more favorable in the last couple of days and is now providing more of a boost to XIV. 3) Unless the Fed announcement triggers a sharp selloff, the VIX should drop a bit after the announcement is out of the way. The Aggressive XIV system is still 50% long and I'll hold this trade idea open a little longer.

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